Part III - Administrative, Procedural, and Miscellaneous

Tax Avoidance Using Distributions of Encumbered Property

Notice 99-59

The Internal Revenue Service and Treasury Department have become aware of certain types of transactions, as described below, that are being marketed to taxpayers for the purpose of generating tax losses. This notice is being issued to alert taxpayers and their representatives that the purported losses arising from such transactions are not properly allowable for federal income tax purposes.

The transactions are cast in a variety of forms. In one typical arrangement, taxpayers act through a partnership to contribute cash to a foreign corporation, which has been formed for the purpose of carrying out the transaction, in exchange for the common stock of that corporation. Another party contributes additional capital to the corporation in exchange for the preferred stock of that corporation. The foreign corporation then acquires additional capital by borrowing from a bank and grants the bank a security interest in securities acquired by the foreign corporation that have a value equal to the amount of the borrowing. Thereafter, the foreign corporation makes a distribution of the encumbered securities to the partnership that holds its common stock. The effect of the distribution, combined with fees and other transaction costs incurred at the corporate level, is to reduce the remaining value of the foreign corporation's common stock to zero or a minimal amount. Although the distributed securities are encumbered by the bank debt (and the taxpayers or their partnership may be secondarily liable for the debt as guarantors), the foreign corporation has sufficient other assets to repay the debt, and it is the understanding of all parties that the foreign corporation will repay the debt with such other assets.

For example, if the taxpayers' partnership had contributed $100x for the common stock of the foreign corporation, the partnership might receive a distribution of securities with a fair market value of approximately $100x, and that distribution would have the economic effect of reducing the remaining value of the foreign corporation's common stock to zero. Nonetheless, because the distribution to the partnership is subject to the bank debt, the parties take the position, pursuant to § 301(b)(2) of the Internal Revenue Code, that the amount of the distribution is zero for purposes of § 301. On that theory, no part of the distribution is treated either as a dividend or as a reduction of stock basis under § 301(c).

The partnership is treated as having subsequently disposed of the stock of the foreign corporation, giving rise to a tax loss equal to the excess of the partnership's original basis in the stock ($100x in the example) over the fair market value of the common stock after the distribution of securities (zero). The deemed disposition of the stock may be based upon an election under § 301.7701-3(c) of the regulations to change the federal income tax classification of the foreign corporation from a corporation to a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under § 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Thereafter, typically in a later taxable year, the bank debt is repaid out of other assets held by the foreign corporation. Although the parties previously treated the debt as reducing the amount of the earlier distribution from the foreign corporation, promoters advise taxpayers to take the position that the foreign corporation's repayment of the debt is not treated as a distribution on its common stock.

A loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); Scully v. United States, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); § 1.165-1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

In the view of the Service and the Treasury Department, the arrangement described above (or any similar arrangement) does not produce an allowable loss. Through a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered. Such artificial losses are not allowable for federal income tax purposes.

The purported tax benefits from these transactions may also be subject to challenge under other provisions of the Code and regulations, including but not limited to §§ 269, 301, 331, 446, 475, 482, 752, and 1001 of the Code.

Additionally, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The principal author of this notice is Ken Cohen of the Office of Assistant Chief Counsel (Corporate). For further information regarding this notice, contact Mr. Cohen on (202) 622-7790 (not a toll-free call).