61st Annual William & Mary Tax Conference

Corporate Tax Update

November 13, 2015

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Section 355 Developments
Background – Section 355
Section 355 Transactions

- Section 355 provides for the tax-free distribution of the stock of a controlled corporation ("controlled") by a corporation ("distributing") to its shareholders.
- A distribution qualifying under section 355 will not result in the imposition of tax at the shareholder level.
- A distribution qualifying under section 355 will also not result in the imposition of any corporate-level tax (unless section 355(d), (e), or (f) applies).
- Boot distributed as part of a section 355 transaction will, however, be subject to both corporate- and shareholder-level tax.
- The basis of the stock received in a section 355 transaction is determined with reference to the recipient's basis in the stock of distributing.
  - The recipient's aggregate basis in the stock and securities of distributing, before the distribution, is allocated based on relative fair market values between the stock retained in distributing and the stock received in controlled.
Section 355 – Overview

• A section 355 transaction can be structured in one of three ways – a spin-off, a split-off, and a split-up.
  • A spin-off is the pro rata distribution of the stock of controlled.
  • A split-off is the distribution of the stock of controlled generally to some (but not all of the shareholders) who surrender stock of distributing.
  • A split-up is the distribution of stock of two or more controlled corporations in complete liquidation of distributing.
Section 355 – Spin-off

A spin-off is the pro rata distribution of the stock of a corporation that is controlled by the distributing corporation. In a spin-off, the shareholders of distributing do not surrender any stock.
A split-off is the distribution of the stock of a controlled corporation (generally to some but not all of the shareholders). In a split-off, the recipient shareholders of distributing surrender stock of that corporation.
A split-up is the distribution of the stock of two or more controlled corporations in complete liquidation of the distributing corporation.
Divisive D Reorganization using Section 355

- In a divisive "D" reorganization, part of the assets of the distributing corporation that constitute a business are transferred to a controlled corporation (often, but not necessarily, newly formed). The stock of controlled is then distributed to the shareholders of distributing in a section 355 transaction.
Section 355 – Overview of Basic Requirements

1. Distributing must be in control of controlled (i.e., at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of each class of nonvoting stock) immediately before the distribution.

2. Distributing must distribute all the stock of controlled owned by Distributing.

3. The distribution must be motivated by a corporate business purpose of distributing or controlled.

4. The distribution must not be principally a device for converting what otherwise would be a dividend into capital gain.

5. Both distributing and controlled must be actively engaged in a qualifying 5-year trade or business immediately after the distribution.

6. Pre-distribution shareholders of distributing must have a continuing interest in distributing and controlled after the distribution.
Section 355 – Overview of Basic Requirements (cont’d)

7. No person may have purchased stock of distributing or controlled within five years prior to the distribution that results in that person owning 50 percent or more of the stock in either distributing or controlled immediately after the distribution.

8. There cannot be a plan pursuant to which one or more persons acquire directly or indirectly stock representing a 50 percent or greater interest in distributing or controlled within 2 years of the distribution.

9. In a split-off, the FMV of investment-type assets held by distributing and controlled generally must be less than 2/3 of the FMV of all of the assets of distributing and controlled, respectively.
Device Restriction –
Section 355(a)(1)(B); Treas. Reg. § 1.355-2(d)

- The distribution must not be used principally as a device for the distribution of the earnings and profits of either the distributing or the controlled corporation.

- According to the applicable regulations, "[s]ection 355 recognizes that a tax-free distribution of the stock of a controlled corporation presents a potential for tax avoidance by facilitating the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation. A device can include a transaction that effects a recovery of basis."

- However, section 355(a)(1)(B) states that the mere fact that, subsequent to the distribution, "stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device."
Example – Device Restriction

- D distributes all of its C stock to A. A has an adjusted basis of $50 in his D stock. D has a FMV of $60 and earnings and profits of $40, and C has a FMV of $40.
- In the absence of section 355, the distribution of C stock by D is a $40 dividend to A.
- If section 355 applies, the sale of the C stock by A would result in capital gain of $20.
Device Restriction –
Section 355(a)(1)(B); Treas. Reg. § 1.355-2(d)

• Treas. Reg. § 1.355-2(d)(1) provides that the determination of whether a transaction is used principally as a device is made from all the facts and circumstances, including, but not limited to, certain enumerated device and non-device factors.

• Device Factors (Treas. Reg. § 1.355-2(d)(2))
  • Pro rata distribution
  • Sale or exchange of distributing or controlled stock after the distribution
  • Distributing or controlled has excessive non-business assets

• Non-Device Factors (Treas. Reg. § 1.355-2(d)(3))
  • Corporate business purpose
  • Distributing is publicly traded and has no significant (5 percent) shareholder
  • Distributee corporation(s) would have been entitled to a dividends received deduction
Device Restriction –
Section 302(a) Transactions

- A distribution is ordinarily not considered to have been used principally as a device if, in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied. Treas. Reg. § 1.355-2(d)(5)(iv).

- According to the regulations, such distributions ordinarily do not present the potential for the type of tax avoidance targeted by the device requirement and, thus, are ordinarily not considered to have been used principally as a device notwithstanding the presence of any of the device factors listed in Treas. Reg. § 1.355-2(d)(2).
Device Restriction – Nature and Use of Assets:
Treas. Reg. § 1.355-2(d)(2)(iv)

• The determination of whether a transaction was used principally as a device must take into account the nature, kind, amount, and use of the assets of distributing and controlled immediately after the transaction.
  • The existence of assets that are not used in an active trade or business, such as cash and other liquid assets that are not related to the reasonable needs of such business, is evidence of device.
  • Additionally, there is evidence of device if a business of either distributing or controlled (i) is a “secondary business” that continues as a secondary business for a significant period after the separation, and (ii) can be sold without adversely affecting the business of the other corporation.
    • A “secondary business” is a business of either distributing or controlled if its principal function is to serve the business of the other corporation.
Device Restriction – Business Purpose: 

• A corporate business purpose for the transaction is evidence that the transaction is not being used principally as a device.

• The stronger the evidence of device, the stronger the corporate business purpose required to prevent the determination that the transaction was used principally as a device.

• Evidence of device presented by the transfer or retention of assets not used in a business can be outweighed by the existence of a corporate business purpose for those transfers or retentions.

• The strength of a corporate business purpose is based on all of the facts and circumstances, including, but not limited to:
  
  • The importance of achieving the purpose to the success of the business;

  • The extent to which the transaction is prompted by a person not having a proprietary interest in either corporation, or by other factors outside the control of distributing; and

  • The immediacy of the conditions prompting the transaction.
Section 355(g)

- Section 355 does not apply to any distribution that is part of a transaction (including a series of transactions) if:
  - Either distributing or controlled is, immediately after the transaction, a disqualified investment corporation; and
  - Any person holds, immediately after the transaction, a 50-percent or greater interest in any disqualified investment corporation, but only if such person did not hold such an interest immediately before the transaction.

- A "disqualified investment corporation" is generally any distributing or controlled corporation if the FMV of the investment assets of the corporation constitutes two-thirds or more of the FMV of all of the corporation's assets.
  - "Investment assets" include (i) cash; (ii) any stock or securities in a corporation; (iii) any interest in a partnership; (iv) any debt instrument or other evidence of indebtedness; (v) any option, forward or futures contract, notional principal contract, or derivative; (vi) foreign currency; or (vii) any similar asset.
  - A look-through rule applies with respect to 20-percent owned subsidiary corporations (based on vote and value).
Active Trade or Business Requirement –
Section 355(b); Treas. Reg. § 1.355-3

• Distributing and controlled must, immediately after the distribution, be engaged in the active conduct of a trade or business.

• A corporation is treated as engaged in the active conduct of a trade or business if:
  • The corporation is engaged in the active conduct of a trade or business;
  • The trade or business has been actively conducted throughout the five-year period ending on the date of the distribution;
  • The trade or business was not acquired within the five-year pre-distribution period in a transaction in which gain or loss was recognized; and
  • Control of a corporation that, at the time of acquisition of control, was conducting the trade or business was not acquired within the five-year pre-distribution period in a transaction in which gain or loss was recognized.

• Under section 355(b)(3), in determining whether a corporation is engaged in the active conduct of a trade or business under section 355(b)(2)(A), all members of the corporation’s separate affiliated group (“SAG”) are treated as one corporation (as determined under section 1504(a) without regard to section 1504(b)).
  • Congress added section 355(b)(3) to the Code in 2006 “to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355.” H. Rep. No. 109-304.
Active Trade or Business Requirement – Size of Business

- Neither section 355(b) nor Treas. Reg. § 1.355-3 make specific reference to the required size of the relative active trade or business.

Rev. Rul. 73-44 (1973-1 C.B. 182)

- X, a publicly traded corporation, owned three lines of business: (i) a qualifying five-year business (Biz 1), (ii) another qualifying five-year business (Biz 2), and (iii) a business operated through its subsidiary, Y, that was recently acquired in a taxable transaction (Biz 3). X transferred Biz 2 to Y. Biz 2 represented a substantial portion, but less than 50 percent, of the value of Y's total assets. X then distributed all of the Y stock pro rata to its shareholders.

- “There is no requirement in section 355(b) that a specific percentage of the corporation’s assets be devoted to the active conduct of a trade or business. In the instant case, therefore, it is not controlling for purposes of the active business requirement that the active business assets of the controlled corporation, Y, represent less than half of the value of the controlled corporation immediately after the distribution.”

- The fact that more than half of the value of Y's total assets consisted of a non-qualifying trade or business was evidence of device. However, the facts and circumstances, as well as the nature, kind, and amount of the assets involved, indicated that the distribution was not a device.

  - The fact that the stock of X was widely held and publicly traded, that investment assets were not involved, and that the transaction was compelled by valid business purposes were indicative of non-device. Moreover, the assets included in Y represented operating businesses and not assets that could be used to facilitate the distribution of the earnings and profits of X or Y or both.
Active Trade or Business Requirement –
Size of Business


• Prior to 2003 the IRS list of no-rule areas included the following:
  • Whether a distribution qualified under section 355 when the gross assets of the trades or businesses relied on to satisfy the active trade or business requirement had a FMV that was less than 5 percent of the total FMV of the gross assets of the corporation directly conducting the trades or businesses.
  • Notwithstanding this rule, the IRS indicated that it could still rule if it could be established that, based upon all relevant facts and circumstances, the trades or businesses were not de minimis compared with the other assets or activities of the corporation and its subsidiaries.
• The IRS deleted this no-rule in Rev. Proc. 2003-48, 2003-2 C.B. 86, in which the IRS also ceased issuing rulings on business purpose and device.
Business Purpose Requirement –
Treas. Reg. § 1.355-2(b)

• The distribution must be motivated in whole or in substantial part by one or more corporate business purposes.

• A corporate business purpose is a real and substantial non-federal tax purpose germane to the business of distributing, controlled, or distributing’s affiliated group.

• The distribution itself must be carried out for one or more corporate business purposes.
  • A distribution is not carried out for a corporate business purpose if such purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of controlled and which is neither “impractical nor unduly expensive.”

• Prior to 2003, the IRS would rule on whether a distribution satisfied the business purpose requirement.
  • Rev. Proc. 96-30, 1996-1 C.B. 696, provided a non-exclusive list of IRS-approved corporate business purposes, including to provide key employee equity compensation, to facilitate a stock offering or borrowing, to produce cost savings, to enhance the fit and focus of each business, to eliminate competition with customers or suppliers, to facilitate an acquisition, and to insulate a business from risk.
Recent Developments in IRS Section 355 Ruling Policy

• On September 14, 2015, Treasury and the IRS issued Notice 2015-59, which identifies several issues of “concern” under sections 355 and 337(d) that are under study.

• The issues under study relate to transactions having one or more of the following characteristics:
  – Ownership by distributing or controlled of investment assets (as defined in section 355(g)(2)(B), with certain modifications) (“Investment Assets”), having substantial value in relation to (i) the value of all of the corporation’s assets, and (ii) the value of the assets of the active trade(s) or business(es) on which distributing or controlled relies to satisfy the requirements of section 355(b);
  – A significant difference between distributing's ratio of Investment Assets to assets other than Investment Assets and such ratio of controlled;
  – Ownership by distributing or controlled of a small amount of qualifying business assets in relation to all of its assets (a “Qualifying Business” or “Qualifying Business Assets”); and
  – An election by distributing or controlled (but not both) to be a RIC (as defined in section 851), or a REIT (as defined in section 856).

• Concurrently with Notice 2015-59, the IRS issued Rev. Proc. 2015-43, which updates the IRS’s no-rule policy under section 355 by adding certain of the transactions listed above.
  – Rev. Proc. 2015-43 applies to all ruling requests that are postmarked or, if not mailed, received on or after September 14, 2015, and relate to distributions that occur after such date.

• An IRS official has indicated that, if the IRS decides to issue new guidance with respect to the issues identified in Notice 2015-59, such guidance will not be retroactive to the date of the notice.

- According to Notice 2015-59:
  - "The Treasury Department and the Service have become aware, in part through requests for letter rulings, that some taxpayers are taking the position that certain distributions that have one or more of the characteristics described in section 1 of this notice satisfy the requirements of § 355. The Treasury Department and the Service believe that these transactions may present evidence of device for the distribution of earnings and profits, may lack an adequate business purpose or a Qualifying Business, or may violate other § 355 requirements. In addition, these transactions may circumvent the purposes of Code provisions intended to repeal the Supreme Court's decision in General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) (General Utilities repeal). See, e.g., §§ 311(b), 337(d), 367(a)(5), and 367(e); H.R. Rep. No. 100-391, at 1080-1084 (1987)."
Pro Rata Distributions v. Non-Pro Rata Exchanges

• The no-rule areas identified in Rev. Proc. 2015-43 do not distinguish between transactions involving distributing corporations the stock of which is or is not publicly traded or between pro rata and non-pro rata distributions.

• Treasury and the IRS understand that, in many instances, a publicly traded corporation may structure a distribution as either pro rata with respect to its stock or a non-pro rata exchange of controlled stock for some shareholders' stock in distributing.
  – If the distribution is pro rata, section 355(g) will not disqualify the distribution.
  – In most instances, section 355(g) will also not apply to a distribution that is a non-pro rata exchange because no single shareholder or group of related shareholders will own 50 percent or more of the stock of either distributing or controlled after the distribution.

• Notice 2015-59 indicates that certain characteristics of a transaction may overcome both the nondevice factor of public trading and the non-pro rata structure of a distribution, including:
  – Distributing or controlled owning Investment Assets with substantial value in relation to the value of all of the corporation's assets and the value of its Qualifying Business Assets, together with a disparity of such relationships between distributing and controlled (citing Treas. Reg. § 1.355-2(d)(2)(iv), relating to the nature and use of assets);
  – In certain situations, distributing or controlled owning a small amount of Qualifying Business Assets in relation to all of its assets; and
  – A prompt or planned RIC or REIT election by distributing or controlled.

• Treasury and the IRS also believe that such characteristics may make it less likely that a distribution will satisfy the section 355 business purpose requirement or will qualify as a strong corporate business purpose constituting a nondevice factor.

- Treasury and the IRS are more concerned with transactions in which stock of controlled is distributed outside an affiliated group (as defined in section 243(b)(2)(A)), including a distribution that is part of a series of related transactions in which controlled stock (including, for example, a controlled corporation that was a distributing corporation with respect to a lower-tier distribution) is distributed outside an affiliated group.

- The IRS will continue to follow its current ruling practice with respect to distributions within affiliated groups if there is no plan or intention for stock of any corporation to be distributed outside the affiliated group in a distribution described in the transactions identified in Rev. Proc. 2015-43.

• Treasury and the IRS requested comments on the following:
  – The facts and circumstances relevant to whether the transactions satisfy the requirements of section 355 and/or circumvent the purposes of General Utilities repeal;
  – Whether Investment Assets are the appropriate assets to consider in addressing the concerns raised by the transactions;
  – Whether the treatment of transactions solely within an affiliated group should differ from the treatment of transactions in which stock of one or more corporations will be distributed outside the affiliated group;
  – Whether the IRS should rule on issues presented in distributions in which distributing or controlled owns a relatively small amount of Qualifying Business Assets, and if so in what circumstances; and
  – Whether other classes of transactions should be excepted from the no-rule areas identified Rev. Proc. 2015-43.
Active Trade or Business No-Rules
Example – Active Trade or Business Issue

Facts: D owns a 10-percent interest in X, a publicly traded corporation. To facilitate a distribution of its interest in X to its shareholders that qualifies under section 355, D contributes its stock in X to newly formed C along with a small historic D business. The value of D’s stock interest in X is $99 and the value of the contributed D business is $1.

- Does C satisfy the section 355(b) active trade or business requirement?
- See section 355(a)(1)(B) and Treas. Reg. § 1.355-2(d) (device test); see also section 355(g) (cash-rich split-offs).
Notice 2015-59 –
Nature of Assets of Distributing and Controlled

• Treasury and the IRS are most concerned about transactions that result in:
  – Distributing or controlled owning a substantial amount of cash, portfolio stock or securities, or other Investment Assets, in relation to the value of all of its assets and its Qualifying Business Assets; and
  – One of the corporations having a significantly higher ratio of Investment Assets to Non-Investment Assets than the other corporation.
Rev. Proc. 2015-43 – Investment Assets No-Rule

- The following area is under IRS study and letter rulings will no longer be issued pending the issuance of formal guidance:
  - Any issue relating to the qualification, under section 355 and related provisions, of a distribution, or another distribution that is part of the same plan or series of related transactions, if, immediately after any such distribution, all of the following conditions exist:
    - The FMV of the Investment Assets of distributing or controlled is two-thirds or more of the total FMV of its gross assets;
    - The FMV of the gross assets of the trade(s) or business(es) on which distributing or controlled relies to satisfy the section 355(b) active trade or business requirement is less than 10 percent of the FMV of its Investment Assets; and
    - The ratio of the FMV of the Investment Assets to the FMV of the assets other than Investment Assets of distributing or controlled is three times or more of such ratio for the other corporation (i.e., controlled or distributing, respectively).
  - For purposes of the above FMV determinations, all members of the corporation's SAG are treated as one corporation.
  - If distributing or controlled relies on an active trade or business of a partnership for section 355(b) purposes, then, in determining the FMV of the gross assets of the trade(s) or business(es) on which distributing or controlled relies to satisfy the section 355(b) active trade or business requirement, such corporation is treated as owning its ratable share of the partnership's gross assets.
Definition of Investment Assets

• The meaning of "Investment Assets" is the same as under section 355(g)(2)(B) with the following modifications:
  - In the case of stock or securities in a corporation any stock of which is publicly traded, section 355(g)(2)(B)(iv) is applied by substituting "50-percent" for "20-percent;"
  - An interest in a publicly traded partnership (as defined in section 7704(b), regardless of whether the partnership is treated as a corporation pursuant to section 7704(a)) is generally treated in the same manner as publicly traded stock;
  - An interest in a partnership that is not a publicly traded partnership is generally treated in the same manner as stock that is not publicly traded stock; and
  - The preceding two modifications regarding partnership interests do not apply in the case of an interest in a partnership (other than a publicly traded partnership treated as a corporation pursuant to section 7704(a)), the active trade or business of which is taken into account by distributing or controlled for section 355(b) purposes, or would be taken into account without regard to the five-year requirement of section 355(b)(2)(B).

Anti-Abuse Rule

• The IRS also will not rule on any issue relating to the qualification, under section 355 and related provisions, of a distribution if, as part of a plan or series of related transactions, Investment Assets are disposed of, or property, including property qualifying as an active trade or business within the meaning of section 355(b), is acquired with a principal purpose of avoiding this no-rule.
Notice 2015-59 – Small Amounts of Qualifying Business Assets

- Treasury and the IRS are also concerned with transactions in which distributing or controlled owns a small amount of Qualifying Business Assets compared to its other assets (non-Qualifying Business Assets).
- Notice 2015-59 states that, before the enactment of section 355(b)(3), such transactions were common because of the restrictive nature of the “holding company” rule previously in section 355(b)(2)(A).
  - Treasury and the IRS have concluded that, under current law, distributions involving small Qualifying Businesses may have become “less justifiable.”
Rev. Proc. 2015-43 – Small Active Trade or Business No-Rule

- The IRS will not ordinarily issue rulings (i.e., a taxpayer must demonstrate unique and compelling reasons to justify the issuance of a ruling) with respect to:
  - Any issue relating to the qualification, under section 355 and related provisions, of a distribution, or another distribution that is part of the same plan or series of related transactions, if, immediately after any such distribution, the FMV of the gross assets of the trade(s) or business(es) on which distributing or controlled relies to satisfy the section 355(b) active trade or business requirement is less than 5 percent of the total FMV of the gross assets of such corporation.
- In determining the FMV of the gross assets of a corporation and of the gross assets of such trade(s) or business(es), (i) all members of a SAG are treated as one corporation; and (ii) if distributing or controlled relies on an active trade or business of a partnership for section 355(b) purposes, the corporation is treated as owning its ratable share of the partnership's gross assets.
- Cf. Rev. Proc. 96-43 (which contained a similar 5-percent threshold for IRS ruling purposes along with a non de minimis exception).
REIT / RIC No-Rule
Background: REIT Spin-Offs

Rev. Rul. 73-236 (1973-1 C.B. 183)
- Distributing spun off its sales business and assets as a separate entity, retaining its property rental business and assets. Distributing then elected to be a REIT.
  - As then in effect, section 856(d)(3) prevented entities from qualifying as REITs if they provided services to tenants or managed/operated property.
  - Thus, distributing, as a REIT, could not satisfy the section 355(b) active trade or business requirement.

- As a result of a statutory amendment in 1986, a REIT is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property under section 856(d).
- The IRS concluded that “[a] REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d).”
- Rev. Rul. 2001-29 obsoleted Rev. Rul. 73-236, but the IRS noted that this did “not imply a view as to whether a distribution of stock involving a REIT election by the distributing or controlled corporation would otherwise satisfy the requirements of section 355, including the corporate business purpose requirement of [Treas. Reg. §] 1.355-2(b).”
- Notwithstanding Rev. Rul. 2001-29, in many opco/propco transactions, the real estate is subject to triple-net leases and relatively small operating businesses in taxable REIT subsidiaries are relied on to satisfy the active trade or business requirement.
Real Property Interests:

Example – Section 355
Opco / Propco Transaction

Shareholders

D

C stock

C

Real Property Interests

Shareholders

D

C

Lease of Real Property

C

Makes REIT Election

Facts: D conducts a qualifying operating business. D also owns certain real property interests associated with such business, which D contributes to newly formed C (along with certain operating assets that are held through a taxable corporate subsidiary of C). D then distributes the stock of C to its shareholders. Following the distribution, C elects to be a REIT under section 856. C leases the real property to D and other D subsidiaries engaged in D’s business.

Issue: Does this transaction qualify under section 355? See PLRs 201528006; 201433007; 201411002/201431020; and 201337007.
Issues with REIT Spin-Offs

• Under Treas. Reg. § 1.355-2(b)(2), obtaining favorable federal tax treatment is not a valid business purpose.
  – REITs are permitted to deduct any income distributed as dividends at the corporate level, effectively eliminating one level of tax.
  – Is the intent to facilitate a REIT election by distributing or controlled an impermissible business purpose?

• Under Treas. Reg. § 1.355-3(b)(2)(iii), the IRS will “carefully scrutinize” separations of owner-occupied real estate with respect to the active trade or business requirement.
  – Does a plan to elect REIT status following a distribution constitute evidence of device?
**Notice 2015-59 –**

**Distributions Involving REITs or RICs**

- Treasury and the IRS are concerned that an increasing number of distributions intended to qualify under section 355 involve a distributing or controlled corporation that elects to be a REIT.
  - According to Notice 2015-59, such distributions may involve corporations that, prior to the distribution, do not meet the requirements to be REITs and intend to separate REIT-qualifying assets from non-qualifying assets so that distributing or controlled can be a REIT. In some cases, a REIT election may be made or become effective within a short period of time before the distribution. These transactions may involve relatively small Qualifying Businesses and retention of control over or use of the REIT's assets through long-term leases or other arrangements.
  - Notice 2015-59 states that these and similar transactions involving RICs involve significant concerns relating to (i) the device prohibition, (ii) the section 355 business purpose and active trade or business requirements, and (iii) the Code provisions intended to repeal the General Utilities decision.

- Notwithstanding the above concerns, Treasury and the IRS are generally not concerned with (i) transactions in which both distributing and controlled will be and will continue to be REITs or will be and will continue to be RICs, or (ii) transactions in which distributing has been a REIT or RIC for a substantial period of time, whether or not controlled will be a REIT or RIC after the distribution.
  - The IRS will continue to consider these transactions under its current ruling practice.
Rev. Proc. 2015-43 – REIT / RIC No-Rule

- The IRS will not ordinarily issue rulings (i.e., a taxpayer must demonstrate unique and compelling reasons to justify the issuance of a ruling) with respect to:
  - Any issue relating to the qualification, under section 355 and related provisions, of a distribution, or another distribution that is part of the same plan or series of related transactions, if property owned by any distributing corporation or any controlled corporation becomes the property of a RIC or a REIT in a "conversion transaction" (as defined in Treas. Reg. § 1.337(d)-7(a)(2)(ii)) with respect to which no deemed sale election described in Treas. Reg. § 1.337(d)-7(c) is made, and the conversion transaction and the distribution are parts of a plan or series of related transactions.
- This no-rule is inapplicable if, immediately after the date of the distribution, (i) both distributing and controlled will be REITs, or both of such corporations will be RICs; and (ii) there is no plan or intention on the date of the distribution for either distributing or controlled to cease to be a REIT or a RIC.
Other Changes to IRS Ruling Policy
Reduction in IRS Corporate Ruling Practice
IRS Ruling Policy for Corporate Transactions –
Rev. Proc. 2013-32

• In Rev. Proc. 2013-32, 2013-28 I.R.B. 55, the IRS announced its intention to broaden its no-ruling policy with respect to whether a transaction qualifies for nonrecognition treatment under section 332, 351, 355, or 1036, or on whether a transaction constitutes a reorganization within the meaning of section 368.

• Under its prior policy, unless the IRS determined that there was a significant issue, the IRS would not issue a letter ruling on (i) whether a transaction qualified for nonrecognition treatment under section 332, 351 (except for certain transfers undertaken before section 355 distributions), or 1036; (ii) whether a transaction constituted a reorganization under section 368(a)(1)(A), (B), (C), (E), or (F); or (iii) the tax consequences (such as nonrecognition and basis) that resulted from the application of those sections.
  – If the IRS determined that there was a significant issue, and to the extent the transaction was not described in another no-rule area, the IRS would rule on the entire transaction and not just the significant issue.

• Under Rev. Proc. 2013-32, the IRS will no longer rule on whether a transaction qualifies for nonrecognition treatment under section 332, 351, 355, or 1036, or on whether a transaction constitutes a reorganization within the meaning of section 368, regardless of whether the transaction presents a significant issue and regardless of whether the transaction is an integral part of a larger transaction that involves other issues upon which the IRS will rule.
  – The IRS will rule, however, on one or more issues under the above-cited sections (or on issues arising under related sections) to the extent that such issue or issues are significant.
  – A “significant issue” is defined as “an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.”

  – Under this program, a taxpayer could request a letter ruling on part of a larger transaction or on a particular issue under a section that a transaction presented. The IRS would issue a letter ruling on the particular issue raised in the letter ruling request and not on any other issue (including, in some cases, qualification of the distribution under section 355) or on any other aspect of the transaction.

• The revenue procedure cites the need to conserve IRS resources as the reason behind the more restrictive letter ruling policy.
Specific IRS No-Rule Areas
IRS – Specific No-Rule Areas

- In Rev. Proc. 2013-3, 2013-1 I.R.B. 113, the IRS added several areas as under study with respect to which letter rulings will no longer be issued pending the issuance of formal guidance –
  
  - **Control Requirement** – “Whether a corporation is a ‘controlled corporation’ within the meaning of § 355(a)(1)(A) if, in anticipation of a distribution of the stock of the corporation, a distributing corporation acquires putative control of the controlled corporation (directly or through one or more corporations) in any transaction (including a recapitalization) in which stock or securities were exchanged for stock having a greater voting power than the stock or securities relinquished in the exchange, or if, in anticipation of a distribution of the stock of the putative controlled corporation, such corporation issues stock to another person having different voting power per share than the stock held by the distributing corporation.”
  
  - **North-South Transactions** – “Whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called ‘north-south’ transactions), at least one of which is a distribution with respect to the corporation’s stock, a contribution to the corporation’s capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes.”
  
  - **Use of Controlled Stock/Securities to Satisfy Distributing Debt** – “Whether either § 355 or § 361 applies to a distributing corporation’s distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution.”
IRS – Specific No-Rule Areas

• In Rev. Proc. 2014-3, 2014-1 I.R.B. 111, the IRS added several areas with respect to which letter rulings will no longer be issued.

• To the areas in which rulings will not be issued, the IRS added:
  – "The treatment of transactions in which stock of a corporation is transferred with a plan or intention that the corporation be liquidated in a transaction intended to qualify under [section] 331.” (i.e., transactions similar to that in Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956)).

• To the areas in which rulings will not ordinarily be issued, the IRS added:
  – "The treatment or effects of hook equity, including as a result of its issuance, ownership, or redemption.”
  – The IRS indicated that this exclusion generally does not apply if (i) an interest’s status as hook equity is only transitory (e.g., in a triangular reorganization), or (ii) the treatment of the hook equity is not relevant to the treatment of the overall transaction and issue presented.
  – For this purpose, “hook equity” means an ownership interest in a business entity (such as stock in a corporation) that is held by another business entity in which at least 50 percent of the interests (by vote or value) in such latter entity are held directly or indirectly by the former entity. However, if an entity directly or indirectly owns all of the equity interests in another entity, the equity interests in the latter entity are not hook equity.
Section 355 Control Requirement
Recap into Control for 355 Spin-off, followed by Unwind of Recap – PLR 201007050

(1) C is recapped to create Class A & B stock; D1 is issued Class B stock

(2) shares of Class A stock are issued to D2 for assets

(3) shares of Class A stock are issued to the public in an IPO

(4) D1 distributes Class B stock of C to D2 ("Internal Spin-off")

Step 5: D2 offers to exchange its Class A stock in C for D2 stock owned by the D2 shareholders ("Exchange Offer" resulting in an "External Split-off" to the D2 shareholders).

Step 6: If the conditions to the Exchange Offer are met, then D2 will convert the Class B stock received in the Internal Spin-off to Class A stock (the "Unwind") prior to consummation of the Exchange Offer/External Split-off.
The IRS ruled that "The Unwind will not cause the Internal Spin-off to fail to satisfy the control immediately before requirement of Section 355(a)(1)(A)."

The taxpayer represented that immediately after the Internal Spin-off, there would be "no legally binding obligation to change the capital structure or the Charter of Controlled" and "no legally binding obligation to proceed with the remainder of the Proposed Transaction."

- Compare to prior PLRs requiring no plan or intention. See PLRs 200731025 and 200705016.

Consummation of the Exchange Offer/External Split-off was conditioned upon a minimum level of participation in the Exchange Offer.

- The exchange ratio for the Exchange Offer was set at a level intended to encourage the D2 shareholders to tender their D2 stock.
North-South Transactions
Facts: P contributes ATB 1 (active business relied on by D in spin-off) to D. D distributes the stock of C to P. Taxpayer made the following representation: “There is no regulatory, legal, or economic compulsion or requirement that the [contribution by P] be made as a condition of the [internal distribution of C]. The fact that the value of [D] will decrease as a result of the [internal distribution] was not a consideration in the decision to contribute property to [D]. The [internal distribution] is not contingent on there being contributed to [D] assets having a specified (or roughly specified) value.”

Result: The ruling held that the contribution by P will not be treated as having been received by D in exchange for the C stock distributed by D. What if D’s distribution to P was a split-off? Does it matter if the shares redeemed include the D shares issued (or deemed issued) in the contribution by P?
North-South Transactions Between Shareholder and Distributing

- Other recent north-south rulings have required a similar representation.
  - See, e.g., PLRs 201034005, 201030005, and 201007050; see also PLR 201202007 (non-exchange ruling involving north-south transfers between shareholder and distributing, where distributing made both a distribution of stock under section 355 and a separate distribution of assets under section 301); PLR 201047016 (cash investment by significant D shareholder into D, followed by D’s distribution of C and cash to public shareholders in a split-off, not treated as purchase of D shares by significant D shareholder; transaction was respected as cash investment into D followed by split-off with boot).

- The IRS required a somewhat shorter representation in PLR 201149012 (in ruling that contribution will not be treated as having been received by distributing in exchange for distribution of controlled stock, requiring taxpayer representation that there “is no regulatory, legal, contractual, or economic compulsion or requirement that [shareholder] make part or all of the [shareholder contribution] to [distributing] as a condition to the Distribution”).

- Earlier rulings only contained the representation that no part of the consideration distributed by distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.
  - See, e.g., PLR 200611006 (shareholder’s contribution of property to distributing, followed by distributing’s distribution of controlled to shareholder and shareholder’s distribution of distributing stock to its shareholders); PLR 200411021 (parent contributed property to distributing, followed by distribution of controlled stock), PLR 200215031 (distributing’s parent contributed cash to distributing); PLR 9708012 (parent contributed property to distributing, followed by distribution of controlled stock).
PLR 201136009 – North-South Transactions Between Distributing and Controlled

Facts: C distributes cash to D, and D contributes assets to C. D distributes the stock of C to its shareholder.

- If the cash distribution and asset contribution are integrated and treated as an exchange, the cash distribution would be treated as boot received by D.
- If the cash distribution and asset contribution are respected as separate, the cash distribution would be treated as a dividend separate from the “D” reorganization.
- The taxpayer made the following representation: “There is no regulatory, legal, contractual, or economic compulsion or requirement that [D] make part or all of the [D] Contribution as a condition to the distribution by [C] of the Cash Distribution.”

Result: The IRS ruled that the cash distribution was a section 301(a) distribution (i.e., not “boot” in a divisive “D” reorganization).

Query: What if C is a newco and the distribution is supported by an equity infusion?
North-South Transactions
Between Distributing and Controlled

- As with north-south transactions between shareholder and distributing, earlier rulings involving north-south transactions between distributing and controlled required a more significant taxpayer representation.
  - See, e.g., PLR 201106004 (taxpayer represented that there "is no regulatory, legal, contractual, or economic compulsion or requirement that the [controlled distribution] be made as a condition to the distribution of [controlled] by [distributing]. The fact that the value of [distributing] will decrease as a result of the distribution of [controlled] by [distributing] was not a consideration in the decision to make the [controlled distribution]. The distribution of [controlled] by [distributing] is not contingent on there being distributed to [distributing] assets having a specified (or roughly specified) value.").
Transfers to Creditors in Divisive Reorganizations
Treatment of Transfers to Creditors in Divisive Reorganizations

- Under section 361(b)(3), the amount of money plus the FMV of other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) is limited to the amount of the basis of the assets contributed to the controlled corporation.
  - Such limitation does not apply to securities of a controlled corporation that a distributing corporation receives and distributes to its creditors as part of the reorganization.
- Several recent legislative proposals would have treated securities as “other property” under section 361, so that a distributing corporation would recognize gain to the extent that securities it receives and transfers to creditors exceed the adjusted basis of the assets transferred by the corporation (net of liabilities). See, e.g., Section 302 of the Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849.
  - Such proposals were intended to address concerns with respect to the levels of debt incurred in divisive transactions in which one corporation is relieved of debt while the newly-separate corporation is burdened.
  - However, unlike the distribution of cash, a distributing corporation’s creditors have to agree to take the controlled corporation debt securities in satisfaction of the distributing corporation’s debt, which such creditors would be unlikely to do if the controlled corporation were unduly burdened with debt in relation to its assets.
Treatment of Transfers to Creditors in Divisive Reorganizations – Example

Facts: D owns all of the stock of C in which it has a basis of $100. D conducts Businesses A and B, and C conducts Business A. C borrows $300 from a bank. D contributes its Business A assets, which have an aggregate FMV of $500 and an adjusted basis of $250, to C in exchange for $200 worth of C stock and $300. D uses the cash to repay its outstanding debt. D then distributes all of its C stock to its shareholders.

Analysis: The amount of money and the FMV of other properties that D can receive tax-free under section 361(b) and then distribute to D creditors without gain recognition is limited to the total adjusted basis of the properties transferred by D to C. Therefore, D has $50 of gain ($300 cash distributed to D's creditors - $250 aggregate basis in property contributed to C). See section 361(b)(3).

If, instead of cash, D received C securities worth $300 and used such securities to satisfy its debt, D would not recognize any gain, as the limitation in section 361(b)(3) would not apply.
Treatment of Transfers to Creditors in Divisive Reorganizations – IRS Rulings

- The IRS has issued private letter rulings approving the use of controlled securities received in a divisive "D" reorganization to satisfy debt of the distributing corporation.
- Formerly, the IRS only approved such exchanges if the distributing corporation debt satisfied by the controlled securities was "old and cold" debt that was not incurred as part of the transaction.
  - More recently, the IRS has approved transactions where the distributing company's debt is newly issued and short-term, and the exchange between distributing and controlled is facilitated by an intermediary (e.g., an investment bank or an underwriter).
  - In such rulings, the IRS has generally limited the amount of distributing debt that can be retired with controlled securities to historic average outstanding debt levels.
- In a typical transaction, an investment bank purchases distributing debt (on the open market or directly from distributing) and enters into an exchange agreement with the distributing corporation. In connection with the distribution of controlled, distributing transfers controlled securities to the investment bank in exchange for the distributing debt, with the investment bank selling the controlled securities on the open market.
  - The IRS has generally required a "5-14 representation" in connection with such transactions, which is intended to ensure the existence of event risk and credit risk (i.e., that the investment bank was a real creditor and not merely an agent of distributing).
  - Generally, the IRS has defined event risk as the investment bank holding the distributing debt for at least 5 days before entering into the exchange agreement, and credit risk as the investment bank holding the distributing debt for at least 14 days before executing the exchange of distributing for controlled debt.
Facts: D contributes Business A to newly formed C in exchange for all of C’s stock, the assumption of certain D liabilities by C, and C securities. D distributes the C stock to its shareholders, and D exchanges the C securities for debt of D. The debt exchange is facilitated by investment banks that will acquire the D debt at least m days (believed to be 14 days) prior to the date of the exchange. D and the investment banks will enter into exchange agreements no sooner than n days (believed to be 5 days) after the investment banks acquire the D debt. The investment banks enter into agreements to sell the C securities received in the exchange to unrelated third parties. The D debt exchanged for the C securities will not exceed the weighted quarterly average of D’s third-party debt for the 12-month period ending on the date before the date D’s board of directors directed management to pursue actively the distribution transaction.

Rulings:
- The contribution to C and the distribution by D qualify as a reorganization under section 368(a)(1)(D).
- D will generally not recognize any gain or loss with respect to the C securities under section 361(c).
- See also PLRs 201032017, 200808006, and 200802009.
Treatment of Transfers to Creditors in Divisive Reorganizations – IRS Rulings

• Taxpayers have also obtained rulings from the IRS in debt-for-debt exchanges where distributing securities are issued directly to third-party creditors/investors without the use of an intermediary.
  – In this type of transaction, involving so-called “traveling debt,” there is no exchange agreement; rather, the terms of such instruments generally permit the distributing corporation to exchange the debt for securities of controlled.

• The IRS has generally required a similar 5-14 representation to ensure sufficient event and credit risk is assumed by the third-party creditors/investors.
Facts: D is a publicly-traded corporation that operates Businesses A and B. D operates Business A through a disregarded entity, C, which elects to be treated as a corporation. D contributes to C certain Business A assets and interests in exchange for C stock, cash, C securities, and the assumption of certain liabilities by C. D issues new securities to third-party investors at least 5 days prior to the declaration of its distribution of C stock and 14 days before such distribution. D distributes C stock to its shareholders.
Facts (cont’d): Around the same time as the distribution, and at least 14 days after D’s issuance of new securities, D delivers C securities in satisfaction of its recently issued securities and certain other debt related to Business A. D also uses all of the cash received from C to repay outstanding D debt.

Rulings:
• The contribution to C and the distribution by D qualify as a reorganization under section 368(a)(1)(D).
  – D recognizes no gain or loss on the contribution and the distribution, and no gain or loss is recognized by the D shareholders on the receipt of the C stock.
• D will generally not recognize any gain or loss with respect to the C securities under section 361(c).
  – The taxpayer represented that the amount of D debt (including the newly issued D securities) exchanged for the C securities would not exceed the average of D’s outstanding third party indebtedness at the end of each of the four calendar quarters preceding the date on which the distribution was first presented to D’s board of directors.
PLR 201232014

Rulings (cont’d):

- The ruling required a 5-14 representation, with event risk tied to the distributing corporation’s declaration of the distribution of its C stock instead of the entering into of an exchange agreement (i.e., requiring the third-party investors to hold the distributing securities for at least 5 days before D declared the C stock distribution).
  - The risk that the distribution would not be consummated was presumably viewed by the IRS as sufficient event risk, subjecting the bank to the risk that it would be stuck with distributing securities rather than controlled securities.
  - Such terms appear to place greater risk on the investment bank, which would effectively be subject to 14 days of both event and credit risk because it had no rights to effectuate the exchange of D securities for C securities with the distributing corporation.
- See also PLR 201029007.
- Compare to prior rulings requiring D Debt to be “old and cold.” See PLRs 200716024, 200345050, and 200137011.
Granite Trust
Granite Trust Transaction

- Parent owns all of the stock of Sub. Parent has a built-in loss in its Sub stock and wants to recognize the loss on the liquidation of Sub.
- Parent reduces its ownership in Sub to less than 80 percent by making a bona fide sale of its stock to an unrelated party.
  - Parent recognizes the loss on the sold Sub shares.
- Sub later liquidates under section 331, and Parent recognizes the loss on its retained Sub stock.
Hook Stock
Section 338 – Qualified Stock Purchase

Target Stock Owned by Subsidiary

- The public owns 60 percent of T stock. X owns the remaining 40 percent of T stock.
- P purchases the T stock held by the public.
- Has P made a qualified stock purchase of T? See PLR 8425120.
Consolidation

- P owns 70 percent of S stock.
- S owns 100 percent of S1, which owns the remaining 30 percent of S stock.
- Are P, S and S1 part of an affiliated group that can file a consolidated return?
Final Regulations – “F” Reorganizations
Final Regulations – “F” Reorganizations

• On September 18, 2015, Treasury and the IRS issued final regulations on the qualification of a transaction as a reorganization under section 368(a)(1)(F) (an “F” reorganization).
  – In 2005, Treasury and the IRS finalized a portion of the 2004 proposed regulations by adopting the rule that exempts “F” reorganizations from the continuity of interest and continuity of business enterprise requirements generally applicable to reorganizations. See Treas. Reg. § 1.368-1(b).
• The final regulations generally adopt the rules in the 2004 proposed regulations, with certain modifications.
  – The final regulations also include rules relating to outbound “F” reorganizations (i.e., where the acquiring corporation is a foreign corporation) by adopting, without substantive change, provisions in proposed regulations issued in 1990 relating to section 367(a). See 55 Fed. Reg. 1472 (Jan. 16, 1990).
• The final regulations are effective for transactions occurring on or after September 21, 2015.
Final Regulations – “F” Reorganizations: Overview

• Under section 368(a)(1)(F), a reorganization includes “a mere change in identity, form, or place of organization of one corporation, however effected.”
  - In form, an “F” reorganization generally involves two corporations – a corporation ("Transferor Corporation") that transfers or is deemed to transfer assets to another corporation ("Resulting Corporation").
  - The rules in the final regulations are “based on the premise that it is appropriate to treat the Resulting Corporation in an F reorganization as the functional equivalent of the Transferor Corporation and to give its corporate enterprise roughly the same freedom of action as would be accorded a corporation that remains within its original corporate shell.”

• “F” reorganizations benefit from a number of favorable rules, in addition to the non-recognition treatment afforded to reorganizations, including:
  - The Resulting Corporation generally can carry back losses to prior taxable years of the Transferor Corporation.
  - The taxable year generally does not close as a result of an “F” reorganization (the taxable year can close in certain “F” reorganizations involving foreign corporations).
Final Regulations – “F” Reorganizations: Series of Transactions as a “Potential F Reorganization”

• The final regulations confirm that a series of related transactions may qualify as an “F” reorganization.

• To help determine the steps in a multi-step transaction that should be considered, the final regulations introduce the concept of a “Potential F Reorganization,” which begins when the Transferor Corporation begins transferring (or is deemed to begin transferring) its assets to the Resulting Corporation, and ends when the Transferor Corporation has distributed (or is deemed to have distributed) the consideration it receives from the Resulting Corporation to its shareholders and has completely liquidated.

• The final regulations clarify that deemed asset transfers include (i) transfers treated as occurring as a result of an entity classification election under Treas. Reg. § 301.7701-3, and (ii) transfers resulting from application of step transaction principles (e.g., a “liquidation-incorporation” transaction or a “drop-and-check” transaction).

• The final regulations provide that a series of transactions may constitute an “F” reorganization irrespective of whether certain steps in the series could be subject to other Code provisions if viewed in isolation (e.g., sections 304(a), 331, 332, or 351).
  – However, pursuant to Treas. Reg. § 1.368-2(k), a completed reorganization will not be recharacterized as an “F” reorganization as a result of a subsequent transfer of assets or stock.
Final Regulations – “F” Reorganizations:
Six Requirements for “F” Reorganization Qualification

- Under the final regulations, a Potential F Reorganization will generally qualify as an “F” reorganization if six requirements are satisfied:
  - (1) Immediately after the Potential F Reorganization, all of the stock of the Resulting Corporation must have been distributed (or deemed distributed) in exchange for stock of the Transferor Corporation (disregarding the issuance of a de minimis amount of Resulting Corporation stock to facilitate its organization or maintain its legal existence);
  - (2) The same person or persons own (in identical proportions) all the stock of the Transferor Corporation at the beginning of the Potential F Reorganization and all of the stock of the Resulting Corporation at the end of the Potential F Reorganization (disregarding the issuance of a de minimis amount of Resulting Corporation stock to facilitate its organization or maintain its legal existence);
  - (3) The Resulting Corporation may not hold property or have any tax attributes immediately before the Potential F Reorganization (aside from a de minimis amount of assets to facilitate its organization or maintain its existence, or proceeds from borrowings relating to the Potential F Reorganization);
  - (4) The Transferor Corporation must completely liquidate for federal income tax purposes (but is not required to legally dissolve and can retain a de minimis amount of assets to preserve its legal existence);
  - (5) Immediately after the Potential F Reorganization, no corporation other than the Resulting Corporation may hold property that was held by the Transferor Corporation immediately before the Potential F Reorganization if the corporation would, as a result, succeed to and take into account the items of the Transferor Corporation described in section 381(c) and
  - (6) Immediately after the Potential F Reorganization, the Resulting Corporation may not hold property acquired from a corporation other than the Transferor Corporation if the Resulting Corporation would, as a result, succeed to and take into account the items of the other corporation described in section 381(c).
Final Regulations – “F” Reorganizations: Addition of Fifth and Sixth Requirements

- While the first four requirements are generally adopted from the 2004 proposed regulations, the final regulations added the fifth and sixth requirements to address certain “overlap” transactions.

- The fifth requirement ensures that a transaction that divides the property or tax attributes of the Transferor Corporation between or among acquiring corporations, or leads to potential competing claims as to such tax attributes, does not qualify as an “F” reorganization.

- The sixth requirement ensures that a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations does not qualify as an “F” reorganization.
  - Thus, if more than one corporation transfers assets to the Resulting Corporation in a Potential F Reorganization, none of the transfers would constitute an “F” reorganization (however, if one transfer occurs before all other transfers, the first transfer may qualify as an “F” reorganization).
Final Regulations – “F” Reorganizations: Permitted Changes in Ownership and Distributions

- Under the final regulations, a corporation may recapitalize, redeem its stock, or make distributions to its shareholders without jeopardizing qualification as an “F” reorganization. Thus, the final regulations permit changes of ownership that result from:
  - A shareholder in the Transferor Corporation exchanging such stock for stock of equivalent value in the Resulting Corporation with different terms; or
  - Receiving a distribution of money or other property from either the Transferor or Resulting Corporation, whether or not in redemption of such stock.

- If a shareholder receives money or other property (including in a redemption) from the Transferor or Resulting Corporation in an “F” reorganization, the receipt of such money or other property is treated as an unrelated, separate transaction from the “F” reorganization. See Treas. Reg. § 1.301-1(I).
Final Regulations – "F" Reorganizations: 
"F" Reorganization in a "Bubble"

• The final regulations confirm that an "F" reorganization may occur before, within, or after other transactions that effect more than a mere change, even if the Resulting Corporation has only a transitory existence following the mere change.
  
  – Related events that precede or follow the Potential F Reorganization generally will not affect qualification under section 368(a)(1)(F).
  
  – The qualification of a Potential F Reorganization under section 368(a)(1)(F) will also not alter the character of other transactions for federal income tax purposes.

  – Step transaction principles may be applied to other transactions without regard to whether certain steps qualify as an “F” reorganization (or as part of such “F” reorganization).
Final Regulations – “F” Reorganizations: Interaction with Other Section 368 Reorganizations

• If the Potential F Reorganization (or a step thereof) qualifies as another type of reorganization (or as part of such reorganization) in which a corporation in control of the Resulting Corporation is a party to the other reorganization the Potential F Reorganization does not qualify under section 368(a)(1)(F).
  – Such rule applies to transactions qualifying as (i) a triangular “C” reorganization, (ii) an “A” reorganization by reason of section 368(a)(2)(D), and (iii) an “A” or “C” reorganization by reason of section 368(a)(2)(C).

• Except for the above, if a Potential F Reorganization qualifies as both an “F” reorganization and an “A,” “C,” or “D” reorganization, then the Potential F Reorganization will qualify only as an “F” reorganization.
  – The IRS has historically taken the position that, if a Transferor Corporation’s transfer of property qualifies as a step in both an “F” reorganization and another type of reorganization in which the Resulting Corporation is the acquiring corporation, the transaction qualifies for the benefits accorded to an “F” reorganization. See, e.g., Rev. Rul. 57-276, 1957-1 C.B. 126; Rev. Rul. 79-289, 1979-2 C.B. 145.
  – This rule does not apply to “E” or “G” reorganizations.
Example 1: "F" Reorganization with Distribution

Facts
- S merges into Newco, with P receiving Newco stock and cash.

Analysis
- The merger of S into Newco qualifies as an "F" reorganization.
- The cash distribution to P is treated as a separate section 301 distribution.
Example 2: Transaction with New Shareholder

Facts
• Y seeks to acquire the assets of X for cash. Y forms Newco and contributes cash in exchange for Newco stock. X merges into Newco, with Newco distributing the cash to C in exchange for its X stock. After the merger, Y holds all of the stock of Newco, which holds all of the assets and liabilities previously held by X.

Analysis
• The merger of X into Newco does not qualify as an "F" reorganization because Newco stock is not distributed to C in exchange for its X stock and the transaction results in the introduction of a new shareholder.
• See Treas. Reg. § 1.368-2(m)(4), ex. 1.
Example 3: “F” Reorganization with Redemption

Facts
- X merges into Newco. X distributes the stock of Newco to B and cash to A in redemption of its X stock.

Analysis
- The merger of X into Newco qualifies as an “F” reorganization.
- A’s surrender of X stock for cash is treated as a transaction separate from the reorganization to which section 302(a) applies.
- What if A were a corporation owning 80 percent of X?
Example 4: Post-Transaction Stock Sale

Facts
• P forms Newco, followed by the merger of S into Newco. P then sells all of its Newco stock to B, an unrelated party, for cash.

Analysis
• The merger of S into Newco qualifies as an “F” reorganization.
• P’s sale of the Newco stock is disregarded in determining whether the merger is a mere change.
• See Treas. Reg. § 1.368-2(m)(4), ex. 6; cf. Example 2 above (similar substance, but different order of steps yields different result).
Example 5: Other Acquiring Corporation

Facts

- P and A decide to liquidate S while A continues to operate part of the S business in corporate form. S liquidates, distributing 80 percent of its assets to P and 20 percent of its assets to A. S's distribution to P meets the requirements of section 332. A contributes the assets it receives to newly formed Newco.

Analysis

- The transfer of assets to Newco does not qualify as an "F" reorganization because section 381(a) applies to P's acquisition of assets held by S immediately before the potential "F" reorganization.
- Sections 331 and 336 apply to A's acquisition of assets from S and S's distribution of assets to A, and section 351 applies to A's contribution to Newco.
Example 6: Other Acquiring Corporation

Facts
• S merges into P. Immediately thereafter and as part of the same plan, P contributes 50 percent of the former assets of S to newly formed Newco.

Analysis
• The merger does not qualify as a complete liquidation under section 332, but does qualify as an “A” reorganization (see section 368(a)(2)(C) and Treas. Reg. § 1.368-2(k)).
• The transfer of assets to Newco does not qualify as an “F” reorganization because section 381(a) applies to P’s acquisition of assets held by S immediately before the potential “F” reorganization.
• P, the corporation in control of S under section 368(c), is also a party to the “A” reorganization.
• See Treas. Reg. § 1.368-2(m)(4), ex. 10.
Example 7: Multiple Transferor Corporations

Facts
- P decides to operate S1 and S2 as a single corporation. P forms Newco, and S1 and S2 simultaneously merge into Newco.

Analysis
- The mergers of S1 and S2 into Newco will not qualify as "F" reorganizations because, immediately after the mergers, Newco holds property acquired from a corporation other than the transferor corporation and section 381(a) would apply to the acquisition of such property.
- The mergers may qualify as "A" or "D" reorganizations.
- The result would be different if the mergers were not simultaneous (the first merger should qualify as an "F" reorganization).
Step Transaction Doctrine Developments
Rev. Rul. 2015-9
Facts: P is a domestic corporation that owns all of the stock of foreign corporations S1 and S2. S2 owns all of the stock of foreign corporations X, Y, and Z.

- Step 1: S2 organizes foreign corporation N.
- Step 2: P transfers all of the stock of S1 to S2 in exchange for additional voting common stock of S2.
Facts (cont'd):

- Step 3: S1, X, Y, and Z transfer substantially all of their assets to N in exchange for N common stock.
- Step 4: S1, X, Y, and Z liquidate and distribute all of their N stock to S2.
Rev. Rul. 2015-9

Holding:

• The transactions are treated as a transfer of the S1 stock in a section 351 exchange followed by reorganizations under section 368(a)(1)(D).

• P's transfer of the stock of S1 is respected as a section 351 exchange.
  – P's transfer satisfies the requirements of section 351, including the requirement that P control S2 immediately after the exchange.
  – Even though P's transfer and S1's transfer and liquidation are steps in a prearranged plan, "an analysis of the transaction as a whole does not dictate that P's transfer be treated other than in accordance with its form in order to reflect the substance of the transaction."

• The asset transfers by S1, X, Y, and Z, followed by the liquidation of such corporations, are reorganizations under section 368(a)(1)(D).

  – In that ruling, the IRS held on the same facts that P's transfer of the stock of S1 to S2 did not constitute a section 351 exchange.
  – Instead, N was viewed as directly acquiring the assets of S1 in exchange for S2 stock, which did not qualify as a section 368(a)(1)(D) reorganization because neither S1 nor P was in control of N immediately after the transaction. The IRS noted that the transaction, as recast, may qualify as a reorganization under section 368(a)(1)(C).

• The IRS will apply Rev. Rul. 2015-9 prospectively and generally will not challenge prior positions taken in reasonable reliance on Rev. Rul. 78-130.

Rev. Rul. 2015-10
Facts: P owns all of the interests in LLC, which is treated as a corporation for federal tax purposes. P also owns all of the stock of S1. S1 owns all of the stock of S2, which owns all of the stock of S3, which owns all of the stock of S4.

- Step 1: P transfers all of the LLC interests to S1 in exchange for additional S1 stock.
- Step 2: S1 transfers all of the LLC interests to S2 in exchange for additional S2 stock.
- Step 3: S2 transfers all of the LLC interests to S3 in exchange for additional S3 stock.
- Step 4: LLC elects to be treated as a disregarded entity for federal tax purposes. S3, through LLC, will continue to conduct the business conducted by LLC prior to the transaction.
Rev. Rul. 2015-10

Holding:

• The transactions are treated as two transfers of stock in exchanges under section 351 followed by a reorganization under section 368(a)(1)(D).
• The transfers of the LLC interests by P and S1 are respected as section 351 exchanges.
  – The transfers satisfy the requirements of section 351, including the control immediately after the exchange requirement.
  – Even though the transfers are steps in a prearranged plan involving successive transfers of the LLC interests, “an analysis of the transaction as a whole does not dictate that P’s [or S1’s] transfer be treated other than in accordance with its form in order to reflect the substance of the transaction.”
Treas. Reg. § 1.337(d)-3T (May Company Regulations)
Treas. Reg. § 1.337(d)-3T

• On June 12, 2015, Treasury and the IRS issued temporary and final regulations intended to prevent corporate taxpayers from using a partnership to avoid corporate-level gain under section 311(b) or 336(a) (also known as the "May Company" regulations).
  - The regulations apply prospectively to transactions occurring on or after June 12, 2015.

• Section 337(d) permits Treasury to prescribe regulations that are necessary or appropriate to carry out the purposes of the repeal of the General Utilities doctrine, "including regulations to ensure that [the repeal of the General Utilities doctrine] may not be circumvented through the use of any provision of law or regulations."

• Previously, in 1992, Treasury and the IRS issued proposed regulations in response to transactions in which taxpayers were using a partnership to postpone or avoid gain generally required to be recognized under section 311(b).

• In issuing the new regulations, Treasury and the IRS have withdrawn the 1992 proposed regulations (although certain aspects of the 1992 proposed regulations have been retained).
A corporation, X, enters into a partnership and contributes appreciated property. The partnership then acquires X stock and subsequently makes a liquidating distribution of such stock to X.

- Under section 731(a), X does not recognize gain on the partnership distribution. Thus, the corporation has disposed of the appreciated property and acquired its own stock, thereby permanently avoiding its gain in the appreciated property.
Treas. Reg. § 1.337(d)-3T

- General (Treas. Reg. § 1.337(d)-3T(b), (c))
  - The regulations apply when a partnership, either directly or indirectly, owns, acquires, or distributes "Stock of the Corporate Partner." A "Corporate Partner" is required to recognize gain "when a transaction has the effect of the Corporate Partner acquiring or increasing an interest in its own stock in exchange for appreciated property in a manner that contravenes the purpose of [the regulations]."

  - **Corporate Partner** – a person that is classified as a corporation for federal income tax purposes and holds or acquires an interest in a partnership.

  - **Stock of the Corporate Partner** – includes the Corporate Partner’s stock or other equity interests, including options, warrants, and similar interests, in the Corporate Partner or a corporation that controls (within the meaning of section 304(c), except that section 318(a)(1) and (3) shall not apply) the Corporate Partner. Also includes interests in any entity to the extent that the value of the interest is attributable to the Stock of the Corporate Partner.

    - Does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership’s capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the Corporate Partner.
Treas. Reg. § 1.337(d)-3T

- Deemed redemption rule (Treas. Reg. § 1.337(d)-3T(d))
  - A Corporate Partner in a partnership that engages in a "Section 337(d) Transaction" recognizes gain at the time, and to the extent, that the Corporate Partner's interest in appreciated property (other than Stock of the Corporate Partner) is reduced in exchange for an increased interest in Stock of the Corporate Partner.
  - Section 337(d) Transaction - a transaction (or series of transactions) that has the effect of an exchange by a Corporate Partner of its interest in appreciated property for an interest in Stock of the Corporate Partner owned, acquired, or distributed by a partnership.
  - A Section 337(d) Transaction may occur, for example, when:
    - A Corporate Partner contributes appreciated property to a partnership that owns Stock of the Corporate Partner;
    - A partnership acquires Stock of the Corporate Partner;
    - A partnership that owns Stock of the Corporate Partner distributes appreciated property to a partner other than a Corporate Partner;
    - A partnership distributes Stock of the Corporate Partner to the Corporate Partner; or
    - A partnership agreement is amended in a manner that increases a Corporate Partner's interest in Stock of the Corporate Partner.
  - The amount of gain recognized equals the product of:
    - The Corporate Partner's "Gain Percentage," which is a fraction, the numerator of which is the Corporate Partner's interest (by value) in appreciated property effectively exchanged for Stock of the Corporate Partner, and the denominator of which is the Corporate Partner's interest (by value) in the appreciated property immediately before the Section 337(d) Transaction; and
    - The gain from the appreciated property that the Corporate Partner would recognize if, immediately before the Section 337(d) Transaction, all assets of the partnership and any assets contributed to the partnership in the Section 337(d) Transaction were sold in a fully taxable transaction for cash in an amount equal to the FMV of such property, reduced, but not below zero, by any gain the Corporate Partner is required to recognize with respect to the appreciated property in the Section 337(d) Transaction under any other provision of Chapter 1 of the Code.
Treas. Reg. § 1.337(d)-3T

- Distribution of Stock of the Corporate Partner (Treas. Reg. § 1.337(d)-3T(e))
  - Upon the distribution of Stock of the Corporate Partner to the Corporate Partner, the deemed redemption rule will apply as though immediately before the distribution the partners amended the partnership agreement to allocate to the Corporate Partner a 100 percent interest in that portion of the Stock of the Corporate Partner that is distributed and to allocate an appropriately reduced interest in other partnership property away from the Corporate Partner.
  - Applies to distributions to the Corporate Partner of Stock of the Corporate Partner to which section 732(f) does not apply and that have previously been the subject of a Section 337(d) Transaction or become the subject of a Section 337(d) Transaction as a result of the distribution.
Treas. Reg. § 1.337(d)-3T

- De Minimis and Inadvertence Exceptions (Treas. Reg. § 1.337(d)-3T(f))
  - **De minimis rule** – The regulations do not apply to a Corporate Partner if at the time that the partnership acquires Stock of the Corporate Partner or at the time of a revaluation event (as described in Treas. Reg. § 1.704-1(b)(2)(iv)(f)) (without regard to whether or not the partnership revalues its assets) –
    - The Corporate Partner and any persons related to the Corporate Partner under section 267(b) or section 707(b) own in the aggregate less than 5 percent of the partnership;
    - The partnership holds Stock of the Corporate Partner with a value of less than 2 percent of the partnership’s gross assets (including the Stock of the Corporate Partner); and
    - The partnership has never, at any point in time, held in the aggregate—
      - Stock of the Corporate Partner with a FMV greater than $1,000,000; or
      - More than 2 percent of any particular class of Stock of the Corporate Partner.
  - **Inadvertence rule** – The regulations do not apply to Section 337(d) Transactions in which the partnership satisfies two requirements—
    - The partnership must dispose of, by sale or distribution, the Stock of the Corporate Partner before the due date (including extensions) of its federal income tax return for the taxable year in which the partnership acquired the stock (or in which the Corporate Partner joined the partnership, if applicable).
    - The partnership must not have distributed the Stock of the Corporate Partner to the Corporate Partner or a person possessing section 304(c) control of the Corporate Partner.
Example 1 – Deemed Redemption Rule
Contribution of Stock of a Corporate Partner

Facts: In Year 1, X, a corporation, and A, an individual, form partnership AX as equal partners in all respects. X contributes Asset 1 with FMV of $100 and a basis of $20. A contributes X stock, which is Stock of the Corporate Partner, with a basis and FMV of $100.

Result: Because A and X are equal partners in AX in all respects, the partnership formation causes X's interest in X stock to increase from $0 to $50 and its interest in Asset 1 to decrease from $100 to $50. Thus, the partnership formation is a Section 337(d) Transaction, because it has the effect of an exchange by X of $50 of Asset 1 for $50 of X stock.

X's Gain Percentage equals 50%, which is $50 (X's interest in Asset 1 effectively exchanged for X stock) divided by $100 (X's interest in Asset 1 immediately before the Section 337(d) Transaction). X would recognize gain of $80 on the sale of Asset 1 if, immediately before the Section 337(d) Transaction, all assets were sold in a fully taxable transaction for cash in an amount equal to the FMV of such property. Thus, X recognizes gain of $40 (50% multiplied by $80).

X's basis in its AX partnership interest increases from $20 to $60, and AX's basis in Asset 1 also increases from $20 to $60.

See Treas. Reg. § 1.337(d)-3T(h), ex. 1.
Example 2 – Deemed Redemption Rule
Subsequent Purchase of Stock of the Corporate Partner

**Facts:** Same facts as Example 1, except that A contributes cash of $100 instead of X stock. In Year 2, AX uses the contributed cash to purchase X stock for $100. The FMV of Asset 1 has not changed.

**Result:** AX’s purchase of X stock has the effect of an exchange by X of appreciated property for X stock, and is thus a Section 337(d) Transaction. X must recognize gain to the extent that X’s share of appreciated property (other than X stock) is reduced in exchange for X stock. Thus, the consequences of AX’s purchase of X stock are the same as those described in Example 1, resulting in X recognizing $40 of gain.

See Treas. Reg. § 1.337(d)-3T(h), ex. 4.
Example 3 – Distribution of Stock of the Corporate Partner

Year 9

Asset 1
FMV = $200
Basis = $20

X Stock
FMV = $200
Basis = $100

Facts: Same facts as Example 1. AX liquidates in Year 9, when Asset 1 and the X stock each have a FMV of $200. X and A each receive 50% of Asset 1 and 50% of the X stock in the liquidation. At the time AX liquidates, X’s basis in its AX partnership interest is $60 and A’s basis in its AX partnership interest is $100.

Result: The liquidation is not a Section 337(d) Transaction because X’s interests in its stock and in Asset 1 do not change upon liquidation. Under Treas. Reg. § 1.732-1T(c)(1)(iii), the distribution to X of X stock is deemed to immediately precede the distribution of 50% of Asset 1 to X for purposes of determining X’s basis in the distributed property.

For purposes of determining X’s basis in Asset 1 and X’s gain on distribution, the basis of the distributed X stock is treated as $50, which represents the greater of (i) 50% of the stock’s $100 basis in the hands of the partnership, or (ii) the FMV of that distributed X stock ($100) less X’s allocable share of gain from the distributed X stock if AX had sold all of its assets in a fully taxable transaction for cash in an amount equal to the FMV of such property immediately before the distributions ($50). Thus, X reduces its basis in its partnership interest by $50 prior to the distribution of Asset 1. Accordingly, X’s basis in the distributed portion of Asset 1 is $10. Because AX’s basis in the distributed stock immediately before the distribution ($50) does not exceed X’s basis in its partnership interest ($60), X recognizes no gain under Treas. Reg. § 1.337(d)-3T(e)(3).

See Treas. Reg. § 1.337(d)-3T(h), ex. 2.
Final Regulations Under Sections 312 and 381
Movement of Attributes Following an Asset Reorganization

- What if Acquirer transfers all the T assets to Sub?
- What if Acquirer retains $1?
- What if Acquirer transfers 50 percent of the T assets?
- What if Acquirer transfers the T assets for $? 

T

Acquirer

T assets

Sub
Background – Section 381

• Under Treas. Reg. § 1.381(a)-1(b)(2), in the context of a reorganization, attributes move to the acquiring corporation.
  - Only a single corporation may be an acquiring corporation for section 381 purposes.
  - Previously, the acquiring corporation was the corporation that ultimately acquires all of the assets transferred by the transferor corporation. If no one corporation ultimately acquires all of the assets transferred by the transferor corporation, the corporation that directly acquires the assets transferred was the acquiring corporation for section 381 purposes, even though that corporation ultimately retains none of the assets transferred.
• Accordingly, under prior law, the initial transferee corporation was effectively permitted to elect where attributes move:
  - If, under section 368(a)(2)(C), that corporation drops all of the assets acquired into a single lower-tier subsidiary, such subsidiary would be the acquiring corporation and succeed to the attributes of the transferor corporation.
  - Alternatively, if only a portion of the assets acquired are dropped into a lower-tier subsidiary, the lower-tier subsidiary does not succeed to any of the attributes of the transferor corporation.
Background – Section 312

• The IRS historically interpreted the section 312 regulations as providing that E&P of the transferor corporation moves in the same manner as do other attributes under section 381 (or in a divisive reorganization, to the extent provided in Treas. Reg. § 1.312-10).

• Some practitioners suggested that the IRS’s interpretation was unclear and that E&P could be allocated between the transferor and transferee. See –
  – Former Treas. Reg. § 1.381(c)(2)-1(d) (providing that where part of the acquired assets is transferred to one or more controlled corporations, or all of the acquired assets are transferred to two or more controlled corporations, the allocation of E&P is made without regard to section 381).
  – Former Treas. Reg. § 1.312-11(a) (providing for proper adjustment and allocation of E&P with respect to asset transfers in connection with reorganizations, and cross referencing the regulations under section 381 for specific rules).
On April 13, 2012, IRS and Treasury issued proposed regulations clarifying how E&P is allocated in tax-free corporate acquisitions.

Under the proposed regulations, the rules for the allocation of E&P conform to the rules for the allocation of other tax attributes under section 381.

Consistent with the IRS’s historical position, the proposed regulations clarify that:

- Except as provided in Treas. Reg. § 1.312-10 (divisive reorganization), if property is transferred from one corporation to another, no allocation of the E&P of the transferor is made to the transferee unless the transfer is described in section 381(a).

- In a transfer described in section 381(a), only the acquiring corporation (as defined in Treas. Reg. § 1.381(a)-1(b)(2)) succeeds to the E&P of the distributor or transferor corporation.

This proposed rule would have retained the electivity that exists under the IRS’s historical position.

- If the initial acquiring corporation drops down all the assets to a single subsidiary, the E&P moves to that subsidiary.

- If the initial acquiring corporation keeps $1 of assets, all the E&P stays with that corporation.
Treas. Reg. §§ 1.312-11 and 1.381(a)-1

- After considering comments to the proposed section 312 regulations, on May 6, 2014, IRS and Treasury issued proposed regulations under section 381 that would adopt a different approach.
  - These regulations provide that the acquiring corporation is the corporation that directly acquires the assets transferred by the transferor corporation.
  - This change is made not just with respect to the location of the transferor's E&P, but also for the other tax attributes governed by section 381.
  - The proposed rule eliminates the possibility of attributes going anywhere but to the direct acquiring corporation.

- On November 7, 2014, IRS and Treasury finalized these regulations under section 381.
  - Concurrently, IRS and Treasury finalized the 2012 proposed regulations under section 312.
  - The final rules are effective November 10, 2014.
Treas. Reg. §§ 1.312-11 and 1.381(a)-1

• IRS and Treasury believe that the adopted rule under section 381 is more appropriate because it –
  – Eliminates the electivity in the prior section 381 regulations.
  – Eliminates the administrative burden of determining whether a corporation acquired all of the assets transferred by the transferor corporation.
  – Eliminates the disparate effect of the existence of a plan of reorganization and produces results consistent with those obtained if a corporation that has not engaged in a reorganization transfers assets to a controlled subsidiary in a nonrecognition transaction.

• Additionally, IRS and Treasury believe that the adopted rule is appropriate for determining the location of the transferor corporation’s E&P because the E&P is generally maintained at the corporation closest to the transferor corporation’s former shareholders (except in the case of triangular reorganizations).
Developments –
Codified Economic Substance Doctrine
Section 7701(o)
Section 7701(o)

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(1) APPLICATION OF DOCTRINE.—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.—Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.
Section 7701(o)

(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

(A) ECONOMIC SUBSTANCE DOCTRINE.—The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) TRANSACTION.—The term ‘transaction’ includes a series of transactions.
ES Codification – Penalties

Section 6662(b)(6) (20% accuracy-related penalty)

Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

Section 6662(i) -- INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTION

(1) IN GENERAL.—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.

(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—For purposes of this subsection, the term ‘nondisclosed noneconomic substance transaction’ means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) SPECIAL RULE FOR AMENDED RETURNS.—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.
ES Codification – Penalties

Section 6664(c)(2):

Paragraph (1) [reasonable cause exception for underpayments] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).

Section 6664(d):

(2) EXCEPTION.—Paragraph (1) [reasonable cause exception for reportable transaction understatements] shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6)

Section 6676(c) (erroneous claim for refund penalty):

(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.

Section 6662A(e)(2) (coordination of section 6662A penalty with 40% nondisclosed noneconomic substance transaction penalty)

This section [section 6662A] shall not apply to any portion of an understatement on which a penalty is imposed under section 6662 if the rate of the penalty is determined under subsections (h) or (i) of section 6662.
The only legislative history of section 7701(o) is the post-enactment JCT Explanation, which includes the following:

"The determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus, the provision does not change present law standards in determining when to utilize an economic substance analysis.

"The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.

"Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied."

The examples are illustrative and not exclusive.

Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10), March 21, 2010 [Other footnotes omitted]
Notice 2010-62
Notice 2010-62

- On September 13, 2010, the IRS issued Notice 2010-62, which provides interim guidance under section 7701(o).

IRS Position on Section 7701(o) Guidance

- Notwithstanding concerns regarding the need for guidance on section 7701(o), Treasury and the IRS “do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”

- Further, the IRS will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).

- Notice 2010-62 provides that “the IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o).”
  - Thus, according to the IRS, if authorities provided that the economic substance doctrine was not relevant to whether certain tax benefits were allowable prior to the enactment of section 7701(o), the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.
  - However, an IRS official has warned that the economic substance doctrine may be relevant in cases in which the IRS has not previously raised economic substance or considered it in a private letter ruling.

- The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop, and states that the codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue.

Application of Conjunctive Test

- In Notice 2010-62, the IRS states that it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1).

- The IRS will challenge taxpayers who seek to rely on prior case law for the proposition that a transaction will be treated as having economic substance because it satisfies either prong of the two-prong test.
Notice 2010-62

Reasonably Expected Pre-Tax Profit

- Under section 7701(o)(2)(A), a transaction’s profit potential is taken into account in determining whether the two-prong economic substance test is met if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for tax purposes.
  - According to Notice 2010-62, the IRS will apply existing relevant case law and other published guidance in performing this calculation.

- Treasury and the IRS also intend to issue regulations pursuant to section 7701(o)(2)(B) on the treatment of foreign taxes as expenses in determining pre-tax profit in appropriate cases.
  - In the interim, the IRS notes in Notice 2010-62 that the enactment of section 7701(o) does not restrict the ability of courts to consider the appropriate treatment of foreign taxes in economic substance cases.

Accuracy-Related Penalties

- Notice 2010-62 provides details on what constitutes adequate disclosure under section 6662(i) for purposes of reducing the no-fault penalty from 40 to 20%.

- The disclosure will be considered adequate under section 6662(i) if made on a Form 8275 or 8275-R, or in a manner consistent with Rev. Proc. 94-69.

- If a transaction lacking economic substance is a reportable transaction, the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if (i) the taxpayer meets the disclosure requirements described above, and (ii) the disclosure requirements under the section 6011 regulations.
2011 LB&I Directive
LB&I Directive

• On July 15, 2011, the IRS issued an LB&I directive to instruct examiners on how to determine when it is appropriate to seek the approval of the appropriate Director of Field Operations in asserting the codified economic substance doctrine.

• The directive provides that the examiner must develop and analyze a series of inquiries in order to seek approval for the ultimate application of the doctrine in the examination.
  - As a first inquiry, an examiner should evaluate whether the circumstances in the case are those under which application of the economic substance doctrine to a transaction is likely not appropriate.
    • The directive provides a list of facts and circumstances that tend to show that application of the doctrine is likely not appropriate.
  - Second, an examiner should evaluate whether the circumstances in the case are those under which application of the doctrine to the transaction may be appropriate.
    • The directive provides a list of facts and circumstances that tend to show that application of the doctrine may be appropriate.
  - Third, if an examiner determines that the application of the doctrine may be appropriate, the directive provides a series of inquiries an examiner must make before seeking approval to apply the doctrine.
  - Fourth, if an examiner and his or her manager and territory manager determine that application of the economic substance doctrine is merited, guidance is provided on how to request approval of the appropriate Director of Field Operations.
The directive provides that, until further guidance is issued, the penalties in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed with respect to the application of any other “similar rule of law” or judicial doctrine, such as step transaction, substance over form, or sham transaction.

The directive indicates that the examiner should notify the taxpayer that he or she is planning to perform an economic substance analysis before commencing that analysis, and that if the Director of Field Operations decides to proceed, the taxpayer should be given an opportunity to be heard regarding whether the doctrine should apply.

Depending on the nature of the transaction, the directive provides for various levels of review of an examiner’s decisions before assertion of the doctrine may proceed.

In applying the directive, when a transaction involves a series of interconnected steps with a common objective, the term “transaction” generally refers to all of the steps taken together.

- The directive indicates that in certain circumstances it may be appropriate to analyze separately one or more steps that are included within a series of interconnected steps, such as situations where an integrated transaction includes one or more tax-motivated steps that bear a minor or incidental relationship to a single common business or financial transaction.
Notice 2014-58
Notice 2014-58

• On October 9, 2014, the IRS released Notice 2014-58, which is intended to amplify the prior guidance on the codified economic substance doctrine provided in Notice 2010-62.

Definition of “Transaction”

• Notice 2014-58 provides that, for purposes of determining whether the codified economic substance doctrine applies, the term “transaction” generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and any or all of the steps that are carried out as part of a plan.

• According to the Notice, facts and circumstances determine whether a plan’s steps are aggregated or disaggregated when defining a transaction.

  – When a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the “transaction” generally includes all the steps taken together, and every step is considered in analyzing whether the transaction as a whole lacks economic substance.

  – However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, the “transaction” may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals.

  – Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis depending on the particular facts and circumstances.
Notice 2014-58

Meaning of “Similar Rule of Law”

- Notice 2014-58 also clarifies the meaning of “similar rule of law” in applying the strict liability penalty, stating that it means a rule or doctrine that applies the same factors and analysis required under section 7701(o), even if a different term or terms are used to describe the rule or doctrine (e.g., the “sham transaction doctrine”).

- Notice 2014-58 states that the IRS will not assert the strict liability penalty unless it also raises section 7701(o) to support the underlying adjustments.
  - Thus, if the IRS does not raise section 7701(o) to disallow the claimed tax benefits and instead relies on other judicial doctrines to support the underlying adjustments (e.g., the substance over form or step transaction doctrines), the IRS will not assert the strict liability penalty because the transaction will not be treated as failing to meet the requirements of a similar rule of law.
  - Other Code sections and regulations that disallow tax benefits are not similar rules of law for purposes of the strict liability penalty.
Proposed Regulations – Next-Day Rule
Current Next-Day Rule

• General rule: “End of the day rule” (Treas. Reg. § 1.1502-76(b)(1)(ii)(A)(1))
  – Target’s old tax year ends at end of the Closing Date
  – Target joins the Acquiring consolidated group on the day after the Closing Date
  – Income and deduction arising on Closing Date are reported on Target’s final short-year return, not on Acquiring return

• Exception: “Next-day rule” for items “properly allocable” to post-closing portion of Closing Date (Treas. Reg. § 1.1502-76(b)(1)(ii)(B))
  – Transactions on Closing Date that are “properly allocable” to the portion of the day after the closing are deemed to occur at the beginning of the next day
  – Income and deduction under next-day rule are reported on Acquiring’s return, not on Target’s final short-year return
  – Purpose of next-day rule = protect seller of Target from tax on transactions implemented by Acquiring on Closing Date but after the closing
  – For the next-day rule to apply two conditions must be true:
    • The transaction must occur on the Closing Date
    • The item of income or deduction must be “properly allocable” to the portion of the Closing Date after the closing

• “Properly allocable” determination by parties is respected if reasonable and consistently applied by all parties
  – Multiple factors may be considered to determine if allocation is “reasonable”
  – Some items may be allocated ratably between Target short-year and Acquiring year, but ratable allocation may not be used for “extraordinary items” (e.g., compensation-related deductions in connection with Target’s change in status)
Proposed Regulations – Next-Day Rule

• On March 6, 2015, Treasury and the IRS issued proposed regulations that would replace the current next-day rule in Treas. Reg. § 1.1502-76(b)(1)(ii)(B) with a rule that, according to the preamble, is “more narrowly tailored to clearly reflect taxable income.”

• The preamble indicates that Treasury and the IRS are concerned that the standards provided in the current next-day rule have been “inappropriately interpreted by taxpayers” as “providing flexibility in reporting tax items that result from transactions occurring on the day of [Target’s] change in status so that those items can be allocated by agreement to the day of, or to the day following, [Target’s] change in status.”
  – According to the preamble, the proposed next-day rule is intended to eliminate this “perceived electivity.”

• Under the proposed rules, if an “extraordinary item” results from a transaction that occurs on the day of Target’s change in status, but after the event resulting in the change, and if the item would be taken into account by Target on that day, the transaction resulting in the “extraordinary item” is treated as occurring at the beginning of the following day for purposes of determining the period in which Target must report the item.
  – The proposed next-day rule is expressly inapplicable to any extraordinary item that arises simultaneously with the event that causes Target’s change in status.
    • Under the proposed rule, success-based fees paid to financial advisory or investment banking firms contingent on the successful closing of the deal would be treated as simultaneously occurring with the transaction and would be allocated to the prior period.
  – The proposed regulations clarify that an “extraordinary item” includes “[a]ny compensation-related deduction in connection with [Target’s] change in status (including, for example, a deduction for fees for services rendered in connection with [Target’s] change in status and for bonus, severance, and option cancellation payments made in connection with [Target’s] change in status).”
Proposed Regulations – Next-Day Rule

- In addition, the proposed regulations do the following:
  - Clarify the S corporation exception to the end of the day rule
    - The proposed regulations add a “previous-day rule” for S corporation targets.
    - The rule states that, if an extraordinary item results from a transaction that occurs on the termination date, but before or simultaneously with the event resulting in the termination of the target’s election under section 1362(a), and the item would be taken into account by the target on that day, “the transaction resulting in the extraordinary item is treated as occurring at the end of the previous day for purposes of determining the period in which [Target] must reporting the item.”
  - Revise the scope of the end of the day rule and related rules
    - The proposed regulations provide that the end of the day rule, the proposed next-day rule, the S corporation exception, and the previous day rule apply for purposes of determining the period in which Target must report its tax items, as well as for purposes of sections 382(h) and 1374.
  - Expand anti-avoidance provision
    - Under the anti-avoidance rule in current Treas. Reg. § 1.1502-76(b)(3), if any person acts with a principal purpose contrary to the purposes of Treas. Reg. § 1.1502-76(b) to substantially reduce the federal income tax liability of any person (a “prohibited purpose”), adjustments must be made as necessary to carry out the purposes of Treas. Reg. § 1.1502-76.
    - The proposed regulations clarify that the anti-avoidance rule may apply to situations in which a person modifies an existing contract or other agreement in anticipation of Target’s change in status in order to shift an item between the taxable years that end and begin as a result of Target’s change in status if such actions are undertaken with a prohibited purpose.
Final Regulations –
Agent for Consolidated Group
Background –
Agent for Consolidated Group

- In 2002, Treasury and the IRS issued final regulations under Treas. Reg. § 1.1502-77 to provide rules on the identity and authority of the agent of a consolidated group.
  - Under the 2002 regulations, the common parent of a group ceased to be the agent if its existence terminated under applicable law, if it became a disregarded entity for federal tax purposes, or if it became an entity classified as a partnership for federal tax purposes.
  - In such cases, the common parent could generally designate its successor, another member of the group, or a group member's successor as the substitute agent for the group (provided such designee was a domestic corporation for federal tax purposes), although such designation required IRS approval.
- Proposed regulations issued in 2012 would have retained the general rules, concepts, and examples of the 2002 regulations, but would have made several changes, including:
  - If an agent had a sole successor (default successor), the default successor automatically became the group's agent when the prior agent ceased to exist (e.g., in a merger). The terminating agent was not permitted to designate an agent unless there was no default successor, in which case the agent could only designate an entity that was a member of the group for the consolidated return year (or a successor of such a member).
  - Disregarded entities and partnerships were among the entities permitted to be agents for prior years in which they or their predecessors were not treated as disregarded. Thus, if a common parent converted or merged into a disregarded entity or partnership, whether by reason of a state law merger, a state law conversion, or a federal tax election, the continuing or successor juridical entity (whether a disregarded entity or partnership) would continue as the agent for the prior periods.
  - The requirement that the IRS approve any designation was eliminated. However, a default successor, or a terminating agent that has no default successor, was required to notify the IRS when the default successor or an entity designated by a terminating agent becomes the group's new agent.
  - The proposed regulations provided several limited circumstances in which the IRS could designate or replace an agent, either on its own initiative or at the request of other members.
Final Regulations – Agent for Consolidated Group

• On April 1, 2015, Treasury and the IRS issued final regulations regarding the agent for a consolidated group that make a few changes to the rules in the proposed 2012 regulations.
  – The final regulations apply to consolidated return years beginning on or after April 1, 2015.
  – The IRS contemporaneously released Rev. Proc. 2015-26, 2015-15 I.R.B., which provides instructions for all communications relating to the identification of the agent to act on behalf of the consolidated group.

• Treas. Reg. § 1.1502-77(c)(6)(i)(A) expands the circumstances under which the IRS may replace an agent on its own accord. The IRS may designate an agent if:
  – The agent’s existence terminates, other than in a group structure change, without there being a default successor and without any designation made;
  – An agent previously designated by the IRS is no longer a member of the group in the current year and does not have a default successor that is a member of the group;
  – The IRS believes that the agent or its default successor exists but such entity has either not timely responded to the IRS’s notices or has failed to perform its obligations as agent as prescribed by the Code or regulations; or
  – The agent is or becomes a foreign entity (including, for example, through the agent’s continuance into a foreign jurisdiction or certain transactions subject to the inversion rules of section 7874).
Final Regulations –
Agent for Consolidated Group

• Treas. Reg. § 1.1502-77(c)(5)(i) provides that if a terminating agent was itself designated by the IRS on the IRS’s own accord and does not have a default successor, the terminating agent is not permitted to designate an agent if it was designated because the agent it replaced (i) ceased to be a member of the group in a current year; (2) failed to timely respond to notices or failed to fulfill its obligations under the Code or regulations; or (3) became a foreign entity.
  – In such cases, the terminating agent should request that the IRS designate an agent.
  – Other categories of agents previously designated by the IRS may designate an agent upon termination, provided the terminating agent does not have a default successor or terminate in a group structure change.
    • The terminating agent may designate an agent only with respect to completed years.
• Treas. Reg. § 1.1502-77(c)(6)(i)(B) permits a member to request that the IRS designate a new agent in circumstances other than the specifically enumerated circumstances in which the IRS may designate an agent on the IRS’s own accord.
  – The IRS may, but is not required to replace an agent under such circumstances.
• Treas. Reg. § 1.1502-77(c)(7)(i) provides a mechanism for agents to resign with respect to certain years, provided that the following four conditions are met:
  – The agent must provide written notice to the IRS that it no longer intends to be the agent for a completed year;
  – An entity that could have been designated by the resigning agent upon its termination must consent, in writing, to be the agent for that year;
  – Immediately after its resignation takes effect, the resigning agent must not be the agent for the current year; and
  – The IRS must not object to the agent’s resignation.