Effective Date: April 4, 2003

COORDINATED ISSUE
ALL INDUSTRIES
CONTINGENT LIABILITIES
UIL: 9300.17-00

ISSUES:

1. Whether the taxpayer satisfies the technical requirements of I.R.C. § 351.

2. Whether the transaction took place on or after October 19, 1999, such that I.R.C. § 358(h) applies.

3. Whether the contingent liability is a liability that gives rise to a deduction within the meaning of I.R.C. § 357(c)(3) and whether the taxpayer's basis in its stock is determined by reference to I.R.C. § 358(d)(1) or I.R.C. § 358(d)(2).

4. Whether the liability assumption should be treated as money received under I.R.C. § 357 (b).

5. Whether the liability assumption should be treated as a promise to pay, rather than as a legal obligation, such that the promise constitutes "other property" within the meaning of I.R.C. § 358(a).

6. Whether preferred stock issued in connection with the 351 transaction is nonqualified preferred stock within the meaning of I.R.C. § 351(g), or whether the sale of stock should be recharacterized.

7. Whether the stock loss should be disallowed or recharacterized under applicable judicial principles, including step transaction, economic sham, or sham in fact.

8. Whether the liability assumption has been properly valued.

9. Whether the transferor or the transferee is entitled to subsequent tax benefits associated with the subsequent deduction of the contingent liabilities.

10. Whether the Service should assert the negligence or disregard of rules or regulations and/or the substantial understatement of income tax portions of I.R.C. § 6662 against a taxpayer for engaging in a contingent liability transaction.

Any capital loss disallowance attributable to the contingent liability transaction should not rely upon I.R.C. § 165, a section 351 business purpose argument, or the duplicated loss rules. The application of section 269 should be examined (but do not assert it

simply because a dormant subsidiary has been re-activated to engage in the transaction).

CONCLUSIONS:

The basis of the stock received in the transaction is either limited to its fair market value, or reduced by the amount of the liabilities assumed in the transaction with the result that the taxpayer recognizes no loss on the sale of the stock.

The transferee liability management company may not deduct amounts paid for liabilities in subsequent years if the transferor retains the benefit of the deduction.

The accuracy related penalty should be asserted in all applicable cases.

OVERVIEW:

The transactions described below are designated as a listed transaction pursuant to Notice 2001-17, 2001-1 C.B. 730, ("Contingent Liability Transactions"). The transactions in question involve an exchange which purports to comply with section 351 of the Internal Revenue Code. A transferor corporation (Taxpayer) transfers high basis assets to a transferee corporation controlled by the transferor. The assets are transferred in exchange for stock of the transferee corporation and the transferee's assumption of a liability of the transferor, which has not yet been taken into account for tax purposes. The taxpayer takes the position that the basis of the stock of the transferee corporation equals the bases in the assets transferred, without a reduction in basis for the liability assumed. The transferor subsequently sells the stock at a reported capital loss equivalent to the present value of the assumed liability. When the liability ultimately is taken into account for tax purposes, the transferee claims the tax benefits associated with the liability.

There may be differences among the different cases with respect to the structuring of the transaction, the type of contingent liability assumed, the purported business purpose and the extent to which such business purpose was executed. However, it is the Service position that any business purpose is far outweighed by the taxpayer's interest in generating deductible losses. Extensive factual development is necessary to evaluate and assess the taxpayers' purported business reasons for entering into I.R.C. § 351 contingent liability transactions. Examination teams are directed to contact the Technical Advisors for IRC 351 Contingent Liability to coordinate the factual development of all contingent liability transactions.

There are several statutory and judicial legal bases for challenging the contingent liability transaction including I.R.C. sections 351(g), 357(c)(3), 357(b)(1), 358(a), economic sham, sham in fact, and step transaction. Many of the legal arguments are factual and not all arguments are applicable to each case.

FACTS:

The transaction involves the transfer of one or more assets to a corporation in exchange for the transferee corporation's stock and the transferee corporation's assumption of a liability that would be deductible by the transferor when paid. The asset transferred by the taxpayer to the transferee has a basis that approximately equals its value. The asset will typically be cash or a security. In the case of a consolidated group, the asset will be a security issued by a member of the group (or other property that is used to acquire a member security)[1]. The liability assumed by the transferee subsidiary is only slightly less than the basis/fair market value of the asset. The liabilities being transferred are primarily employee benefits. Most of these are post retirement benefits with a few involving future benefit expenses. The second largest category of liability transferred is for environmental remediation transactions or other tort or insurance liabilities.

Often the taxpayer will recapitalize a dormant subsidiary to effect the contingent liability transaction by authorizing a new class of preferred stock. The purported business purpose of the dormant subsidiary is redefined as risk or liability management. Amended or restated certificates or articles of incorporation may be filed in the state of incorporation. The taxpayer and the transferee (purported risk or liability management company) may enter into a separate agreement relating to the assumption of the liability. The agreement may cover all or a portion of existing and/or future liabilities. In some cases, such as those involving tort or environmental liabilities, the taxpayer may face legal impediments to the transfer of the liabilities. Often, the taxpayer and the transferee enter into other ancillary agreements such as support or administrative agreements, which minimize the business consequences of the restructuring. The extent to which the transferee liability management company was actively engaged in a business activity varies among the cases.

The transaction is purported to qualify as an exchange under section 351 of the Internal Revenue Code, with the intent that the basis of the stock that the transferor receives from the transferee corporation will be determined by the basis of the transferred asset. The liability is purported to be a liability described in section 357(c)(3)(A) because the assumption of such a liability does not reduce the basis of the stock received. I.R.C. § 358(d)(2). The interplay of I.R.C. § 351, coupled with the exclusion of the contingent liability purportedly under I.R.C. § 357(c), results in the creation of the high-basis, low-fair market value stock.

Shortly after the exchange, and as part of the overall plan, the transferor sells the stock received in the exchange for its fair market value and claims a loss in an amount

[1] The transaction was structured using member securities so as to avoid the potential application of the duplicated loss rules under Treas. Reg. § 1.1502-20(c)(2)(vi)(A)(1). However, In Rite Aid Corp. v. United States, 255 F.3d 1357 (D.C. Cir. 2001), the Federal Circuit held that the duplicated loss component of the LDR represents an invalid exercise of regulatory authority. In view of this decision and the Service's interim guidance, the Service will not argue that the duplicated loss rules apply in subsequent contingent liability transactions.

approximating the present value of the liability assumed by the transferee corporation. The effect is to accelerate the tax benefit of the deduction of the liabilities assumed by the transferee. In the case of a transaction involving members of an affiliated group that has elected to file a consolidated return, the transaction may be structured to avoid deconsolidation so that, when the transferee pays the liability, the group may claim that it is entitled to a deduction for the payments, thus duplicating the tax benefit within the group. The purchaser of the stock may be an employee, a consultant or other entity related to liability management. The purchaser may also be an accommodating party such as a bank or insurance company. Frequently, the stock purchase agreements contain put and call options, or other mechanisms minimizing the risk to the purchaser. In some contingent liability transactions the outside purchaser of the stock has a guaranteed return on its investment.

Taxpayers assert various business purposes for entering into the contingent liability transactions such as centralizing or reducing liabilities. Cases differ widely regarding the strength of the taxpayer's business purpose arguments. However, the taxpayer's purported business purpose does not explain or justify the overriding tax structuring of the contingent liability transaction.

Settlement:

Rev. Proc. 2002-67 sets forth a resolution initiative available to all qualified taxpayers who elect to participate in such procedure on or before March 5, 2003.[2] In all other cases, Examination Teams are directed to fully develop all applicable issues as set forth below.

Applicable Authorities:

I.R.C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by a person solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

I.R.C. § 351(b) provides that if I.R.C. § 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under I.R.C. § 351(a), other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount received, plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

I.R.C. § 357(a) provides that, except as provided in I.R.C. § 357(b), if the taxpayer receives property, which would be permitted to be received under I.R.C. § 351 without the recognition of gain if it were the sole consideration and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption

[2] See Announcement 2002-110 extending the date for electing the settlement initiative from January 3, 2003 to March 5, 2003.

shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of I.R.C. § 351.

I.R.C. § 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in I.R.C. § 357(a) was a purpose to avoid Federal income tax on the exchange, or if not such a purpose was not a bona fide business purpose, then such assumption shall, for purposes of I.R.C. § 351, be considered as money received by the taxpayer on the exchange.

I.R.C. § 357(c)(1) provides that in the case of an exchange (A) to which I.R.C. § 351 applies, or (B) to which I.R.C. § 361 applies by reason of a plan of reorganization within the meaning of I.R.C. § 368(a)(1)(D), if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as gain from the sale or exchange of a capital asset or of a property which is not a capital asset, as the case may be.

I.R.C. § 357(c)(2) provides that I.R.C. § 357(c)(1) shall not apply to an exchange (A) to which I.R.C. § 357(b)(1) applies, or (B) which is pursuant to a plan of reorganization within the meaning of I.R.C. § 368(a)(1)(G) where no former shareholder of the transferor corporation receives any consideration for his stock.

I.R.C. § 357(c)(3)(A) provides that if a taxpayer transfers, in an exchange to which I.R.C. § 351 applies, a liability the payment of which either (i) would give rise to a deduction, or (ii) would be described in I.R.C. § 736(a), then, for purposes of I.R.C. § 357(c)(1), the amount of such liability shall be excluded in determining the amount of liabilities assumed or to which the property transferred is subject.

I.R.C. § 358(a)(1) provides that, in the case of an exchange to which I.R.C. §§ 351, 354, 355, 356, or 361 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e., the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the amount of money received by the taxpayer, and increased by the amount of gain to the taxpayer which was recognized on such exchange.

I.R.C. § 358(d)(1) provides that where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of I.R.C. § 358, be treated as money received by the taxpayer on the exchange.

I.R.C. § 358(d)(2) provides that I.R.C. § 358(d)(1) shall not apply to the amount of any liability excluded under I.R.C. § 357(c)(3).

Discussion:

1. The transaction must satisfy the technical requirements of I.R.C. § 351.

The first step of the contingent liability transaction is the transfer of an asset to a liability management company in exchange for stock and a liability assumption purportedly as part of an I.R.C. § 351 exchange. Therefore, the threshold inquiry is whether the transaction in which the transferee stock is received satisfies the technical requirements of section 351,[3] including the control requirements of I.R.C. § 368(c) and the requirement that the transferee is not an investment company within the meaning of I.R.C. § 351(e). If the exchange fails to qualify under section 351, it is a section 1001 exchange; the basis of the transferor's stock is its fair market value. Thus, there is no loss realized on the stock sale. Although most contingent liability transactions will adhere to these technical requirements, the examining agent should review the stock agreements to verify compliance with I.R.C. § 351.

2. Stock acquired in transactions subject to section 358(h).

Section 358(h)(1) provides that, if, in a section 351 exchange, the basis of the stock received exceeds its fair market value, then such basis shall be reduced (but not below fair market value) by the amount of any liability assumed in exchange for the stock (unless the assumption was treated as money received by the transferor under section 358(d)(1)). Section 358(h)(2)(A) excludes the assumption of any liability that is assumed in connection with the transfer of the trade or business with which the liability is associated; section 358(h)(2)(B) provides a similar exclusion for the assumption of a liability in connection with the transfer of substantially all of the assets with which the liability is associated. Section 358(h) is effective for transfers after October 18, 1999.

Contingent liability transactions wherein the section 351 exchange occurred after October 18, 1999, are subject to section 358(h). Thus, in these cases, even if the stock would otherwise be treated as having a basis equal to the transferor's basis in the property transferred, the stock basis will be reduced by the amount of the liability assumption (but not below the fair market value of the stock).[4] It should be noted that, in some cases, e.g., those involving the transfer of post-employment retirement obligations of an inactive corporation, taxpayers may claim that the transfer is within the scope of section 358(h)(2)(A) (exceptions for the transfer of a trade or business)

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[3] Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock, and, immediately after the exchange, the transferor or transferors are in control of the corporation. "Control" is defined in section 368(c), which provides that control requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. For this purpose, ownership must be direct, not by attribution, unless the transferor is a member of a consolidated group (in which case it may be treated as owning stock owned by members of the same group, see Treas. Reg. § 1.1502-34). See Rev. Rul. 56-613, 1956-2 C.B. 212; Rev. Rul. 78-130, 1978-1 C.B. 114.

[4] Note that, in such cases, no further adjustment is made to the stock basis when the transferee makes a payment with respect to the assumed liability. See § 1.1502-32(a)(2) (subsidiary stock basis "must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment").

because they have transferred all that remains of the business. While guidance has not been issued on the scope of the exception, this exception is not intended to apply to contingent liability transactions as such cases present the very abuse at which the provision was directed.

In addition, in certain cases taxpayers may raise issues as to whether the transfer took place after the effective date of I.R.C. section 358(h). In such cases, the taxpayer is obligated to respect its own decisions regarding the form of the transaction, including the date of the transfer of the liabilities for book purposes. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974).

3. The liability is not within the scope of I.R.C. § 357(c)(3); therefore, I.R.C. § 358(d)(2) does not prevent the application of I.R.C. § 358(d)(1) to reduce basis by amount of the liability assumed.

Assuming the transaction qualifies as a § 351 exchange, the taxpayer's basis in the transferee stock received is equal to the basis in the property transferred, reduced by the liabilities assumed in the exchange. I.R.C. §§ 358(a) and (d)(1).

Taxpayers claim that, because the liability is one that will give rise to a deduction, it is a liability described in section 357(c)(3), and that, therefore, section 358(d)(2) prevents the basis reduction required under section 358(d)(1). It is Service position that: 1) the legislative history of I.R.C. § 357(c)(3) contemplated that the excepted liability be a liability, the payment of which would give rise to a deduction to the transferee and 2) the assumed liabilities in the contingent liability transaction do not give rise to a deduction of the transferee. Either by reference to I.R.C. §§ 162 or 482, the assumption of the liabilities is for the benefit of the transferor and is not deductible by the transferee. Since the liabilities assumed in the contingent liability transaction are not within the intended scope of section 357(c)(3) because the liabilities do not give rise to a deduction to the transferee, section 358(d)(2) is inapplicable. Accordingly, section 358(d)(1) requires the reduction of stock basis by the amount of the assumed liability.

Section 357(c)(3) provides that the liabilities "the payment of which…would give rise to a deduction" are not subject to the general rule of section 357(c)(1)(requiring a transferor to recognize gain to the extent that liabilities assumed in a § 351 exchange exceed the basis of assets transferred in the exchange). Section 358(d)(2) effectively provides that a liability "excluded under I.R.C. § 357(c)(3)" does not reduce the basis of stock received in a section 351 exchange. While the language in I.R.C § 357(c)(3) does not specify whether it refers to the deduction of the transferee or the transferor, the legislative history is explicit. For example, the Senate Report for the Technical Corrections Act of 1979 states:

> Liabilities excluded under this provision are those liabilities the payment of which by the transferor would give rise to a deduction and those liabilities the payment with respect to which would be described in section 736(a) of the Code.

> In general, liabilities the payment of which would give rise to a deduction include trade accounts payable, and other liabilities (e.g. interest and taxes), which relate to the transferred trade or business. However, such liabilities may be excluded only to the extent payment thereof by the transferor would have given rise to a deduction. A liability would not be excluded under this provision to the extent the liability has already been deducted by the transferor. In addition, a liability would not be excluded under this provision to the extent that the incurrence thereof resulted in the creation of, or increase in, the basis of any property.

S. Rep. No. 96-498 (1979), 1980-1 C.B. 517, 546. Also see, S. Rep. No. 95-1263 (1978) and Pub. L. 95-600 (General Explanation of the Revenue Act of 1978).

The legislative history further expressly states that it is codifying the approach taken in Focht v. Commissioner, 68 T.C. 223 (1977). Focht, likewise set forth the rule that:

> The assumption of a deductible obligation of a cash method taxpayer is a non-realizable event because it is improper to treat the assumed liability as income to the transferor and deny him the tax benefit for its satisfaction. However, a cash basis taxpayer transferring a nondeductible liability realizes gain irrespective of whether he enjoyed a prior tax benefit, as actual payment would generate no additional tax deduction.[5]

It is clear from the legislative comments that I.R.C. §§ 357(c)(3) and 357(d)(2) were intended to: 1) prevent the taxation of phantom gain on the assumption of a liability that has not been taken into account for tax purposes (and that will give rise to a tax benefit when taken into account), and 2) to ensure that a transferor will realize the tax benefit of the liability (by preserving the transferor's economic position in the liability in the basis of the stock).

In the typical contingent liability transaction, the taxpayer transfers a liability, such as retirement benefits, workforce liabilities, environmental liabilities, or insurance liabilities, while retaining the related assets such as its workforce or its physical property. It also continues its business activities. In many cases, the management of the liabilities is uninterrupted. Further, the transaction is structured with the plan that the shares of stock in the liability management company be sold within a short period of time.

Because of the way the transaction is structured, there is no need to preserve the transferor's basis in the stock acquired in the § 351 exchange, i.e., preserve the benefit of the transferor's deduction, because the deduction remains with the transferor. There are several principles compelling the conclusion that the exclusion under I.R.C. § 357(c)(3) does not apply. First, the taxpayers in these cases are subject to the rule set forth in Holdcroft Transp. Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946). Pursuant to Holdcroft, the assumption of the liability is part of the cost of acquiring the transferred

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[5] While Focht addressed an inequity arising out of the treatment of accounts payable to a cash basis taxpayer, the principle enunciated remains applicable.

asset and so the payment of the liability does not give rise to a deductible expense for the transferee.[6] Also see, Smith v. Commissioner, 418 F.2d 589, 596 (5th Cir. 1969); Buten v. Commissioner, T.C. Memo. 1972-44. In such a case, the deduction upon payment by the transferee should accrue to the transferor, in which case there is no need to preserve the loss in the stock basis. Hood v. Commissioner, 115 T.C. 172 (2000)(Legal fees paid by a corporation on behalf of a shareholder are deductible as an ordinary and necessary expense of the shareholder).

Second, the payment of the liability by the transferee does not qualify as a § 162 deduction because it is not a payment of an ordinary and necessary expense of the transferee's trade or business. Section 162 permits deduction of a taxpayer's own necessary and ordinary business expenses. Welch v. Helvering, 290 U.S. 111, 113 (1933). It does not permit deduction of expenses paid or incurred for the benefit of another person or entity. Welch, 290 U.S. at 114; see also Deputy v. du Pont, 308 U.S. 488, 494 (1940)(No deduction allowed to an individual for payment of corporate expenses). In the contingent liability transaction the transferee is not paying its own expenses but rather those of the parent. In transactions involving environmental liabilities, for example, the transferor may remain obligated for the liability.

Several contingent liability transactions involve the assumption of employee benefit liabilities. I.R.C. § 404 sets forth the provisions relating "to the deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan." By express operation of the statute, the deduction for such benefits accrues to the employer. Since the right to the deduction for the benefit liability accrues to the transferor, I.R.C. § 357(c)(3) does not apply. I.R.C. §§ 419 and 419A contain similar limitations as to the deductibility of welfare benefit funds. For contributions made in taxable years after December 31, 1985, I.R.C. §§ 419 and 419A limit the deductibility of employer contributions to a welfare benefit fund to the qualified cost for the fund's taxable year ending with or within the employer's taxable year. These sections allow a limited current-year deduction for contributions to fund expenses paid in a subsequent year only if such expenses represent claims incurred but unpaid at the fund's year end, or a reserve for post-retirement medical and life insurance benefits. I.R.C. §§ 419A(c)(1) and (2).

Finally, pursuant to I.R.C. § 482, the deduction for the assumed liability should be allocated to the transferor. Section 482 provides that "[i]n any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute apportion, or allocate gross income, deductions . . . between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of

[6] Note that the transferee's basis in the assets received is determined under section 362; therefore, the later payment of the liability gives rise to no additional basis to the transferee. See Ways and Means Committee Report, H. Rept. No. 855, 76th Congress 1st Sess. (1939), 1939-2 C.B. 518, 519.

such organizations, trades, or businesses." The Secretary may allocate any item or element affecting taxable income, including basis. Section 1.482-1(a)(2) of the Income Tax Regulations. The taxpayer must meet a heavier than normal burden of proof and demonstrate that the Commissioner's determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner's determinations. Generally, the Commissioner's determinations under § 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 358 (1988).

In the typical contingent liability shelter case, there are at least two "organizations, trades or businesses" that engage in the § 351 exchange in which liabilities are purportedly assumed, the parties involved in the transaction are "owned or controlled directly or indirectly by the same interests," and the payment of the liability is a payment of expenses arising in the transferor's business so that the transfer of the deduction would serve only to avoid taxes and prevent the clear reflection of income. Accordingly, the government could properly allocate to the transferor any deductions arising on the payment of the assumed liabilities under the authority granted under § 482.

Taxpayers improperly rely on Rev. Rul. 95-74, 1995-2 C.B. 36, as support for the conclusion that the contingent liability should be excluded under I.R.C. § 357()(3). Rev. Rul. 95-74 permits a corporate transferee to claim deductions accruing upon payment of contingent assumed liabilities. Rev. Rul. 95-74 confers step-in-the shoes treatment on the transferee, allowing the transferee to deduct payments of assumed liabilities associated with the transferred business. The key facts of the revenue ruling are that there is a transfer of a trade or business and, at the time of the section 351 exchange, the taxpayer had no plan to dispose of the stock received. Hence the transferee's entitlement to the deduction preserves the Congressional intent to preserve the benefit of a transferor's deduction through a tax free exchange. This factual scenario is inapposite to the contingent liability transaction. In the contingent liability transactions, there is no transfer of a trade or business and there is a plan to dispose of the stock immediately after the sale. Since the taxpayer's business is ongoing, it retains the right to the deduction for the contingent liability when it is incurred. Since these contingent liability transactions are distinguishable from the facts of Rev. Rul. 95-74, the general rule of Holdcroft, supra., applies. Since the liability is not excluded under section 357(c)(3)(A)(i), section 358 (d)(2) is inapplicable, and the general rule of section 358(d)(1) applies to reduce the stock basis by the amount of the liability.

4. The liability assumption is treated as a distribution of money under section 357(b).

If the principal purpose of the liability assumption is to facilitate the creation of high basis, low value stock the disposition of which results in a substantial capital loss, such purpose is not a bona fide business purpose. Accordingly, under section 357(b), the assumption of the liability is considered a distribution of money that, under section 358(a), reduces stock basis. Section 357(b) provides generally:

(1) In general. — If taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or
(B) if not such purpose, was not a bona business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, or 371 (as the case may be), be considered as money received by the taxpayer on the exchange.

(2) Burden of proof. — In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

Under I.R.C. § 357(a), a liability assumption (or acquisition of an asset subject to a liability) is not considered "as other property or money received by the taxpayer" in an otherwise tax-free exchange. If the principal purpose of the taxpayer with respect to the assumption or acquisition was a purpose to avoid Federal income tax on the exchange, or if not such purpose, was not a bona business purpose, Code section 357(b) applies and the liability assumption is treated as money or other property. In the typical contingent liability transaction the taxpayer's tax savings far outweigh any non-tax profit from the transaction.[7]

I.R.C. § 357(b) was enacted to prevent the tax deferment rule in section 357(a) from encouraging schemes to avoid taxes. Campbell v. Wheeler, 342 F.2d 837, 838 (5th Cir. 1965); Simpson v. Commissioner, 43 T.C. 900, 915 (1965). The legislative history indicates that section 357 was designed primarily to protect assumptions and transfers following in the ordinary course of converting a business from one form to another. The operative Code provisions should be applied consistent with the legislative purpose they were designed to serve. Griffiths v. Commissioner, 308 U.S. 355 (1939).

In determining the principal purpose of the taxpayer, the statute requires consideration of "the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made." For example, in Investment Research Associates v. Commissioner, T.C. Memo. 1999-407, the Tax Court evaluated a complex series of transactions in their entirety in reaching the conclusion that a liability assumption violated section 357(b). All relevant facts relating to the structuring of the contingent liability transaction should be analyzed, including: the timing of the transaction, tax advice received, structuring to avoid capital gains, and the business activities of the taxpayer and the transferee prior to and subsequent to the liability

[7] It may be possible to establish in certain contingent liability transactions that no non-tax savings were obtained.

assumption. The nature of the liability should also be analyzed. In several cases the taxpayer transferred only isolated liabilities, leaving others within its control. In other cases, only the liabilities for a fixed period of time were transferred. In certain cases the taxpayer cannot substantiate its transfer of the covered liability. In other instances, the taxpayer transferred an obligation which had not yet been incurred. The circumstances surrounding the transaction and the nature of the liability will bear upon whether the principal purpose of the taxpayer is not a bona fide purpose.

One factor of particular significance is the fact that at the time of the § 351 exchange, the parent corporation intended to dispose of the stock. The Tax Court denied the benefit of a tax free exchange to a taxpayer in a case involving a purported reorganization under I.R.C. § 354 where the intermediary corporation acted as a mere conduit and taxpayer had a prearranged intent to sell its interest. West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966).

Section 357(b)(1)(B) applies if the taxpayer's *principal* purpose is not a bona fide business purpose. Thus, section 357(b) can apply even if the taxpayer in fact has some business purpose, as may arguably be the case in some of the contingent liability transactions under consideration.

Several cases have considered the application of I.R.C. § 357(b), or its predecessor § 112(k). Among the factors relevant to a determination that the primary purpose of the liability assumption was a bona fide purpose are the following:

1) Whether the assets subject to the liabilities assumed were also transferred. Stoll v. Commissioner, 38 T.C. 223 (1962). The contingent liability transaction involves the transfer of a liability without the corresponding asset.

2) Whether the liability assumption was incident to the transfer of a business, or closely related to the taxpayer's business, or motivated primarily by business, not personal, considerations. Campbell v. Wheeler, 342 F.2d at 841. There is no transfer of any ongoing business activity and the only purported activity is the management of the liability.

3) Whether the taxpayer incurred the liabilities to which the transferred securities were subject immediately prior to the transfer and in anticipation thereof. Drybrough v. Commissioner, 376 F.2d 350 (6th Cir. 1967). The liabilities are contingent. The taxpayer arrives at a present value of the liabilities for purposes of determining the liability assumption.

Taxpayers have a strong evidentiary hurdle to overcome in demonstrating that the principal business for entering into the contingent liability transaction was bona fide. The burden of proof rests with the taxpayer to prove by the clear preponderance of the evidence that such assumption, i.e. the assumed liability, should not be treated as money received by the taxpayer.

Taxpayers may assert that there is a potential statutory impediment to the application of § 357(b) to the contingent liability transaction The language of I.R.C. § 357(b)(1)(A) refers to a tax avoidance purpose "on the exchange." Arguably in the contingent liability transaction, the assumption of the liability is not for purposes of avoiding taxation "on the exchange." There is an issue of interpretation as to whether I.R.C. § 357(b)(1)(B) sets forth a separate alternative test that the principal purpose of the assumption of the liability must be a bona fide business purpose. The literal reading of the statute as well as the legislative intent of the statute should be construed to treat a liability assumption, which was structured as part of an arrangement to avoid the realization of capital gain, "as other property or money received."

5. The liability assumption should be treated as a promise to pay, rather than as a legal obligation, such that the promise constitutes "other property" within the meaning of I.R.C. § 358(a).

I.R.C. § 358(a)(1)(A)(ii) provides generally that in the case of an exchange to which I.R.C. § 351 applies,- the basis of the property permitted to be received without the recognition of gain or loss shall be the same as that of the property exchanged, – decreased by the fair market value of any other property (except money) received by the taxpayer. Section 358(a)(2) specifies that the basis of any other property shall be its fair market value.

Several contingent liability transactions include the assumption of benefit obligations for a work force in place. (For example the transferee assumes the obligation to pay retirement benefits for current employees as compared with FASB 106 liabilities). At the time of the "liability assumption" the transferor has incurred no obligation to pay such liabilities and in fact such obligation could be terminated. As such the obligation is essentially a promise to pay. Contingent liability transactions involving this type of liability may be particularly abusive. For example, the taxpayer may have claimed a large capital loss based on projected workforce liabilities, yet such obligation never accrued because the taxpayer's workforce was eliminated in an acquisition transaction.

The promise to pay such obligation is not a liability, contingent or otherwise, at the time of the assumption. If the obligation assumed is not a "liability" within the meaning of I.R.C. 358(d), it is "other property" (boot) within the meaning of I.R.C. 358(a).

There is significant case support for the position that the obligation is not a liability. For example, the Tax Court held that severance pay obligations assumed by a taxpayer could not be included in the cost basis of the assets purchased. Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd. 333 F.2d 653 (2d Cir. 1964). The holding was premised on several factors present in the workforce contingent liability transactions. First, the taxpayer did not assume a liability for the severance pay because the seller had not accrued such obligation at the time of the assumption. Second, the liability was "so speculative" that it could not be fairly considered as part of the cost. Albany Car Wheel, 40 T.C. at 841.

Relevant authorities further provide that where a contingent liability is insusceptible to present valuation, such liability is taken into consideration at such time when the liability is paid. David R. Webb Co. v. Commissioner, 708 F.2d 1254 (7th Cir. 1983); Illinois Tool Works, Inc v. Commissioner, 117 T.C. 39 (2001)(Assumed contingent liability added to cost basis of purchaser at the time the liability is incurred). These cases contemplate that if a liability assumption is too speculative to present value , such liability would not be included in amount realized if the transaction was governed by I.R.C. § 1001. Since the assumption of the purported liability would not be part of "amount realized" it is not an assumption of a liability under I.R.C. §357. Accordingly, the promise to pay is boot and the taxpayer's basis in the stock received in the exchange is reduced in the amount of the promise to pay.

6. **The stock may be nonqualified preferred stock within the meaning of I.R.C. § 351(g), or the stock sale may be otherwise disregarded for tax purposes**.

In the transactions under consideration, taxpayers claim to have recognized capital losses on their sale of stock received in the §351 exchanges. Often, no after-market exists for the sold stock and the stock, in the purchaser's hands, is subject to transfer restrictions, such as a right of first refusal exercisable by the taxpayer. Typically, the purchaser can, however, "put" the stock back to the taxpayer, or cause the issuing corporation to redeem it; and the taxpayer can "call" the stock, or the issuing corporation can force its redemption on the purchaser. In other cases, the dividend rate is akin to that of an interest rate or other similar indices. In many cases, statements by the purchasers suggest that the stock was purchased because of the rate of return on the stock, and such return was effectively guaranteed. In cases involving these types of facts, the stock may be governed by I.R.C. § 351 (g) or the sale of stock could be disregarded based on similar judicial principles. It is strongly recommended that an expert be used to develop the relevant facts regarding the effect of the stock restrictions (the puts and calls), the marketability of the stock, the likelihood that such options will be exercised, and the determination of the dividend.

For transactions occurring after June 8, 1997, I.R.C. § 351(g) provides that a transfer of property in exchange for nonqualified preferred stock is not eligible for non-recognition under section 351(a). If the transferor receives stock other than nonqualified preferred stock in the transaction, the nonqualified preferred stock is treated as other property (i.e., boot) for purposes of applying section 351(b).

The term "nonqualified preferred stock" means preferred stock if-

(i) the holder of such stock has the right to require the issuer or a related person to redeem or purchase the stock,
(ii) the issuer or a related person is required to redeem or purchase such stock,
(iii) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or
(iv) the dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.

The above clauses (i), (ii), and (iii) apply only if the right or obligation referred to therein may be exercised within the 20-year period beginning on the issue date of such stock and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase. I.R.C. § 351(g)(2)(A).

Although there are several limitations and exceptions, generally nonqualified preferred stock includes stock which can be viewed as more secure than the average share of preferred stock. There is no case law specifically defining "preferred stock" under I.R.C. § 351(g).

However, the related case law and Revenue Rulings regarding whether a stock sale should be either disregarded or recast as a loan provide a framework for analysis of the issue.

Whether analyzing the puts and calls under § 351(g)(2) or considering whether there has been a shift in the benefits and burdens of ownership, the following factors are relevant: the transferor continued to pay normal operational expenses; the repurchase price is predetermined; the put and call prices are identical; the parties intended for the transferor to repurchase the stock within a specified period of time. Rev. Rul. 72-543, 1972-2 C.B. 87.

Penn Dixie Steel Corp. v. Commissioner, 69 T.C. 837(1978), specifically addresses the issue of whether the put and call arrangements legally, or as a practical matter, imposed a mutual obligation to sell and buy back the outstanding stock. In this regard the Tax Court looked at both whether the put and call options were exercisable and expired on the same date, and whether the possibility that neither option would be exercised is remote. Based on the facts of that case (taxpayer argued that the transaction was a sale), the Court concluded that there was a more than a remote possibility that non-simultaneous options might not be exercised. However, the mere existence of non-simultaneous options may not be sufficient for the taxpayer to meet its burden of proof. See Kwait v. Commissioner, T.C. Memo. 1992-433 (holding that the applicable test for tax purposes is whether the benefits and burdens of ownership may shift regardless of whether a sale is consummated).

The rate of return is relevant to consideration of whether the contingent liability transaction should be considered a loan (Kwait v. Commissioner, T.C. Memo. 1992-433), or the stock boot (I.R.C. § 351(g)(2)(iv)).

In summary, consideration should be given to the following: whether the stock is restricted; whether the rate of return on the stock is fixed or predetermined; whether the likelihood that the stock repurchase and sale options will be exercised is remote, and whether the transferor has retained all business risks. The facts of the contingent liability transactions should be examined to see if they support a determination that the stock should be reclassified under I.R.C. § 351(g) or that no stock sale should be recognized for tax purposes.

7. **The substance of the transaction requires the recharacterization or disregard of all or part of the transaction.**

It is axiomatic that the substance rather than the form of a transaction governs the federal income tax treatment of the transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935). Substance over form and related judicial doctrines all require "a searching analysis of the facts to see whether the true substance of the transaction is different from its form or whether the form reflects what actually happened." Harris v. Commissioner, 61 T.C. 770, 783 (1974). The issue of whether any of those doctrines should be applied involves an intensely factual inquiry. See Gordon v. Commissioner, 85 T.C. 309, 327 (1985), Gaw v. Commissioner, T.C. Memo. 1995-531, aff'd without published opinion, 111 F.3d 962 (D.C. Cir. 1997).

a. **Step Transaction Doctrine**.

Under the step transaction doctrine, a series of formally separate steps may be collapsed and treated as a single transaction if the steps are in substance integrated and focused toward a particular result. See Andantech v. Commissioner, T.C. Memo. 2002-97. Courts have applied three alternative tests in deciding whether the step transaction doctrine should be invoked in a particular situation; namely, (1) if at the time the first step was entered into, there was a binding commitment to undertake the later step (binding commitment test),[8] (2) if separate steps constitute prearranged parts of a single transaction intended to reach an end result (end result test), or (3) if separate steps are so interdependent that the legal relations created by one step would have been fruitless without a completion of the series of steps (interdependence test). See Penrod v. Commissioner, 88 T.C. 1415, 1428-1430 (1987). More than one test might be appropriate under any given set of circumstances; however, the circumstances need satisfy only one of the tests in order for the step transaction doctrine to operate. Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1527-1528 (10th Cir. 1991) (finding end result test inappropriate but applying the step transaction doctrine using the interdependence test). For a recent detailed discussion of the three alternative tests applied in deciding whether the step transaction doctrine should be invoked in a particular situation, see Andantech v. Commissioner, supra.

The existence of business purposes or economic effects does not preclude the application of the doctrine:

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[8] The purpose of the binding commitment test is to promote certainty in tax planning; it is the most rigorous limitation of the step transaction doctrine. It is seldom used and is applicable only where a substantial period of time has passed between the steps that are subject to scrutiny. Thus, generally it is not an appropriate test to apply to transactions that fall entirely within a single tax year and so will generally not be the preferred test in the cases at issue here. See, e.g., Andantech v. Commissioner, T.C. Memo. 2002-97; Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1522 n. 6 (10th Cir. 1991) (rejecting use of the binding commitment test because the case did not involve a series of transactions spanning several years).

> Events such as the actual payment of money, legal transfer of property, adjustment of company books, and execution of a contract all produce economic effects and accompany almost any business dealing. Thus we do not rely on the occurrence of these events alone to determine whether the step transaction doctrine applies. Likewise, a taxpayer may proffer some non-tax business purpose for engaging in a series of transactional steps to accomplish a result he could have achieved by more direct means, but that business purpose by itself does not preclude application of the step transaction doctrine.

True v. United States, 190 F.3d 1165, 1177 (10th Cir. 1999). Also Associated Wholesale Grocers v. United States, 927 F.2d 1517 (1991).

In order to collapse a transaction under the step transaction doctrine, the government must have a logically plausible alternative explanation that accounts for all the results of the transaction. Thus, the step transaction doctrine permits a particular step in a transaction to be disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes, Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), aff'g T.C. Memo. 1999-411; see also Penrod v. Commissioner, supra at 1428-1430. Tracinda Corp. v. Commissioner, 111 T.C. 315, 327 (1998). The explanation may combine steps, however, courts have generally declined to apply the doctrine where the Government's explanation would invent new steps. See Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 196 (1988), aff'd without published opinion 886 F.2d 1318 (7th Cir. 1989). "'Useful as the step transaction doctrine may be . . . it cannot generate events which never took place just so an additional tax liability might be asserted.'" Grove v. Commissioner, 490 F.2d 241, 247-248 (2d Cir. 1973), aff'g T.C. Memo. 1972-98 (quoting Sheppard v. United States, 176 Ct. Cl. 244; 361 F.2d 972, 978 (1966)).

The step transaction doctrine may have application to the present cases, depending upon how a particular transaction is structured. One fact pattern in which the application of the doctrine is recommended is that in which the taxpayer has attempted not merely to double, but triple, the tax benefit of the liability by dropping the property and the liability through multiple layers of subsidiaries. That can occur in the following situation. Assume corporation P transfers an asset to a wholly-owned subsidiary, S1, in return for S1 stock and the assumption of a liability, and that S1 then transfers that same asset to another corporation, S2, also a subsidiary of P, in return for S2 preferred stock and the assumption of that same liability. P and S1 (and perhaps S2) file a consolidated return. S1 sells the S2 preferred stock to an accommodating party for a loss that is utilized by P on the consolidated return. In addition, at some point, P can sell the S1 stock it received in the first exchange and claim a loss on that stock. And, when the liability is actually paid, P (either directly or as the parent of a consolidated group) will obtain the third tax benefit--all manufactured out of that one liability. There is a likelihood that the facts could be viewed in a manner that would collapse the steps involving S1, with the result that P is treated as making a capital contribution directly to S2 in the net amount of the asset contributed over the liability assumed and S2 is

treated as issuing preferred stock directly to the accommodating party for its fair market value.

The step transaction doctrine is particularly tailored to the examination of transactions involving a series of potentially interrelated steps for which the taxpayer seeks independent tax treatment. True v. United States, 190 F.3d at 1177. Consideration should be given to whether the interdependence test and/or end result test could be used to disregard the liability management company and treat the transaction as a direct sale to a third party. The viability of this argument will depend on the particular facts of the case. For example, the "interdependence test" will be strongest in a situation where the liability management company is a shell. Are there administrative arrangements whereby the parent continues to be responsible for the liabilities? Is there a circular funding of the liability management company, wherein the parent receives stock in exchange for cash or security in the liability management company and the liability management company lends the money back to the parent? The critical inquiry is whether the individual steps of the arrangement make independent economic sense but for the tax benefit, the creation of the high basis stock through the 351 exchange. The "end result test" may also be used to collapse the transaction directly into a transfer of a liability assumption to a third party.

In this regard, the prearrangement of the sale to the third party is highly significant. In those cases where the stock is sold to an accommodating party, such as a bank or unrelated investor, the sale has no relation to the fulfillment of the taxpayer's business purpose. The transaction only makes sense in the light of the tax loss realized. In most cases, the Service can argue that the complexities of the transaction can only be rationalized in the context of the creation of the high basis stock and the realization of the capital loss. The taxpayer's purported business justification (the consolidation of liabilities and the creation of incentives to reduce the liabilities) could be achieved through more direct means.

Examiners should look at the facts on a case-by-case basis to determine if this doctrine would be applicable in their specific case.

b. Sham Transaction Doctrine.

Under this doctrine, a transaction that is not in substance what it purports to be in its form may be viewed as a mere sham and disregarded for tax purposes. Certain aspects of these cases typically suggest the application of this doctrine. In particular, it is recommended that close scrutiny be given to the arrangements through which the purportedly assumed liability is paid. Typically, these cases involve the transfer of an inter-company note to the corporation that purportedly assumes the liability, but at the same time there are put in place (as part of the overall plan) interrelated, complicated, and circular financial arrangements pursuant to which the transferor or some other group member actually pays the claims. The "payments" are charged against an "account" of the transferee, as are "payments" purportedly received by the transferee with respect to the intercompany note that funded the original exchange. Often there

are credit facilities between the transferor and the transferee pursuant to which all payments in settlement of claims are “loaned” by the transferor to the transferee, and all reimbursements are “loaned” by the transferee to the transferor. In this manner, the transferor retains control over the financing of the liabilities and, as a result, it can be argued that the note was in fact a sham, as was the assumption of the liability (if in fact there is a liability at all for tax purposes).

To be clear, the argument is not that there is no economic substance to the overall transaction, or even to the note and liability, but rather that the substance of the purported note transfer and liability assumption was actually just a complicated financing arrangement among members of a consolidated or controlled group--shams that cannot be respected for tax purposes. See, e.g., National Lead Company v. Commissioner, 336 F.2d 134 (2d Cir. 1964). In National Lead Company, the court held that an inter-corporate sale of stock at a loss by a parent corporation to its wholly owned subsidiary had no reality for tax purposes and, thus, must be disregarded (because of the parent’s continuing control over the property for fifteen years following the alleged sale). Thus, the parent was taxed on dividends and profits from the resale of such property by the subsidiary in the intervening years. While the court did not completely disregard the separate corporate identity of the subsidiary, it disregarded the inter-corporate stock sale as a sham.

Again, examiners should look at the facts on a case-by-case basis to determine if this doctrine would be applicable in their specific case.

c. Economic sham

Notice 2001-17 sets forth the Service position that contingent liability transactions lack economic substance and should be disregarded for tax purposes. When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective is without effect for federal income tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Rice's Toyota World Inc. v. Commissioner, 752 F.2d 89, 92 (4th Cir. 1985). In addition, even transactions having an economic effect may be disregarded if they are tax motivated and have no business purpose. Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991).[9] Contingent liability transactions should be evaluated to determine whether the transaction had a legitimate business purpose and whether the transaction had an economic effect.

An economic substance analysis hinges on all of the facts and circumstances surrounding the transactions leading up to and involved in a series of transactions. No single factor will be determinative. Whether a court will respect the taxpayer's characterization of the transaction depends on whether there is a bona fide transaction

[9] Cf. Compaq v. Commissioner, 277 F.3d 778 (5th Cir. 2001) rev'g. 113 T.C. 363 (1999), United Parcel Service v. Commissioner, 254 F.3d 1014 (11th Cir. 2001)(Narrowly defines altering the form an existing bona fide business as a sufficient "business purpose." to "neutralize any tax avoidance motive.").

with economic substance, compelled or encouraged by business or regulatory realities, imbued with tax-independent considerations, and not shaped primarily by tax avoidance features that have meaningless labels attached. See Frank Lyon Co. v. United States, 435 U.S. 561 (1978); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), aff'g in part T.C. Memo. 1997-115; Casebeer v. Commissioner, 909 F.2d 1360 (9th Cir. 1990); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89 (4th Cir. 1985), aff'g in part 81 T.C. 184 (1983); ; Winn-Dixie v. Commissioner, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999).

In ACM Partnership, the Tax Court found that the taxpayer desired to take advantage of a loss that was not economically inherent in the object of the sale, but which the taxpayer created artificially through the manipulation and abuse of the tax laws. T.C. Memo. 1997-115. Courts have further recognized that offsetting legal obligations, or circular cash flows may effectively eliminate any real economic significance of a transaction. Knetsh v. United States, 364 U.S. 361 (1960); Modest or inconsequential profits relative to substantial tax benefits are insufficient to imbue an otherwise questionable transaction with economic substance. ACM Partnership, 157 F. 3d at 258; Sheldon v. Commissioner, 94 T.C. 738, 767-768 (1990); Saba Partnership v. Commissioner, T.C. Memo 1999-359, 78 T.C.M. (CCH) 684, 721- 722.

In most cases an economic sham argument will not be viable because of the taxpayer's ability to demonstrate a business purpose for entering into the contingent liability transaction. However, appropriate factors for consideration include whether (1) the transfer achieved its stated business purpose; (2) the amount of the potential non-tax benefit to be realized by the parties is far exceeded by the losses generated; (3) the transferee corporation is a meaningless shell;(4) the property was transferred, both prior to and after the §351 transaction; (5) there is evidence of pre-arranged plans concerning the future sale of the stock; (6) where there is no evidence that independent parties (such as creditors) requested a specific structure for the transaction; and (7) the transaction originated in the tax department, in lieu of the appropriate business unit.

8. The valuation of the liability should be considered.

An important decision in these cases is whether to hire expert witnesses to assist in valuation of the liabilities purportedly assumed in the exchanges. The value of the liabilities may have relevance for two reasons. Whether these reasons are sufficient justification for hiring expert witnesses is, of course, a litigation strategy decision. The decision will vary depending on whether the team has reason to believe that the valuation of the liability assumption is reliable.

The first reason that valuation may be relevant is that it may have an effect on the tax treatment of the purported §351 exchange. First, if it can be established that the liability was undervalued, there will be gain recognized on the transaction to the extent the true value of the liability exceeds the basis of the assets transferred. This is a

straightforward application of §357(c) (because, as addressed below, these liabilities are not excluded from §357(c)(1) by §357(c)(3)).

The second reason that the valuation of the liabilities may be relevant is that, if the facts establish that the liabilities were actually overvalued, that can affect the credibility of the taxpayer's purported business purpose. For example, if the taxpayer asserts a cost-savings business purpose, the fact that liabilities were overvalued (and so capable of being settled at an apparent cost savings) can be used to refute the business purpose. Arguably such a finding would also support any argument attacking the bona fides of the transaction.

9. The transferor is entitled to subsequent tax benefits associated with the subsequent deduction of the contingent liabilities.

If the taxpayer respects the existence of the liability management company, the liability management company will claim any subsequent deductions or tax benefits resulting from the payment of the liabilities. However, pursuant to Holdcroft, supra., as well as I.R.C. sections 162, 404, 419 and 482, the transferee is not entitled to the deduction.[10] (See discussion 3, above).

10. Penalties apply in all appropriate cases.

Whether penalties apply to capital losses and other deductions attributable to the section 351 contingent liability transaction must be determined on a case-by-case basis depending on the specific facts and circumstances of each case. The application of a penalty must be based upon a comparison of the facts developed with the legal standard for the application of the penalty. Examination teams should accordingly ensure that the scope of their factual development encompasses those matters relevant to penalties. A separate report should be prepared for the penalty issue.

One important issue relevant to the potential assertion of the accuracy-related penalty attributable to a substantial understatement is whether the transaction constitutes a tax shelter as defined in section 6662(d)(2)(C)(iii). The transaction will constitute a tax shelter if a significant purpose of the transaction is the avoidance or evasion of federal income tax (if the transaction was entered into before August 6, 1997, a "principal purpose" standard applies). If the transaction is a tax shelter, then, as explained below, the requirements of section 1.6664-4(e) should be carefully scrutinized to determine whether a corporate taxpayer had "reasonable cause" sufficient to avoid the accuracy-related penalty attributable to a substantial understatement. If the transaction is not a tax shelter, then sections 1.6664-4(a) through (d) apply in determining whether a corporate taxpayer had reasonable cause sufficient to avoid the accuracy-related penalty.

[10] Rev. Proc. 2002-67 permits taxpayers, who elect the fast track option, to negotiate with the Service as to whether the transferor or transferee receives subsequent tax benefits. This provision is part of the settlement and should not be construed to create any inference that the transferee is entitled to the deduction.

a. The Accuracy-Related Penalty

Section 6662 imposes an accuracy-related penalty in an amount equal to 20 percent of the portion of an underpayment attributable to, among other things: (1) negligence or disregard of rules or regulations, (2) any substantial understatement of income tax, and (3) any substantial valuation misstatement under chapter 1. Section 1.6662-2(c) provides that there is no stacking of the accuracy-related penalty components. Thus, the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40% in the case of a gross valuation misstatement), even if that portion of the underpayment is attributable to more than one type of misconduct (e.g., negligence and substantial valuation misstatement). See DHL Corp. v. Commissioner, T.C. Memo. 1998-461, where the Service alternatively determined that either the 40-percent accuracy-related penalty attributable to a gross valuation misstatement penalty under section 6662(h) or the 20-percent accuracy-related penalty attributable to negligence was applicable. The accuracy-related penalty provided by section 6662 does not apply to any portion of an underpayment on which a penalty is imposed for fraud under section 6663. Section 6662(b).

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code or to exercise ordinary and reasonable care in the preparation of a tax return. See Section 6662(c) and Section 1.6662-3(b)(1). Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances. See Marcello v. Commissioner, 380 F.2d 499 (5th Cir. 1967), aff'g 43 T.C. 168 (1964). Section 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances. The accuracy-related penalty attributable to negligence may be applicable if the taxpayer failed to make a reasonable attempt to properly evaluate the capital loss transaction.

The phrase "disregard of rules and regulations" includes any careless, reckless, or intentional disregard of rules and regulations. The term "rules and regulations" includes the provisions of the Internal Revenue Code and revenue rulings or notices issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. Section 1.6662-3(b)(2). Therefore, if the facts indicate that a taxpayer took a return position contrary to any published notice or revenue ruling, the taxpayer may be subject to the accuracy-related penalty for an underpayment attributable to disregard of rules and regulations, if the return position was taken subsequent to the issuance of the notice or revenue ruling.

The accuracy-related penalty for disregard of rules and regulations will not be imposed on any portion of underpayment due to a position contrary to rules and regulations if: (1) the position is disclosed on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation.

This adequate disclosure exception applies only if the taxpayer has a reasonable basis for the position and keeps adequate records to substantiate items correctly. Section 1.6662-3(c)(1). Further, a taxpayer who takes a position contrary to a revenue ruling or a notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits. Section 1.6662-3(b)(2).

A substantial understatement of income tax exists for a taxable year if the amount of understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). Section 6662(d)(1). Understatements are generally reduced by the portion of the understatement attributable to: (1) the tax treatment of items for which there was substantial authority for the treatment, and (2) any item if the relevant facts affecting the item's tax treatment were adequately disclosed in the return or an attached statement and there is a reasonable basis for the taxpayer's tax treatment of the item. Section 6662(d)(2)(B).

In the case of items of taxpayers other than corporations attributable to tax shelters, exception (2) above does not apply and exception (1) applies only if the taxpayer also reasonably believed that the tax treatment of the item was more likely than not the proper treatment. Section 6662(d)(2)(C)(i). In the case of items of corporate taxpayers attributable to tax shelters, neither exception (1) nor (2) above applies. Section 6662(d)(2)(C)(ii). Therefore, if a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to the underpayment attributable to the understatement unless the reasonable cause exception applies. See Section 1.6664-4(e) for special rules relating to the definition of reasonable cause in the case of a tax shelter item of a corporation.

The definition of tax shelter includes, among other things, any plan or arrangement a significant purpose of which is the avoidance or evasion of federal income tax. Section 6662(d)(2)(C)(iii). For transactions entered into before August 6, 1997, the relevant standard was whether tax avoidance or evasion was the "principal purpose" of the entity, plan, or arrangement. Section 1.6662-4(g)(2)(i). If the facts establish that an understatement attributable to the contingent liability transaction exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies), a substantial understatement penalty may be applicable.

In most instances, if the facts support a determination that the penalty is applicable, Compliance should assert that the contingent liability transaction is a tax shelter item of a corporation under section 6662(d)(2)(C)(iii). Therefore, the taxpayer will be liable for the penalty unless reasonable cause can be demonstrated.

For the accuracy-related penalty attributable to a substantial valuation misstatement to apply, the portion of the underpayment attributable to a substantial valuation misstatement must exceed $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). A substantial valuation misstatement

exists if the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of the value or adjusted basis. Section 6662(e)(1)(A). If the value or adjusted basis of any property claimed on a return is 400 percent or more of the amount determined to be the correct amount of the value or adjusted basis, the valuation misstatement constitutes a "gross valuation misstatement." Section 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20% penalty under section 6662(a) is increased to 40%. Section 6662(h)(1). One of the circumstances in which a valuation misstatement may exist is when a taxpayer's claimed basis is disallowed for lack of economic substance. Gilman v. Commissioner, 933 F.2d 143 (2d Cir. 1991), cert. denied, 502 U.S. 1031 (1992).

With respect to a contingent liability transaction, the “property” claimed on the return for purposes of section 6662(e) is the stock of the liability management company. If the facts establish that the adjusted basis of the stock of the risk or liability management company is 200 percent or more of the correct amount, then a substantial valuation misstatement exists; if the facts establish that the adjusted basis of the stock of the risk or liability management company is 400 percent or more of the correct amount, then a gross valuation misstatement exists.

b. The Reasonable Cause Exception.

The accuracy-related penalty does not apply with respect to any portion of an underpayment with respect to which it is shown that there was reasonable cause and that the taxpayer acted in good faith. Section 6664(c)(1). The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Section 1.6664-4(b)(1). Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Id.

Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reliance on professional advice, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. Id. See also United States v. Boyle, 469 U.S. 241 (1985) (reasonable cause is established when a taxpayer shows that he reasonably relied on the advice of an accountant or attorney). In determining whether a taxpayer has reasonably relied on professional tax advice as to the tax treatment of an item, all facts and circumstances must be taken into account. Section 1.6664-4(b)(1).

The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purpose (and the relative weight of those purposes) for entering into a transaction and for structuring a transaction in a particular manner. A taxpayer

will not be considered to have reasonably relied in good faith on professional tax advice if the taxpayer fails to disclose a fact it knows, or should know, to be relevant to the proper tax treatment of an item. Section 1.6664-4(c)(1)(i). The same facts relevant to the substantive issues will bear on the penalty, including the motivation to offset unrelated gain, the prearrangement of the stock sale to a third party, the transfer of the liabilities without the related asset to take advantage of section 357(c)(3).

The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Section 1.6664-4(c)(1)(i). Accordingly, Compliance should evaluate the accuracy of critical assumptions contained in any opinion letter.

Further, where a tax benefit depends on non-tax factors, the taxpayer also has a duty to investigate those underlying factors. The taxpayer cannot simply rely on statements by another person, such as a promoter. See Novinger v. Commissioner, T.C. Memo. 1991-289 (taxpayer could not avoid the negligence penalty merely because his professional advisor had read the prospectus and had advised the taxpayer that the underlying investment was feasible from a tax perspective, assuming the facts presented were true). Moreover, if the tax advisor is not versed in these non-tax factors, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54 (2d Cir. 2000) (taxpayer's reliance on tax advisor was not reasonable given the cautionary language in offering memoranda and the tax advisor's lack of adequate knowledge to evaluate essential aspects of underlying investment); Freytag v. Commissioner, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990) (reliance on tax advice not reasonable where taxpayer did not consult experts with respect to the bona fides of the financial aspects of the investment); Goldman v. Commissioner, 39 F.3d 402 (2d Cir. 1994) (taxpayer's reliance on accountant's advice to invest in a partnership engaged in oil and gas was not reasonable where accountant lacked industry knowledge); Collins v. Commissioner, 857 F. 2d 1383 (9th Cir. 1988) (penalties upheld where advisor " knew nothing firsthand" about the venture).

Reliance on tax advice may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of the federal tax law. Section 1.6664-4(c)(1). For a taxpayer's reliance on advice to be sufficiently reasonable so as possibly to negate a section 6662(a) accuracy-related penalty, the Tax Court stated that the taxpayer has to satisfy the following three-prong test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer gave to the advisor the necessary and accurate information, and (3) the taxpayer actually relied in good faith on the adviser's judgment. Neonatalogy Associates P.A. v. Commissioner, 115 T.C. 46 (2000).

With respect to reasonable cause for the substantial understatement penalty attributable to tax shelter items of a corporation, special rules apply; see section 6662(d)(2)(C)(iii) for the definition of a tax shelter. The determination of whether a corporation acted with reasonable cause and good faith is based on all pertinent facts and circumstances. Section 1.6664-4(e)(1). A corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but only if there is substantial authority within the meaning of section 1.6662-4(d) for the treatment of the item and the corporation reasonably believed, when the return was filed, that the treatment was more likely than not the proper treatment. Section 1.6664-4(e)(2)(i).

The regulations provide that in meeting the requirement of reasonably believing that the treatment of the tax shelter item was more likely than not the proper treatment, the corporation may reasonably rely in good faith on the opinion of a professional tax advisor if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in section 1.6662-4(d)(3)(ii) and the opinion unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Service. Section 1.6664-4(e)(2)(i)(B)(2). Therefore, if possible, the tax advisor's opinion should be obtained to determine whether these requirements are met.

Although satisfaction of the "substantial authority" and "belief" requirements is necessary to a reasonable cause finding, this may not be sufficient. For example, reasonable cause may still not exist if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed benefits that were unreasonable in comparison to the initial investment in the tax shelter, or if the taxpayer agreed with the shelter promoter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. Section 1.6664-4(e)(3).

Generally, if a taxpayer is unwilling to produce a copy of its opinion letter, the taxpayer should not be relieved from penalty consideration. Moreover, an opinion letter prepared by a promoter should not be accorded significant weight.