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Internal Revenue Service
National Office Technical Advice Memorandum

SEP 22 1998

Third Party Contact:
Index Number: 1032.00-00
Control Number: TAM-48535-96
District Director:

Taxpayer Name:
Taxpayer Address:

Taxpayer E.I.N.:

Year Involved:

LEGEND:

Parent =

Seller =

Day A =

Day B =

ISSUE:

Does a subsidiary corporation recognize gain on its use of stock and warrants of its parent corporation that it receives from its parent for the purpose of immediately making a taxable acquisition of property pursuant to a plan?

CONCLUSION:

A subsidiary corporation does not recognize gain on its use of stock and warrants of its parent corporation that it receives from its parent for the purpose of immediately making a taxable acquisition of property pursuant to a plan.

BACKGROUND:

On Day A, Parent, acting as agent for certain of its domestic and foreign subsidiaries, entered into a purchase agreement with Seller. Under the agreement, the subsidiaries agreed to purchase the stock of certain of Seller's domestic and foreign subsidiaries. The consideration for the purchases was to include Parent stock and Parent warrants. Certain of the subsidiaries were to provide their own cash as consideration.

The parties to the agreement understood that one or more of

the subsidiaries designated as buyers were corporations yet to be formed. They also understood that the subsidiaries would be formed by Parent directly or indirectly through its wholly-owned subsidiaries before the stock purchases. The purchasing subsidiaries ratified the actions of Parent, their agent, through performance of the agreement on Day B, a day before July 12, 1995. The corporate actions on Day B are described below.

Parent and its subsidiaries structured the transaction to achieve state and foreign tax savings. As structured, the plan called for the subsidiaries to purchase from Parent for notes an amount of Parent stock and warrants sufficient to satisfy their respective obligations under the agreement. The interest that the subsidiaries would accrue on the notes owed to Parent would be deductible by the subsidiaries.

On Day B, Parent transferred stock and warrants to the subsidiaries in exchange for notes. The subsidiaries immediately transferred the same stock and warrants to Seller in exchange for the stock of Seller's subsidiaries.

Some of the actions of Parent and its subsidiaries with regard to the notes following Day B were inconsistent with a true creditor-debtor relationship. For purposes of this technical advice request, Parent and the Revenue Agent agree that we should ignore the subsidiaries' purchase of the Parent stock and warrants for the notes. Instead, for purposes of this technical advice memorandum, we will treat Parent's subsidiaries as having received the Parent stock and warrants directly or indirectly from Parent as a contribution to capital or through a series of such transfers.

LAW AND ANALYSIS:

Citing Rev. Rul. 74-503, 1974-2 C.B. 117, the Revenue Agent argues that Parent has a zero basis in its stock and warrants that transfers to its subsidiaries under § 362(a). Therefore, the subsidiaries recognize gain on the disposition of Parent stock and warrants.[1] The Revenue Agent further contends that, under Rev. Rul. 70-305, 1970-1 C.B. 169, § 1032 does not apply to the subsidiaries' disposition of Parent stock because Parent stock is not the stock of the subsidiaries.

[1] In the case of transfers of Parent stock and warrants from a domestic subsidiary of Parent to a foreign subsidiary of Parent, the Revenue Agent contends that the domestic subsidiary recognizes gain under § 367(a). The domestic subsidiaries of Parent, the Agent asserts, recognize gain on the disposition of Parent stock and warrants in exchange for the stock of the Seller's subsidiaries under § 1001.

Parent argues that Rev. Rul. 74-503, by its terms, does not control the resolution of its case because Rev. Rul. 74-503 states as a fact that "[t]he transfer of [parent] stock was not for the purpose of enabling [the subsidiary corporation] to acquire property by use of such stock." Parent also contends that Service pronouncements subsequent to Rev. Rul. 74-503 confirm the inapplicability of the zero basis result in transactions in which a subsidiary corporation immediately disposes of stock of its parent corporation pursuant to plan to acquire property. Parent cites Rev. Rul. 80-76, 1980-1 C.B. 15 (holding a subsidiary does not recognize gain or loss on disposition of parent corporation stock as compensation), § 1.1032-2 (disposition of parent stock by its controlled corporation in certain triangular reorganizations), and § 1.1502-13(f)(6)(ii) (disposition of parent stock by consolidated group member) as support. Parent also asserts that the particular facts of this transaction, including the subsidiaries' contractual obligation to immediately transfer the Parent stock and warrants to Seller, support recasting the transaction as a tax-free acquisition of the stock of Seller's subsidiaries by Parent. In addition, Parent argues that, as a matter of law, Parent should be treated as directly acquiring the stock of the Seller's subsidiaries and contributing that stock to Parent's subsidiaries. Parent contends that its subsidiaries' immediate disposition of Parent stock and warrants should have the same tax consequences as Parent's direct acquisition of the stock of Seller's subsidiaries followed by a drop-down of that stock because these transactions are economically equivalent.

In determining whether a subsidiary corporation recognizes gain on the use of its parent corporation's stock and warrants in a taxable acquisition, we must consider Rev. Ruls. 74-503, 1974-2 C.B. 117, and 80-76, 1980-1 C.B. 15.

In Rev. Rul. 74-503, corporation X holds $3,000x of treasury stock which it purchased several years before for $2,000x. It transfers the stock to corporation Y in exchange for 80 percent of Y stock. The ruling states that the transfer of X stock to Y was not for the purpose of enabling Y to acquire property by use of such stock. It holds in part that X's exchange is governed by § 351. It further reasons that Y must take a transferred basis in the X stock under § 362. It holds that Y takes a transferred basis of zero.

Rev. Rul. 80-76 concerns the use of a parent corporation's stock as compensation for an employee of a subsidiary corporation. Under the facts, A, a shareholder of P, transfers P stock directly to B, a key employee of S. The ruling holds in part that because § 83 applies to the transfer of P stock to B, S does not recognize gain or loss on the transfer of the P stock.

After carefully considering the legal arguments set forth by

Parent and by the Revenue Agent, we conclude that the subsidiaries do not recognize gain on the disposition of the stock and warrants of Parent. Rev. Rul. 74-503 by its terms does not apply to a transfer of parent corporation stock for the purpose of enabling its subsidiary corporation to acquire property. The concern of Rev. Rul. 74-503 of preventing recognition of fictitious losses is not present where parent stock and warrants are immediately transferred by a subsidiary to acquire property.

> Among the reasons for [§ 1032] were the tax avoidance possibilities of the prior law, under which a corporation expecting a gain upon disposition of treasury shares might avoid such gain by cancelling its treasury shares and issuing "new" stock, whereas a corporation might produce a fictitious loss by purchasing its own shares and reselling them at a lower price.
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> Rev. Rul. 74-503, 1974-2 C.B. 117, 118.

The risk of fictitious losses does not arise where parent corporation stock transferred to a subsidiary corporation is immediately used to acquire property pursuant to a plan because the parent stock has no time to decline in value.

Moreover, published guidance issued with respect to a subsidiary corporation's immediate disposition of parent stock indicates that no gain is recognized in these integrated acquisition transactions. Rev. Rul. 80-76, 1980-1 C.B. 15, holds that a subsidiary corporation does not recognize gain or loss where the subsidiary corporation is treated as receiving parent corporation stock as a contribution to capital and immediately disposing of that stock to compensate its employee. Section 1.1032-2(b) provides that, in certain triangular reorganizations, "P[arent] stock provided by P to S[ubsidiary], or directly to T[arget] or T's shareholders on behalf of S, pursuant to a plan of reorganization is treated as a disposition by P of its own stock for T's assets or stock, as applicable." Section 1.1032-2(c) provides that S must recognize gain or loss on its exchange of P stock if S did not receive the P stock pursuant to a plan of reorganization. Section 1.1502-13(f)(6)(ii) eliminates gain recognition under certain conditions on a member's disposition of the stock of its common parent. Among other requirements, under §1.1502-13(f)(6)(ii)(B), the member must, pursuant to a plan, transfer the stock "immediately to a nonmember that is not related."

In summary, Rev. Rul. 74-503 and the published guidance described above unanimously decline to apply the zero basis result where parent stock is transferred to a subsidiary pursuant to a plan in which the subsidiary immediately disposes of the

parent stock. In such transactions, the opportunity to recognize fictitious losses does not arise and the zero basis result of Rev. Rul. 74-503 is inappropriate. Accordingly, the subsidiaries of Parent in this case did not recognize gain on the disposition of the stock and warrants of its Parent.

CAVEATS:

No opinion is expressed about the tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered herein.

A copy of this technical advice memorandum is being given to the taxpayer. Section 6110(j)(3) provides that it may not be used or cited as precedent.