2011 Law Student Tax Challenge Bench Briefs

The Law Student Tax Challenge (LSTC) was established in 2001 by the Young Lawyers Forum. It is an annual inter-law school transactional planning and client counseling competition designed to focus on the tax consequences of a complete business planning problem. LSTC problem drafters prepare separate problems for J.D. and LL.M. competitors and provide detailed bench briefs for use by judges.

The discussion below condenses the extensive analysis provided in both bench briefs. Because of space constraints, some issues are omitted. *NewsQuarterly* acknowledges the efforts of Ivan Golden and Melissa Galetto (LSTC co-chairs) and Ivan Golden, Gary Scanlon, and Matthew Mauney (problem drafters).

For more information about the 2011 winners and the 2012 announcement and rules, see the back cover of this issue or go to http://www.americanbar.org/groups/taxation/awards/law_student_tax_challenge.html. — *Gail Levin Richmond, Nova Southeastern University Law Center, Davie, FL*

J.D. Problem

Introduction

The 2011 J.D. division problem involves the owner of a children's overnight camp outside San Diego who receives an unsolicited offer to sell the camp. The problem consists of three major federal income tax issues: (1) a like-kind exchange between related parties; (2) depreciation, amortization, and section 179 expensing; and (3) the exclusion of gain on the sale of a principal residence.

Monica Hightower is the owner of a popular children's overnight camp. She purchased the unimproved camp real estate in 2005 for $200,000 in cash and $1.5 million in nonrecourse indebtedness. She immediately constructed several permanent improvements, including cabins for the campers and staff, a recreation center, a dining hall, swimming pools, outdoor theater, and a horse stable, for which she paid cash. The remaining basis in these improvements is $100,000. Monica owns the camp real estate and improvements as an individual. She has repaid $500,000 of the mortgage principal on the land.

In July 2010, she purchased an additional acre of land with a personal residence directly adjacent to her camp property for $100,000 in cash and $450,000 of nonrecourse indebtedness. She moved into the home in September 2010.

A few weeks ago, a group of investors approached Monica and offered to purchase the camp property (*i.e.*, the real property plus permanent improvements) for $5 million in cash, plus assumption of the remaining $1 million mortgage on the property. They want to develop the camp property into a resort.

Monica is interested in the proposal but she has several concerns: First, she would like to continue running a camp, and, if she decides to sell, she will need to find suitable replacement property. Second, she is concerned that the sale may generate a large tax liability—leaving less money available to purchase replacement property and to make any needed improvements. Finally, she is worried that, depending on the location of the new property, she may have to sell her new home, which she purchased less than a year-and-a-half ago.

She called her brother, Joe, a real estate investor, to ask his opinion. Joe agreed that $5 million (plus assumption of the mortgage) is a reasonable price for the camp property. He also mentioned that his company (a corporation of which he is the sole shareholder) owns property that might fit the bill as replacement property. The property Joe has in mind is a 100-acre tract of undeveloped land about two hours north of San Diego. His company purchased the property for $2 million in 2007; the property currently is listed for sale for $4.6 million. The property is about 48 miles from the current camp location. There is no highway or direct route between the two properties, however, and the trip takes nearly 90 minutes by car (sometimes longer in Southern California traffic).

Monica and Joe toured the property that he suggested, and she agreed that it could be developed into a summer camp. However, the property is just raw land and will require significant improvements before it can open as a camp. Monica called an architect, and he provided her with an estimate to develop the property into a viable summer camp. The $575,000 estimate includes specific amounts for cabins, recreation center, dining hall, basketball and tennis courts, swimming pool, utilities infrastructure, landscaping associated with building improvements, and general landscaping.

The architect assured Monica that, as long as construction begins by January 1, 2012, the improvements can be completed in time for the camp to open in June. Monica also asked the architect how much it would cost to build a camp director's residence on the new property. She envisions that she could live in the new property year-round. The architect estimated that it would cost $200,000 to build a director's residence on a one-acre parcel of the property. Monica also needs to purchase a variety of items for the camp for next summer, including

trucks, kitchen equipment, telephones, and sporting goods.

A few days ago, the investors called Monica to find out whether she had made a decision about their proposal. She told them that she was still unsure. To sweeten the deal, the investors offered to purchase her home adjacent to the camp for $750,000.

Issues

The competitors were asked to address three issues (the analysis below focuses only on the first issue). First, if Monica decides to accept the investors' offer, how can the transaction be structured to recognize the least amount of gain? If gain must be recognized, at what rate would it be taxed? And what would be her basis in the new camp property if the transaction is structured in the way that you suggest?

Second, what are the tax consequences of the improvements (including construction of a director's residence on the property) and the purchases of tangible personal property? Third, if Monica agrees to sell her personal residence to the investors for $750,000, how much gain, if any, must she recognize on the sale? If gain must be recognized, at what rate would it be taxed? And what would be her basis in the new residence on its one-acre parcel?

Like-Kind Exchange

If the exchange of the current camp property (the old camp property) for Joe's company's developed 100-acre parcel (the new camp property) fails to qualify as a section 1031 like-kind exchange, Monica must recognize her $4.2 million realized gain, equal to the excess of her $6 million amount realized on the exchange (the $4.6 million value of the new camp property, plus $1 million in assumed debt, plus $400,000 in cash) over her $1.8 million adjusted basis in the old camp property (her original cost basis in the land of $1.7 million plus her remaining $100,000 basis for the improvements). She would take a $4.6 million cost basis in the new camp property (equal to its fair market value).

If, on the other hand, this exchange satisfies the requirements of section 1031, Monica would recognize her $4.2 million realized gain only to the extent of the $1.4 million of non-like-kind property received (the $1 million debt relief plus $400,000 cash). Moreover, she would take a basis in the new camp property equal to her basis in the old camp property ($1.8 million), less the boot received ($1.4 million), plus the recognized gain ($1.4 million), or $1.8 million. Because the new camp property is worth $4.6 million, this $1.8 million basis would preserve the $2.8 million of realized gain that went unrecognized on the exchange.

Section 1031(a) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. [This excerpt omits the discussion of Monica's home as non-like-kind property.] If an exchange fails to satisfy section 1031(a) because the property received consists of both like-kind property and other property or money to boot, then gain, if any, is recognized but not exceeding the amount of boot received. If Monica acquires property in a section 1031 exchange, her basis in the property acquired is the same as her basis in the property exchanged, decreased by the amount of any money received (including debt relief), and increased by the amount of any gain recognized, thus preserving the unrecognized gain or loss for future reckoning when the replacement property is sold.

In determining whether Monica's exchange of the old camp property for the new camp property qualifies as a like-kind exchange, the first issue is whether the improved old camp property and the unimproved new camp property are of like kind. As used in section 1031(a), the phrase like kind refers to the nature or character of the property and not its grade or quality. Treas. Reg. § 1.1031(a)-1(b). The regulation indicates that whether real estate involved in an exchange is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Thus, the two camp properties will qualify as like-kind for purposes of section 1031.

If Monica sells the old camp property to the investors and uses the cash obtained to purchase the replacement property owned by Joe's company, the transaction would fail the exchange requirement in section 1031(a). Thus, she must use a qualified intermediary (QI), as described in Regulation section 1.1031(k)-1(g), for this three-corner exchange in order to avoid having constructive receipt of cash from the investors. Monica, Joe's company, and the investors would transfer to the QI the old camp property (subject to the $1 million nonrecourse debt), the new camp property, and the $5 million in cash, respectively. In turn, the QI would distribute the new camp property plus $400,000 in cash, $4.6 million in cash, and the old camp property (subject to the $1 million nonrecourse debt) to Monica, Joe's company, and the investors, respectively. In order for such a deferred exchange to qualify, however, the new camp property must be identified within the time limits provided in section 1031(a)(3).

Even if this three-corner exchange is structured properly using a QI, one major issue remains: whether Monica's exchange of the old camp property for new camp property owned by Joe's company raises any related party issues under section 1031(f). If a taxpayer directly or indirectly exchanges property with a related person in a transaction that would otherwise qualify for section 1031 nonrecognition, the taxpayer and the related person must hold the exchanged properties for at least two years after the exchange in order to

qualify for nonrecognition treatment. Section 1031(f) does not prohibit related parties from exchanging like-kind property without recognition of gain or loss, but it adds a two-year holding period requirement with respect to the properties exchanged. If either party to the exchange disposes of the property received or exchanged before the end of the two-year holding period, any gain or loss that would have been recognized on the original exchange must be recognized on the date the disqualifying disposition occurs. A disqualifying disposition does not include (1) a disposition that occurs by reason of the death of the taxpayer or the related person, (2) a compulsory or involuntary conversion of the exchanged property, or (3) any disposition, if it is established to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes of the avoidance of Federal income tax.

The purpose of section 1031(f) is to prevent basis shifting—*i.e.*, exchanging low-basis property for high-basis property—among related parties, which could facilitate an immediate sale at a reduced tax cost. *Teruya Bros. Ltd. v. Commissioner*, 580 F.3d 1038, 1045 (9th Cir. 2009), *aff'g* 124 T.C. 45 (2005).

Monica and Joe's company are related persons for purposes of section 1031(f) because it uses the section 267 and section 707 definitions. One of the section 267(b) relationships is members of a family, including the individual's brothers and sisters. Another is an individual and a corporation more than 50 percent of the value of the outstanding stock of which is owned, directly or indirectly, by such individual. It is irrelevant that Monica is transacting with Joe's company instead of Joe because section 267(c)(2) treats her as owning the stock owned, directly or indirectly, by or for her brother Joe. In this case, Monica is deemed to own stock in Joe's corporation directly owned by Joe. Therefore, she and Joe's company are related persons for purposes of section 1031(f).

If a taxpayer transfers property to a QI, who transfers the property to an unrelated third party for cash and then uses the cash to acquire replacement property from a related party, the transaction may be recast as a direct exchange between the taxpayer and the related party, followed immediately by a sale to the third party for cash. In that case, the deemed exchange will fail to qualify for nonrecognition because the two-year holding period of section 1031(f) is immediately violated. On our facts, Monica would be deemed to engage directly in an exchange with Joe's company (a related party) of the old camp property for the new camp property, followed immediately by a sale of the old camp property by the company to the investors for cash. *Ocmulgee Fields, Inc. v. Commissioner*, 132 T.C. 105 (2009), *aff'd*, 613 F.3d 1360 (11th Cir. 2010); *Teruya Bros. Ltd. v. Commissioner*, *supra*; *see also* Rev. Rul. 2002-83. In that case, she would need to establish that this transaction did not have as one of its principal purposes the avoidance of federal income tax in order to come within the exception in section 1031(f)(2)(C) and avoid recognizing all of her realized gain. [Editor's note: the model answer's extensive discussion of these cases is omitted here.]

Although the burden of proof is high, Monica should be able to exchange the old camp property for the new camp property in a tax-deferred, three-corner, like-kind exchange using a QI, even though one of the parties to the exchange is a related person, because there is no basis shifting or other tax avoidance purpose. First, unlike the exchanges in the two cases cited, in which related parties exchanged low-basis property for high-basis property, Monica and Joe's company are exchanging properties with roughly equal bases. The old camp property has a $1.8 million basis in her hands, and the new camp property has a $2 million basis in Joe's company's hands. Moreover, the new camp property is highly appreciated, and Joe's company will recognize $2.6 million of gain in the exchange, all of which will be taxed as ordinary income. Under these circumstances, Monica has a good argument that the exchange does not have as one of its principal purposes the avoidance of federal income tax nor was it structured to avoid the purpose of section 1031(f).

None of Monica's $1.4 million recognized gain would be recaptured as ordinary gain under section 1250. Because this property is described in section 1231(b)(1), and because this appears to be her only section 1231 gain or loss for the year, this gain will be treated like long-term capital gain. Nevertheless, to the extent of the prior depreciation taken with respect to the improvements, the gain will be taxed at 25% rather than the 15% preferential rate usually accorded net capital gain within the meaning of section 1222(11) because it is unrecaptured section 1250 gain. I.R.C. § 1(h)(1)(D), (6). Any gain in excess of prior depreciation taken is eligible for the 15% rate.

LL.M. Problem

Introduction

The 2011 LL.M. problem addresses two separate issues faced by Gapple, a high tech company specializing in smart-phones and related technologies. For the first issue (repatriation), the students must address the U.S. tax consequences under Subchapter C (including section 367) of three alternative structures for a transaction intended to consolidate Gapple's foreign operations and repatriate foreign cash into the U.S., and, based on these consequences, make a recommendation regarding the alternative that the client should pursue. The second issue (sale versus license) addresses whether the Service can recharacterize a transaction that Gapple

structured as a license into a sale. The analysis below focuses only on the repatriation issue.

Repatriation

The three alternative structures discussed below are economically identical, but result in significantly different U.S. federal tax consequences. The students were informed that, in weighing the different alternatives, the following U.S. tax consequences related to the receipt of the Luxco cash are preferred by Gapple in descending order: (1) tax-free, (2) a dividend sourced from GmbH's high-tax E&P, (3) a dividend sourced from Luxco's low-tax E&P, and (4) capital gain.

The three alternatives are briefly described in this paragraph. First, Gapple could sell its GmbH stock to Luxco in exchange for $1 billion cash. The second alternative begins with the same sale, followed by GmbH electing to be classified as a disregarded entity. The third alternative reverses the order: GmbH elects to be treated as a disregarded entity and Gapple sells its GmbH stock to Luxco in exchange for $1 billion cash.

Alternative #1 should be treated as a section 304 exchange (to the extent of $1 billion of GmbH stock) and a section 351 exchange (to the extent of the fair market value of GmbH in excess of $1 billion). There are two primary consequences of the transaction: (1) Gapple will be deemed to have received a $1 billion dividend sourced from Luxco's low-tax E&P, (2) Gapple will not recognize gain or loss with respect to its GmbH stock under section 367(a) so long as Gapple files a gain recognition agreement (GRA) with respect to the GmbH stock deemed contributed to Luxco.

Section 304(a)(1) applies here because there is "one . . . person[] in control of each of two corporations" and "in return for property, one of the corporations acquires stock in the other corporation from the person . . . so in control" (Luxco acquires GmbH from Gapple in exchange for $1 billion cash). The second sentence of section 304(a)(1) is satisfied because the deemed redemption of the GmbH stock would be one to which section 301 applies. Under section 302(d), section 301 applies to a redemption if it fails to satisfy one of the non-dividend-equivalence tests of section 302(b). Section 302(b) generally tests to determine whether the redeemed shareholder experiences a meaningful reduction in its interest in the redeeming corporation as a result of the redemption. Under section 304(b)(1), determining whether a redemption is dividend equivalent is made by reference to the issuing corporation (here, GmbH). Luxco's deemed redemption here is dividend equivalent because Gapple does not experience a meaningful reduction in its interest in GmbH as a result of the transaction; in fact, Gapple owned 100% of GmbH immediately before the transaction and is treated as owning 100% of GmbH immediately after the transaction, applying the constructive ownership rules of section 318, cross-referenced by section 302(c).

Under section 304(a)(1), the sale of $1 billion of the GmbH stock to Luxco is treated in the following manner: (1) Gapple is treated as contributing the GmbH stock to Luxco in exchange for newly issued Luxco stock and then (2) Luxco is treated as redeeming its newly issued stock in exchange for the $1 billion. Because the deemed redemption is dividend equivalent within the meaning of section 302(d), Gapple is treated as receiving a $1 billion dividend from Luxco under section 301(c)(1). Accordingly, in the section 304 exchange, Gapple receives a $1 billion dividend sourced from Luxco's low-tax earnings.

To the extent that the fair market value of GmbH exceeds $1 billion (the excess value), Gapple is treated as contributing the excess value to Luxco in a tax-free section 351 exchange. Section 351(a) generally provides tax-free treatment to the transferor on the exchange of property for the stock of the transferee. The stock of GmbH constitutes property under section 317. Under the meaningless gesture doctrine, the fact that Gapple does not receive any stock in exchange for the excess value does not violate section 351's exchange requirement; Luxco is deemed to issue stock for purposes of section 351(a). *See, e.g.*, *King v. United States*, 79 F.2d 453 (4th Cir. 1935) and Rev. Rul. 64-155, 1964-1 C.B. 138. Luxco recognizes no gain or loss on the deemed exchange of its stock for the GmbH stock under section 1032.

Section 367(a) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation will not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. Accordingly, the transfer of the GmbH stock (property) by Gapple (a U.S. person) to Luxco (a foreign corporation) in a section 351 exchange generally would result in gain recognition. However, under section 367(a)(2) and Treas. Reg. § 1.367(a)-3(b)(1), a U.S. transferor is not subject to section 367(a) on the transfer of the stock of a foreign corporation to another foreign corporation if either (1) the U.S. person owns less than 5% of the transferee immediately after the transfer or (2) the U.S. person enters into a five-year gain recognition agreement with respect to the transferred stock or securities as provided in Regulation section 1.367(a)-8. Under section 1.367(a)-9T, Gapple does not have to file a GRA with respect to the $1 billion of GmbH stock deemed contributed by Gapple to Luxco in the section 304 exchange. However, Gapple must file a GRA for the excess value of the GmbH stock that is deemed exchanged for Luxco stock in the section 351 exchange.

Alternative #2 should qualify as a reorganization under section 368(a)(1)(D). As a result, Gapple should recognize gain under section 356 equal to the appreciation in its GmbH stock (*i.e.*, section 356 is gain limited). Assuming that GmbH has sufficient E&P, the gain should be recharacterized as a dividend sourced from GmbH under section 356(a)(2). If GmbH has no or minimal E&P, a possibility posed in the problem, then the gain recognized by Gapple will either be (1) capital gain under section 356(a)(1) or (2) or a dividend sourced from Luxco's low-tax earnings under section 356(a)(2). Section 367(a) does not apply to Gapple's exchange of its GmbH stock for deemed issued Luxco stock and, therefore, Gapple is not required to file a GRA to avoid gain recognition under that provision.

The sale of the GmbH stock to Luxco in exchange for $1 billion seems like a section 304 exchange, as in Alternative #1. Further, the election by GmbH to change its classification from a corporation to a disregarded entity for U.S. federal tax purposes is treated as a deemed liquidation of GmbH under Regulation section 301.7701-3(g)(1)(iii), which seems as if it would qualify as a complete liquidation under section 332. However, under the so-called *Kimbell-Diamond* doctrine, the stock sale and the deemed liquidation should be stepped together and treated as if GmbH transferred all of its assets, subject to its liabilities, to Luxco in exchange for Luxco stock, and then GmbH distributed the Luxco stock to Gapple in liquidation of GmbH. *See* Rev. Rul. 67-274, 1967-2 C.B. 141 (purported stock reorganization under section 368(a)(1)(B) followed by liquidation of the target recharacterized as an asset reorganization under section 368(a)(1)(C)). Assuming that all the judicial and statutory requirements of section 368 are satisfied, the transaction as recharacterized should qualify as a D reorganization, rather than a section 304 exchange followed by a section 332 liquidation. *See* Rev. Rul. 2004-83, 2004-2 C.B. 157.

Section 368(a)(1)(D) covers a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred—but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356. Here, GmbH is treated as transferring all of its assets to Luxco and Gapple (a shareholder of GmbH) is in control of Luxco immediately after the transaction. In addition, under Regulation section 1.368-2(l), GmbH is treated as transferring its assets in exchange for Luxco stock, and distributing the Luxco stock to Gapple in exchange for its GmbH stock in a section 356 exchange.

Furthermore, the judicial requirements for section 368 of business purpose and continuity of business enterprise (COBE) are also presumably satisfied here. Gapple's desire to consolidate its foreign operations under a single holding company to centralize its foreign cash management and create foreign tax savings constitutes a valid business purpose. Moreover, Luxco will continue to conduct the business enterprise of GmbH after the transaction. The continuity of interest requirement (COI) generally does not apply to D reorganizations.

Because the transaction qualifies as a reorganization, Gapple's exchange of its GmbH stock (and deemed issued Luxco stock) is described in section 356. Gapple's recognized gain is the lesser of its gain in the GmbH stock and the boot received. The problem asks the students to assume that Gapple has been moderately profitable and Gapple has some unrecognized gain in its GmbH stock. It is a reasonable assumption, therefore, that the gain recognized by GmbH under section 356 is significantly less than the $1 billion cash received. Because section 356 is gain limited, Gapple should recognize less gain in Alternative #2 than as a result of the deemed dividend under section 304 in Alternative #1.

Under section 356(a)(2), the gain recognized by Gapple will be recharacterized as a dividend to the extent of the undistributed E&P of the corporation. Though there is some ambiguity in this regard, it is generally assumed that the corporation referred to in section 356(a)(2) is the target corporation (here, GmbH). *See*, *e.g.*, *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970); *Estate of Bell v. Commissioner*, T.C. Memo 1971-285; *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980); *but cf. Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966) and Rev. Rul. 70-240, 1970-1 C.B. 81 (looking to the E&P of both the target and acquiring corporation, where the target corporation's E&P is insufficient). Accordingly, assuming GmbH has sufficient E&P, section 356(a)(2) would recharacterize Gapple's gain recognized under section 356(a)(1) into a dividend sourced from GmbH's high-tax E&P.

If GmbH has no or minimal E&P, a possibility posed in the problem, then the question becomes more complex. It is the Service's position (in Rev. Rul. 70-240) and the Fifth Circuit's (in *Davant*) that, where there is complete identity of shareholders (*i.e.*, the acquiring corporation and target corporation are controlled by the same shareholders in the same proportions), then the E&P of both the target and acquiring corporation are available to fund the dividend under section 356(a)(2). However, the Tax Court (in *American Mfg. Co.* and *Estate of Bell*) and the Third Circuit (in *Atlas Tool Co.*) have rejected this position and held that only the target corporation's E&P is available for purposes of section 356(a)(2). Because Gapple is in a jurisdiction that has not considered this issue, the answer here is unclear. If Gapple follows the precedent of the Tax

Court and the Third Circuit, and GmbH has no or minimal E&P, then its gain recognized under section 356(a)(1) will be entirely capital gain. If, on the other hand, Gapple follows the position of the Service and the Fifth Circuit, then its recognized gain will be recharacterized as a dividend sourced out of the low-tax E&P of Luxco.

Because the transaction is recharacterized as a foreign-to-foreign reorganization (from GmbH to Luxco), Gapple's transfer of the GmbH stock to Luxco is disregarded. Instead, Gapple is treated as surrendering the GmbH stock to GmbH in exchange for Luxco stock and $1 billion cash in a section 356 exchange. Regulation section 1.367(a)-3(a)(2)(ii) provides that if, in an exchange under section 354 or 356, a U.S. person exchanges stock or securities of a domestic or foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer, section 367(a) does not apply to the exchange. Because this transaction does not fall within any of the indirect stock transfer categories of section 1.367(a)-3(d), section 367(a) does not apply to Gapple's exchange of its GmbH stock for deemed issued Luxco stock and Gapple is not required to file a GRA.

Alternative #3's check-the-box election should constitute an upstream C reorganization, and the sale of the GmbH stock to Luxco should be treated as a section 351(b) exchange. As a result of the upstream C reorganization, Gapple should be treated as receiving a dividend to the extent of the full amount of GmbH's high-tax E&P (the all E&P amount) under Regulation section 1.367(b)-3. Under section 351(b), Gapple may recognize gain (but not loss) to the extent that the $1 billion cash is allocated to an asset of GmbH with appreciation. The contribution qualifies for the active trade or business exception of section 367(a)(3) and Regulation section 1.367(a)-2T. However, section 367(d) applies to cause Gapple to take into account a deemed royalty contingent upon the productivity, use, or disposition of the trademark.

The election by GmbH to change its classification from a corporation to a disregarded entity for U.S. federal tax purposes is treated as a deemed liquidation of GmbH under Regulation section 301.7701-3(g)(1)(iii). The tax treatment of this deemed liquidation "is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine." Treas. Reg. § 301.7701-3(g)(2)(i). Because of the liquidation–reincorporation doctrine, the deemed liquidation cannot qualify as a complete liquidation under section 332; the transfer of the assets of a liquidated corporation to a related corporation violates the complete liquidation requirement of section 332. *See*, *e.g.*, Rev. Rul. 69-617, 1969-2 C.B. 57 and *Telephone Answering Service Co. v. Commissioner*, 63 T.C. 423 (1974). Because Gapple reincorporates all the assets of GmbH into Luxco as a result of the second step of the transaction, the deemed liquidation in the first step cannot qualify under section 332.

However, the deemed liquidation of GmbH should qualify as an upstream C reorganization, in which Gapple is treated as acquiring 100% of the assets of GmbH, subject to its liabilities, in exchange for Gapple voting stock. Section 368(a)(1)(C) defines a C reorganization as the acquisition by one corporation, in exchange solely for all or a part of its voting stock of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded. In *Bausch & Lomb Optical Co.*, 30 T.C. 602 (1958), *aff'd*, 267 F.2d 75 (2d Cir.1959), *cert. denied*, 361 U.S. 835 (1959), the Second Circuit held that the prior ownership of the target corporation stock by the acquiring corporation invalidated the solely for voting stock requirement. However, in 2000, the Service and Treasury issued final regulations overriding *Bausch & Lomb*. Under those regulations, an acquiring corporation's prior ownership of stock of the target corporation (*i.e.*, old and cold target stock) will not preclude an upstream acquisition from qualifying as a C reorganization. Though the regulations do not specifically deem an issuance of acquiring voting stock where no actual stock is issued, the Service has issued numerous private letter rulings indicating that such voting stock will be deemed issued. *See*, *e.g.*, PLRs 200952032 and 201127004. Further, the other requirements of section 368(a) should be satisfied here, including business purpose, COBE, and COI. Accordingly, the deemed liquidation of GmbH into Gapple should qualify as a C reorganization in which Gapple is treated as acquiring all the assets of GmbH in exchange for Gapple voting stock.

The liquidation-reincorporation doctrine does not apply to disqualify a reorganization under section 368. Specifically, under section 368(a)(2)(C) and Regulation section 1.368-2(k), a transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of a subsequent contribution of the assets of the acquired corporation, so long as COBE is satisfied. Because COBE will be satisfied, the subsequent transfer of the GmbH assets to Luxco will not disqualify the upstream C reorganization. *See* Rev. Rul. 69-617, 1969-2 C.B. 57.

The upstream C reorganization is tax-free to Gapple (under sections 354 and 1032) and GmbH (under section 361(a) and (c)). However, under Regulation section 1.367(b)-3, Gapple must include as a deemed dividend the all E&P amount of GmbH on the deemed inbound transfer of all the GmbH assets. Regulation section 1.367(b)-3 applies to an acquisition by a domestic corporation of the assets of a foreign corporation in a

liquidation described in section 332 or an asset acquisition described in section 368(a)(1). Where the regulation applies, Regulation section 1.367(b)-3(b)(3) provides that an exchanging shareholder must include in income as a deemed dividend the all E&P amount with respect to its stock in the foreign acquired corporation. The all E&P amount is defined under Regulation section 1.367(b)-2(d)(1) as the net positive E&P of the corporation. Because Gapple acquires all the assets of GmbH in an upstream C reorganization, Gapple must include the E&P of GmbH (the all E&P amount) as a deemed dividend. Unlike the dividend amount under section 356(a)(2) in Alternative #2, but similar to the dividend amount under section 304(a)(1) in Alternative #1, this dividend is not gain limited (*i.e.*, not limited to Gapple's gain in its GmbH stock). Accordingly, in the upstream C reorganization, Gapple is treated as receiving a dividend sourced from GmbH's high-tax E&P to the extent of the full amount of any E&P of GmbH.

The problem indicates that there is an aggregate loss in the assets of GmbH immediately before the transaction. Under section 362(b), Gapple's basis in the assets of GmbH should equal the basis of the assets in the hands of GmbH. However, under section 362(e)(1), because there is an importation of a built-in loss (*i.e.*, the assets being transferred from GmbH, a foreign corporation, to a U.S. person have an aggregate loss) being imported from a foreign corporation into the U.S., Gapple's basis in any loss asset will be reduced to fair market value.

Because GmbH is a disregarded entity, the second step of Alternative #3 is treated as a transfer by Gapple of the assets of GmbH to Luxco in exchange for $1 billion. Section 351(b) should apply to this transaction. Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock of the transferee corporation, other property or money, the transferor must recognize gain (if any), but not in excess of the amount of the boot. Section 351(a) would apply to the transfer because, as discussed above with respect to Alternative #1, under the meaningless gesture doctrine Luxco should be treated as issuing its stock to the extent that the fair market value of the GmbH stock exceeds the $1 billion cash issued in exchange. Accordingly, Gapple should recognize gain to the extent of the lesser of the gain in the assets of GmbH and the $1 billion cash.

While immediately before the transaction there is an aggregate built-in loss in the assets of GmbH (though under section 362(e)(1) Gapple will have to take a "haircut" with respect to its basis in any loss asset), Gapple may still recognize gain under section 351(b) on the transfer of the GmbH assets to Luxco for $1 billion. Specifically, Rev. Rul. 68-55, 1968-1 C.B. 140, provides that in determining gain or loss under section 351(b), the boot received in the exchange must be separately allocated among each of the assets transferred in accordance with the relative fair market value of each asset. Accordingly, Gapple may still recognize gain if one or more of the assets transferred have a built-in gain, even if the aggregate basis of the assets exceed their fair market value. In fact, it would be a reasonable assumption that the trademark, if a self-created intangible in the hands of GmbH, may have little or no basis.

As discussed above with respect to Alternatives #1 and #2, a U.S. person may recognize gain (but not loss) under section 367(a) on the transfer of stock or property to a foreign corporation in a section 351 exchange. However, section 367(a)(3) provides an exception if the property is transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States. Because Luxco will continue the business of GmbH, the transfer of the assets of GmbH to Luxco should qualify under the active trade or business exception. *See* Treas. Reg. § 1.367(a)-2T. Moreover, except for the trademark, the assets of GmbH do not include any hot assets identified in section 367(a)(3)(B) and Regulation section 1.367(a)-5T that would require immediate gain recognition notwithstanding the active trade or business exception.

Section 367(d)(1) provides that, except as provided in the regulations, if a U.S. person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351, section 367(a) will not apply to the transfer of such property. Rather, section 367(d)(2) provides generally that the U.S. person transferring the intangible property will be treated as having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property (a deemed royalty). A trademark is an intangible property within the meaning of section 367(d). *See* section 936(h)(3)(B)(iii). Further, the active trade or business exception of section 367(a)(3) does not apply, as intangible property within the meaning of section 936(h)(3)(B) is specifically excepted from the exception. *See* section 367(a)(3)(B)(iv). Accordingly, Gapple will be treated as receiving a deemed royalty from Luxco over the life of the trademark.

The law is not clear, but there is an argument that any boot allocated to the trademark should be treated as a prepayment of the section 367(d) deemed royalty. *See* CCA 200610019. If the cash allocated to the trademark pursuant to the principle of Rev. Rul. 68-55 is treated as a section 367(d) prepayment, then Gapple would not recognize any gain with respect to the trademark under section 351(b). Rather, the entire amount of the cash received would be treated as proceeds from the deemed royalty (and ordinary income), rather than gain on the assets. ■