Department of the Treasury **Internal Revenue Service**

Office of Chief Counsel

Notice

CC-2002-001

October 19, 2001

Subject: Section 302 Basis Shifting Tax Shelter **Cancel Date:** October 18, 2002

PURPOSE

The purpose of this Notice is to assist Chief Counsel attorneys in advising field personnel in the development of cases involving transactions that are described in Notice 2001-45, 2001-33 I.R.B. 129 (dealing with "§ 302 basis shifting tax shelters").

SUMMARY

The transaction involves the redemption of stock purportedly owned by a foreign person in a transaction in which dividend treatment is claimed and the basis of the redeemed stock is purported to transfer to stock held by a U.S. taxpayer. It is the view of Counsel that even if the several steps of the transaction are respected, the redemption should be treated as a distribution in part or full payment in exchange for stock and not as a dividend. However, alternatively, if the redemption is treated as the distribution of a dividend, the basis of the redeemed stock should not be transferred to the basis of other stock owned by the U.S. taxpayer because the transfer would not be a "proper adjustment" as contemplated by § 1.302-2(c) of the Income Tax Regulations. In addition, any basis purportedly transferred to stock owned by the U.S. taxpayer, or any loss claimed with respect to the transfer of such basis, must be reallocated to the redeemed shareholder under § 482 of the Internal Revenue Code. Any loss claimed with respect to the transfer of such basis should be disallowed for reasons that may include, but are not limited to, §§ 165, 269 and 465, and the economic substance doctrine.

DISCUSSION

The transaction at issue here and in Notice 2001-45 has been widely marketed, primarily to individuals. While there are some variations in the various steps, the typical pattern is as follows:

Taxpayer (TP) is a U.S. taxpayer with substantial capital gains. TP desires to shelter the gain from tax. After consultation with Promoter and/or Advisor, TP purchases a small number of shares of the stock of Foreign Bank (FB) on the open market. FB is a widely held, publicly-traded foreign bank that is not subject to U.S. tax. In addition, TP purchases from Foreign Corporation (FC) a warrant to acquire at least 50 percent of the outstanding stock of FC, a foreign corporation not subject to U.S. tax. The remaining issued and outstanding stock of FC is typically owned by Foreign Person (FP), a foreign person or persons also not subject to U.S. tax. The warrant also allows TP the option to put the warrant back to FC. Under this put option, TP may surrender or cash settle the warrant for a nominal amount based on a percentage of FC's net asset value.

FC borrows money from FB in approximately the amount of TP's capital gain. With the proceeds of that loan, FC purchases bearer shares of FB stock; the FB stock secures the loan. These bearer shares, however, remain in FB's possession. Settlement on the FB stock acquisition contract is set for a date at least 30 days in the future (Date1). At the same time FC enters into the contract to acquire FB stock, FC purchases a put option from FB, obtaining the right to sell its FB bearer shares if the price of its FB bearer shares falls below the initial purchase price and insulating FC from significant loss. The put is out of the money. In addition, FC sells FB a call option with a strike price reset feature, giving FB the right to purchase its bearer shares at a price below their initial purchase price and limiting FC's opportunity for significant gain. The call includes an integrated forward feature that, in the event of a change in the value of FB stock, may result in income or gain to FC. The call option is in the money.

On or about Date1, FB redeems the stock purportedly owned by FC. FB effects the redemption through the exercise of its call option. FC uses the redemption proceeds to repay the loan from FB. Simultaneously, TP purchases an option to acquire a number of FB bearer shares that is approximately equal to the number of FB shares that FC contracted to purchase. TP's option is deep out of the money and acquired at little cost.

In some variants of the transaction, TP then transfers its FB stock (and possibly its FB options) to a partnership.

TP (or the partnership) then sells all or a significant portion of the FB stock. At some point before or after the stock sale, TP also surrenders the FC warrants. TP (or the partnership) either sells the FB options or allows them to lapse with a relatively insignificant amount of gain or loss.

The series of transactions is generally accomplished within several months, but in all known cases, within one year.

Typically, the Promoter not only markets the plan, but also makes the necessary arrangements to accomplish the various steps and monitors the entire transaction to ensure that the steps within the transaction are done timely and in accordance with the plan.

Known variations include the use of other derivative products in lieu of stock or options, as well as the use of the transaction to reduce gain (rather than generate loss). We anticipate there are others.

TP takes the position that the proper analysis and tax consequences of the transaction are as follows. Pursuant to § 318(a)(4), TP is treated as owning the stock that would be received upon exercise of FC warrants and FB options, and, pursuant to § 318(a)(3)(C), FC is treated as owning the stock owned and treated as owned by TP. As a result, FC is treated as owning the same number of FB shares before and after the redemption of the FB shares. Thus, the redemption fails to satisfy any of the criteria of § 302(b) and, under § 302(d), it is treated as a distribution of property to which § 301 applies. By applying the provisions of § 301, the distribution is treated as a dividend. Dividend treatment is inconsequential to FC because it is not subject to U.S. tax. Because FC holds no FB stock directly after the redemption, TP claims that FC's basis in its FB stock is added to TP's basis in its FB stock citing § 1.302-2(c). TP asserts that, upon completion of the redemption, TP's basis in its FB stock greatly exceeds the stock's value and the disposition of the stock will result in the recognition of a substantial loss (in an amount approximately equal to TP's original gain in need of shelter).

In addition to the arguments under §§ 302 and 318, TP takes the position that under § 1.465-22(c)(1) of the proposed Income Tax Regulations, published in the Federal Register on June 5, 1979 (44 Fed. Reg. 32235), FC's at risk amount is increased by the purported dividend resulting from the redemption of FB stock. TP also argues that FC's increased at risk amount is added to TP's at risk amount citing Prop. Treas. Reg. § 1.465-68, 44 Fed. Reg. 32235 (June 5, 1979).

The position of Counsel, as summarized in part by Notice 2001-45, is that the result urged by TP is not proper for several reasons, which may include, but are not limited to, the following:

I. <u>The redemption of FB stock held by FC is not a dividend distribution</u>.

A. <u>FC did not, in substance, own shares of FB stock</u>.

The facts of each case should be closely scrutinized to determine whether FC should be treated as having ever owned shares of FB stock. In order for FC to sell FB stock, the benefits and burdens of ownership of FB stock must first have passed to FC. <u>See</u> <u>Highland Farms, Inc. v. Commissioner</u>, 106 T.C. 237, 253 (1996); <u>Grodt & McKay Realty, Inc. v. Commissioner</u>, 77 T.C. 1221, 1237 (1981). In determining whether the benefits and burdens of ownership have shifted, courts have taken various factors into account, including whether the purported purchaser bears the risk of loss and enjoys the opportunity for gain and whether the parties to the transaction actually intend a sale.

It is the view of Counsel that in the case described above, FC did not, in substance, acquire shares of FB stock. In the subject transaction, FC's acquisition of FB stock is highly leveraged, the equity collar minimizes the possibility that FC will realize any significant gain or loss on its FB stock, and the terms of the instruments make FB's reacquisition of the stock by exercising its call option a virtual certainty. <u>See</u> <u>Comtel Corp. v. Commissioner</u>, 376 F.2d 791 (1967) (declining to treat a sale of shares followed by the seller's purchase of a call on those shares as a sale of the shares); Rev. Rul. 85-87, 1985-1 C.B. 268 (treating a put option as a contract to sell the underlying stock where the economics of the option render its exercise certain; under the facts of that ruling, there was no substantial likelihood the put would not be exercised based on the term of the put, the premium paid, the historic volatility in the value of the stock, and the difference between the strike price of the put and the price of the shares at the time the put was purchased); Rev. Rul. 72-543, 1972-2 C.B. 87 (treating a purported lessee as the owner of property where the benefits and burdens of ownership had transferred to the lessee). Cf., Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978) (declining to treat a collar transaction as a sale, but indicating that the result could be different on different facts).

We expect that factual development in individual cases will support the position that FC should not be treated as having acquired any shares of FB stock because the terms of the transaction does not contemplate a real investment in FB. Consequently, no stock is redeemed and no stock basis can transfer to TP's FB stock.

B. Even if FC were treated as having acquired the shares of FB stock that were redeemed, the redemption is a payment in exchange for the stock, not a dividend distribution.

A redemption is treated as a sale or exchange if (1) the seller's stock interest in the corporation is completely terminated, (2) the redemption is substantially disproportionate, or (3) the redemption is not essentially equivalent to a dividend. Section 302(b)(1), (2) and (3). In the case of a complete termination of the shareholder's interest, the termination need not result solely from the redemption, but rather can result from a combination of the redemption and other stock dispositions. Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (integrating a sale and redemption of stock to prevent dividend treatment); see also Rev. Rul. 77-226, 1977-2 C.B. 90 (holding that an integrated plan comprised of the partial redemption of stock, followed by the sale of the remainder of the stock to an unrelated third party, was a complete termination under § 302(b)(3)). The Zenz rationale is also applicable in determining whether a redemption is essentially equivalent to a dividend under § 302(b)(1). McDonald v. Commissioner, 52 T.C. 82, 87 (1969). Finally, the Service has approved the Zenz approach to § 302(b)(2) analyses. See Rev. Rul. 75-447, 1975-2 C.B. 113. The Zenz approach should also apply to a related termination of the stock ownership of a person whose stock ownership is attributed to the redeemed shareholder.

On the facts here, as part of the integrated plan, TP terminates its stock ownership in FB shortly after the redemption. Indeed, that termination is the purpose of all the steps. Therefore, the redemption of FC's FB stock is treated as payment in exchange for the stock (by reason of either § 302(b)(1), (2), or (3), depending on the facts), not a dividend, and thus FC has no remaining basis to transfer to TP.

II. Even if the redemption were treated as the distribution of a dividend, the addition of FC's basis in its FB stock to the basis of the FB stock held by TP is not a "proper adjustment" as contemplated under § 1.302-2(c).

Section 1.302-2(c) provides that, where a redemption is treated as a dividend distribution, "proper adjustment" will be made to the basis of other stock held or treated as held by the redeemed shareholder. Section 1.302-2(c) does not provide that, where a redemption is treated as a dividend distribution, basis will, in all cases, shift to such other stock. The regulations provide examples of proper adjustments. In Example 1, a corporation redeems 50 percent of a sole shareholder's stock. The redemption is treated as a dividend distribution, and the basis of the redeemed stock is added to the retained stock. Example 2 involves a situation in which a corporation's stock is held equally by a husband and wife, the husband's stock is completely redeemed, but the redemption is treated as a dividend distribution; the basis of the wife's stock is increased by the husband's basis in the redeemed stock. Example 3 clarifies Example 2 by providing that, if the husband had retained any stock, his basis in the redeemed shares would have transferred to the basis of the shares of stock he retained.

A similar result is provided in the case of a dividend distribution under § 304. See § 1.304-2(c), Example (1) (providing that a shareholder who owns stock in both the acquiring corporation and the sold corporation ("issuing corporation") and is treated as receiving a dividend upon the sale of stock in a § 304 transaction may add its basis in the sold stock to the basis of the stock in the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (providing that a shareholder who directly owns stock *only* in the issuing corporation and is treated as receiving a dividend upon the sale of stock in a § 304 transaction may add its basis in the sold stock to the basis of the stock that it retains in the issuing corporation). Rev. Rul. 70-496, 1970-2 C.B. 74, however, provides that basis shifting is not permitted where a shareholder that is treated as receiving a dividend distribution in a § 304 transaction holds no stock directly in the acquiring corporation, illustrating that basis can disappear in cases where there is no appropriate shift.

TP claims that Example 2 of § 1.302-2(c) provides for a shifting of basis in these cases, but the transaction at issue is distinguishable from that of Example 2 in § 1.302-2(c) in important ways. Although not explicitly stated, the example deals with the paradigm case involving persons subject to U.S. tax on the distribution. In this example, the redeeming shareholder includes the full distribution proceeds in gross income. Moreover, the rule provides a form of equitable relief--preserving, as near as possible, the benefit of the basis for the taxpayer.

Notice 2001-45 transactions, on the other hand, attempt to generate basis through transactions lacking business purpose and economic substance, and then shift that basis from a person not subject to U.S. tax to a person that is subject to U.S. tax. The redeemed shareholder, because it is not (and it must be assumed it never will be) subject to U.S. tax, is wholly indifferent to the U.S. tax treatment of the dividend distribution and the loss of basis. It is not in need of equitable relief. Indeed, by applying this equitable relief provision where none is necessary, there is an unintended windfall to the party claiming the shifted basis. Accordingly, a basis shift in this case is not a "proper adjustment."

In addition to the reasons discussed above, the basis adjustment sought in the present case is not a "proper adjustment" within the meaning of § 1.302-2(c) because the transaction as a whole lacks economic substance, as discussed below.

Note regarding variations on the described transaction. In Notice 2001-45 transactions as first marketed, TP always purchased a small number of FB shares directly. Subsequent transactions, however, have involved only the purchase of FB options and other derivative products relating to FB stock. In such cases, in addition to the arguments that the redemption should not be treated as a dividend and that a basis shift is generally inappropriate where the redeemed shareholder is not subject to U.S. tax on the distribution, there may be a further argument that the basis shift described in § 1.302-2(c) ("proper adjustment of the basis of the remaining stock will be made") provides for the shifting of basis to actual shares of stock, but does not address the situation in which a shareholder who would receive the benefit of the additional basis only holds options or other derivatives.

III. The losses sustained by TP were not bona fide and do not reflect actual economic consequences with the result that the purported stock loss is disallowed under § 165.

Section 165(a), under which losses are allowed, requires that losses be bona fide in substance, and not merely in form. Section 1.165-1(b). As a result, for a loss to be deductible, the taxpayer must suffer a financial detriment and be left poorer in a material sense. Horne v. Commissioner, 5 T.C. 250, 254 (1945). See Shoenberg v. Commissioner, 77 F.2d 446 (8th Cir.), cert. denied, 296 U.S. 586 (1935).

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), the court found that losses similar to the ones in the present case were not bona fide under § 165, as part of its objective economic substance analysis. ACM is similar to the present case in that it involved a tax shelter designed to generate large losses by allocating gain on a transaction to a tax-exempt foreign entity, while allowing the U.S. taxpayer to deduct the basis under recovery rules set forth in the regulations. Significantly, the court distinguished Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, 567-68 (1991), where the Supreme Court rejected a similar § 165 argument, because

> the disposition in Cottage Savings precipitated the realization of actual economic losses arising from a long-term, economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment, which effectively returning ACM to the same economic position it had occupied before. . . .

ACM, 157 F.3d at 251-52; Saba Partnership v. Commissioner, T.C. Memo. 1999-359. The present case is distinguishable from Cottage Savings for the same reasons. The transaction lacks economic substance, as discussed below, and is no more than a series of contrived steps that effect an artificial loss on TP's disposition of FB stock. The stock loss is not bona fide and does not reflect actual economic loss. Consequently, the loss should be disallowed under § 165.

IV. TP acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the purported stock loss is disallowed under § 269.

Section 269 provides that if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance may be disallowed.

"Person" is broadly defined as an individual, trust, estate, partnership, association, company, or corporation. Section 1.269-1(d). "Control" is defined as the ownership of stock representing at least 50 percent of the total combined voting power of all classes of stock or at least 50 percent of the value of all classes of stock. Section 269(a). The "acquisition of control," however, may be direct or indirect. Acquisition of control occurs when one or more persons acquire beneficial ownership of stock representing the requisite control. Section 1.269-5(a). So long as the person has beneficial ownership of the equity of the corporation, record ownership is unnecessary. See also Ach v. Commissioner, 358 F.2d 342, 346 (6th Cir. 1966) (holding that beneficial ownership constituted ownership within section 269 and record ownership was unnecessary); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976) (finding that traditional ownership attributes such as legal title, voting rights, and possession of stock certificates were not conclusive as to the ownership of stock); Rev. Rul. 70-638, 1970-2 C.B. 71. Such equity ownership generally must reflect effective control over the business and management of the corporation. See Briarcliff Candy Corp. v. Commissioner, T.C. Memo 1987-487. A holder of convertible securities, and similar equity stakes such as options, may be considered to have acquired control if the holder has effective control over the business and management of the acquired corporation. See Id. An option holder also may be viewed as acquiring control and assuming the benefits and burdens of ownership of the corporation's stock if the option holder has furnished or will furnish substantially all of the funds at risk (other than a nominal amount contributed by the legal owner) and only the option holder's investment (not that of the legal owner) will appreciate or depreciate. See, e.g., Tennessee Natural Gas Lines v. Commissioner, 71 T.C. 74, 83 (1978), acq., 1979-2 C.B. 2.; Rev. Rul. 82-150, 1982-2 C.B. 110 (concluding that a holder of deep in the money options is the owner of the referenced property).

Finally, the acquisition of control must have occurred for the principal purpose of evasion or avoidance of Federal income tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Section 1.269-3(a). This determination is a factual one which requires a subjective evaluation of the taxpayer's motives. See Briarcliff Candy Corp., supra.

In this transaction, TP is clearly a "person" for purposes of § 269. Furthermore, TP has acquired requisite control of FC and has beneficial ownership of FC stock. Although TP acquires options to convert the FC warrants into FC stock, the options represent at least 50 percent of FC's total combined voting power of all classes of stock. In addition, TP has exercised effective control over the business and management of FC. FC does not appear to have engaged in any appreciable activity other than the transactions required to generate the inappropriate tax benefit afforded to TP. That is, FC's business activities are engaged in solely for the benefit of TP. Finally, TP has assumed the benefits and burdens of ownership because TP provided all of the funds at risk and only TP's investment will appreciate or depreciate. Thus, TP has acquired the requisite control over FC. Finally, TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax. TP does not appear to have any valid and substantiated purpose for engaging in the transaction other than for the avoidance or evasion of Federal income tax. In addition, the transaction and the various steps of the transaction have no economic substance and had relatively insignificant economic results, as discussed below. Thus, even if TP's adjustment to its basis in FB stock was a "proper adjustment," because TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax, the loss resulting from the sale of FB stock and options should be disallowed under § 269.

V. The losses sustained and deductible by TP are limited by § 465 to the amount for which TP is at risk.

Section 465(a)(1)(A) provides in the case of individuals and certain corporations engaged in an activity to which this section applies, any loss from such activity for the taxable year is allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of § 465(b)) for such activity at the close of the taxable year. The limitations of the at risk rules of § 465 also apply to any trade or business activity or any activity undertaken for the production of income. Section 465(c)(3)(A)(i).

Section 465(b)(1) provides that a taxpayer is considered at risk for an activity with respect to the amount of money and the adjusted basis of other property contributed to the activity, and certain amounts borrowed with respect to such activity. Section 465(b)(2) provides that a taxpayer is considered at risk with respect to amounts borrowed for use in an activity to the extent that taxpayer is personally liable for the repayment of such amounts, or has pledged property, other than property used in such activity, as security for such borrowed amount. Section 465(b)(4) provides that notwithstanding any other provision of this section, a taxpayer is not considered to be at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

While the application of the at risk rules in § 465 is most common in cases involving nonrecourse liabilities, neither the statutory language nor the legislative history limits the application of § 465 to those cases. The legislative history notes that the purpose of the at risk rules is to "prevent a situation where the taxpayer may deduct a loss in excess of his economic investment in certain types of activities. . . ." S. Rep. No. 938, 94th Cong., 2d Sess., 1, 48 (1976), 1976-3 C.B. (Vol. 3) 49, 86.

A. FC's at risk amount under § 465 is not increased by the dividend distribution.

Section 1.465-22(c)(1) of the proposed regulations states that a taxpayer's amount at risk in an activity is increased by an amount equal to the excess of the taxpayer's share of all items of income received or accrued from the activity during the taxable year over the taxpayer's share of allowable deductions which are allocable to the activity for the taxable year. A taxpayer's amount at risk in an activity is also increased by the taxpayer's share of tax-exempt receipts of the activity.

For the reasons set forth in Arguments IA, IB, and II, FC's at risk amount is not increased by the purported dividend distribution.

B. Assuming arguendo that the redemption increases FC's at risk amount, the increased amount does not transfer to TP.

Section 465 does not provide for shifting of at risk amounts between taxpayers. Treasury and the Service, however, have provided for transfers of at risk amounts in certain situations. Section 1.465-68 of the proposed regulations provides that upon a transfer or disposition (other than at death), in which (1) the transferor disposes of the entire interest in the activity, (2) the basis of the transferee is determined in whole or in part by reference to the basis of the transferor, and (3) the transferor has an amount at risk which is in excess of losses from the activity, the transferor's amount at risk in the activity (after being reduced by the transferor's current year losses) shall be added to the transferee's amount at risk. As illustrated by its examples, this regulation serves the interests of transferees who receive interests in an activity in certain transfers. In these situations, the transferee acquires an interest in the activity and would suffer an economic detriment if the at risk amount was not transferred with the interest in the activity.

In the transactions at issue, there is no transfer to TP. Section 1.465-68 of the proposed regulations does not address basis shifts similar to the one provided in the § 302 regulations and does not address transfers similar to the redemption between FB and FC. Accordingly, TP has no authority to argue that the at risk amount transferred from FC to TP. Although there may be situations different from those described in § 1.465-68 of the proposed regulations where at risk amounts should transfer between taxpayers, such transfer of at risk amounts is not proper in these transactions.

VI. In addition, any FB stock basis or loss claimed that is attributable to FC's basis in the FB stock must be reallocated to FC under § 482.

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 such organizations, trades, or businesses." The Secretary may allocate any item or element affecting taxable income, including basis. Section 1.482-1(a)(2).

A threshold requirement of § 482 is that "two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated)" be involved before the section can be applied. Whether an individual's activities can constitute a trade or business for purposes of § 482 is a factual determination. See Rollins v. Commissioner, T.C. Memo. 1993-643. In order to make this factual determination, it should be ascertained whether TP engaged in business activities and the trading of investments on his own behalf, rather than being a passive investor. If the Service can establish that TP did engage in such business and active investment activities on his own behalf, he will be deemed to satisfy the trade or business requirement of § 482.

The next requirement of § 482 is that all the parties involved in the transaction are "owned or controlled directly or indirectly by the same interests." "Controlled" is defined broadly as "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." Section 1.482-1(i)(4). Furthermore, "[i]t is the reality of the control that is decisive, not its form or the mode of its exercise." Id. "A presumption of control arises if income or deductions have been arbitrarily shifted." Id. Case law supports this broad definition of control. See, e.g., Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert denied, 385 U.S. 899 (1966); Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5; DHL Corp. v. Commissioner, T.C. Memo. 1998-461. With respect to "the same interests," although the regulations do not provide guidance on the meaning of that term, case law indicates that, in using the term, Congress intended to include more than "the same persons" or "the same individuals." See Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. Thus, where there is a common design for the shifting of income or deductions, different entities may constitute the "same interests." See Hall v. Commissioner, 32 T.C. 390, 409-10 (1959), aff'd, 294 F.2d 82, 86 (5th Cir. 1961).

Finally, the Secretary "may distribute, apportion, or allocate . . . 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 such organizations, trades, or businesses." Section 482. 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). 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. Id.

Section 482 applies between TP and the other parties to the transaction because they are considered to be owned or controlled by the same interests. Income and deductions arising from the transaction appear to have been arbitrarily shifted between the participants pursuant to a common design. Furthermore, to the extent that a common design to shift income and deductions is shown, the participants have "acted in concert" pursuant to that common design. Accordingly, the participants should be treated as members of the same controlled group for purposes of applying § 482.

The Secretary may reallocate the basis in FB stock that is assumed to shift from FC to TP under either the economic substance/tax evasion standard or clear reflection of income standard of § 482. Under the economic substance/tax evasion standard, the Secretary may disregard contractual terms that are inconsistent with the economic substance of the underlying transaction and impute terms that are consistent with the economic substance of the transactions. Section 1.482-1(d)(3)(ii)(B). In this transaction, the Secretary should disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance by denying TP's reported tax loss because (1) there was a common tax avoidance scheme among the participants to shift income and/or deductions arbitrarily and TP's reported tax loss was wholly unrelated to TP's economic gain or loss with respect to the transaction and (2) the transaction lacked any business purpose and was entered into solely for tax avoidance motives. Alternatively, under the clear reflection of income standard, the Secretary may reallocate the basis in FB stock that is assumed to shift from FC to TP. In this transaction, the Secretary should find that TP's basis adjustment (purportedly provided for by § 1.302-2(c)) is not a "proper adjustment" and contravenes the purpose and scope of § 1.302-2(c) because the basis adjustment does not clearly reflect income. Thus, assuming the additional requirements of § 482 are satisfied, the economic substance/tax evasion or clear reflection of income standard of § 482 should apply.

ADDITIONAL ARGUMENTS AND CASE DEVELOPMENT

As stated in Notice 2001-45, Service position is that the stock loss claimed in Notice 2001-45 transactions is not allowed for federal tax purposes. Because the specific fact patterns vary, all the arguments set forth above should be considered in developing Notice 2001-45 cases. Note that the facts of a particular case may support arguments not discussed in this Notice, including additional arguments noted in Notice 2001-45, as well as arguments not discussed in either this Notice or in Notice 2001-45. As facts are developed, some arguments will emerge as stronger than others in a particular case. Initially, however, the facts of each case should be explored and developed with all potential arguments, including all appropriate penalties, in mind.

Facts should be developed from the date the transaction was first contemplated up to the present and include: The source of the proposal (e.g., whether it was proposed by a tax consulting firm); analysis and assessments of the purported business risks and benefits (including the profitability potential) prepared by or for TP prior to the transaction, if any; the activities of TP before and after the transaction; and treatment of the transaction for financial purposes.

As noted above, there may be arguments (or counter-arguments) advanced by individual taxpayers that are not addressed in this Notice, or in Notice 2001-45, and there may be facts in a particular case that suggest additional arguments to be made by the Service. In such cases, the matter should be coordinated with the National Office. Notice 2001-45 and this Notice provide non-taxpayer specific guidance that is to be applied in all cases other than those in which binding, taxpayer specific guidance or case resolution has been issued or entered into.

Field contacts for case coordination and development assistance, including asserting penalties in individual cases: Examination staff should contact Earnest Griffin, Issue Specialist,

(713) 209-3627; Counsel staff should contact Thomas J. Kerrigan, Industry Counsel, CC:LM:FSH:LI, (516) 688-1742.

National Office contact for questions regarding National Office guidance, including questions regarding this Notice, Notice 2001-45, and the need for further taxpayer specific guidance (e.g., Nondocketed Significant Advice Review, Field Service Advice, or Technical Assistance Memoranda): Lisa K. Leong, CC:CORP:4, (202) 622-7530.

/s/

Jasper L. Cummings, Jr.
Associate Chief Counsel (Corporate)