OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

August 24, 2000

Number: **200050013**
Release Date: 12/15/2000
CC:ITA:1, TL-N-2407-00
UILC: 166.06-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, KANSAS-MISSOURI
ATTN: DONALD L. WELLS, SPECIAL LITIGATION
ASSISTANT CC:MSR:KSM:STL

FROM: Associate Chief Counsel (Income Tax & Accounting) CC:ITA

SUBJECT: Tax reduction as a business purpose

This Field Service Advice responds to your memorandum of April 25, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

Corp X =

Corp Z =

Year 1 =

ISSUE

Whether reduction of taxes can be a valid business purpose for engaging in a transaction.

CONCLUSION

Where a transaction objectively affects a taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. The present transaction, however, should be disregarded for tax purposes.

FACTS

Shortly after acquiring Corp Z, Corp X made a series of loans to Corp Z followed immediately by dividend distributions from Corp Z to Corp X. These transactions were reflected by journal entries in a Cash Management Account utilized by all the corporations. Corp Z claims it engaged in this transaction to reduce taxes.

In Year 1, Corp Z did not make principal repayments on the loans. Interest was paid sporadically, if at all. The amount "lent" to Corp Z by Corp X was at least three times what a commercial bank would have lent. The revenue agent contacted revenue authorities from three different states. All three authorities concluded the transactions would be impermissible under that state's laws and would violate state law.

LAW AND ANALYSIS

A transaction may be valid even though it is tax motivated. This accords with the case law.

In Kraft Foods Co. v. Commissioner, 232 F.2d (2d Cir. 1956), the court determined that interest payments made to a parent corporation were deductible. Kraft Foods paid its parent corporation a substantial dividend by using debentures. The purpose underlying the transaction was for the taxpayer to obtain a tax benefit from the interest payments.

The court discussed that transactions between affiliates should be closely scrutinized and sham transactions should be disregarded. However, the court found that the transaction was a genuine transaction affecting legal relations. The parties intended and created an indebtedness enforceable under state law. The court recognized that the structure of the tax law deliberately recognizes tax-conscious motivations and seeks both to encourage some transactions and to discourage others. Tax minimization is a proper objective of corporate management. The court concluded that transactions, even though real, can be disregarded if they are a sham or masquerade or if they take place between taxable entities having no real existence. The court noted that the entities were real and the transactions created actual indebtedness and were not a device to convert equity into debt.

In Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254 (1999), the court concluded that interest claimed on corporate owned life insurance policies was not deductible. The court determined that the overall transaction did not have economic substance. Economic substance requires a change in the economic position of the taxpayer, other than tax effects. The transaction at issue produced negative cash flow and earnings, except for the projected tax benefits. Where the only function of the plan is to produce tax deductions to reduce a taxpayer's income tax liabilities, the transaction lacks economic substance and should not be recognized for tax purposes.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999), the court analyzed a series of transactions designed to artificially create capital gains and losses. The Tax Court concluded that ACM could not deduct its claimed losses because the losses were not economically inherent in the transaction but were artificially created by machinations whose only purpose and effect was to give rise to desired tax consequences. ACM, T.C. Memo. 1997-115. The Third Circuit agreed, recognizing that it must be determined whether a transaction has the economic substance that its form represents. Each step of the transaction, from the commencement to the consummation, is relevant in reaching this determination.

The Third Circuit in footnote 31 summarized the law about when a transaction will be recognized for tax purposes. The court stated:

> While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations...

ACM Partnership, 157 F.3d at 248.

The courts in Kraft foods, in Winn-Dixie, and in ACM Partnership noted that the starting point for determining whether the form of a particular transaction would be recognized for tax purposes is the Supreme Court's opinion in Gregory v. Helvering, 293 U.S. 465 (1935). The Supreme Court stated:

> The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted....But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Gregory, 293 U.S. at 469.

In Kraft Foods, the court determined that the loans would be recognized because there was a change in economic condition. In Winn-Dixie, the transaction was not recognized for federal income tax purposes because it would have caused a negative change in economic condition, absent tax benefits, so the transaction lacked economic substance apart from the anticipated tax benefits. In ACM Partnership, the loss was not recognized because the transactions did not have objective non-tax economic effects or subjective non-tax purposes.

In the present case, the transaction did not objectively affect the corporations' net economic position, legal relations or non-tax business interest. Furthermore, the indebtedness would not have been enforceable under state law. The transaction should be disregarded for tax purposes.

Please call if you have any further questions.

HEATHER C. MALOY
By: CLIFFORD M. HARBOURT
Senior Technician Reviewer
Branch One
Income Tax and Accounting