Corporate Tax Developments: Part 5 of 5

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Agenda

- Service reconsidering “significant issue” limitation on spin-off and reorganization rulings
- Rev. Ruls. 2015-9 and 2015-10
- Next day rule and agent for the group regulations

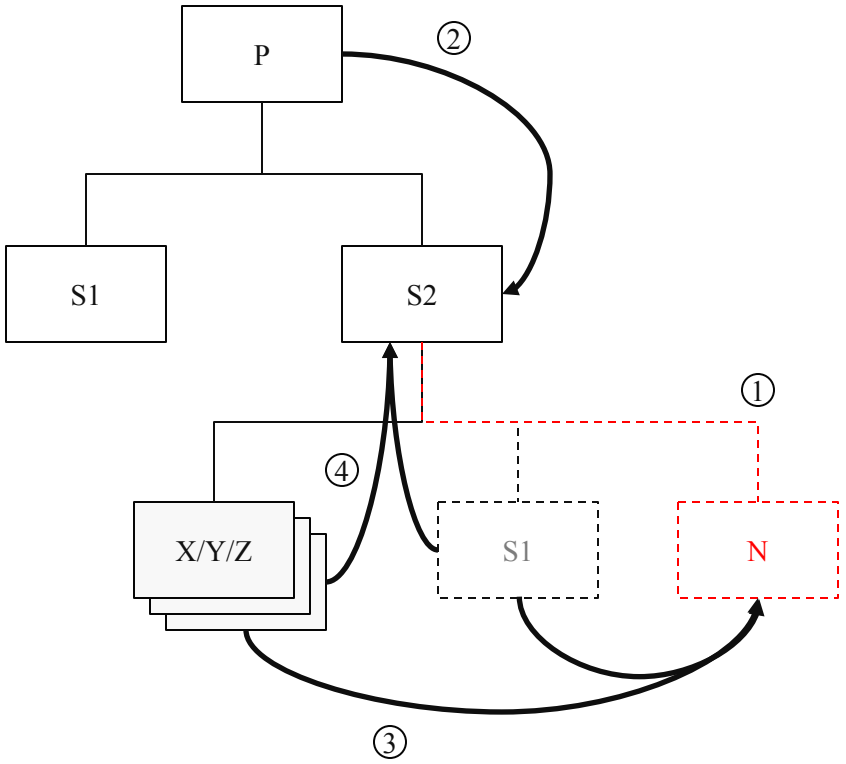
REVISITING “SIGNIFICANT ISSUE” RULING PRACTICE

Revisiting Subchapter C Ruling Practice?

- At a May 9, 2015 ABA conference, IRS Deputy Associate Chief Counsel (Corporate) Alison Burns asked for practitioner comments regarding the Service's practice to issue rulings only on "significant issues" in sections 332, 351, 355, and 368 transactions.
- Burns asked "[w]hat are the issues that are giving you the most amount of heartburn that we're not ruling on? . . . We have decided that we have some bandwidth to rethink whether we can open back up the PLR program somewhat to make it more responsive to your needs."
- Burns said that the "significant issue" limitation reduced the number of rulings more than expected.
- Section 355 may be an area where practitioners need additional PLR support.

REV. RULS. 2015-9 & 2015-10

Rev. Rul. 78-130



Form

1. S2 forms N.
2. P transfers all of its S1 stock to S2.
3. X, Y, Z, and S1 transfer substantially all of their assets to N for N stock.
4. X, Y, Z, and S1 liquidate.

- S1, S2, X, Y, Z, and N are foreign.
- If the form is respected, Step 2 could be treated as a section 351 exchange and Steps 3 and 4 could qualify as a D reorganization.

Conclusions

- The Service ruled that Step 2 was ignored and S1 was treated as directly transferring assets to N for S2 stock.
- This recharacterized transaction would not qualify as a D reorganization, but could be a triangular C reorganization.

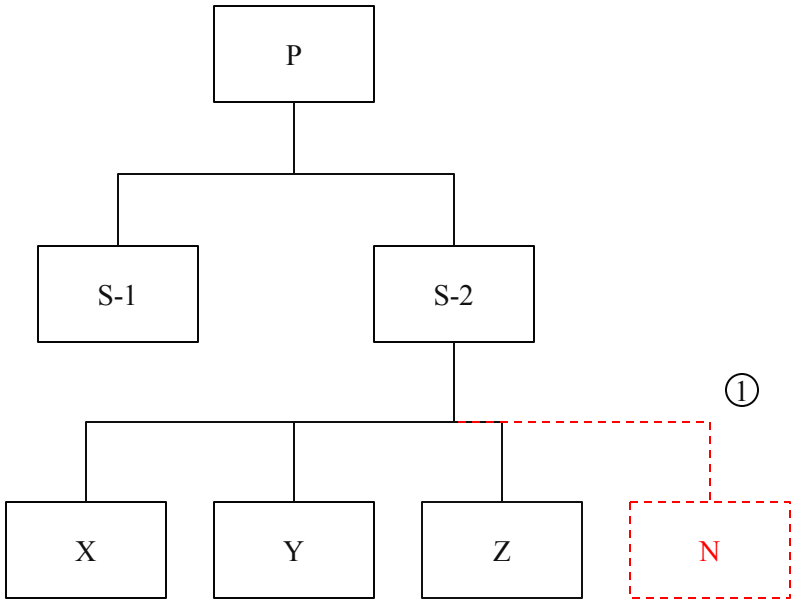
Rev. Rul. 78-130

Why was Rev. Rul. 78-130 issued?

- In 1978, taxpayers engaging in section 367 transactions were required to obtain rulings.
- Rev. Rul. 78-130 states that "the Commissioner of Internal Revenue has determined [the transaction] is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 367 of the Code."
- Section 367(a) would have applied to the form of the transaction under Treas. Reg. section 7.367(b)-4, but not to the recast, so the ruling was apparently issued to help taxpayers who were unaware of the section 367 ruling requirement.

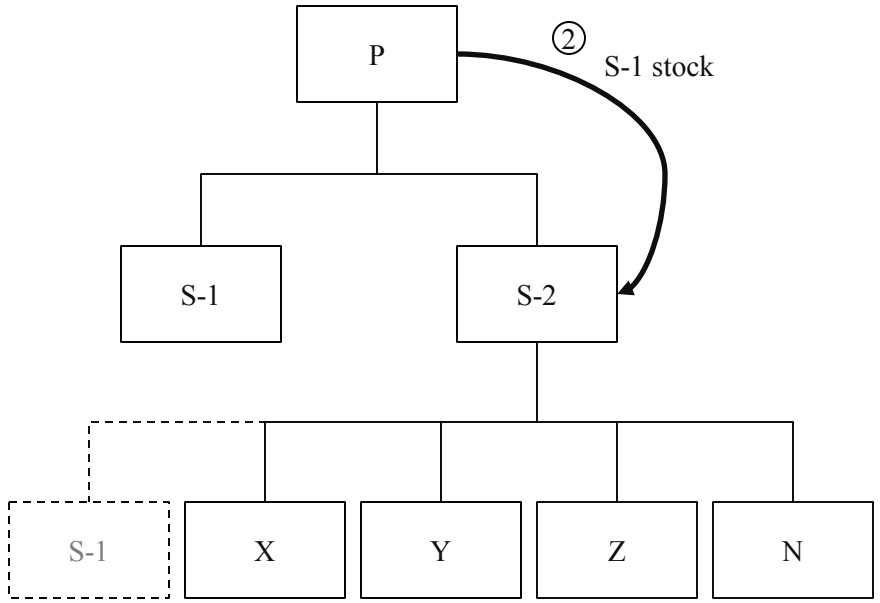
Rev. Rul. 2015-9

Step 1: Formation of N



- P is a U.S. corporation.
- S-1, S-2, X, Y, and Z are all Country R corporations.
- S-1 is an operating subsidiary and S-2 is a holding company.
- S-2 forms N, a foreign corporation incorporated in Country R.

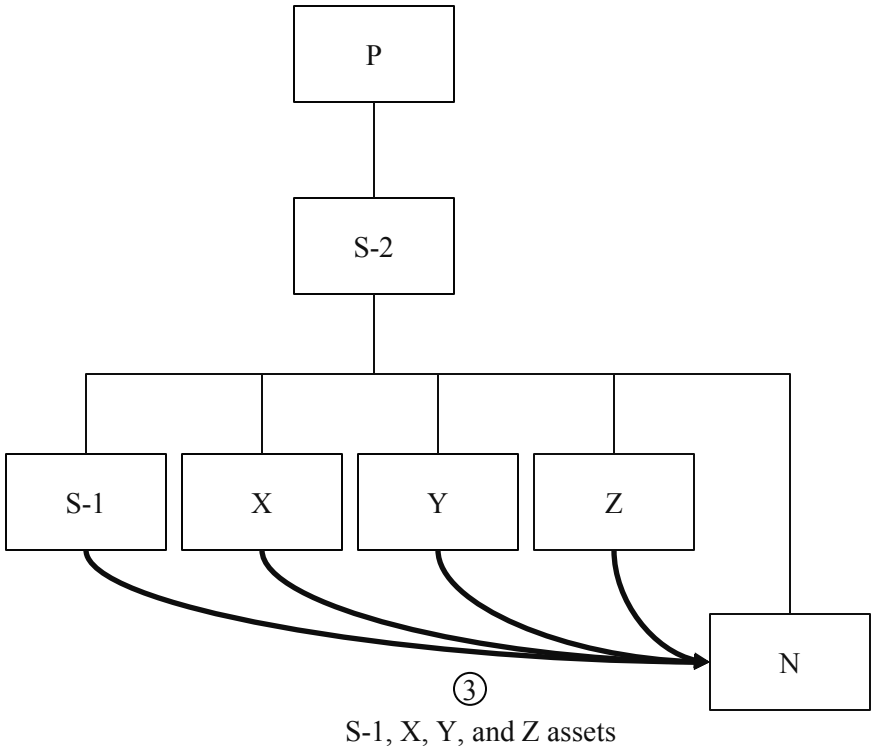
Step 2: Transfer of S-1 to S-2



- P transfers the stock of S-1 to S-2 for additional S-2 common voting stock.
- P enters into a gain recognition agreement.

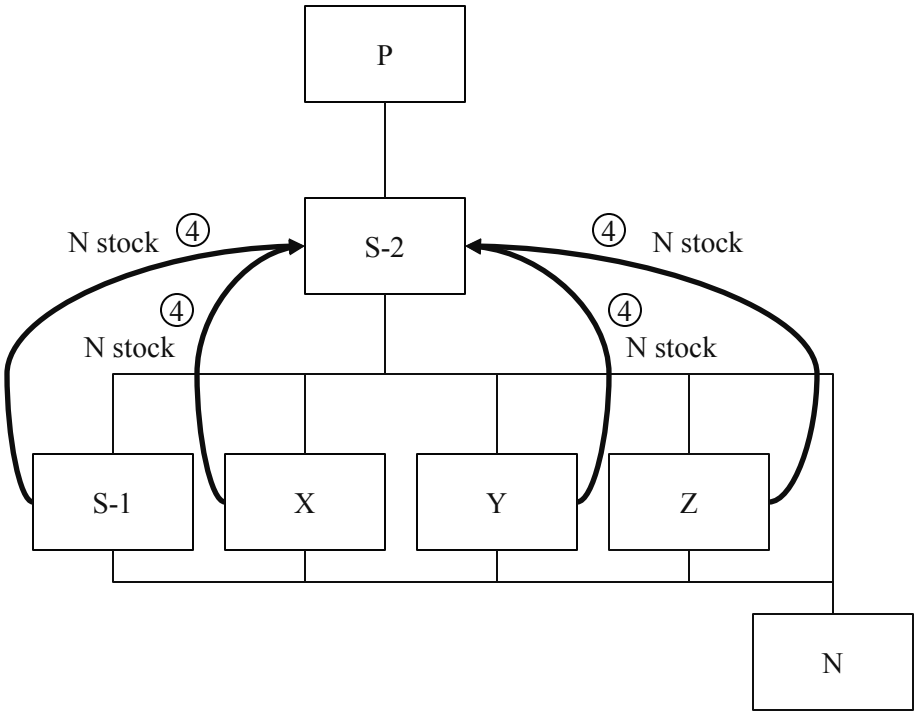
Rev. Rul. 2015-9 (cont'd)

Step 3: Transfer of S-1, X, Y, and Z Assets to N



- S-1, X, Y, and Z transfer substantially all of their assets to N in exchange for N common stock.
- N will continue to conduct the businesses conducted by S-1, X, Y, and Z.

Step 4: Liquidations of S-1, X, Y, and Z



- S-1, X, Y, and Z liquidate, distributing the N common stock received in Step 3 to S-2.

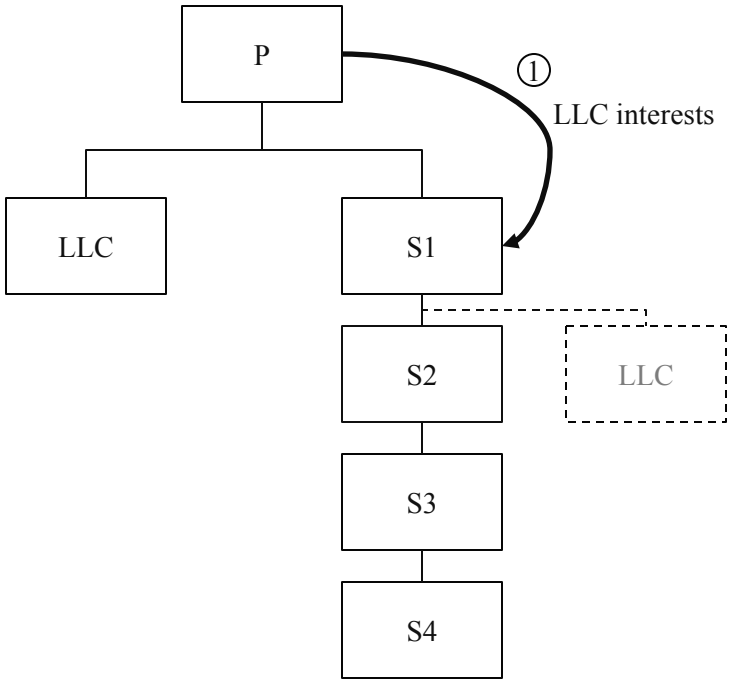
Rev. Rul. 2015-9 (cont'd)

Conclusions:

- P's transfer of its S-1 stock to S-2 is an exchange "governed by" section 351.
- The transfers by S-1, X, Y, and Z of substantially all of their assets to N followed by the liquidations of S-1, X, Y, and Z qualify as reorganizations under section 368(a)(1)(D).
- Rev. Rul. 78-130 is revoked.

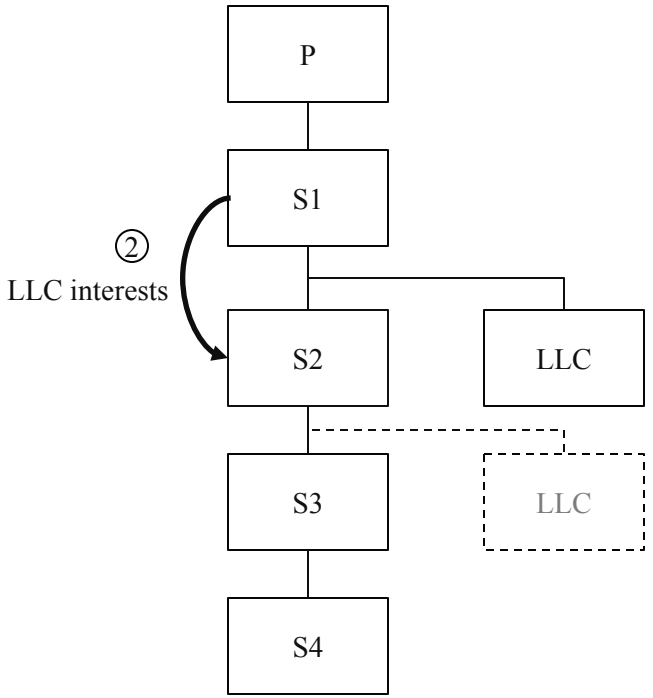
Rev. Rul. 2015-10

Step 1: P Transfer of LLC to S1



- LLC is a limited liability company that elected to be treated as a corporation for U.S. federal tax purposes.
- P transfers all of the LLC interests to S1 for additional voting common stock of S1.

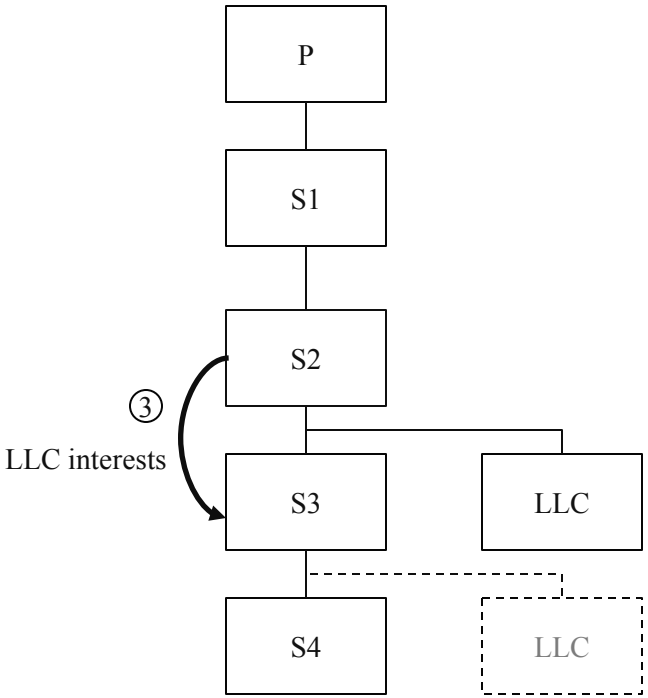
Step 2: S1 Transfer of LLC to S2



- S1 transfers all of the LLC interests to S2 for additional voting common stock of S2.

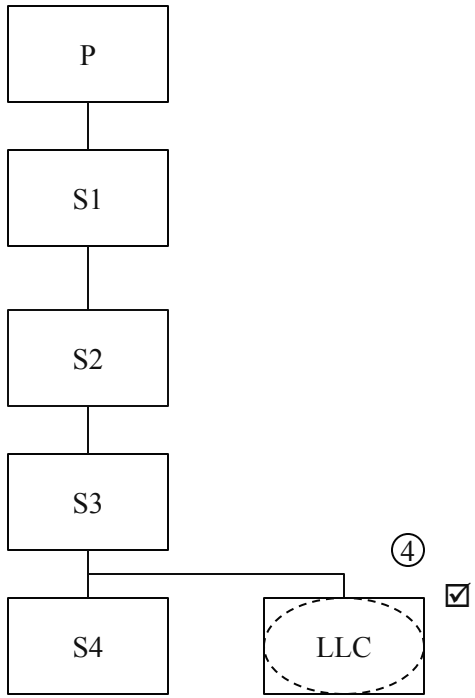
Rev. Rul. 2015-10 (cont'd)

Step 3: S2 Transfer of LLC to S3



- S2 transfers all of the LLC interests to S3 for additional voting common stock of S3.

Step 4: LLC Entity Classification Election



- LLC elects to be treated as a disregarded entity for U.S. federal tax purposes effective at least one day following Step 3.
- S3, through LLC as a branch, will continue the historical business of LLC.

Rev. Rul. 2015-10 (cont'd)

Analysis:

- A transfer of stock can be respected as a section 351 exchange even if it is followed by subsequent transfers of the property as part of an integrated plan. *See* Rev. Rul. 77-449; Rev. Rul. 83-34; Rev. Rul. 2003-51.

- A transfer of property in an exchange otherwise described in section 351 will not qualify as a section 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a whole. *See* Rev. Rul. 54-96; Rev. Rul. 70-140.

- P's transfer to S1 and S1's transfer to S2 satisfy the formal requirements of section 351, and the transaction as a whole does not require the transfers to be treated other than in accordance with their form.

- S2's transfer of LLC to S3 in a section 351 exchange followed by LLC's deemed liquidation is more properly characterized as a reorganization to the extent it so qualifies. *See* Rev. Rul. 67-274, Rev. Rul. 2004-83.

Rev. Rul. 2015-10 (cont'd)

Conclusions:

- P's transfer of the LLC interests to S1 for additional S1 stock is an exchange "governed by" section 351.
- S1's transfer of the LLC interests to S2 for additional S2 stock is an exchange "governed by" section 351.
- S2's transfer of the LLC interests to S3, together with the election by LLC to be treated as a disregarded entity for U.S. federal tax purposes, qualifies as a D reorganization.

Questions

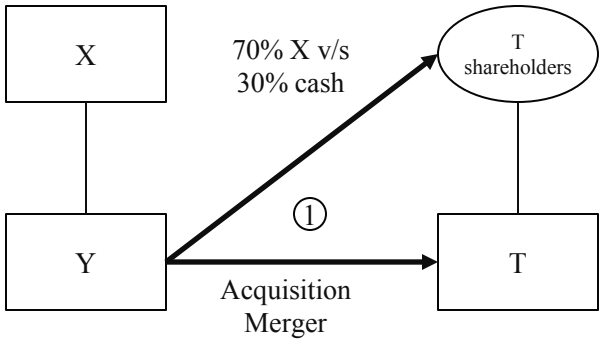
- Why was Rev. Rul. 78-130 revoked instead of obsoleted?
- Why do the rulings conclude that the stock drops are "governed by" section 351? Could they also be B reorganizations?
- The rulings factually provide that stock was issued by the transferee in each exchange. Would the result change if stock, in form, was not issued?
    - If the stock drop is a B reorganization, there may be basis implications in certain fact patterns. *See* Treas. Reg. section 1.358-2(a)(2)(viii).
- Why was S4 included in the facts of Rev. Rul. 2015-10?
- If the final step in Rev. Rul. 2015-10 had not qualified as a D reorganization, would it be characterized as a section 351 exchange followed by a section 332 liquidation?

Rev. Rul. 2015-10 and Check-the-Box

- The Service concluded that S2's transfer of the LLC interests to S3, followed by LLC's check-the-box ("CTB") election effective *no earlier than the following day*, qualifies as a D reorganization.
- Treas. Reg. section 301.7701-3(g)(3) provides that the deemed liquidation in a CTB election occurs "immediately before the close of the day before the election is effective."
- Does Rev. Rul. 2015-10 provide any guidance in a situation where the stock transfer preceding the CTB election also occurs at the end of the day before the CTB election is to be effective, as a result of either local law or drafting?
    - Practitioners sometimes recommend that the CTB election be effective no earlier than *two days* after the transfer to avoid this issue.

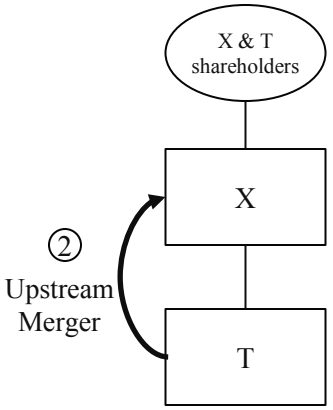
Rev. Rul. 2001-46, Situation 1

Step 1: X Acquires T via Reverse Subsidiary Merger



- Y merges into T in a transaction where the T shareholders receive a mix of 70% X voting stock and 30% cash (the Acquisition Merger).

Step 2: T Merges Upstream into X



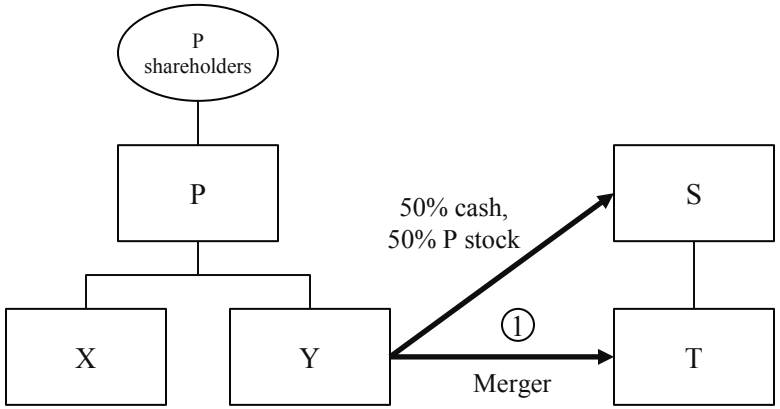
- As part of the same plan as the Acquisition Merger, T merges into X (the Upstream Merger).

Conclusions:

- The Acquisition Merger and the Upstream Merger are not treated as a stock acquisition that is a qualified stock purchase followed by a 332 liquidation. No section 338 election is permitted.
- The Acquisition Merger and the Upstream Merger are treated as an acquisition of T's assets through a single statutory merger of T into X that qualifies as an A reorganization.

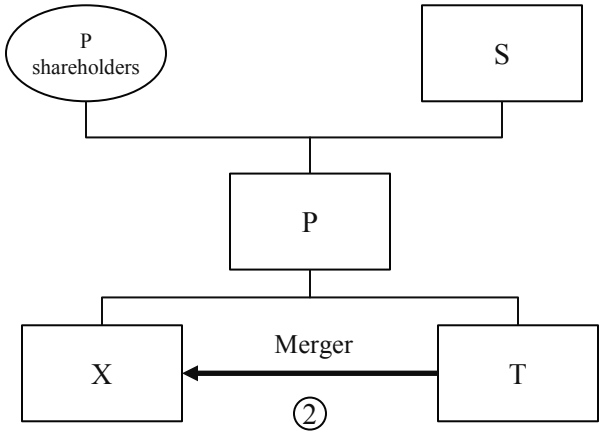
Treas. Reg. section 1.338(h)(10)-1(e), Ex. 13

Step 1: Y Merges into T



- P, X, Y, S, and T are all domestic corporations.
- Y merges into T in a transaction where S receives a mix of 50% cash and 50% P stock.

Step 2: T Merges into X

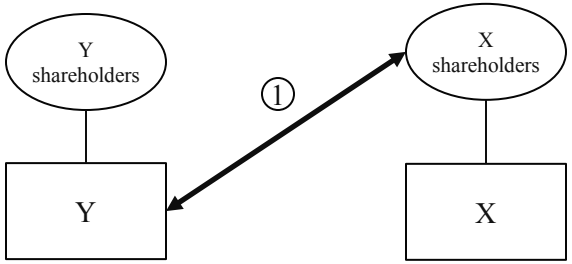


- T merges into X.
- Assumes Step 1 did not qualify for section 351 treatment.

- Absent application of the step transaction doctrine, Step 1 would be treated as a QSP (*see, e.g.*, Rev. Rul. 90-95) and Step 2 would be treated as a D reorganization.
- The regulation states that "absent the application of [Treas. Reg. section 1.338(h)(10)-1(c)(2)], the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into X as an acquisition by X of T's assets in a reorganization described in section 368(a)."
- Following the revocation of Rev. Rul. 78-130, is Step 1 a taxable exchange and Step 2 a D reorganization?
- Are Rev. Ruls. 2015-9 and 2015-10 limited to multi-step transactions where the first step is a section 351 exchange? A non-recognition transaction?

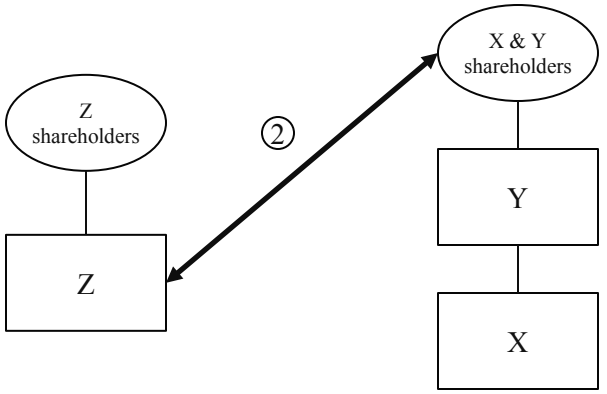
Rev. Rul. 73-16

Step 1: Y Acquires X



- Y acquires all of the X stock solely for Y voting stock.

Step 2: Z Acquires Y



- Z acquires all of the Y stock solely for Z voting stock.

Conclusions:

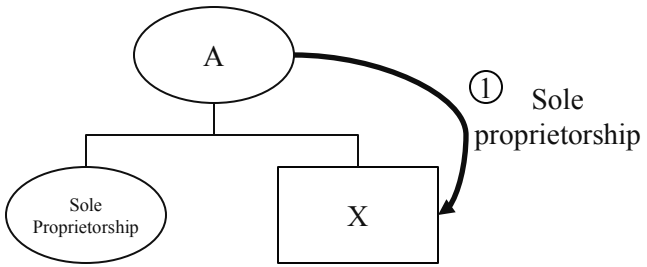
- Z's acquisition of the Y stock in Step 2 is a B reorganization.
- The receipt and surrender of Y stock by X shareholders is disregarded. Y is treated as acquiring all of the X stock for Z stock in a triangular B reorganization.

Question

- What, if any, is the impact of Rev. Ruls. 2015-9 and 2015-10 on Rev. Rul. 73-16?

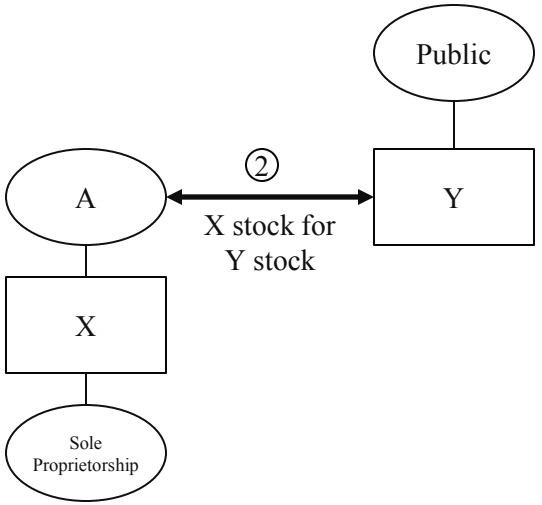
Rev. Rul. 70-140

Step 1: A Contributes Assets to X



- A transfers the sole proprietorship to X in exchange for additional shares of X stock.

Step 2: A Transfers X to Y



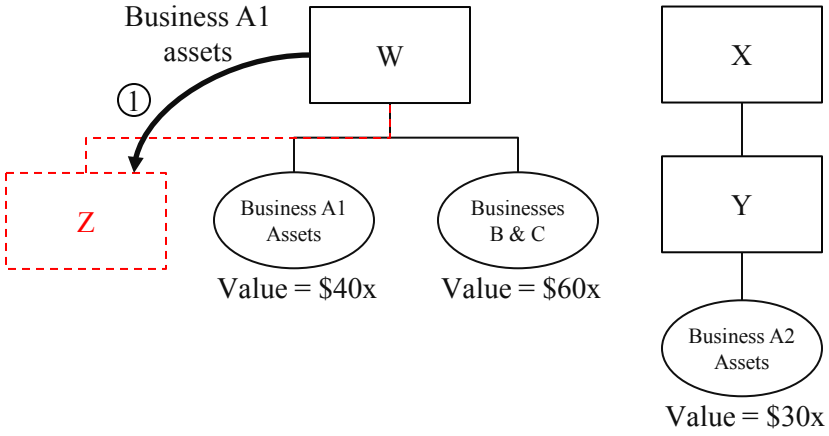
- As part of a plan as Step 1, A transfers all of his X stock to Y solely in exchange for voting common stock of Y, which is widely held.

Conclusions:

- The receipt by A of additional X stock in Step 1 is transitory and without substance.
- A is treated as directly transferring the sole proprietorship assets and the X stock to Y in exchange for Y stock. The transfer of sole proprietorship assets is a taxable exchange. The transfer of the X stock to Y solely for Y stock is a B reorganization.

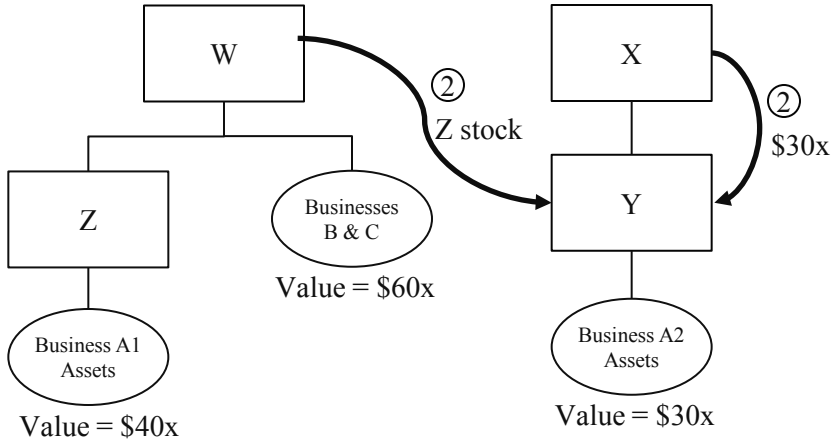
Rev. Rul. 2003-51

Step 1



- W forms Z and transfers all of its Business A1 assets to Z in exchange for all of the stock of Z.

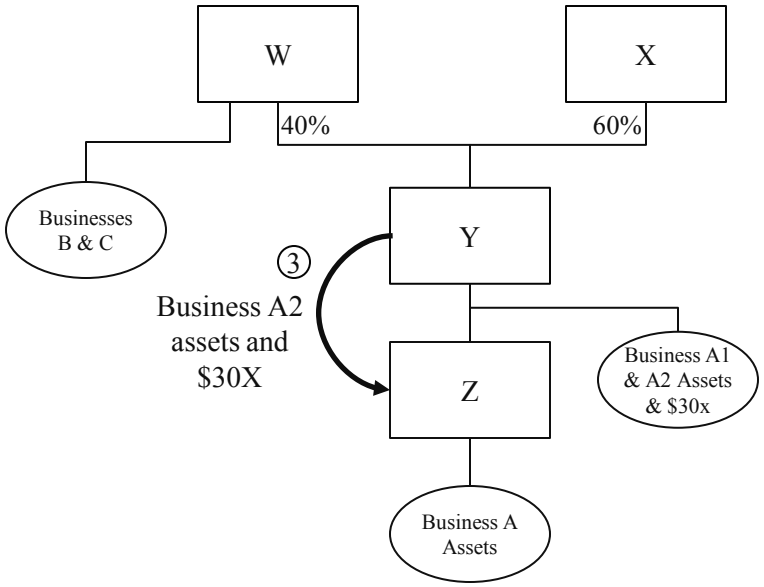
Step 2



- W transfers all of the Z stock to Y in exchange for Y stock.
- X simultaneously contributes $30x of cash to Y.
- Immediately after this Step 2, W owns 40% of the Y stock and X owns 60% of the Y stock.

Rev. Rul. 2003-51 (cont'd)

Step 3



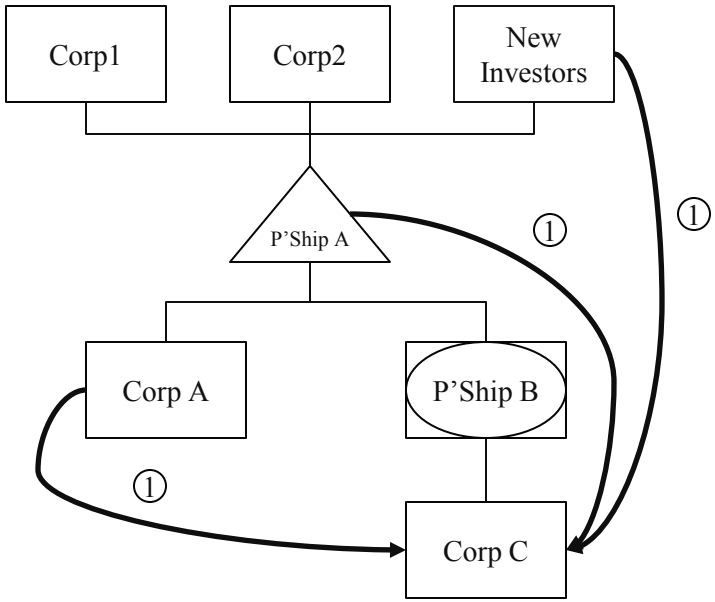
- Y contributes its Business A2 assets and $30X to Z.
- Step 1-3 are all executed pursuant to a binding commitment.

Conclusions:

- The Step 1 transfer of Business A1 assets from W to Z qualifies as a section 351 exchange even though, as part of the same binding commitment, W transfers the Z stock to Y simultaneously with a transfer of assets by X to Y, immediately after which W and X are in control of Y.

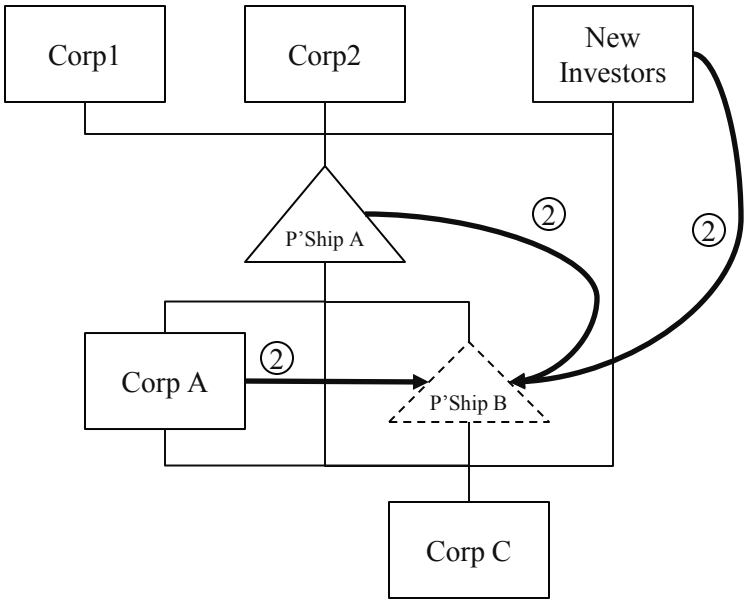
PLR 201506008

Step 1: Contribution of Assets to Corp C



- Partnership A, Corp A, and New Investors transfer assets to Corp C solely in exchange for Corp C stock.
- The taxpayer represented that Step 1 qualified for section 351 treatment.

Step 2: Contribution of Corp C Stock to P'Ship B

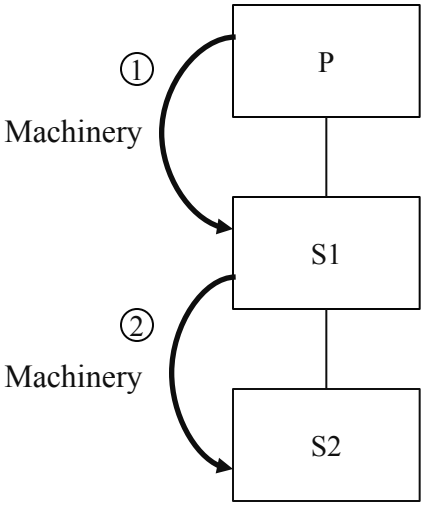


- Pursuant to a pre-existing binding plan, New Investors, Corp A, and Partnership A transfer the Corp C stock received in Step 1 to Partnership B solely in exchange for Partnership B interests.
- The taxpayer represented that Step 2 qualified for section 721 treatment.

Rulings:

- Step 1 qualifies for tax-free treatment under section 351.
- Step 2 did not prevent Step 1 from satisfying the requirements of section 351.

Rev. Rul. 77-449



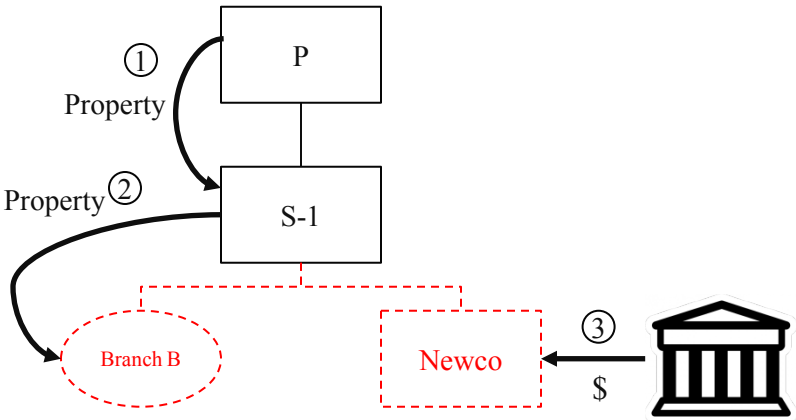
- P, S1, and S2 are U.S. corporations.
- P transfers machinery to S1 for additional shares of S1 stock, and S1 transfers the machinery to S2 solely for additional shares of S2 stock.
- S2 retains the machinery for use in its trade or business.

Conclusions:

- Each transfer is treated as a separate section 351 exchange. *See also* Rev. Ruls. 83-34, 83-156.

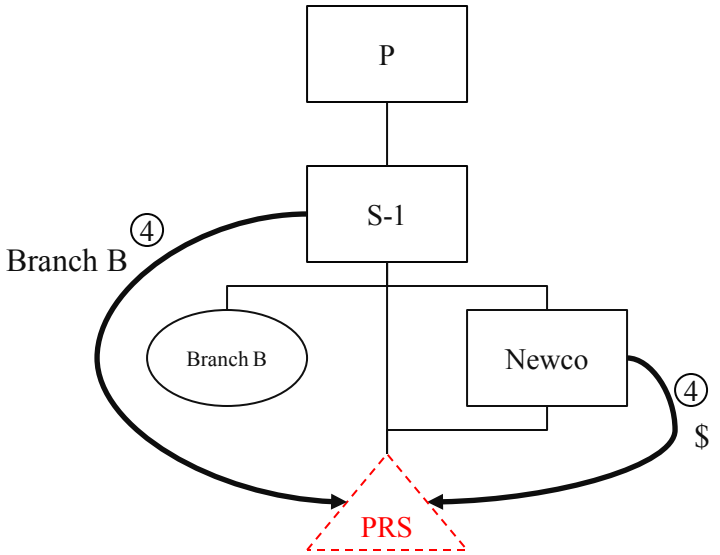
Rev. Rul. 83-156

Steps 1-3



1. P transfers certain property to S-1.
2. S-1 sets up Branch B to use the assets in a business operation.
3. S-1 incorporates Newco, which borrows operating funds from a bank.

Step 4

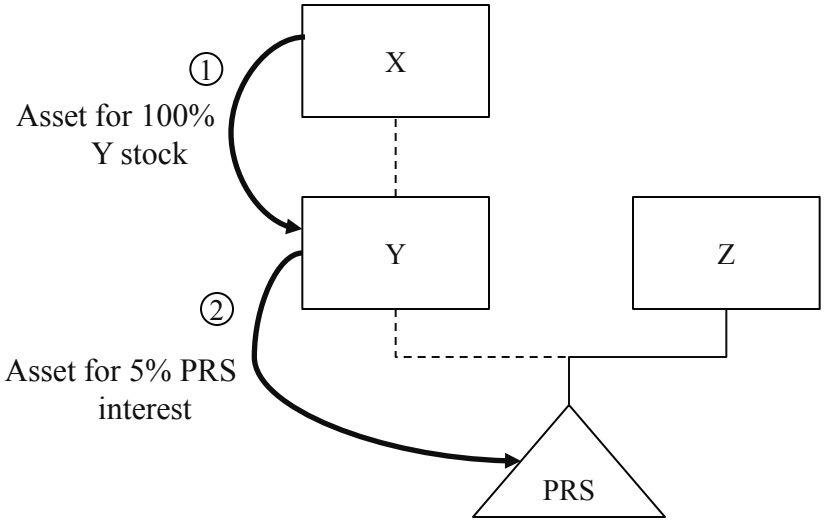


- S-1 and Newco form PRS. Newco contributes cash borrowed in Step 3 to PRS and S-1 contributes Branch B to PRS.

Conclusions:

- The transfer of certain property from P to S-1 in Step 1 is treated as a section 351 exchange.
- The transfer of cash and Branch B from Newco and S-1, respectively, to PRS in Step 4 is treated as a section 721 exchange.
- Amplifies Rev. Rul. 77-449.

Extension of Rev. Rul. 83-156?

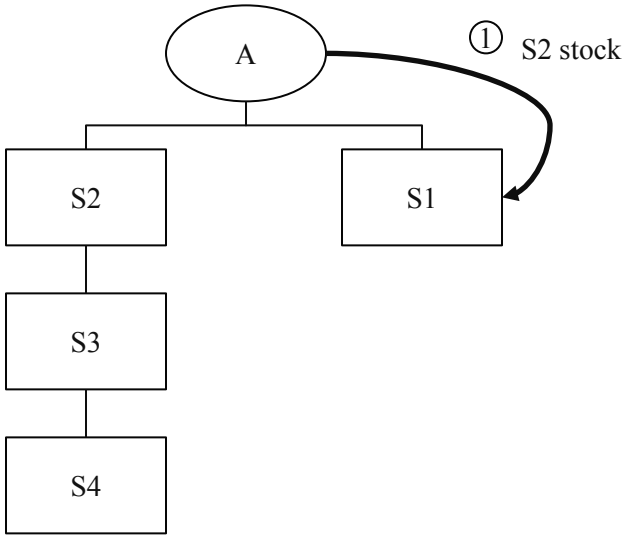


1. X transfers an asset to Y for all of the Y stock.
2. Y transfers the asset to PRS for a 5% PRS interest. The other 95% PRS interest is held by an unrelated party.

- Is X's transfer of the asset to Y a section 351 exchange?
- Does it matter whether Y "controls" PRS?

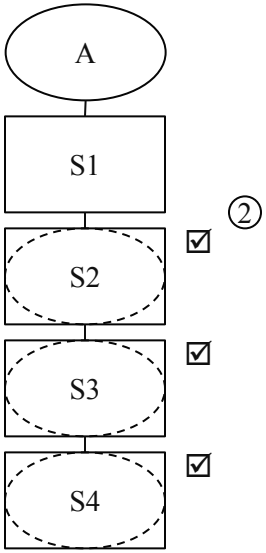
Resorts International Example

Step 1: Contribution of S2 Stock



- A contributes all of its S2 stock to S1.

Step 2: Check-the-Box Elections

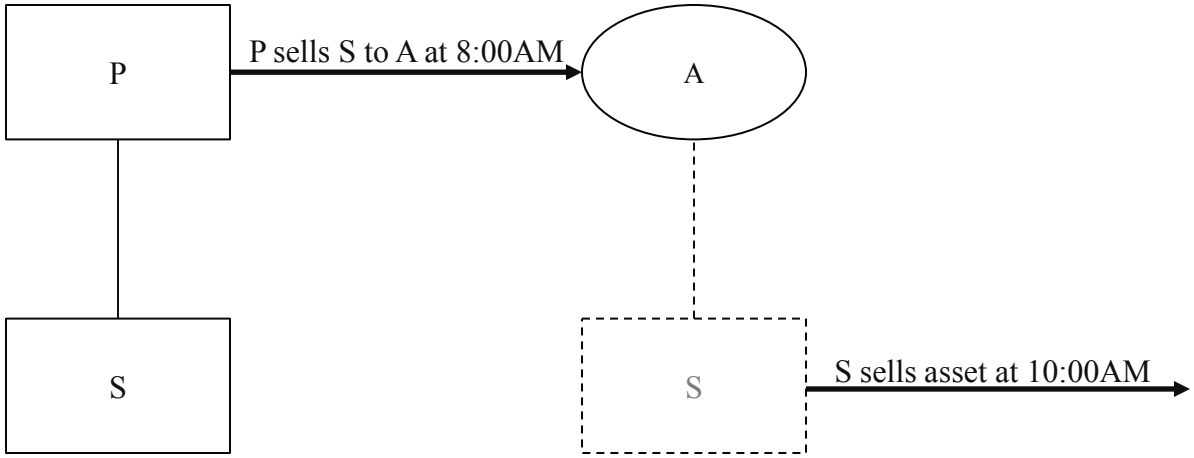


- S2, S3, and S4 elect to be disregarded entities.

- Under *Resorts International,* the transaction would be treated as cross-chain reorganizations of S2, S3, and S4. Is that still the appropriate result? *Compare* PLR 201406005.

NEXT DAY RULE & AGENT FOR THE GROUP REGULATIONS

Next Day Rule



- Suppose S sells an asset at 10:00 a.m. resulting in a significant taxable gain.
- Treas. Reg. section 1.1502-76(b)(1)(ii)(B): "If on the day of S's change in status as a member, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, S and all persons related to S under section 267(b) immediately after the event must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event will be respected if it is reasonable and consistently applied by all affected persons."

Next Day Rule—Reg. 1.1502-76(b)(1)(ii)(B)

- The factors to be considered include:
  - Whether income, gain, deduction, loss, and credit are allocated inconsistently;
  - If the item is from a transaction with respect to S stock, whether it reflects ownership of the stock before or after the event;
  - Whether the allocation is inconsistent with other requirements under the Code; and
  - Whether other facts exist, such as a prearranged transaction or multiple changes of S's status.

Next Day Rule—GLAM 2012-010

- Stand-alone corporation T was acquired by a consolidated group.
- T incurred the following costs:
  - Amounts paid to employees for and in cancellation of nonqualified stock options and stock appreciation rights (SARs) in the event of a change in control;
  - Fees paid to financial advisory and investment banking firms to provide consulting services for T in connection with the acquisition and contingent upon the successful closing of the acquisition; and
  - Retirement of T bonds at a premium after the acquisition closed.

Next Day Rule—GLAM 2012-010 (cont'd)

- The Service concluded that:
  - The Next Day Rule does not permit the expenses associated with the stock options, the SARs, and the success-based consulting fees to be allocated to the period after the acquisition.
    - This conclusion was based on the view that these items are not from a transaction with respect to T stock; rather, they are items from transactions that precede the acquisition and involve the performance of services for T by employees and consultants.
  - Application of the Next Day Rule may be appropriate for the retirement of T's bonds at a premium.
    - This conclusion was based on the view that the retirement relates to a decision made by T after the closing. The facts provide that in contemplation of the acquisition, A and T agree that T will give the bondholders the opportunity to tender their bonds at a premium by a date before the acquisition date. However, T is not obligated to purchase any of the tendered bonds and does so only after the acquisition.

Proposed Reg. 1.1502-76 - Next Day Rule

- Proposed Next Day Rule:
  - If an extraordinary item results from a transaction that occurs on the day of S's change in status, but after the events resulting in the change, and that item would be taken into account by S 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 S must report the item.
  - The next day rule does not apply to any extraordinary item that becomes includible or deductible simultaneously with the event that causes the change in S's status.

Proposed Reg. 1.1502-76 - Previous Day Rule

- Previous Day Rule:
  - The proposed regulations add a Previous Day Rule that mirrors the principles of the Proposed Next Day Rule.
  - The Previous Day Rule requires extraordinary items resulting from the transaction that occur on the termination date (but before or simultaneously with the event causing S's status as an S corporation to terminate) to be allocated to S's tax return for the short period that ends on the previous day.

Proposed Regulations—Scope and Coordination

- Scope
  - The Current Next Day Rule applies for all U.S. federal income tax purposes.
  - The Proposed Next Day Rule and Previous Day Rule generally apply for purposes of determining the period in which S must report the item.

- Section 382(h) Coordination
  - If the day of S's change in status is also the date of an ownership change for purposes of section 382, the rules and principles of this section apply in determining the treatment of any item or asset for purposes of section 382(h).

- Section 1374 Coordination
  - If a member ceases to be an S corporation upon becoming a member of a consolidated group, or if a departing member elects to be an S corporation after ceasing to be a member, the member's recognized built-in gain or loss for purposes of section 1374 will include only the amounts reported on the member's separate return (including items reported on that return under the Previous Day Rule or the Next Day Rule).

Proposed Regulations—Partial Redemption and Anti-Abuse Rule

- Partial Redemption – Prop. Reg. 1.1502-76(b)(5), Example 9(c)
  - P owns 80 shares of S stock and individual X owns 20 shares of S stock. S transfers appreciated property in redemption of 20 shares of S stock held by P, such that after the redemption P owns 75% of S.
  - The End of Day rule does not apply for purposes of determining whether P and S are members of the same consolidated group immediately after the redemption. Because P owns only 75% of S's stock immediately after the redemption, the distribution is not an intercompany distribution described in Reg. 1.1502-13(f)(2)(i).
  - S's gain under section 311(b) must be reported under the End of Day Rule in S's taxable year during which S was a member of the P group.

- Anti-Abuse Rule
  - If any person acts with a principal purpose contrary to this paragraph to substantially reduce the federal income tax liability of any person (including by modifying an existing contract or other agreement in anticipation of change in S's status to shift an item between the taxable years that end and begin as a result of S's change in status) adjustments must be made as necessary to carry out the purposes of this section.

Treas. Reg. Section 1.1502-77

- Effective April 1, 2015 the Service released final "agent for the group" regulations.
- "[O]ne entity (the agent) is the sole agent that is authorized to act in its own name regarding all matters relating to the federal income tax liability for the consolidated return year for each member of the group and any successor or transferee of a member (and any subsequent successors and transferees thereof)."
- The regulations are largely consistent with proposed regulations issued in 2012.
- The Service also released Rev. Proc. 2015-26 containing procedural rules for identifying and designating an agent for the group under the final regulations.

Treas. Reg. Section 1.1502-77 (cont'd)

- Under Treas. Reg. section 1.1502-77:
  - If there is a default successor to the current agent (e.g., by merger), it automatically takes over for the old agent.
  - The common parent of a group can continue as the agent if it elects to be disregarded.
  - An agent can resign and designate a new agent for the group.
  - The IRS can designate an agent for the group if:
    - The current agent goes out of existence, there is no default successor, and the agent does not designate a successor;
    - The current agent or successor does not respond to notices from the IRS;
    - The current agent leaves the consolidated group;
    - The IRS receives a written request from a group member;
    - The current agent fails to perform its obligations; or
    - The current agent becomes a foreign entity.