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Current Developments in Corporate Tax

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Final Regulations on Post-Reorganization Transfers – COBE and Treas. Reg. § 1.368-2(k)

Post-Reorganization Transfers

- Treasury and the IRS issued final regulations concerning transfers of assets and stock following a reorganization on October 24, 2007 (the “2007 Final Regulations”).
- The 2007 Final Regulations concern the satisfaction of the continuity of business enterprise (“COBE”) requirement, as well as the application of Treas. Reg. § 1.368-2(k).
- The 2007 Final Regulations modified the approach set forth in proposed regulations published by Treasury and the IRS on August 18, 2004 (the “2004 Proposed Regulations”).
  - Note that the 2004 Proposed Regulations had replaced a prior set of proposed regulations issued on March 2, 2004.
  - Prior to the 2007 Final Regulations, taxpayers could generally rely upon final regulations issued in 1998 (the “1998 Final Regulations”) and additional IRS guidance to determine whether a transaction satisfied the COBE requirement and Treas. Reg. § 1.368-2(k).
  - The 2007 Final Regulations generally apply to transactions occurring on or after October 25, 2007.
- On May 8, 2008, Treasury and the IRS (re)issued final regulations under Treas. Reg. § 1.368-2(k) that clarified the application of the rules contained in the 2007 Final Regulations (the “2008 Final Regulations”).
  - The 2008 Final Regulations apply to transactions occurring on or after May 9, 2008, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding before May 9, 2008, and at all times after that.

COBE Requirement

- To qualify for tax-free treatment, a reorganization must satisfy the COBE requirement.
- The COBE requirement generally provides that the issuing corporation must either continue the target corporation's business or use a significant portion of the target's historic business assets in a business. *See* Treas. Reg. § 1.368-1(d)(1).
  - The term "issuing corporation" refers to the acquiring corporation except that, in a triangular reorganization, the issuing corporation refers to the corporation in control of the acquiring corporation. *See* Treas. Reg. § 1.368-1(b).
- For purposes of the COBE requirement, the issuing corporation is treated as holding all of the businesses and assets of all of the members of the "qualified group." *See* Treas. Reg. § 1.368-1(d)(4)(i).

COBE Requirement – "Qualified Group"

- Under the 1998 Final Regulations, the definition of "qualified group" was limited to one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock constituting section 368(c) control in at least one other corporation, and one of the corporations owns stock constituting section 368(c) control over each of the other corporations (not including the issuing corporation).
- The 2004 Proposed Regulations would not have amended the definition of qualified group.

COBE Requirement – “Qualified Group”

- The 2007 Final Regulations expand the definition of “qualified group” in Treas. Reg. § 1.368-1(d).
- Under the 2007 Final Regulations, qualified group members aggregate their stock ownership of a corporation in determining whether they own the requisite section 368(c) control, provided that the issuing corporation owns directly stock constituting section 368(c) control in at least one other corporation.
  - The 2007 Final Regulations do not change the requirement that section 368(c) control be established (rather than section 1504(a) control).
  - Section 368(c) control refers to 80 percent of the total combined voting power of voting stock and 80 percent of the number of shares of each other class of stock.
  - Section 1504(a) control refers to 80 percent of total voting power and total value of stock.

Treas. Reg. § 1.368-2(k) – Remote Continuity

- In 1998, Treasury and the IRS included Treas. Reg. § 1.368-2(k) as part of final regulations addressing continuity of interest ("COI") and COBE.
- Treas. Reg. § 1.368-2(k) provided guidance as to when a post-reorganization transfer would be given independent significance and when the step transaction doctrine would apply. The final regulations clarified that reorganizations must be analyzed under all relevant provisions of law, including the step transaction doctrine unless -2(k) applies (safe harbor).
- Treas. Reg. § 1.368-2(k) provided that an "A", "B", "C", "G" or "(a)(2)(E)" reorganization otherwise qualifying as a tax-free reorganization would not be disqualified by reason of the fact that the acquired assets or stock are transferred (or successively transferred) to one or more controlled corporations after the reorganization.
  - The IRS concluded that Treas. Reg. § 1.368-2(k) applies to a forward triangular merger and a "D" reorganization in Rev. Rul. 2001-24 and Rev. Rul. 2002-85, respectively.
- A transaction not described in Treas. Reg. § 1.368-2(k) must be analyzed under the step transaction doctrine to determine whether it qualifies as a tax-free reorganization.

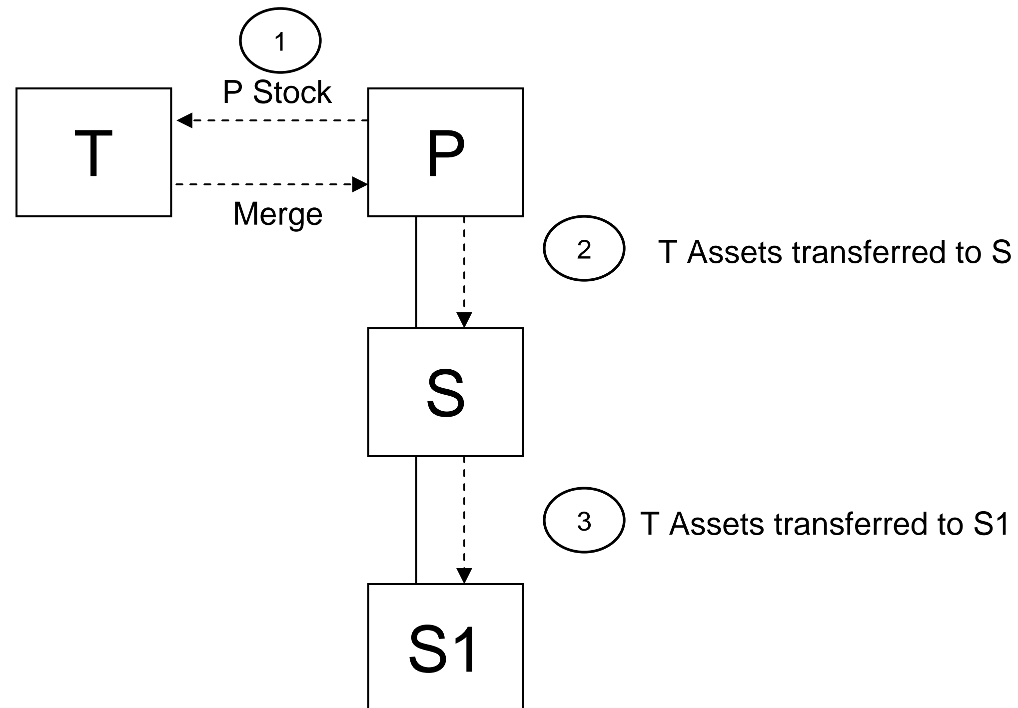
Treas. Reg. § 1.368-2(k) – Remote Continuity

- The 2004 Proposed Regulations would have modified Treas. Reg. § 1.368-2(k) in the following manner --
  - Treas. Reg. § 1.368-2(k) would apply to all reorganizations, rather than only an "A", "B", "C","G" or (a)(2)(E) reorganization.
  - (All or part of) the assets or stock of any party to the reorganization (except stock of the issuing corporation) can be transferred, rather than only the acquired assets or stock.
  - Transfers must be made to a member of the qualified group (or a partnership the business of which is treated as conducted by a member of the qualified group).
    - Note, however, that a transfer of stock to a partnership would not satisfy the COBE requirement.
  - Transfers that are distributions can be made so long as no transferee receives <u>substantially all</u> of the assets or receives acquired stock constituting control.
- The 2004 Proposed Regulations also would have clarified that the distribution or transfer must satisfy the COBE requirement.

Treas. Reg. § 1.368-2(k) – Remote Continuity

- The 2007 Final Regulations further modify the scope of Treas. Reg. § 1.368-2(k), including as follows –
  - For distributions:
    - Assets of the acquired, acquiring, or surviving corporation can be distributed, provided that the distribution does not result in a liquidation of the distributing corporation (disregarding assets held prior to the reorganization).
    - Stock of the acquired corporation can be distributed, as long as (i) less than all of the acquired stock is distributed and (ii) the distribution does not cause the acquired corporation to leave the qualified group.
  - For other transfers:
    - (All or part of) the assets or stock of the acquired, acquiring, or surviving corporation, as the case may be, can be transferred, provided that such corporation does not terminate its corporate existence in connection with the transfer.
      - In the case of a stock transfer, the acquired, acquiring, or surviving corporation cannot leave the qualified group.
- For either "distributions" or "other transfers", the COBE requirement must be satisfied under the 2007 Final Regulations.

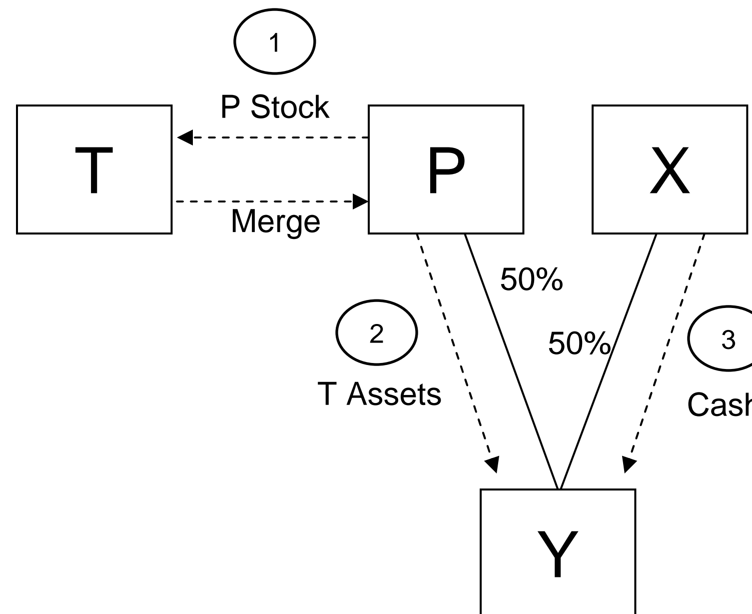
Asset Transfers to Corporations – Example 1
In General



Facts: T merges into P and T shareholders exchange their T stock for P stock. P transfers the T assets to S, which immediately transfers them to S1.

Result: Transaction satisfies the COBE requirement and Treas. Reg. § 1.368-2(k). The same result would obtain under the 1998 Final Regulations.

Asset Transfers to Corporations – Example 2 Non-Controlled Corporations

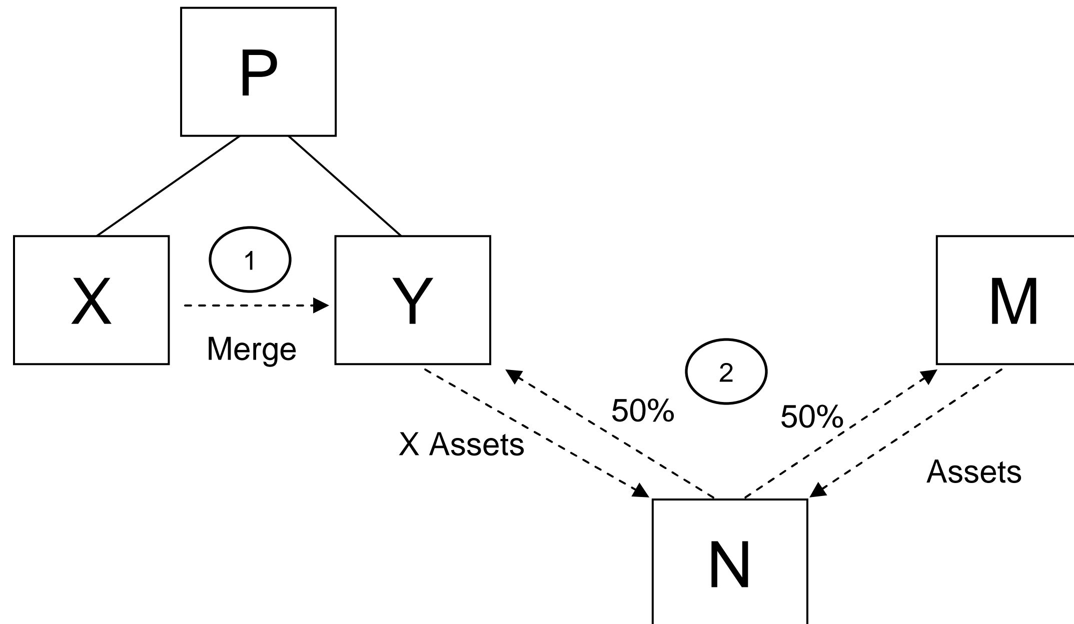


Facts: T merges into P, and T shareholders exchange their T stock for P stock. P transfers the T assets to Y in exchange for 50% of the stock of Y, and unrelated X transfers cash to Y in exchange for 50% of the stock of Y.

Result: The transaction does not satisfy the COBE requirement under the 2008 Final Regulations because Y is not a member of P's qualified group. The same result would obtain under the 1998 Final Regulations.

Treas. Reg. § 1.368-2(k) is not satisfied because COBE is not satisfied.

Asset Transfers to Corporations – Example 3
Non-Controlled Corporations

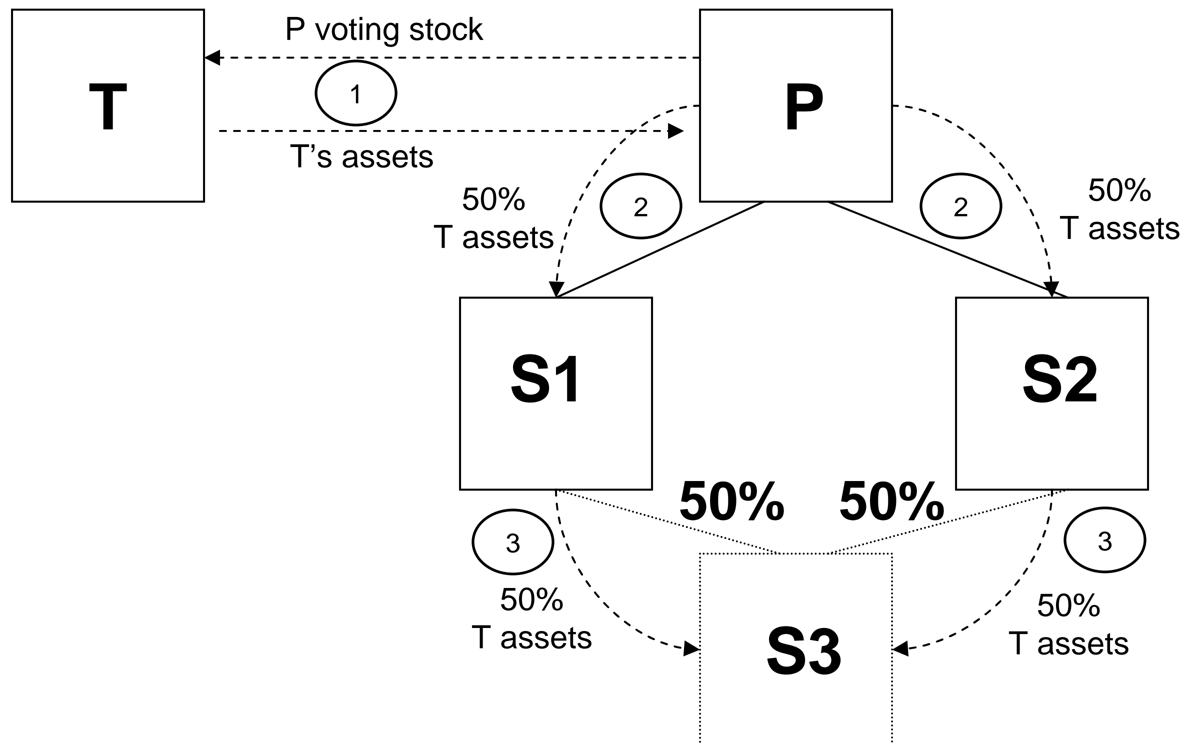


Facts: P owns all of the stock of X and Y. X merges into Y. Y transfers the X assets to newly formed N in exchange for 50% of the stock of N, and unrelated M transfers assets to N in exchange for 50% of the stock of N.

Result: COBE not met, but if P, X, and Y file a consolidated return, the X to Y transfer and the Y to N transfer may nonetheless qualify as Sec. 351 exchanges.

Treas. Reg. § 1.368-2(k) is not satisfied because COBE is not satisfied.

Asset Transfers to Corporations – Example 4
Diamond Structure

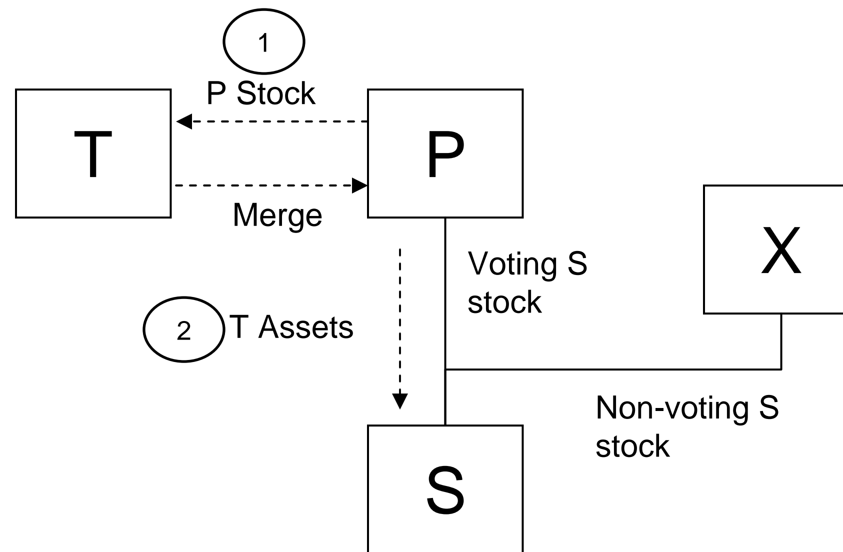


Facts: P owns more than 80 percent of the stock of S1 and S2. T transfers its assets to P in tax-free reorganization qualifying under section 368(a)(1)(C) ("C" reorganization). Immediately after the reorganization, P contributes 50 percent of the T assets to S1 and 50 percent of the T assets to S2. S1 and S2 form S3, and S1 and S2 each contribute to S3 their respective 50 percent of T assets in exchange for 50 percent of the S3 stock.

Result: Under the 2008 Final Regulations, the transaction would satisfy the COBE requirement because P has control over at least one member of the qualified group (S1 or S2) and S3 is controlled by one or more members of the qualified group (both S1 and S2). COBE would not have been satisfied under the 1998 Final Regulations and 2004 Proposed Regulations since S-3 was not controlled by a single member of the qualified group. Note, however, that if S-3 were a partnership, COBE would have been satisfied under the 1998 Final Regulations and the 2004 Proposed Regulations.

The transaction satisfiies Treas. Reg. § 1.368-2(k) because COBE is satisfied and P, as the acquiring corporation, transfers all or part of its assets and does not terminate its corporate existence in connection with the transfer.

Asset Transfers to Corporations – Example 5
Section 368(c) Control

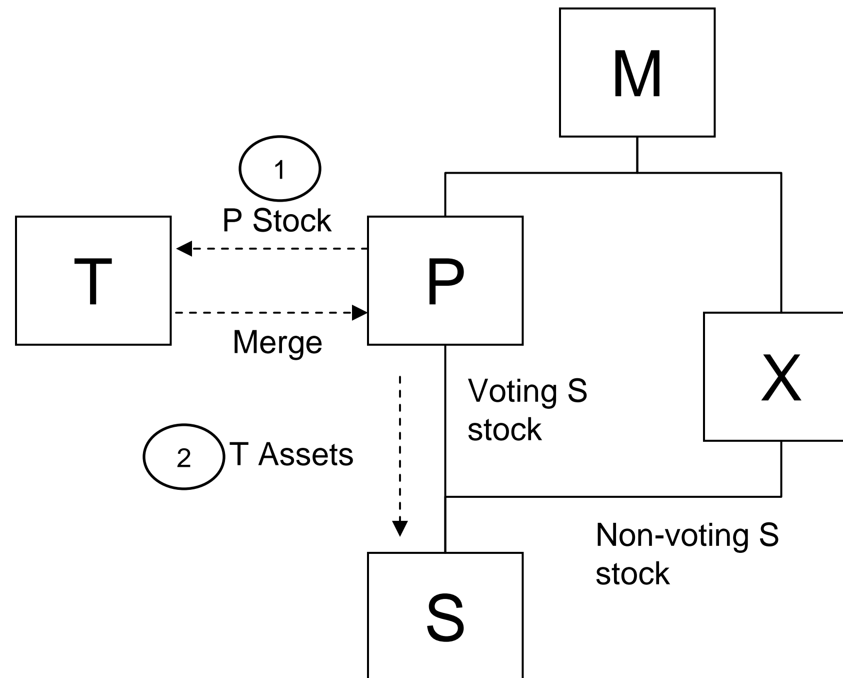


Facts: P owns all of the S voting stock. X, an unrelated entity, owns all of the non-voting S stock. P possesses S stock constituting section 1504(a) control, but not section 368(c) control. P transfers the T assets to S pursuant to the plan of reorganization.

Result: Transaction does not satisfy COBE because COBE requires section 368(c) control.

Transaction does not satisfy Treas. Reg. § 1.368-2(k) because COBE is not satisfied.

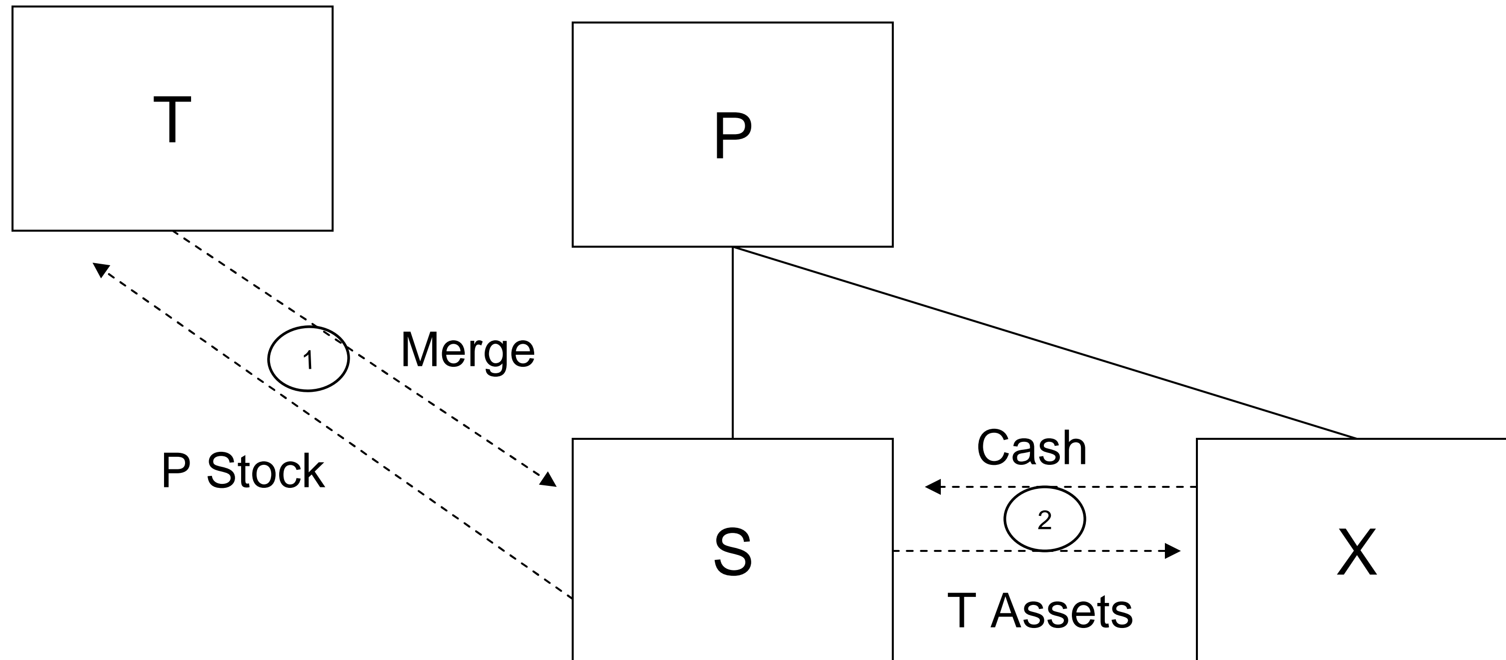
Asset Transfers to Corporations – Example 6
Section 368(c) Control



Facts: M owns all of the stock of P and X. P owns all of the S voting stock. X owns all non-voting S stock. P possesses S stock constituting section 1504(a) control, but not section 368(c) control. P transfers the T assets to S pursuant to the plan of reorganization.

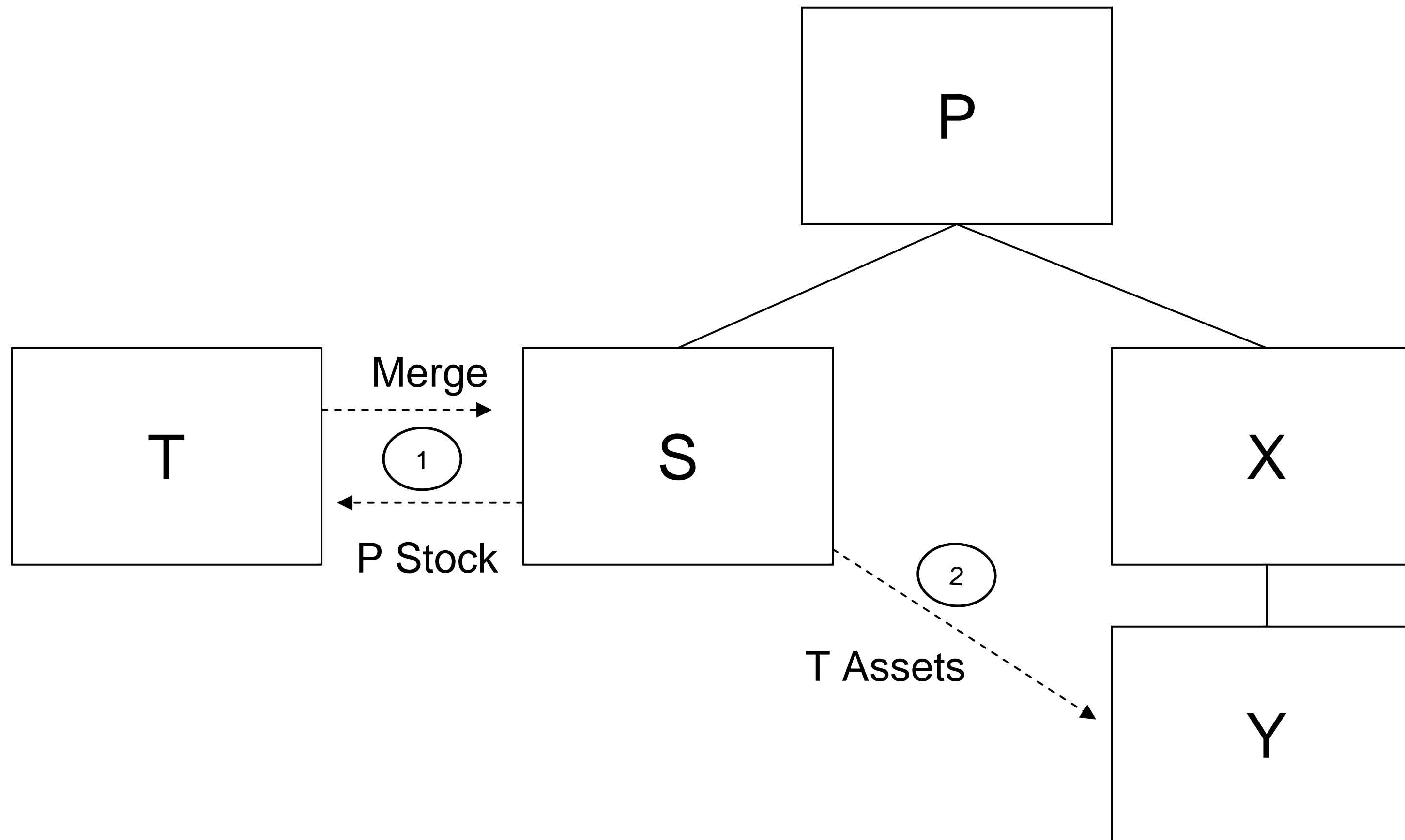
Result: Transaction does not satisfy COBE and Treas. Reg. § 1.368-2(k).

Cross-Chain Transfers – Example 1



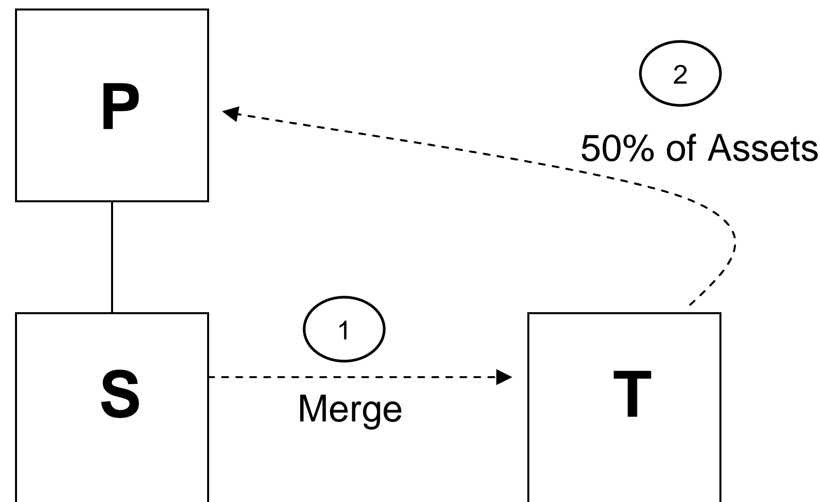
Facts: P owns 100% of the stock of S. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to X in exchange for cash.

Cross-Chain Transfers – Example 2
COBE vs. Step Transaction



Facts: P owns 100% of the stock of S and X. X owns 100% of the stock of Y. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to Y.

Distributions To Corporations – Example 1
Asset Distribution



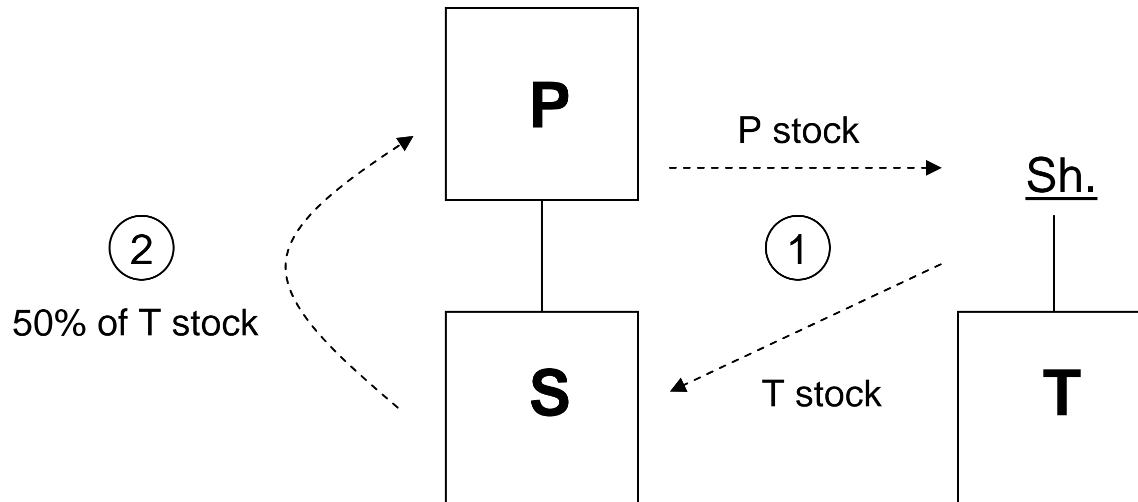
Facts: P owns 100 percent of S. S merges into T in a reverse triangular merger qualifying under section 368. Immediately after the merger of S into T, T distributes 50% of its assets to P.

Result: COBE is satisfied. Under Treas. Reg. § 1.368-2(k), the reorganization is not disqualified by the transfer of 50% of T's assets because T would not be treated as liquidated for Federal income tax purposes, and the distribution is not made to former shareholders of the surviving corporation, T, in exchange for proprietary interests in T.

Alternative 1: Same facts as above, except T distributes 90% of its assets to P.

Alternative 2: Same facts as above, except T liquidates into P. *See* Rev. Rul. 67-274 (testing acquisition of target stock followed by a liquidation of target as a "C" reorganization (and not "B")).

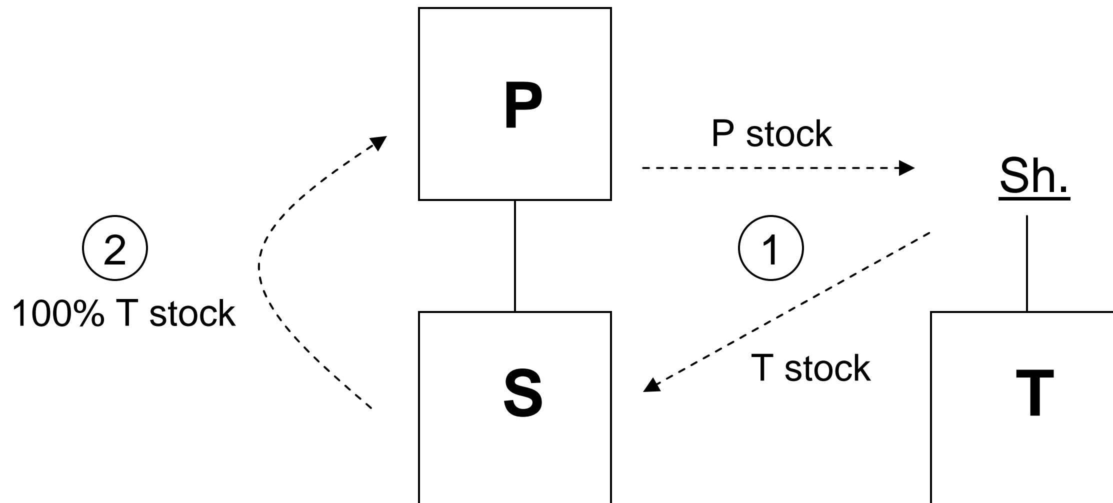
Distributions to Corporations – Example 2
Stock Distribution



Facts: P owns 100 percent of S. In a triangular "B" reorganization, T shareholders transfer T stock to S in exchange for P stock. Pursuant to the plan of reorganization, S distributes 50% of the T stock to P.

Result: COBE is satisfied. Under Treas. Reg. § 1.368-2(k), the step transaction doctrine does not apply because all of the T stock was not transferred, T remains in P's qualified group, and the distribution was not made to former shareholders of the acquired corporation in exchange for proprietary interests in the acquired corporation.

Distributions to Corporations – Example 3 Stock Distribution



Facts: P owns 100 percent of S. In a triangular "B" reorganization, T shareholders transfer T stock to S in exchange for P stock. Pursuant to the plan of reorganization, S distributes all of the T stock to P.

Result: COBE is satisfied. Treas. Reg. § 1.368-2(k) is not satisfied because all of the T stock is transferred to T. What is the result under the step transaction doctrine?

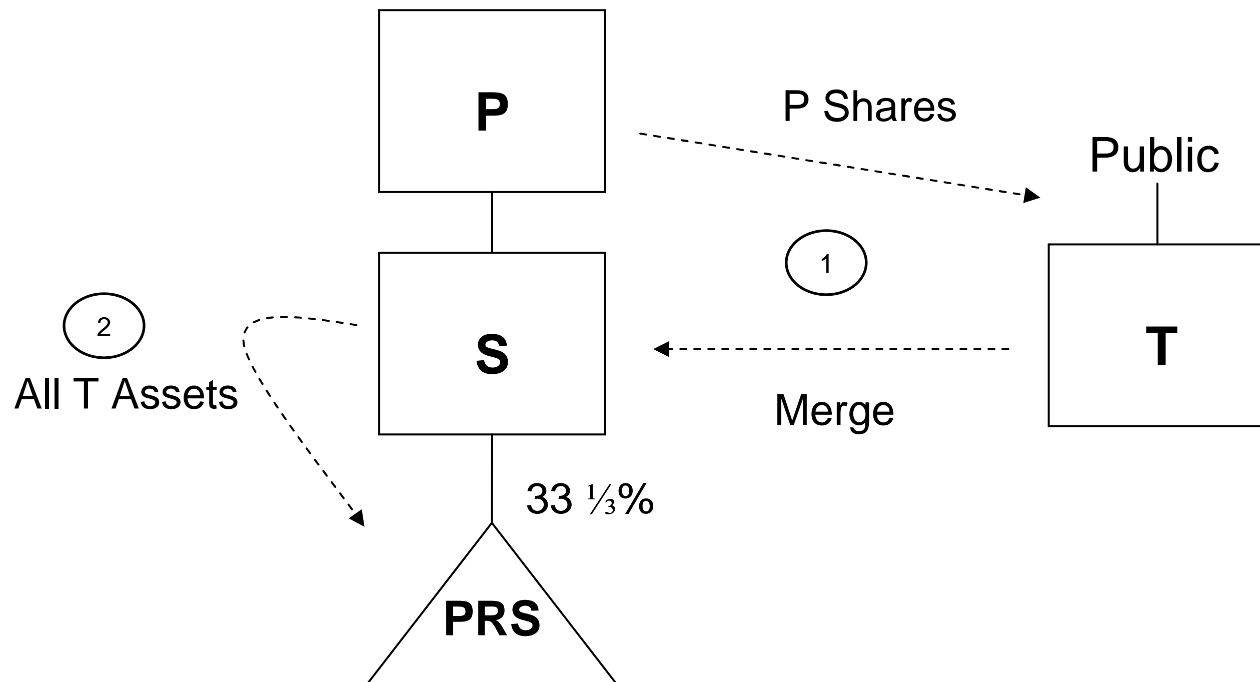
Alternative 1: What if S retains a single share of T stock?

Alternative 2: Same as Alternative 1, but P distributes the T stock to its shareholders in a transaction described in section 355?

COBE Requirement – Partnerships

- Under the 1998 Final Regulations, the COBE requirement was satisfied if acquired assets (not stock) were transferred to a partnership and the acquiring corporation (or member of qualified group) was a 20% partner actively engaged in substantial management functions or a 33% percent limited partner.
- Under the 1998 Final Regulations, as well as the 2004 Proposed Regulations, the COBE requirement was not satisfied if stock (rather than assets) were contributed to a partnership.
- The 2007 Final Regulations provide that if members of the qualified group own an interest in a partnership that meets requirements equivalent to the control definition in section 368(c), any stock owned by such partnership is treated as owned by members of the qualified group.
  - What does control equivalent to section 368(c) mean in the partnership context?

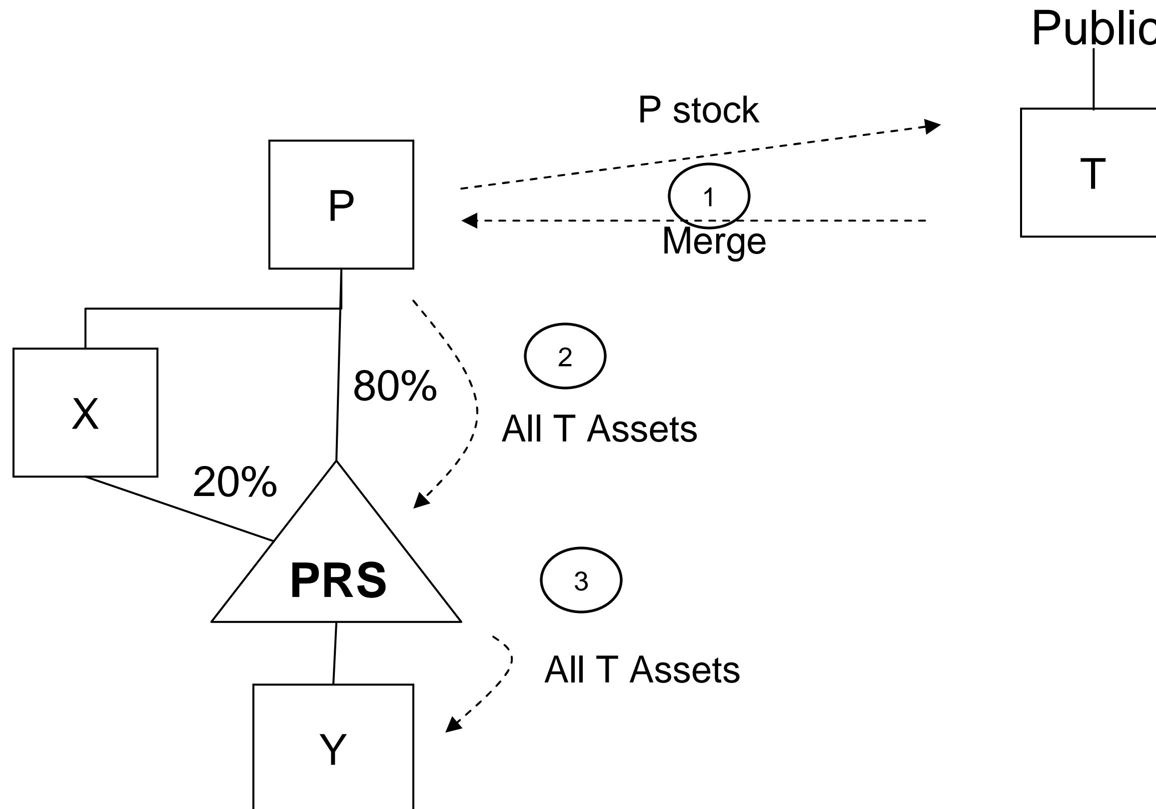
Asset Transfers to Partnerships – Example 1



Facts: S acquires all of the T assets in the merger of T into S. In the merger, the T shareholders receive P stock. Pursuant to the plan of reorganization, S transfers all of the T assets to PRS, a partnership in which S owns a 33 1/3 percent interest. S does not perform active and substantial management functions as a partner with respect to PRS' business.

Result: COBE is satisfied. Treas. Reg. § 1.368-2(k) is satisfied because COBE is satisfied and S, as the acquiring corporation, transfers all or part of its assets and does not terminate its corporate existence in connection with the transfer.

Asset Transfers to Partnerships – Example 2

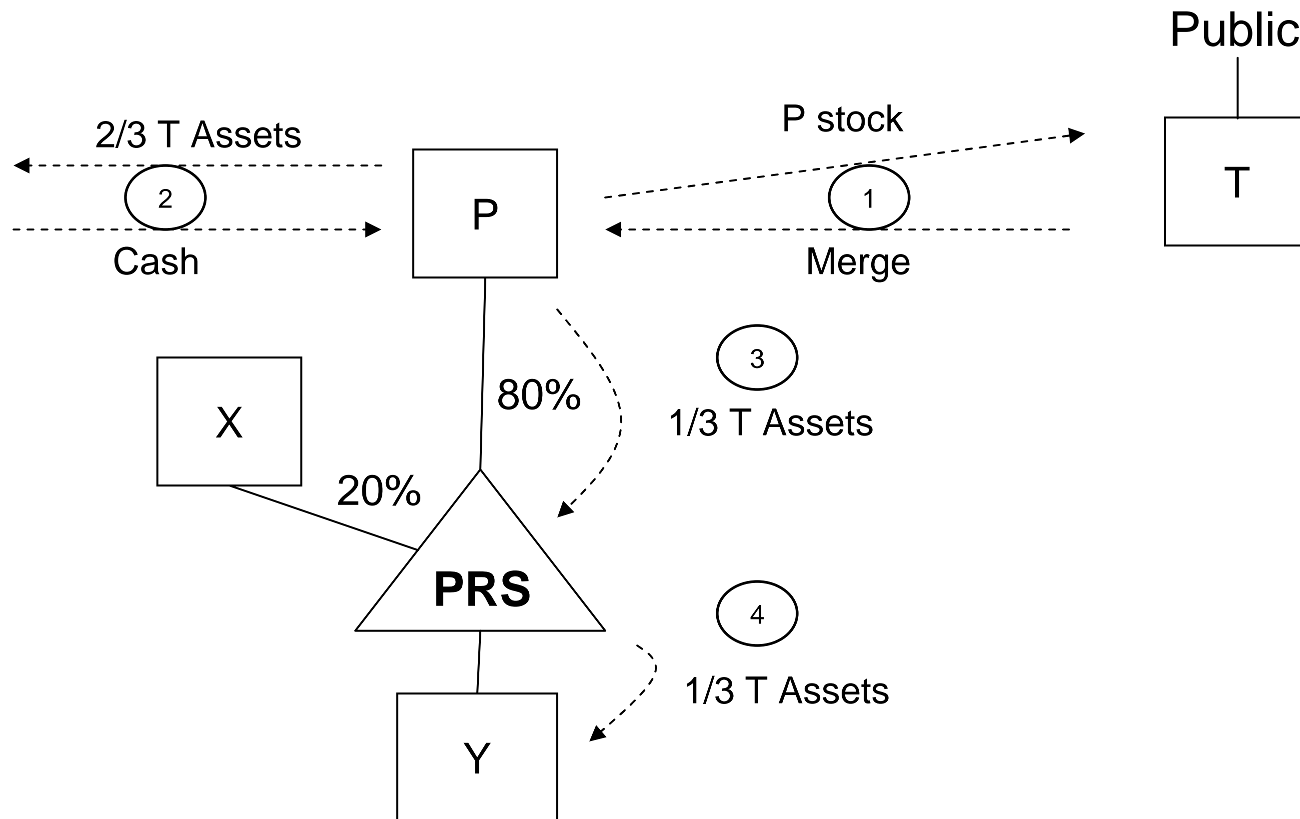


Facts: P acquires all of the T assets in the merger of T into P. In the merger, the T shareholders receive P stock. Pursuant to the plan of reorganization, P transfers all of the T assets to PRS, a partnership in which P owns a 80% interest and a subsidiary of P ("X") owns a 20% interest. PRS transfers all of T assets to Y, which is a corporation the stock of which is owned by PRS.

Result: COBE is satisfied under the 2008 Final Regulations because Y is a member of P's qualified group. Stock held by PRS is attributed to P's qualified group for COBE purposes because members of P's qualified group own interests in PRS equivalent to 368(c) control. COBE would not have been satisfied under the 1998 Final Regulations and 2004 Proposed Regulations.

Treas. Reg. § 1.368-2(k) is satisfied because COBE is satisfied and P, as the acquiring corporation, transfers all or part of its assets and does not terminate its corporate existence in connection with the transfer.

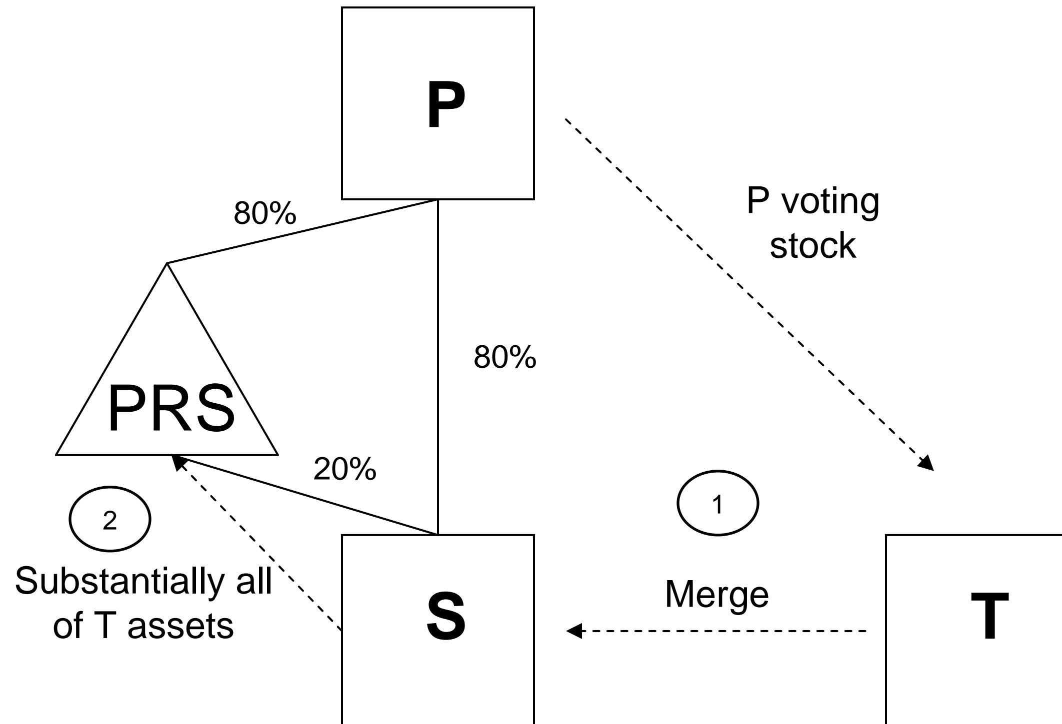
Asset Transfers to Partnerships – Example 3



Facts: P acquires all of the T assets in the merger of T into P. In the merger, the T shareholders receive P stock. P sells 2/3 of T assets acquired in the merger to a third-party for cash. P then transfers 1/3 of the T assets to PRS, a partnership in which P owns a 80%interest. PRS transfers these T assets to Y, which is a corporation the stock of which is owned by PRS.

Result: COBE is satisfied as Y is a member of the qualified group. If, however, PRS retained the T assets, P may be treated as owning only 26.7% of the T's historical business assets (e.g., 80% of 1/3 T's assets) and COBE may not be satisfied.

Distributions to Partnerships – Example 1 Asset Distribution



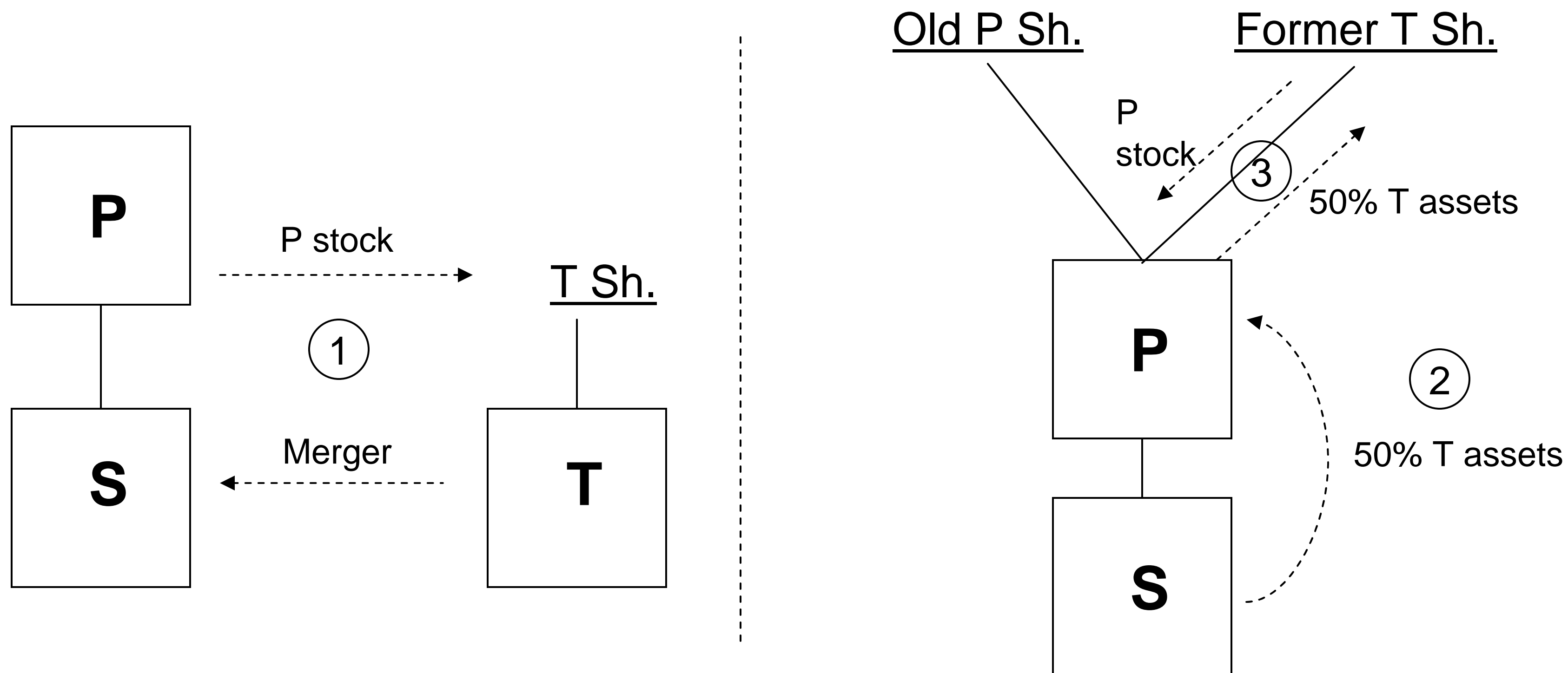
Facts: P owns 80 percent of S and PRS. PRS owns the remaining 20 percent of S. T merges into S in a merger qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D). Immediately after the merger of T into S, S distributes substantially all of T's assets to PRS in redemption of 15% percent of the stock of S owned by PRS.

Result: COBE is satisfied. Under Treas. Reg. § 1.368-2(k), the reorganization is not disqualified by the transfer of T assets from S to PRS provided that S is not treated as liquidated for Federal income tax purposes (disregarding assets held prior to reorganization). Under the 1998 Final Regulations and 2004 Proposed Regulations, Treas. Reg. § 1.368-2(k) would not have been satisfied and the reorganization would have been taxable.

Treas. Reg. § 1.368-2(k) – 2008 Final Regulations

- The 2008 Final Regulations make certain clarifying amendments to the application of the 2007 Final Regulations.
- Certain Distributions to Former Shareholders: The 2008 Final Regulations clarify that post-reorganization distributions to former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, are not eligible for the safe harbor of Treas. Reg. § 1.368-2(k) to the extent that the transfer constitutes consideration in exchange for the proprietary interests in the acquired corporation or surviving corporation, as the case may be.
  - If the safe harbor does not apply, the requirements of a potential reorganization, including the continuity of interest requirement, may not be satisfied.
  - The Preamble provides that certain pro rata distributions may not be treated as disqualified transfers to shareholders.
  - The Preamble provides that certain upstream reorganizations followed by a transfer of acquired assets do not constitute disqualified transfers (e.g., Rev. Rul. 69-617) because the former shareholder of the acquired reorganization is the acquiring corporation.
- Certain Transfers by Former Shareholders: The 2008 Final Regulations clarify that the safe harbor of Treas. Reg. § 1.368-2(k) does not apply to transfers by former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, of consideration initially received in the potential reorganization to the issuing corporation (or a related person).

Distributions to Former Shareholders of the Acquired Corporation



Facts: P owns 100 percent of S. In a forward triangular merger, T merges into S and T shareholders receive P stock in exchange for their T stock. Pursuant to the plan of reorganization, S distributes 50% of T's assets to P, and P transfers the distributed T assets to the former shareholders of T in redemption of the P stock received in the reorganization.

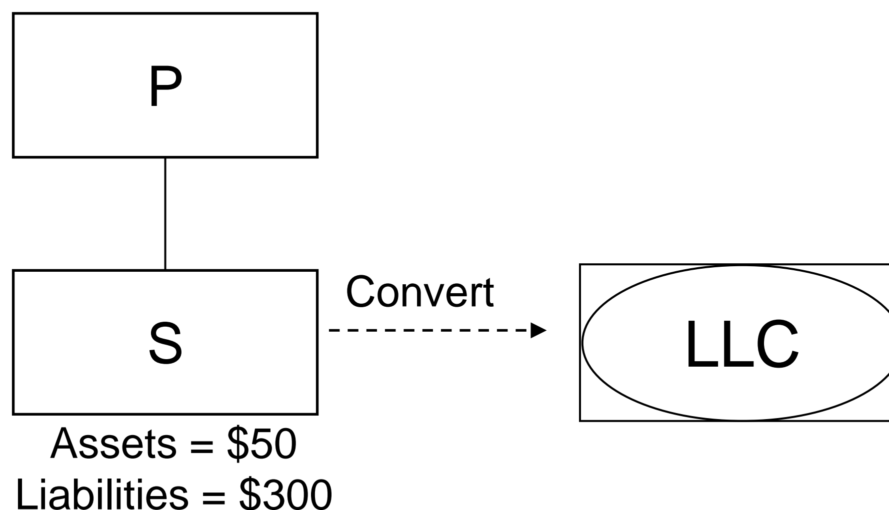
Result: COBE is satisfied if P's qualified group carries on T's historic business or uses a significant portion of T's historic business assets in a business. Treas. Reg. § 1.368-2(k) is not satisfied because the distribution of T's assets has been made to former shareholders of the acquired corporation, T, and the distribution constitutes consideration in exchange for proprietary interests in the acquired corporation.

If the step transaction doctrine applies, would the "substantially all" test and/or the continuity of interest requirement be satisfied?

Insolvency and Debt Restructuring Issues

Consequences of Check-the-Box Election

Election to be a Disregarded Entity

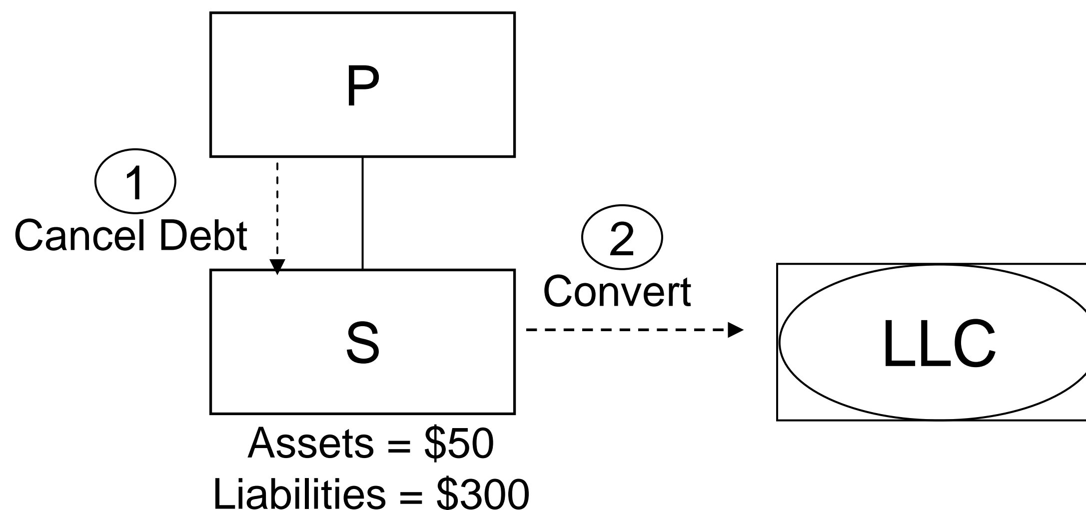


Facts: In year 1, P formed S and capitalized it with $100 of equity and $300 of debt. S loses $350, rendering it insolvent. In year 2, S converts into an LLC under applicable state law.

Result: The conversion does not qualify as a tax-free section 332 liquidation. Instead, P is entitled to a worthless stock deduction under section 165(g)(3). *See* Treas. Reg. § 301.7701-3(g)(1)(iii), (g)(2)(ii); Rev. Rul. 2003-125; *see also* Prop. Treas. Reg. § 1.332-2(b).

Consequences of Check-the-Box Election

Election to be a Disregarded Entity



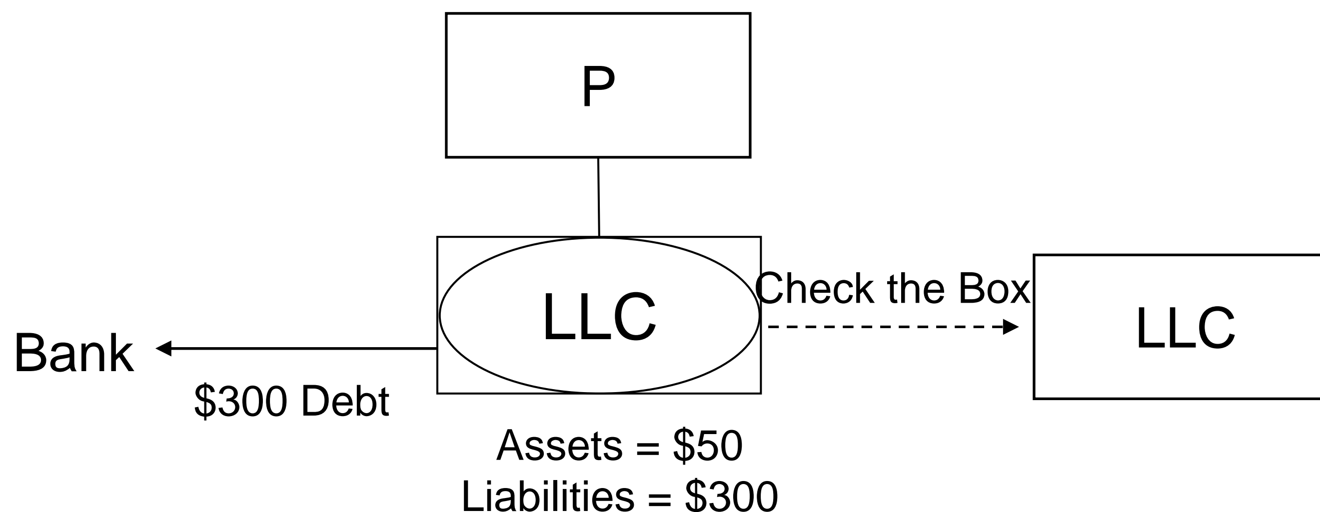
Facts: In year 1, P formed S and capitalized it with $100 of equity and $300 of debt. S loses $350, rendering it insolvent. In year 2, P cancels the S debt and then S converts into an LLC under applicable state law.

Result: The debt cancellation is transitory and has no economic significance. Thus, S is insolvent at the time of the conversion and it does not qualify as a tax-free section 332 liquidation. *See* Rev. Rul. 68-602.

Variation: Buyer wants to purchase the assets of S, and Buyer and P agree that P will convert S into an LLC and sell Buyer the LLC interests. As a condition to the sale, however, Buyer requests that P cancel the debt owed it by S. *See* CCA 200818005.

Consequences of Check-the-Box Election

Election to be Taxed as a Corporation

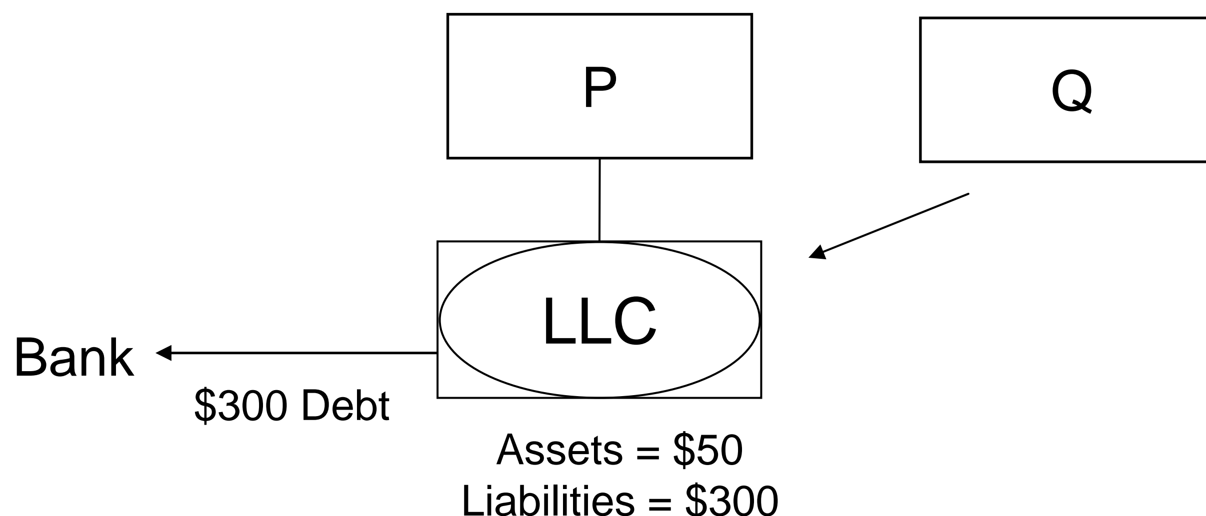


Facts: In year 1, P formed LLC and capitalized it with $100 of equity. LLC borrowed $300 from Bank. LLC loses $350, rendering it insolvent. In year 2, LLC checks the box to be taxed as a corporation.

Result: P is treated as contributing all of LLC's assets and liabilities to a newly formed corporation in a transaction that may not qualify under section 351. *See* Treas. Reg. § 301.7701-3(g)(1)(iv), (g)(2)(ii). *Compare Rosen v. Commissioner,* 62 T.C. 11 (1974), *Focht v. Commissioner,* 68 T.C. 223 (1977), and GCM 33,915 (Aug. 26, 1968) *with DeFelice v. Commissioner,* 386 F.2d 704 (10th Cir. 1967); *Meyer v. United States*, 121 F. Supp. 898 (Ct. Cl. 1954); Prop. Treas. Reg. § 1.351-1(a)(1)(iii).

Consequences of Check-the-Box Election

Partnership Analog



Facts: In year 1, P formed LLC and capitalized it with $100 of equity. LLC borrowed $300 from Bank. LLC loses $350, rendering it insolvent. In year 2, Q contributes $250 in exchange for an interest in LLC.

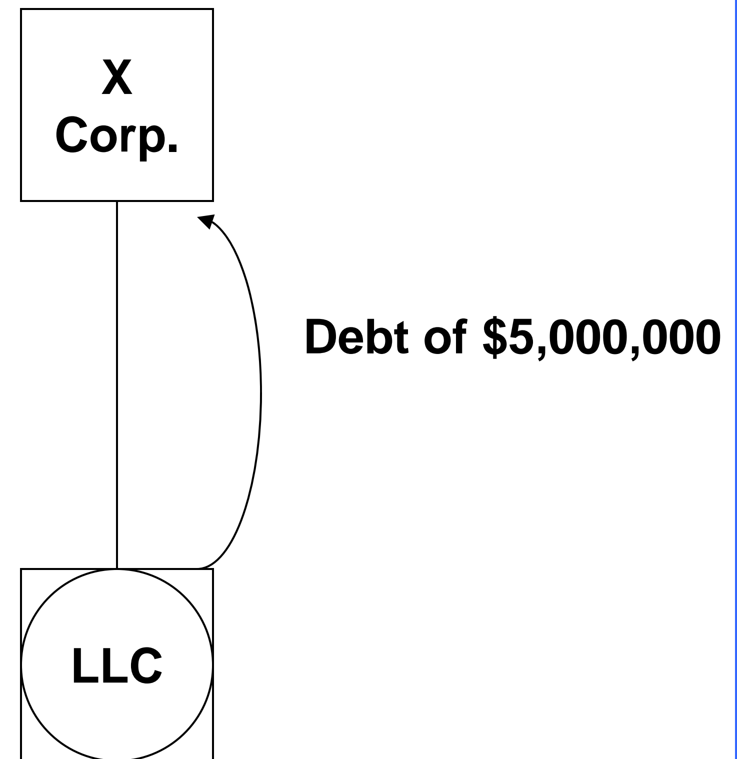
Result: P is treated as transferring all of LLC's assets and liabilities to a newly formed partnership in exchange for an interest in LLC. *See* Rev. Rul. 99-5 (Sit. 2). Query whether such an exchange should be tax-free to P pursuant to section 721. *Compare* section 351(a) *with* section 721(a); *see also* section 752(c); *cf.* Prop. Treas. Reg. § 1.351-1(a)(1)(iii).

Modification of Debt

Debt to Owner

LLC, taxable as a corporation and consolidated with X Corp., borrows $5,000,000 from its owner, X, on a recourse basis. Sometime thereafter, LLC elects to be taxed as a disregarded entity. The change in classification is treated as a liquidation. How does the change in classification affect the debt? *See Kniffen v. Comm'r*, 39 T.C. 553 (1962); Rev. Rul. 72-464; PLR 20084026.

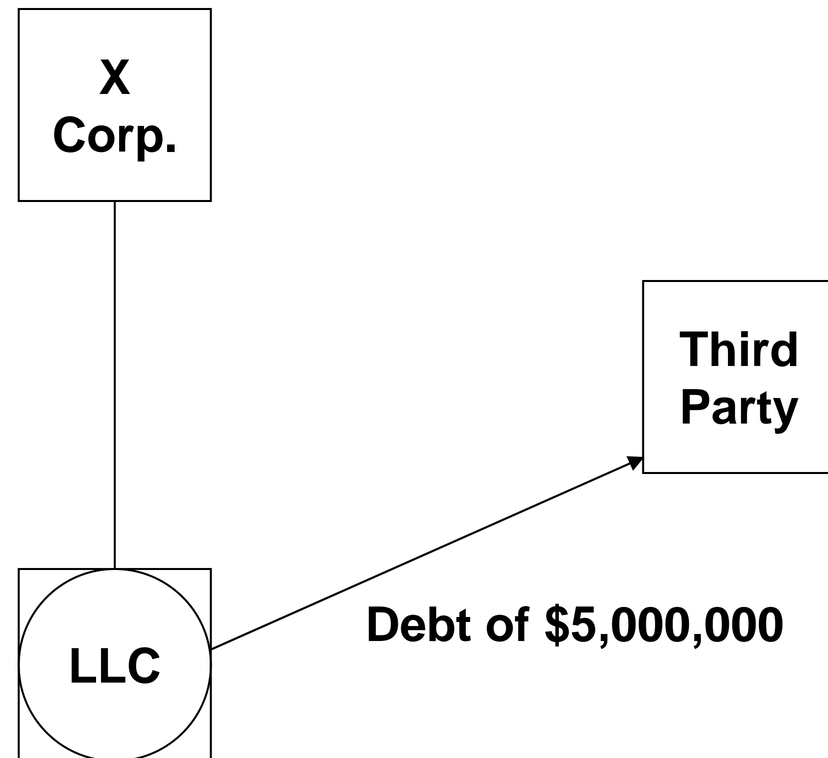
What if the facts are reversed, and LLC is disregarded when it borrows from X and then elects to be taxed as a corporation?



Modification of Debt

Third-Party Debt – Entity Conversion

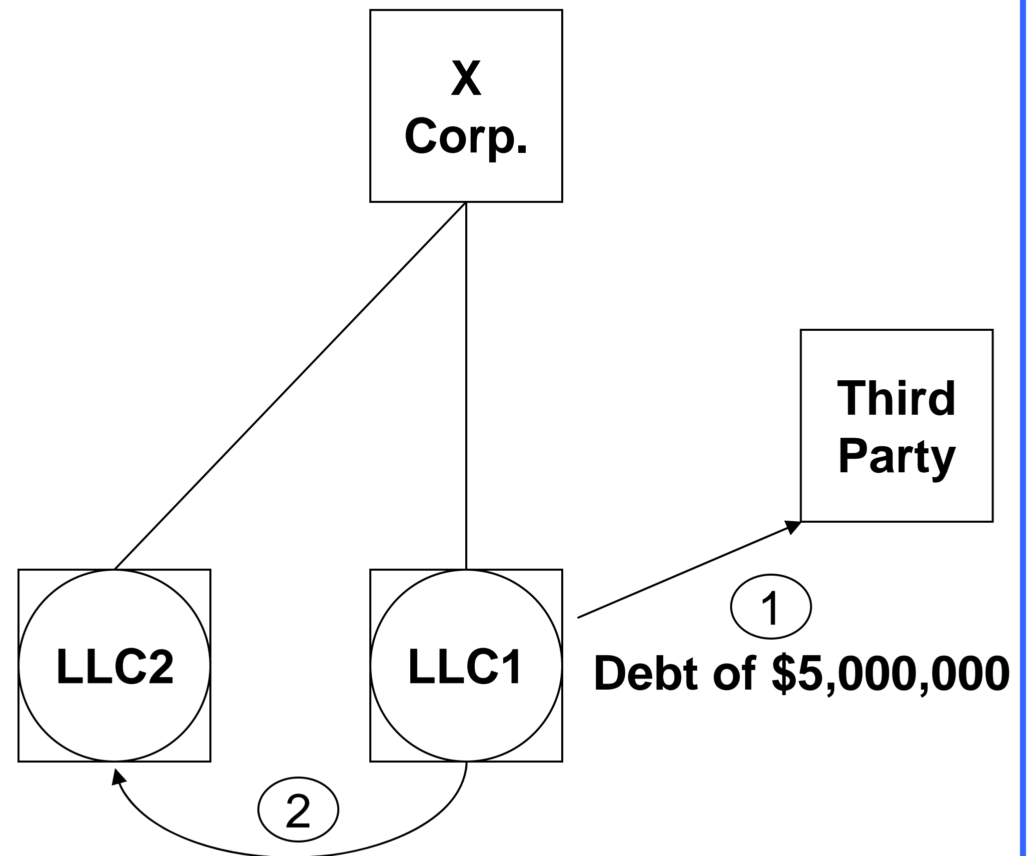
LLC, taxable as a corporation and consolidated with X Corp., borrows $5,000,000 from a third party on a recourse basis. Sometime thereafter, LLC elects to be taxed as a disregarded entity. The change in classification is treated as a liquidation. How does the change in classification affect the debt? *See* Treas. Reg. §§ 1.465-27(b)(6), 1.752-2(k); *cf.* PLRs 200709013; 200630002; 200315001; 199904017.



Modification of Debt

Third-Party Debt – Change in Obligor

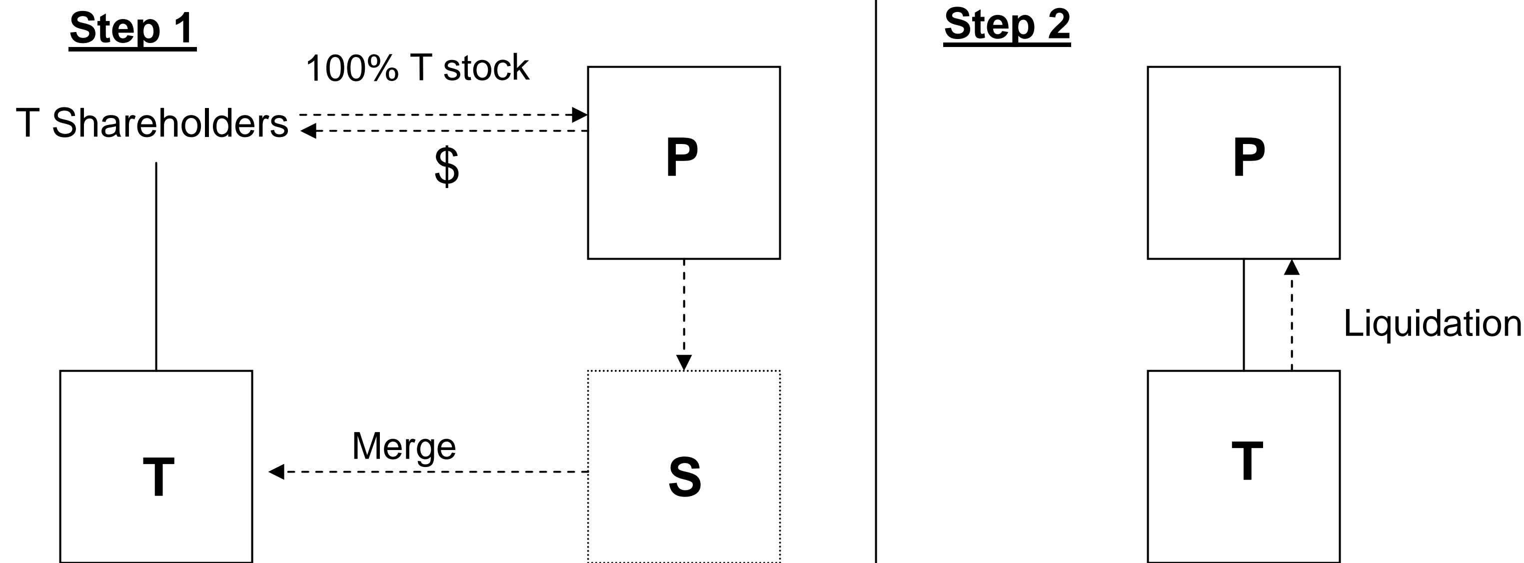
LLC1, a disregarded entity, borrows $5,000,000 from a third party on a recourse basis. For valid business reasons, X would like to transfer the debt to LLC2. Does the transfer give rise to a significant modification of the debt?



Section 338(h)(10)
Step Transaction Issues

Rev. Rul. 90-95 - Situation 2

QSP Followed by Liquidation

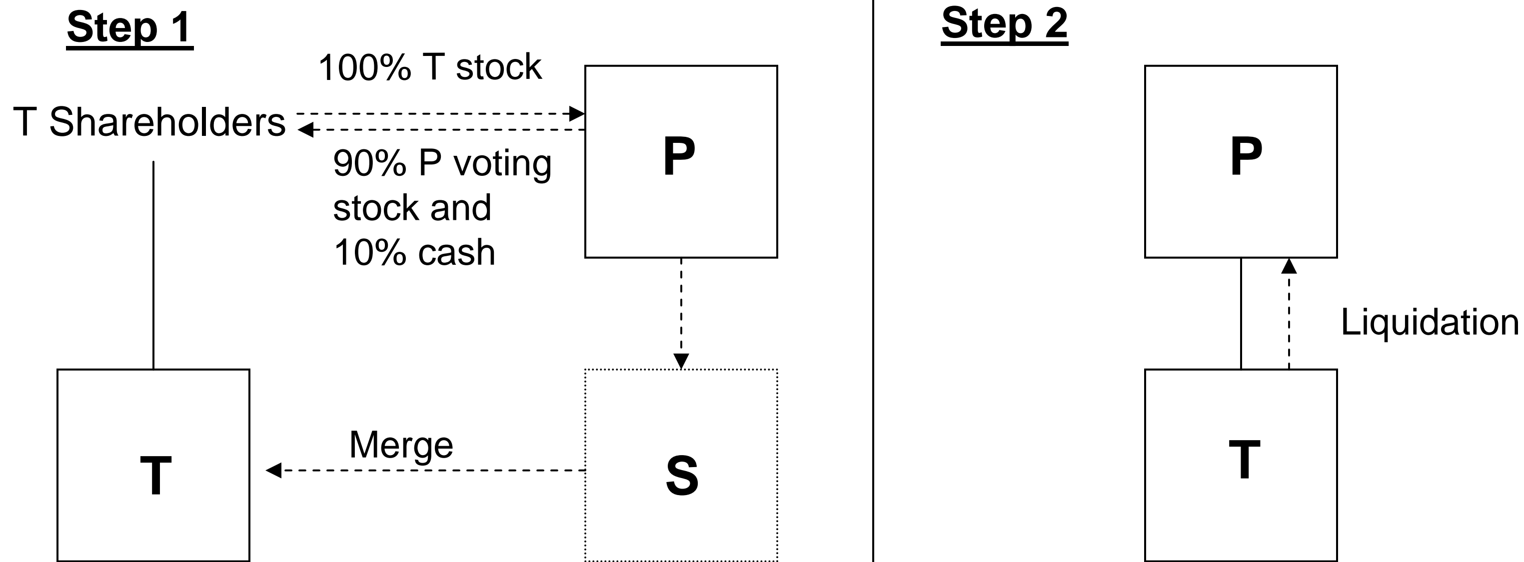


Facts: P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for cash. Immediately thereafter, T liquidates into P.

Result: If the acquisition were integrated with the liquidation of T into P, the result would be an asset purchase by P resulting in a cost basis. The IRS ruled that § 338 replaced the *Kimbell-Diamond* doctrine and, therefore, P should not be able to obtain a cost basis in T's assets without making a § 338 election.

Rev. Rul. 2008-25

Failed Reorganization

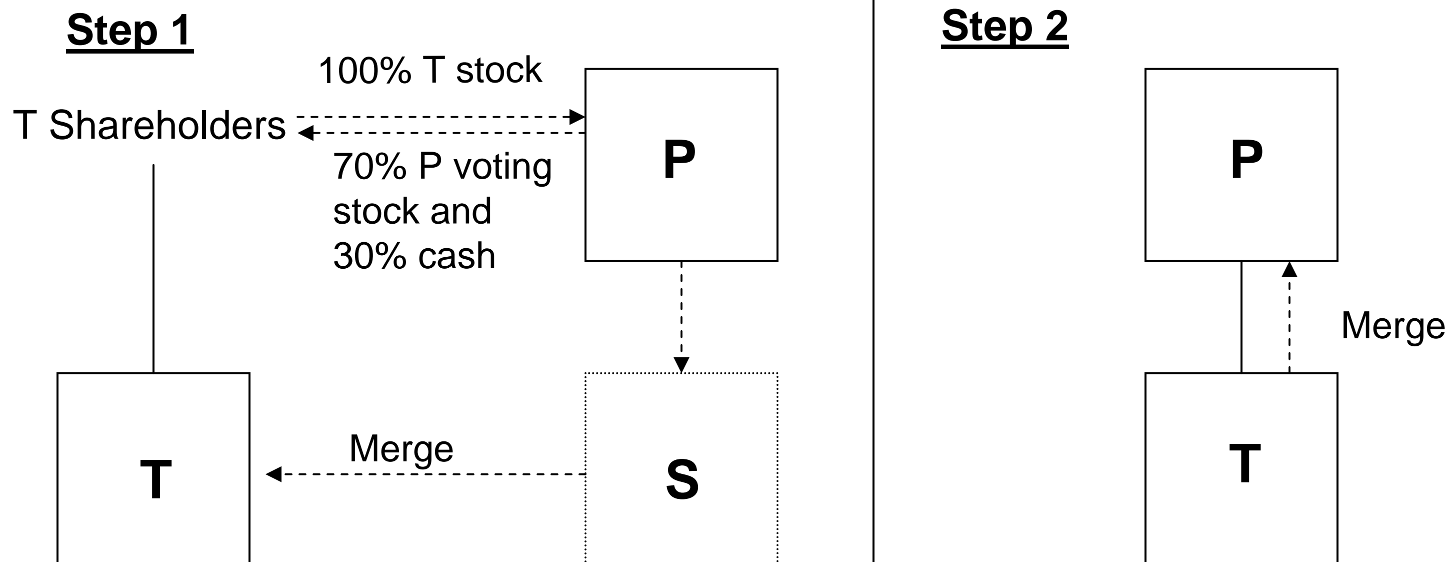


Facts: P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 90% P voting stock and 10% cash. Immediately thereafter, T liquidates into P.

Result: If the acquisition were viewed independently from the liquidation of T into P, the result should be a reverse triangular merger of T stock followed by a § 332 liquidation. If the steps are integrated, the reverse triangular merger fails to qualify under § 368(a)(2)(E) because T does not hold substantially all of the properties of T and S. T's liquidation does not fall within the safe harbor from the application of the step-transaction doctrine under Treas. Reg. § 1.368-2(k). Because application of the step-transaction doctrine does not result in a tax-free reorganization and, therefore, would result in a cost basis in T's assets, the IRS concluded that the analysis of Rev. Rul. 90-95 should apply to treat the transaction as a QSP followed by a § 332 liquidation.

Rev. Rul. 2001-46 – Situation 1

QSP Followed by Upstream Merger

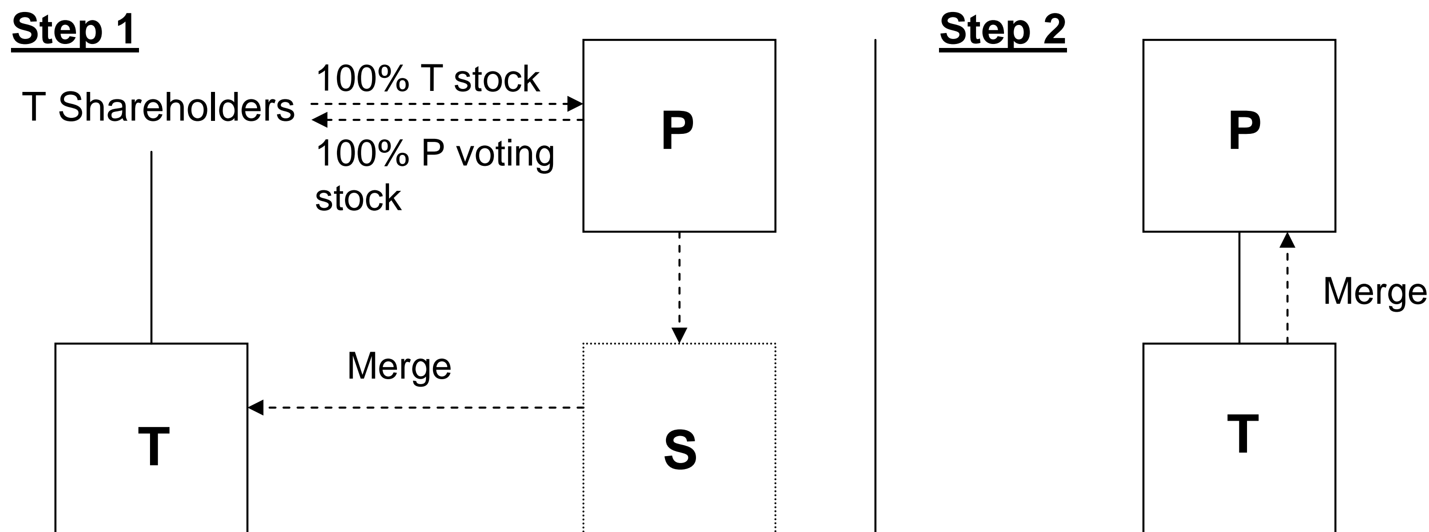


Facts: P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

Result: If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a § 332 liquidation. *See* Rev. Rul. 90-95, 1990-2 C.B. 67. If the steps are integrated, the transaction is treated as a single statutory merger of T into P under § 368(a)(1)(A). *See King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). Because P acquires the T assets with a carry-over basis under § 362, the policies of § 338 are not violated, and the step-transaction doctrine applies. *See* Treas. Reg. § 1.338(h)(10)-1(c)(2), -1(e), Ex. 11.

Rev. Rul. 2001-46 – Situation 2

Non-QSP Followed by Upstream Merger



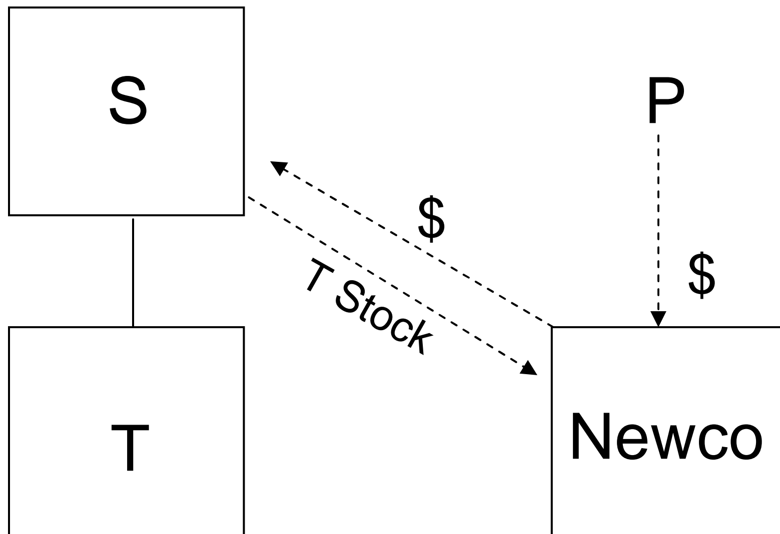
Facts: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under § 368(a)(1)(A) by reason of § 368(a)(2)(E).

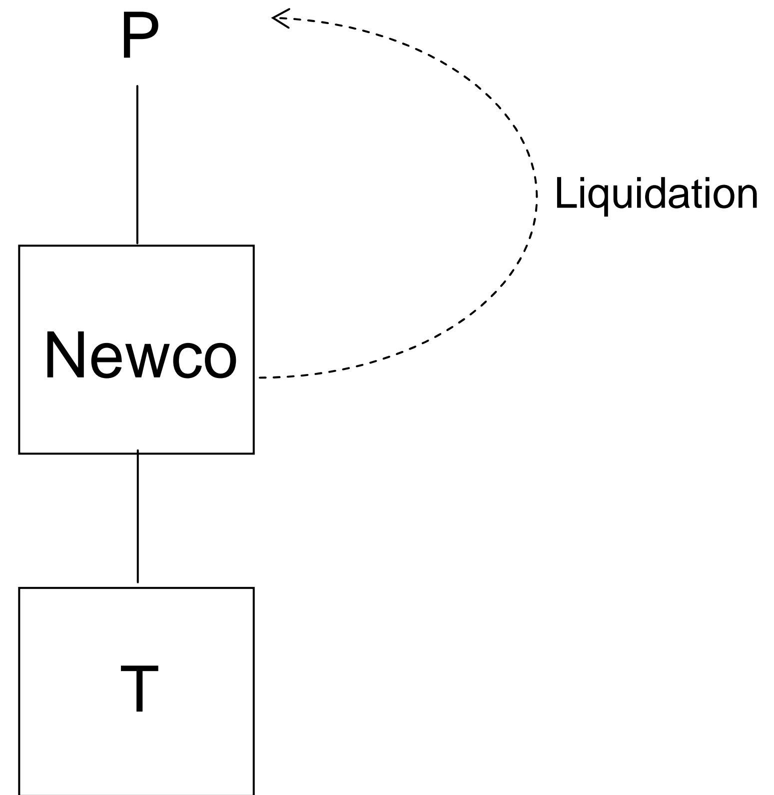
Result: Step-transaction principles apply to treat the transaction as a merger of T directly into P. *See* Treas. Reg. § 1.338(h)(10)-1(c)(2), -1(e), Ex. 14.

Treas. Reg. § 1.338(h)(10)-1(c)(2)

- The IRS issued final regulations on July 5, 2006, which adopted the substance of temporary and proposed regulations issued in 2003.
- The final regulations provide that "a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . ." Treas. Reg. § 1.338(h)(10)-1(c)(2).
  - This rule applies regardless of whether, under the step-transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under § 368(a). *Id.*
  - If a section 338(h)(10) election is made under these facts, P's acquisition of T stock will be treated as a QSP and not as a reorganization under § 368(a). *See* Treas. Reg. § 1.338(h)(10)-1(e), Ex. 12 & 13.
  - However, if taxpayers do not make a § 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under § 368(a). *See id.* at Ex. 11.
- In issuing the final regulations, the IRS rejected a recommendation that the final regulations allow § 338(g) elections, as well as § 338(h)(10) elections, to turn off the step-transaction doctrine, because extending the election as such would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a reorganization under § 368(a).

Has a Corporation Made the Purchase

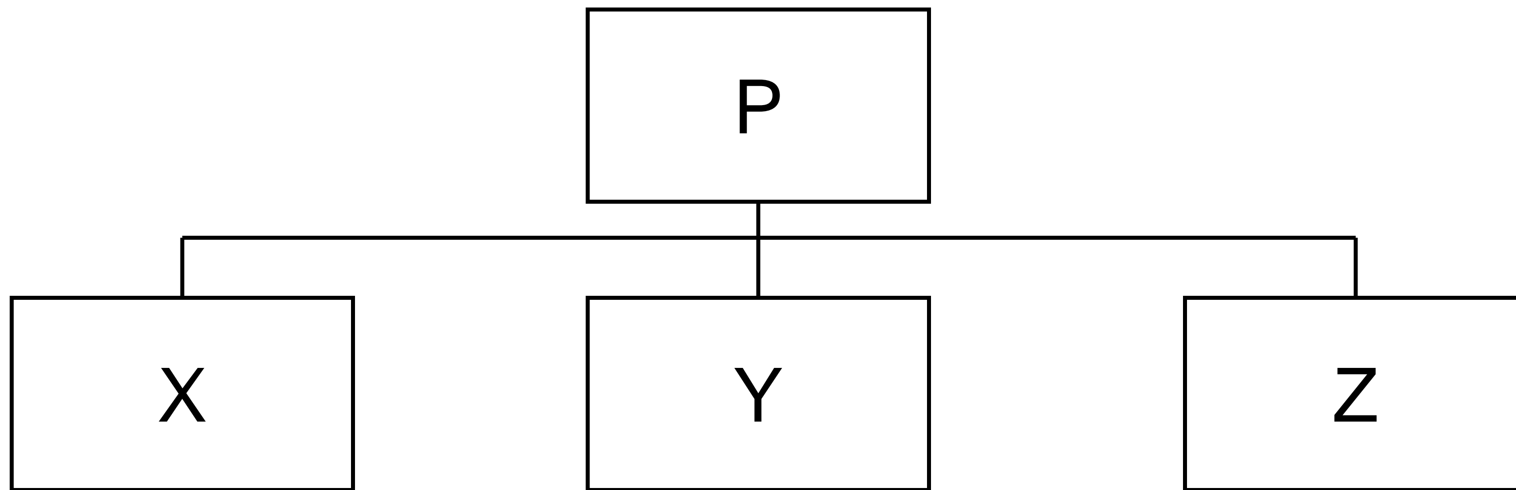




1. P forms Newco with cash.
2. Newco buys T stock from S.
3. Newco is liquidated by P.

See Treas. Reg. § 1.338-3(b)(1).

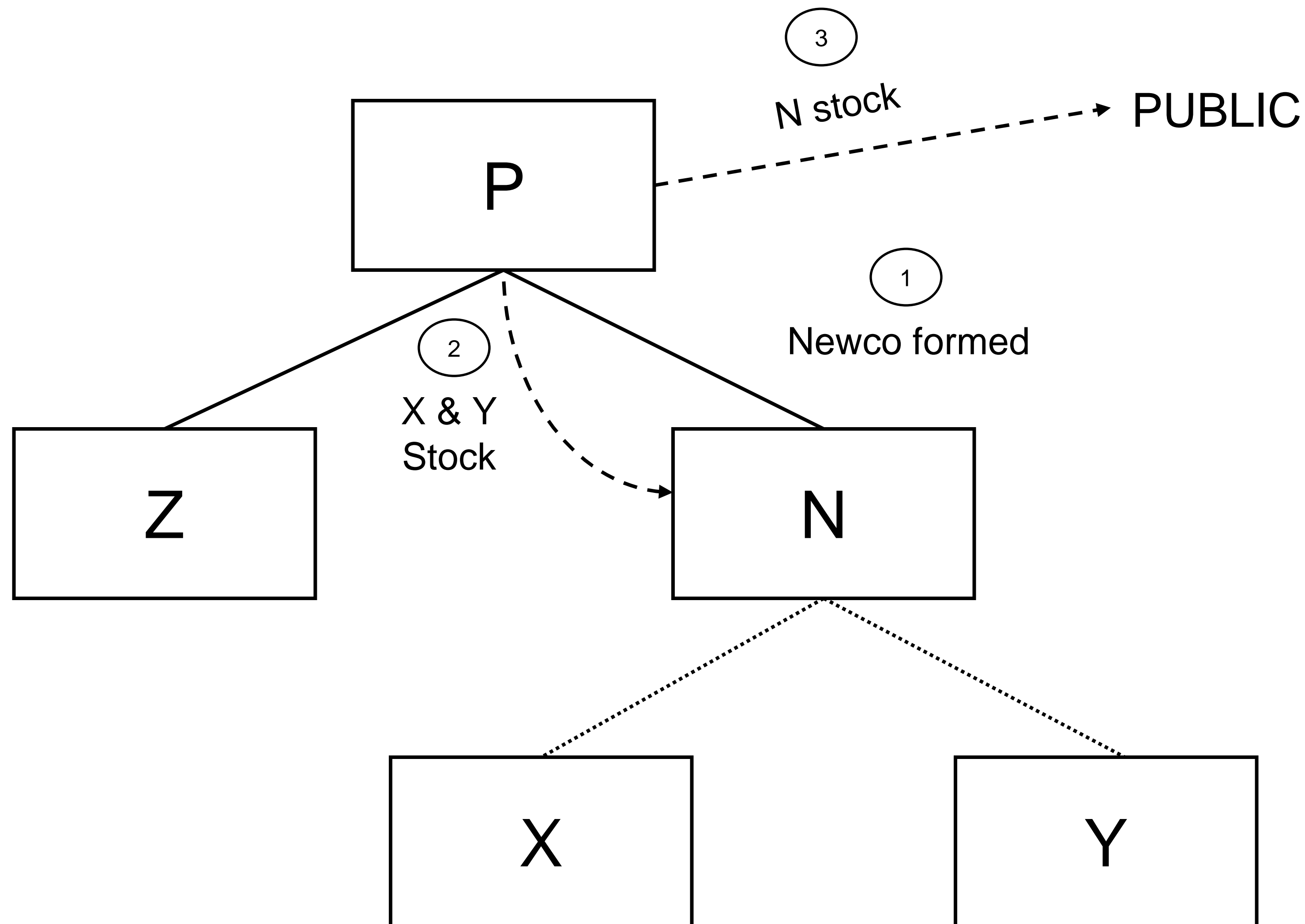
Section 338(h)(10) and "Busted 351" Transaction



Facts:

1. P, X, Y, and Z file a consolidated return.
2. P wishes to sell X and Y to the public and to step up the basis of the X and Y assets.

Section 338(h)(10) and "Busted 351" Transaction (Cont.)



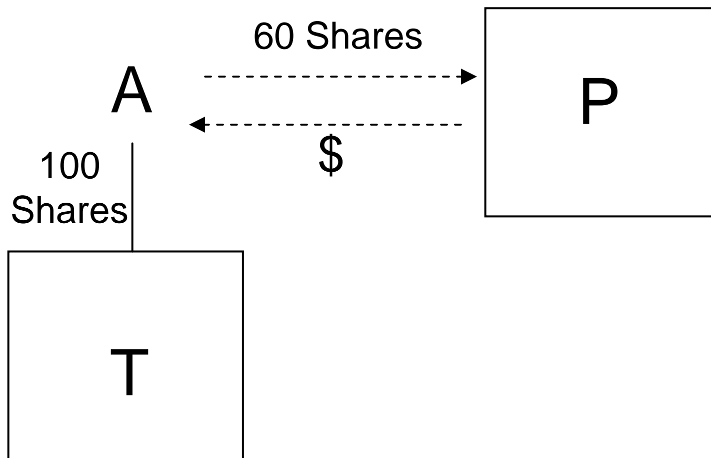
3. P forms Newco (N) and P transfers the X and Y stock to N. Pursuant to a prearranged plan, P sells the N stock to the Public.

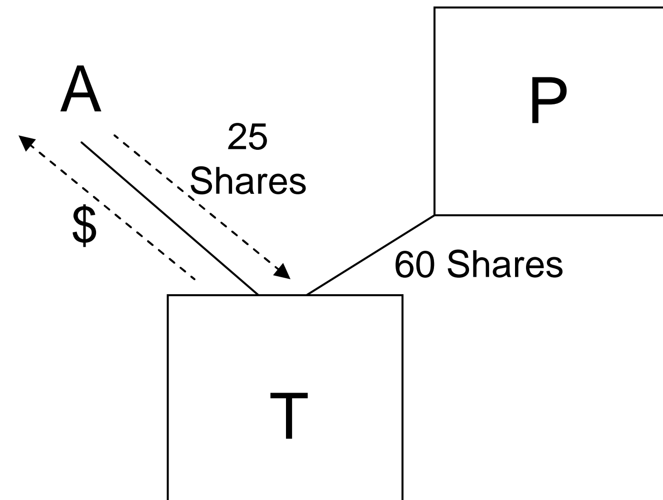
<u>Section 338(h)(10) and “Busted 351” Transaction (Cont.)</u>

<u>Results</u>:

- The transfer of the X and Y stock to N should <u>not</u> qualify as a § 351 transaction. P is not in control of N immediately after the transfer. *See* Rev. Rul. 79-194, 1979-1 C.B. 145; TAM 9747001 (July 1, 1997); PLR 9541039 (July 20, 1995), as modified by PLR 9549036 (Sept. 12, 1995); PLR 9142013 (July 17, 1991).
- Thus, N is deemed to purchase the X and Y stock, and P and N can file a § 338(h)(10) election to treat the transaction as a sale of assets by X and Y followed by § 332 liquidations. *See* Treas. Reg. § 1.338-3(b)(3)(iv), Ex. 1.
- How much stock does P have to sell?
  - P must sell more than 20% of N stock for § 351 not to apply. *See* §§ 351(a) and 368(c).
  - P must sell at least 50% of the N stock so that P and N are not related for purposes of § 338(h)(3)(A)(iii).
  - P must sell more than 80% of the N stock to avoid the application of the anti-churning rules of § 197(f)(9).
- Proposed regulations under section 336(e) would achieve a stepped-up basis without the need to bust the section 351 transaction.

Effect of Redemptions on QSP

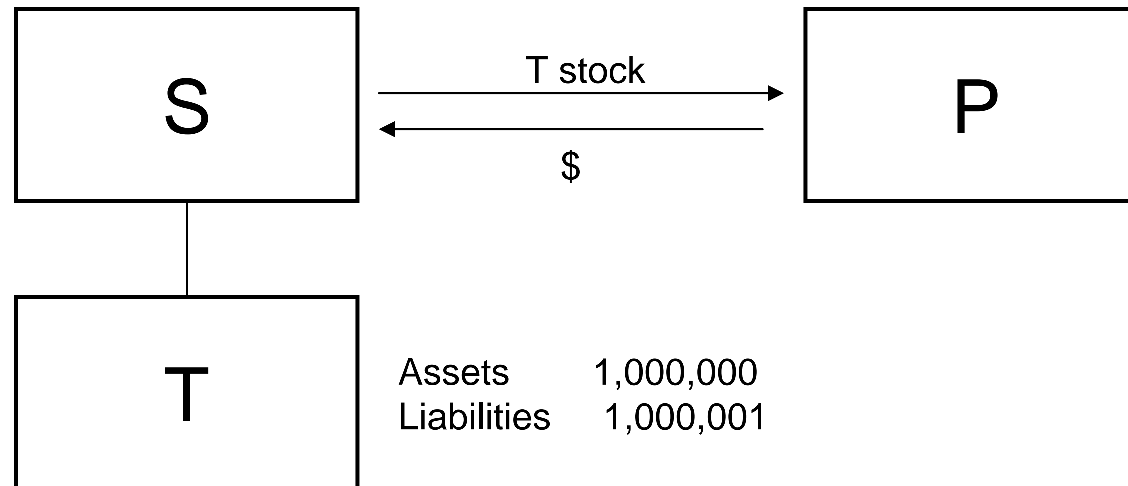




1. On January 1, Year 1, P purchases 60 shares of T stock from unrelated A for cash.
2. On July 1, Year 1, T redeems 25 shares from A.

See Treas. Reg. § 1.338-3(b)(5)(ii), (b)(5)(iv), Ex. 2.

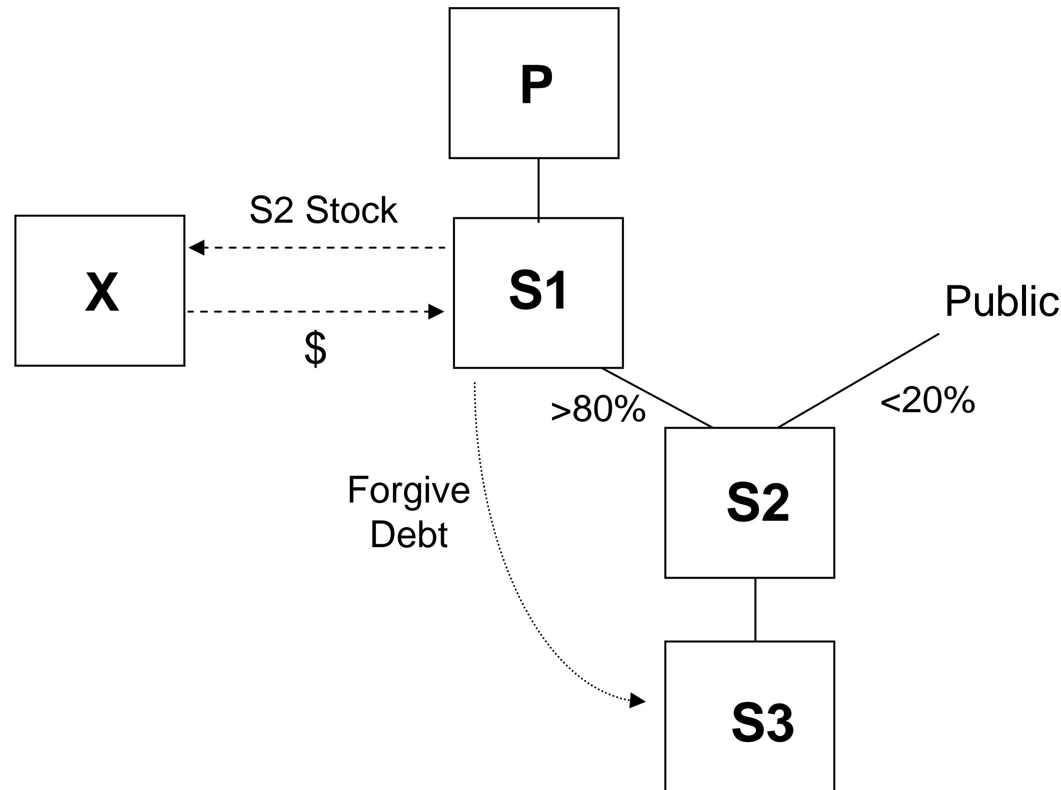
Section 338(h)(10) and Insolvent Target Corporation



Facts: Corporation T owns assets with a value of $1,000,000 and has liabilities of $1,000,001. P purchases all the stock of T from corporation S for $1 and attempts to make a section 338(h)(10) election with respect to T.

References:
Section 338(h)(3)(A); Treas. Reg. § 1.338-3(b)(2)
Treas. Reg. § 1.332-2(b)
Rev. Rul. 56-387, 1956-2 C.B. 189; Rev. Rul. 2003-125, 2003-2 C.B. 1243
Rev. Rul. 68-602, 1968-2 C.B. 135.

Section 338(h)(10) and Insolvent Target Corporation CCA 200818005



Facts: P owns all of the stock of S1. S1 owns more than 80% of the stock of S2, and the remainder is owned by the public. S2 owns all of the stock of S3. S3 is indebted to S1, and as a result, both S3 and S2 are insolvent. S1 sold its S2 stock to X, for which P and X made a § 338(h)(10) election. As a condition of the sale, however, S1 forgave a portion of its debt from S3, thus making S3 and S2 solvent.

Result: The IRS found that the debt forgiveness had economic significance other than tax benefits. Nonetheless, the IRS concluded that the debt forgiveness should be ignored as transitory under Rev. Rul. 68-602, 1968-2 C.B. 135, because it occurred immediately before the deemed § 332 liquidation.

Proposed Section 336(e) Regulations

Section 336(e)

- Section 336(e) was enacted as part of the *General Utilities* repeal in 1986.

- Section 336(e) provides that, under regulations prescribed by the Secretary, if –
  - a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and
  - such corporation sells, exchanges, or distributes all of such stock

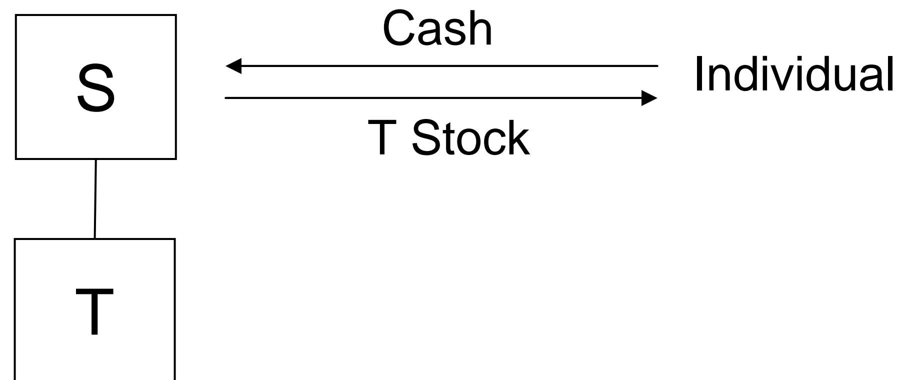
  An election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.

Proposed Section 336(e) Regulations – Transactions Covered

- Regulations were proposed on August 25, 2008, which would permit an election to treat the sale, exchange, or distribution of stock that would not otherwise be eligible for a section 338 election as a deemed asset sale.

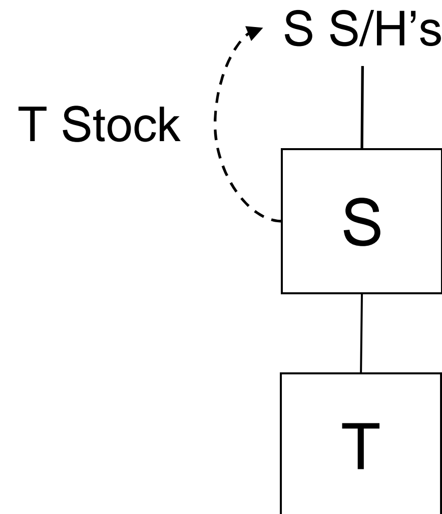
- The proposed regulations do not apply to transactions:
  - Between related persons (as defined in section 318(a) attribution rules, except 318(a)(4));
  - In which either the seller or the target is a foreign corporation; or
  - In which the seller is an S corporation.

Section 336(e) – Stock Sale



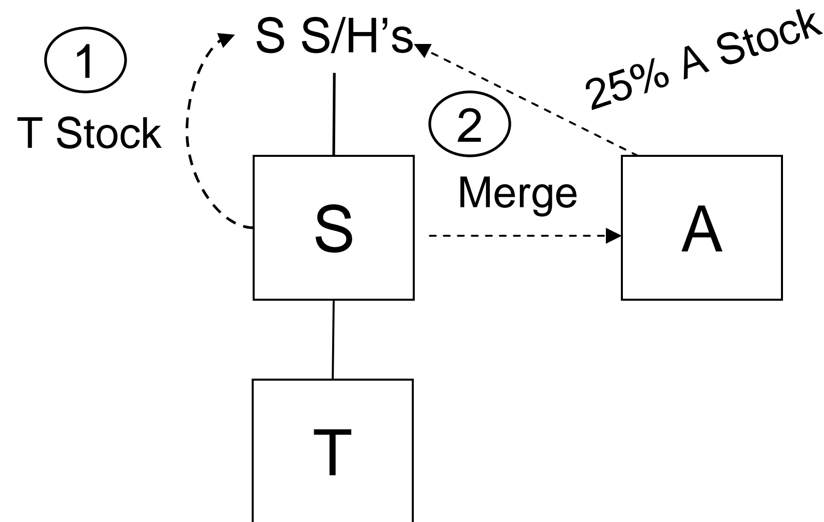
- **Facts:** Individual acquires all of the stock of T from S for cash. S and Individual would like to treat the stock sale as an asset sale.
- **Result:** A section 338(h)(10) election is not available because Individual is not a purchasing corporation. However, a section 336(e) election would be permitted under the proposed regulations.
- The same analysis would apply if Individual were a partnership.

Section 336(e) – Taxable Distribution



- **Facts:** S distributes all of the T stock to its shareholders in a taxable distribution (the transaction does not qualify under section 355).
- **Results:** A section 336(e) election would be permitted under the proposed regulations to treat an otherwise taxable distribution of S stock as a taxable distribution of T's assets.

Section 336(e) – Section 355 Distribution



- **Facts:** S distributes all of the T stock to its shareholders in a transaction that satisfies the requirements of section 355. As part of the same plan, S merges into A, with the S shareholders receiving 25% of A's stock.

- **Results:** Section 355(e) would apply to S's distribution of T stock, thus resulting in a corporate-level tax to S on the distribution of T stock. However, an election should be permitted under section 336(e), which would result in a stepped-up basis in T's assets.

Requirements for Section 336(e) Election

- Seller is a domestic corporation.
- Qualified Stock Disposition.
  - Disposition of stock meeting the requirements of section 1504(a)(2) (80% vote and value).
  - Taxable sale, exchange or distribution.
  - During 12-month disposition period.
- Not a qualified stock purchase under section 338(d)(3).
- Election filed under Prop. Treas. Reg. § 1.336-2(h).

Section 336(e) vs. Section 338(h)(10)

- The proposed regulations rely on the structure and principles of section 338(h)(10) when they are consistent with the purposes of section 336(e). Prop. Treas. Reg. § 1.336-1(a).

Section 336(e) vs. Section 338(h)(10) (Cont'd.)

- Modifications to transactions in Treas. Reg. § 1.338-5:

338	**336(e)**
Section 338 or 338(h)(10) election	Section 336(e) election
Purchasing corporation	Purchaser
Selling consolidated group/affiliate	Seller
Qualified stock purchase	Qualified stock disposition
Acquisition date	Disposition date
12-month acquisition period	12-month disposition period
Recently/nonrecently purchased stock	Recently/nonrecently disposed stock
Aggregate deemed sales price (ADSP)	Aggregate deemed asset disposition price (ADADP)

Proposed Section 336(e) Regulations – Tax Consequences

- Sale of assets by Old T to New T at aggregate deemed asset disposition price (ADADP) =

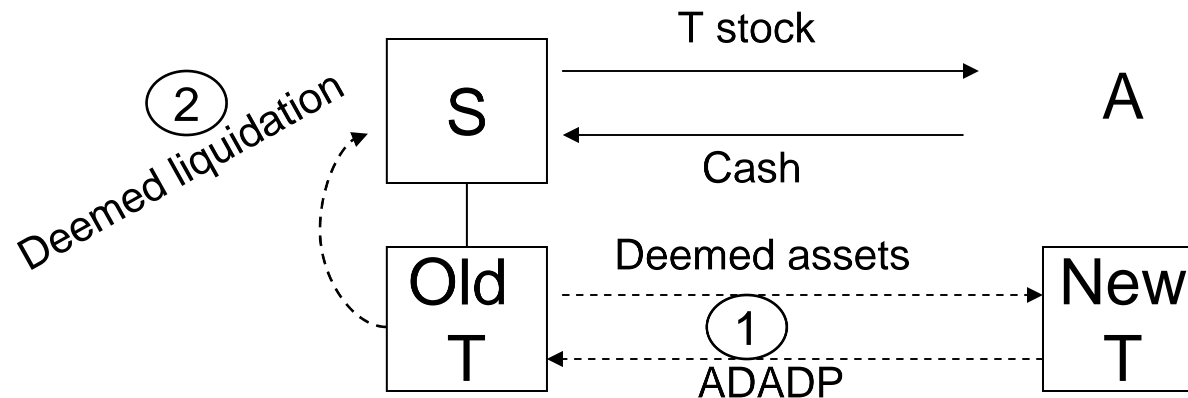
  Grossed up amount realized on sale, exchange, or distribution of target stock

  \- Selling costs

  \+ Liabilities of Old Target

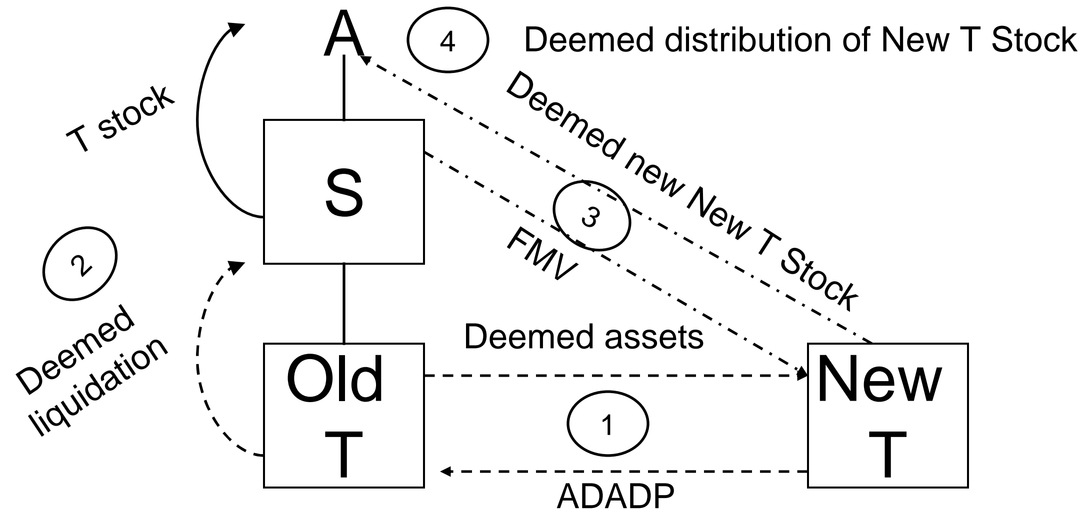
- New T's asset basis is adjusted grossed-up basis (AGUB).
- Limitation of losses on distribution of target stock.
- Deemed liquidation of Old Target generally treated as section 332 liquidation.

Proposed Section 336(e) Regulations – Tax Consequences of Sale or Exchange



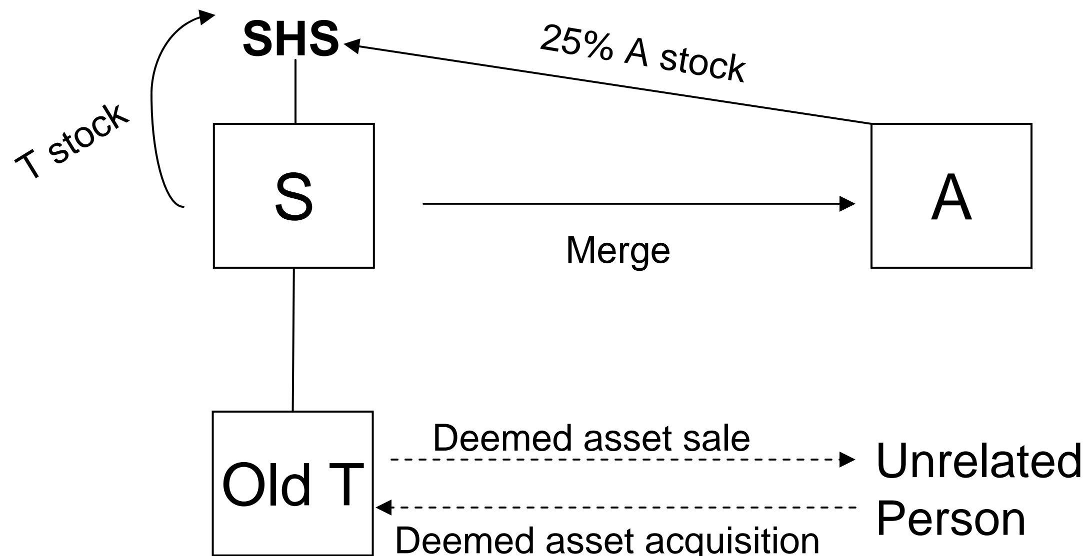
- S disregards the sale of Old T stock.
- Instead Old T is deemed to sell its assets to New T and liquidate into S.
- New T has no tax attributes.
- A is still treated as purchasing Old T stock.

Proposed Section 336(e) Regulations – Tax Consequences of a Taxable Distribution



- S disregards distribution of Old T stock.
- Instead Old T is deemed to sell its assets to New T and liquidate into S. Then S is deemed to purchase an amount of New T stock distributed to A in the qualified stock disposition and distribute that stock to A.
- New T has no tax attributes.
- A is treated as receiving Old T stock in the distribution.

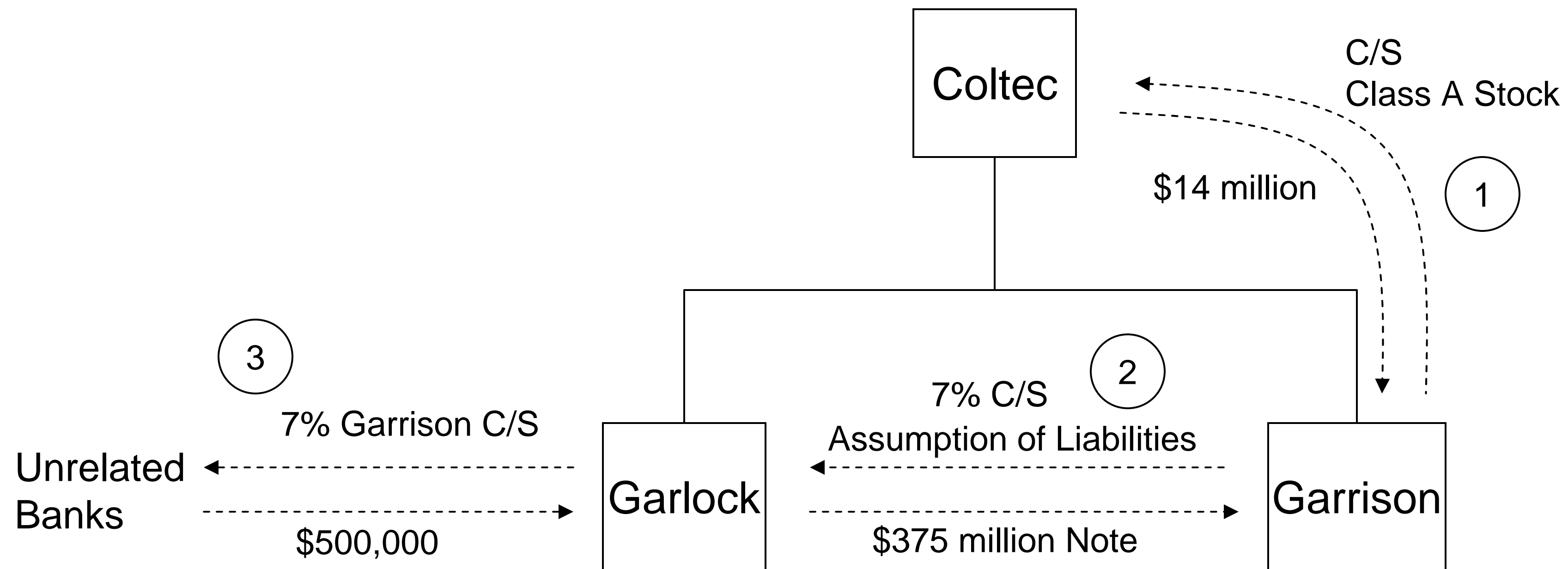
Proposed Section 336(e) Regulations – Tax Consequences of Section 355(d) or (e) Distribution



- The controlled corporation, Old T, is deemed to sell its assets to an unrelated person and then reacquire those assets (sale-to-self treatment).
- Then the distributing corporation, S, is treated as distributing the stock of Old T to its shareholders in the spin-off.
- Old T retains its tax attributes.
- The deemed same and reacquisition will not cause the transaction to fail to satisfy the requirements of section 355.

Recent Economic Substance Case Law

Coltec Transaction



Facts: Coltec, a publicly traded company with numerous subsidiaries, sold the stock of one of its businesses in 1996 and recognized a gain of approximately $240.9 million. Garlock, a subsidiary of Coltec, and its own subsidiary had both previously manufactured or distributed asbestos products and faced substantial asbestos-related litigation claims. Coltec caused another one of its subsidiaries, Garrison, to issue common stock and Class A stock to Coltec in exchange for approximately $14 million. In a separate transaction, Garrison issued common stock to Garlock that represented approximately a 6.6% interest in Garrison and assumed all liabilities incurred in connection with asbestos related claims against Garlock, as well as the managerial responsibility for handling such claims. In return, Garlock transferred the stock of its subsidiary, certain relevant records to the asbestos-related claims, and a promissory note (from one of its other subsidiaries) in the amount of $375 million. Garlock then sold its recently acquired Garrison stock to unrelated banks for $500,000. As a condition of sale, Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. On its 1996 tax return, Coltec's consolidated group claimed a $378.7 million capital loss on the sale of Garrison stock, which equaled the difference between Garlock's basis in the stock ($379.2 million) and the sale proceeds ($500,000).

Coltec Decision – Court of Federal Claims

- The Court of Federal Claims entered a decision after trial in favor of Coltec, upholding the capital loss claimed by Coltec from the contingent liability transaction at issue in this tax refund litigation. *See Coltec Industries, Inc. v. United States*, 2004-2 U.S.T.C. ¶ 50,402 (Ct. Fed. Cl. 2004).
- The Court of Federal Claims held that the operation of the applicable Code sections justified a capital loss.
- The Court of Federal Claims rejected the government's argument that the capital loss should nonetheless be disallowed under the economic substance doctrine.

Coltec on Appeal – Federal Circuit

- The Federal Circuit (Judges Bryson, Gajarsa and Dyk) upheld the technical analysis of the Court of Federal Claims in favor of the taxpayer. *See Coltec Industries, Inc. v. United States*, 2006-2 U.S.T.C. ¶ 50,389 (Fed. Cir. 2006).
- The court concluded that section 357(c)(3) applies because payment of the liability would give rise to a deduction. The court stated that the government's interpretation that the liabilities must be transferred with the underlying business was plainly inconsistent with the statute.
- The court concluded that, if a liability was excluded by section 357(c)(3), then section 357(b)(1) was not relevant. The court reasoned that the exception in section 358(d)(2) for liabilities excluded under section 357(c)(3) does not contain any reference to section 357(b), nor does section 357(b) contain any reference to the basis provisions in section 358.

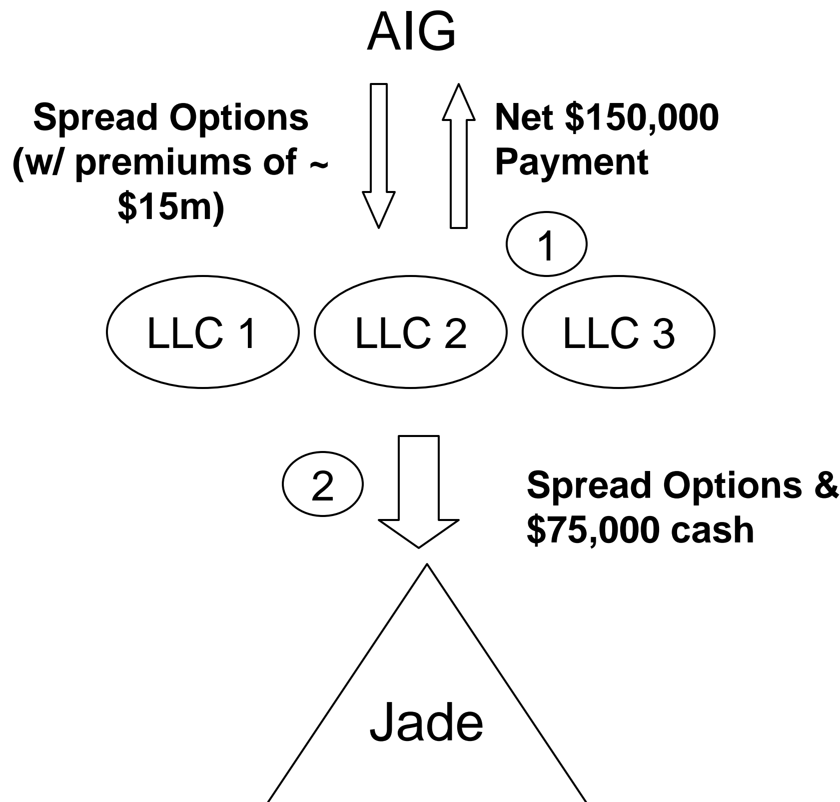
Coltec on Appeal – Federal Circuit

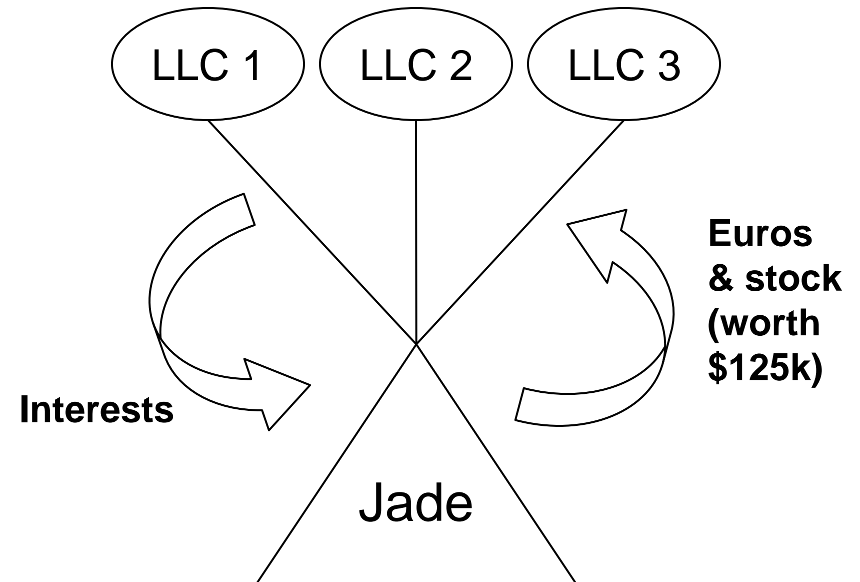
- The Federal Circuit reversed the opinion of the Court of Federal Claims and held that the taxpayer was nevertheless not entitled to a capital loss because the assumption of the contingent liabilities in exchange for the note lacked economic substance.
- The Federal Circuit identified five (5) principles of economic substance.
  - The law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality;
  - It is the taxpayer that has the burden of proving economic substance;
  - The economic substance of a transaction must be viewed objectively rather than subjectively;
  - The transaction to be analyzed is the one that gave rise to the alleged tax benefit;
  - Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

Coltec on Appeal – Federal Circuit

- In applying the economic substance test, the Federal Circuit focused solely on the transaction giving Coltec the high stock basis (*i.e.*, the assumption of the liabilities in exchange for the note) and concluded that Coltec had not demonstrated any business purpose for that transaction.
- The court rejected Coltec's claim that it would strengthen its position against potential veil-piercing claims, since it only affected relations among Coltec and its own subsidiaries and had no effect on third parties.

Jade Trading – Son-of-Boss Transaction





Facts: In March 1999, three taxpayers sold their cable business and realized an aggregate $40.2 million capital gain. Each of the three taxpayers created a single-member LLC on September 17, 1999. On September 23, 1999, Jade Trading LLC was formed by Sentinel Advisors, LLC ("Sentinel") and a foreign financial institution. Sentinel pitched the transaction to BDO Seidman, which marketed the transaction. On September 29, 1999, each of the three LLCs purchased offsetting currency options for a net premium paid of $150,000 to AIG. For each LLC, the options purchased and sold had premiums of $15 million and $14.85 million, respectively. On October 6, 1999, the LLCs contributed their spread options and $75,000 cash to Jade Trading LLC ("Jade"), in exchange for membership interests. About 60 days after the contribution, the three LLCs exited Jade with each receiving Euros and Xerox stock (with a market value of approximately $125,000) in exchange for their interests. Substantial losses were recognized upon the sale of the Euros and Xerox stock.

Jade Trading – Taxpayer's Position

- Each taxpayer claimed that their LLCs' basis in the interest in Jade was increased by the basis of the option purchased ($15 million) but was not decreased by the contingent obligation to deliver property pursuant to the option sold ($14.85 million). Accordingly, each taxpayer subsequently claimed a large capital loss (approximately $14.9 million).
- The primary Code sections at issue in *Jade Trading* were section 752(b) and section 722.
  - Section 752(b) provides that a decrease in a partner's liabilities by reason of a partnership's assumption of those liabilities will be treated as a distribution of money to the partner by the partnership (with the effect of reducing the partner's basis).
  - Under section 722, a partner's basis acquired by a contribution of property, including money, is equal to the amount of money and basis of such property contributed.
- The taxpayers relied principally on *Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975), which provided that a contingent obligation (such as the contingent obligation to deliver property pursuant to an option) was not a liability for purposes of section 752.
- At the time of the transaction, the principle set forth in *Helmer* was good law.
  - The IRS subsequently issued temporary regulations on June 24, 2003, which would have treated the sold option as a liability for purposes of section 752. *See* Treas. Reg. § 1.752-6T.
  - The temporary regulations had retroactive effect to October 18, 1999 (the LLCs contributed the spread options on October 6, 1999).
  - The Preamble to the temporary regulations explicitly states that the regulations do not follow *Helmer*.

Jade Trading – Court of Federal Claims

- The Court of Federal Claims held that the transaction creating the basis increase lacked economic substance. *See Jade Trading, LLC v. United States*, No. 03-2164 (Ct. Fed. Cl. 2007).
- The court found that basis claimed by each LLC satisfied the technical provisions of the Code.
- The court then analyzed the transaction under the economic substance doctrine.
  - The court stated that *Coltec* unequivocally reaffirmed the vitality of the economic substance doctrine in the Federal Circuit.
  - The court found that –
    1. The transaction lacked economic reality because (i) the losses claimed were not tied to any economic loss (*i.e.*, the LLCs did not incur a $15 million loss) and (ii) the use of the partnership structure had no real economic purpose.
    2. The taxpayer had the burden of proving that the transaction had economic substance.
    3. The objective reality of the transaction was the relevant criterion rather than any subjective intent of the taxpayer.
    4. The transaction to be analyzed was the spread transaction that gave rise to the inflated basis (rather than any hypothetical transactions that could have occurred and/or any other trades).
       - The court found that there was no objective profit potential, because the maximum profit potential on the spread ($140,000) was exceeded by the high fees ($934,100).
       - The court also noted that transaction was marketed as a tax avoidance mechanism.
       - The court also noted that the options had to be viewed together rather than as two distinct legal entitlements because of the economic realities of the transaction.
    5. The transaction did not alter the economic interests of independent third parties *(i.e.*, the other partners in Jade).
  - The court held that the transaction lacked economic substance on the basis of the above conclusions, which the court viewed as relevant based upon its interpretation of *Coltec.*

Sala v. United States

- The District Court of Colorado recently held in favor of a taxpayer that entered into a transaction similar to the transaction described in *Jade Trading. See Sala v. United States*, Civ. Case No. 05-cv-00636 (D.C. Co. 2008).
- The IRS has referred to the *Sala* decision as an "anomaly" in the government's continued litigation of "Son-of-Boss" transactions.
- Relevant Facts
  - The taxpayer in *Sala* realized $60 million of income in 2000 in connection with the exercise of stock options.
  - In 2000, the taxpayer invested approximately $9 million in a foreign currency investment program (the "Deerhurst Program").
  - In connection with the "Deerhurst Program," the investment manager acquired long and short options on foreign currencies for a net cost of approximately $730,000.
  - On November 8, 2000, the taxpayer formed an S corporation as its sole shareholder ("Solid"). On November 28, 2000, the taxpayer transferred the long and short options and approximately $8 million of cash to Solid. On the same date, Solid transferred the options and cash to a general partnership ("Deerhurst GP").
  - Deerhurst GP liquidated prior to December 31, 2000. In the liquidation, Solid received approximately $8 million in cash and two foreign currency contracts.
  - Solid subsequently sold the foreign currency contracts prior to December 31, 2000.
  - Solid reinvested the liquidation proceeds into Deerhurst LLC for a minimum of five years.

Sala v. United States

- Taxpayer Position
  - Solid claimed a basis in Deerhurst GP equal to the value of the cash plus the long options, or approximately $69 million. *See Helmer v. Commissioner*, T.C. Memo 1975-60 (1975).
  - Solid claimed a basis in the two foreign currency contracts received in liquidation of Deerhurst GP equal to its partnership basis (~ $69 million) less the cash received in liquidation (~ $8 million), or approximately $61 million.
  - Upon the sale of the two foreign currency contracts, Solid claimed a loss equal to approximately $60 million.
  - The taxpayer claimed the $60 million loss on its original 2000 tax return, but filed a subsequent amended return that did not claim the $60 million loss and paid tax, interest, and penalties of over $26 million in connection with the amended return. The taxpayer subsequently filed a second amended return that claimed the $60 million loss. The taxpayer sued in District Court to claim a tax refund on the basis of the second amended return.
- The Deerhurst Program
  - The District Court found the facts of the Deerhurst Program particularly persuasive.
  - In the program, investors place a minimum of $500,000 in an account for an initial trial period. The account was managed by Deerhurst Management Company, Inc., which was owned and operated by a well-known foreign currency trader.
  - Investors that were interested in remaining in the Deerhurst Program were then required to place additional funds into the program equal to at least 15% of the expected tax loss (for the taxpayer, 15% of ~ $60 million, or ~ $9 million).
  - If the account was profitable after the liquidation in late 2000, investors had to reinvest their liquidation proceeds in Deerhurst LLC for a minimum of five years or be subject to a withdrawal penalty.

Sala v. United States – District Court Decision

The District Court made the following rulings with respect to the Deerhurst Program:

1. The transactions entered into in connection with the Deerhurst Program satisfied the sham transaction / economic substance standard --
   - The court refused to focus its inquiry on the "Son-of-Boss" aspect of the Deerhurst Program and considered the entire investment program.
   - The court found that taxpayer had a potential (albeit small) of obtaining an economic return in excess of the $60 million loss and that the taxpayer entered into the transaction for profit.
   - The court found that the transaction had a good faith business purpose other than tax avoidance, concluding that –
     - The taxpayer's stated purpose of creating Solid to reduce liability exposure was a valid purpose;
     - The creation of Deerhurst GP had the valid purpose of investing in currency options and its liquidation had the valid purpose of "easier accounting and redistribution of the partnership assets";
     - The investment "test period" in the Deerhurst Program had a valid purpose since it permitted taxpayers to gauge their interest in the program at little cost;
     - The fact that "digital options" were not purchased (that would not have created the large tax loss) was immaterial; and
     - The Deerhurst Program, as a whole, had a legitimate business purpose – a good faith and reasonable belief in profitability beyond mere tax benefits.

Sala v. United States – District Court Decision

2. The tax loss was permitted under the Code and applicable regulations --
   - The basis obtained in Solid and Deerhurst GP was equal to the value of long options and contributed cash and was not decreased by liabilities associated with the short options.
   - The at-risk rules of sec. 465 and the loss limitation rule of sec. 1366(d) did not apply.
   - Each of the 24 options contributed to Solid and Deerhurst GP were separate financial instruments. Accordingly, offsetting options were not offset against each other for purposes of determining the “net” value of property contributed to Solid and Deerhurst GP.
   - The two foreign currency contracts received by Solid upon liquidation of Deerhurst GP constituted “property” within the meaning of sec. 732. As a result, Solid obtained a basis in such property equal to Solid’s basis in the partnership reduced by any money distributed.
3. Treasury exceeded its authority when issuing Treas. Reg. § 1.752-6(b)(2) and when making the regulations retroactive. *Compare Klamath Strategic Inv. Fund, LLC v. United States*, 440 F. Supp. 2d 608 (E.D. Tex. 2006) *with Cemco Investors, LLC v. United States*, 515 F.3d 749 (7th Cir. 2008).
4. The taxpayer filed a valid qualified amended return, and the IRS was not entitled to offset excess interest payments made by the taxpayer with an accuracy-related penalty.

Stobie Creek Investments, LLC v. United States

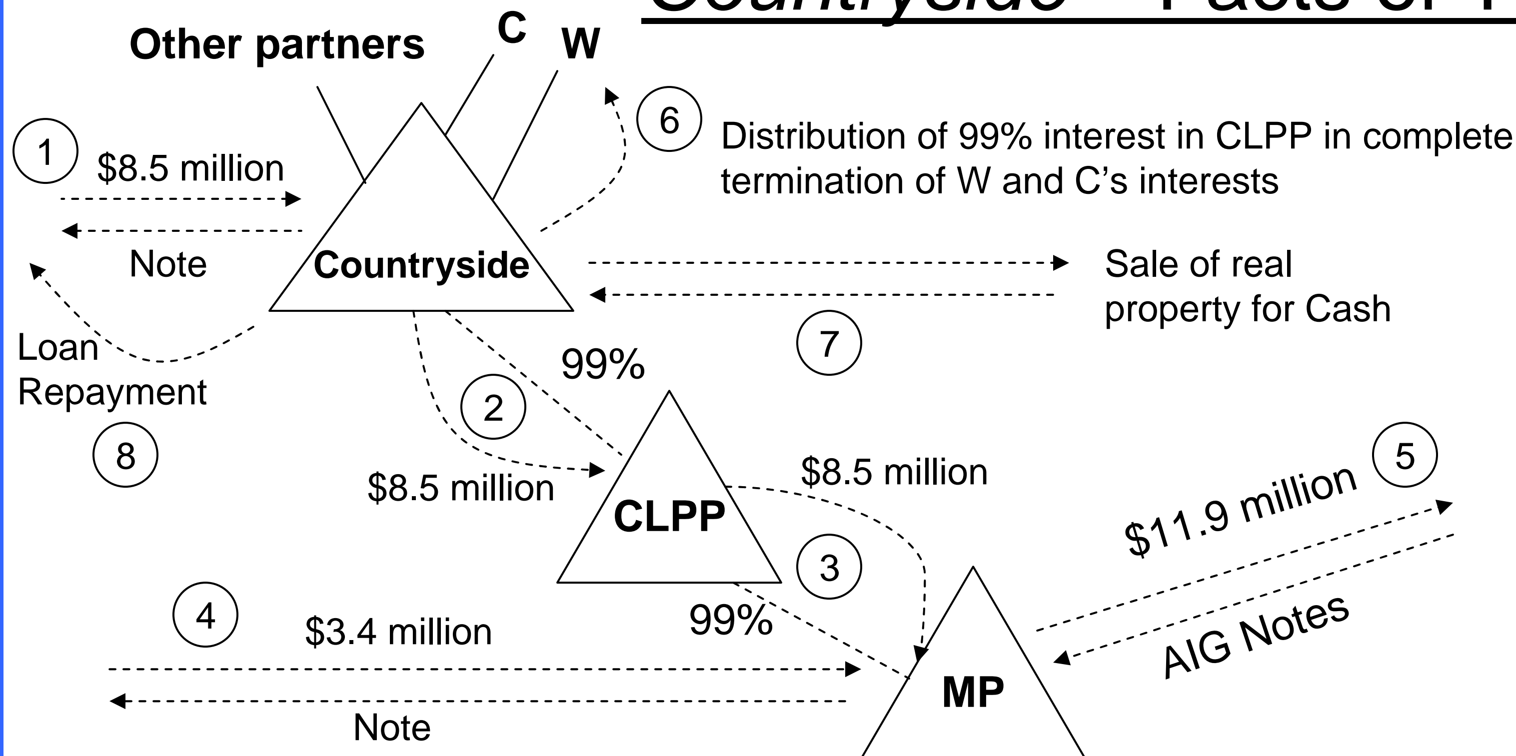
- Stobie Creek involved a "Son of BOSS" transaction similar to the transactions in *Sala* and *Jade Trading*.
- Members of a family sought to eliminate gain on the planned sale of the family business by contributing low-basis stock to a partnership and using offsetting foreign currency options to increase their outside basis.
- Each family member transferred their shares in the family business to an investment partnerhsip, Stobie Creek Investments, LLC. In addition, each family member formed a single-member LLC. Each of the LLCs purchased two offsetting pairs of currency options. The options were digital options which paid off in property if they were in the money and paid nothing if they were out of the money. The long position option and short position option had strike prices that were separated by a very narrow band. There would be a very large profit if the price settled within this narrow band.
- Each LLC then contributed the options to the Stobie Creek investment partnership in exchange for partnership interests. As in *Sala* and *Jade Trading*, the taxpayers relied on *Helmer v. Comm'r* to take the position that the basis of each partner's partnership interest was increased by the assumption of the long option position but not reduced by the short option obligation.
- After the options expired and were worthless, each family member's LLC contributed its Stobie Creek partnership interest to its owner's personal S corporation, causing the Stobie Creek partnership to terminate.
- Upon the termination of the partnership, each family member's increased basis in his or her partnership interest attached to the shares in the family business. Thus, when the shares in the business were sold, there was only a small capital gain.

Stobie Creek Investments, LLC v. United States Court of Federal Claims

- Judge Miller concluded that this Son of BOSS transaction satisfied the literal requirements of the Internal Revenue Code but was a sham.
  - The court relied on the Federal Circuit's decision in *Coltec* and applied the conjunctive form of the economic substance test:

    "If the court finds that a transaction is wholly lacking in economic reality, such that no realistic financial benefit inures to the taxpayer beyond the tax features, or that no reasonable possibility of profit is present, the court need not engage in the subjective inquiry. Conversely, if a transaction was shaped solely by a tax-avoidance purpose, the fact that the transaction may have some objective economic reality cannot save it from being disregarded as an economic sham."
- The court determined that the small possibility of profit presented by the offsetting currency options was overwhelmed by the substantial transaction costs. In addition, it was clear that the transaction was entered into for tax avoidance purposes.
- The court also agreed with the government's application of the step-transaction doctrine because both the interdependence and end result tests were satisfied. Accordingly, the court determined that under the step-transaction doctrine the steps should be collapsed, therefore precluding the basis increase.
- The court also imposed significant penalties. The court rejected the taxpayers' reasonable cause and substantial authority defenses. The court stated that the taxpayer's could not rely on *Helmer* as substantial authority because a substantial authority analysis must include the economic substance and step-transaction doctrines and there was no substantial authority that these doctrines should not apply to the present case. The court also rejected the taxpayers' reliance on an opinion from the law firm Jenkins & Gilchrist. The opinion was contingent on representations from the taxpayers that there was a business purposes for the steps of the transactions and that there was a substantial probability of profit. The court determined that both of these representations were "demonstrably false."

Countryside – Facts of Transaction



Facts: W and C are individual partners in a partnership ("Countryside"). W possessed a 70% interest and C possessed a 25% interest in Countryside. Two other partners held the remaining interests. On or about September 18, 2000, W, acting as president of two separate corporations, formed two separate LLCs ("CLPP" and "MP"). On October 27, 2000, each of the corporations contributed cash to obtain a 1% interest in the LLCs. Countryside borrowed $8.5 million from a third-party bank. On October 30, 2000, Countryside contributed the cash to CLPP in exchange for a 99% interest and CLPP contributed the borrowed funds to MP for a 99% interest. On or about the same day, MP borrowed an additional $3.4 million from the same third-party bank. On or about October 31, 2000, MP used the borrowed proceeds to acquire four privately issued notes (the "AIG Notes") in the aggregate principal amount of $11.9 million. On December 26, 2000, Countryside distributed its 99-percent interest in CLPP to W and C in complete liquidation of their respective partnership interests. As a result of the distribution, both W and C were relieved of their share of Countryside's liabilities, although each retained a share of MP's liabilities. In April 2001, Countryside sold real property and used the sale proceeds to repay the $8.5 million obligation to the third-party bank. In 2003, the AIG Notes were redeemed from MP by AIG. In 2004, MP repaid the $3.4 million loan.

Countryside – Tax Issues

- The IRS issued a notice of final partnership administrative adjustment (the FPAA) on October 8, 2004. The FPAA contained the following adjustments –
  - The distribution in liquidation of W and C's interests in Countryside constituted a taxable event resulting in a large capital gain pursuant to section 731;
  - A denial of Countrywide's basis step-up under section 734(b)(1)(B) for the property remaining after the liquidating distribution (including the real property sold in 2001); and
  - A basis reduction in the AIG Notes held by MP pursuant to section 743(b).
- W filed a partial motion for summary judgment in the Tax Court to resolve the first of the above issues raised by the IRS in the FPAA.
- The IRS argued that Countryside's distribution of its 99% interest in CLPP constituted a distribution of marketable securities for purposes of section 731(a)(1) or, alternatively, it should be treated as such under the economic substance doctrine.
  - Section 731(a) provides that a partner does not recognize gain on a partnership distribution, except to the extent that money distributed (including "marketable securities") exceeds the partner's adjusted basis in the partnership.
  - If the distribution was treated as a distribution of money, then W and C would recognize substantial gain because both would have a low basis in their interests in Countryside (in part, because the relief of Countryside liabilities assumed by W and C would be treated as a distribution under section 752 that would reduce W and C's outside basis).
  - Note that W and C claimed that the $3.4 million borrowing by MP increased their outside basis and thus offset potential gain on the liquidating distribution.
- The Tax Court decided this issue in favor of the taxpayer. *See Countryside Limited Partners v. Commissioner*, 95 T.C.M. (CCH) 1006 (2008).

Countryside – Economic Substance

- The Tax Court rejected the IRS argument that the distribution of the 99% interest in CLPP constituted a distribution of marketable securities under section 731(a)(1).
- The Tax Court also rejected the IRS argument that the economic substance doctrine should apply to treat the distribution as a distribution of money for purposes of section 731(a)(1).
- The crux of the IRS position was that W and C effectively deferred or eliminated the recognition of gain on their share of the sale proceeds Countryside received in the 2001 sale of real property.
- The IRS unsuccessfully argued that Countryside had no potential for profit in the transaction because of interest and transaction costs and, thus, the transaction lacked a business purpose and should be recast under the economic substance doctrine.
  - The Tax Court rejected this IRS argument because it focused on Countryside's pre-tax profit rather than on the partners, W and C, who were the focus of the motion before the court.
  - At most, the Tax Court stated that this argument could support a challenge to any interest deductions claimed by Countryside with respect to the $8.5 million loan.
- The Tax Court concluded that the means of the transaction (*i.e.*, the liquidation of W and C's interests in Countryside) were designed to avoid recognition of gain, but that these means also served "a genuine, nontax, business purpose" – to convert W and C's investments in Countryside into 10-year promissory notes from an independent third-party.
- The Tax Court observed that these two forms of investment were economically distinct and therefore, in form and substance, the transaction constituted a redemption of W and C's interests for property other than marketable securities.
- The Tax Court clearly viewed the tax benefits of the transaction as incidental. Accordingly, the Tax Court found no harm in structuring the transaction in a manner to minimize the tax burdens of W and C.

Countryside – Effect of Continued Litigation?

- The Tax Court only resolved the issue addressed by the partial motion for summary judgment.
- The Tax Court did not resolve the remaining issues raised by the FPAA, and it is uncertain whether W, C, Countryside or MP will retain any tax benefits claimed in connection with the transaction if and when the remaining issues are addressed.
- A footnote in the decision suggests that the Tax Court believes that the tax benefits claimed may not be warranted.
- Footnote 29 states that, given the totality of the circumstances, including (i) the formation of CLPP and MP and (ii) the section 754 elections made by Countryside and CLPP (but not by MP), there may be grounds to invoke the partnership anti-abuse rule of Treas. Reg. § 1.701-2 and/or the economic substance doctrine in order to determine –
  - Whether Countryside should obtain a basis step-up in the retained assets and/or
  - Disregard CLPP and MP as sham entities, and/or
  - Require a basis step-down in the AIG Notes held by MP.
- The remaining issues have been consolidated before the Tax Court judge.

Notice 2008-20 – Intermediary Tax Shelter

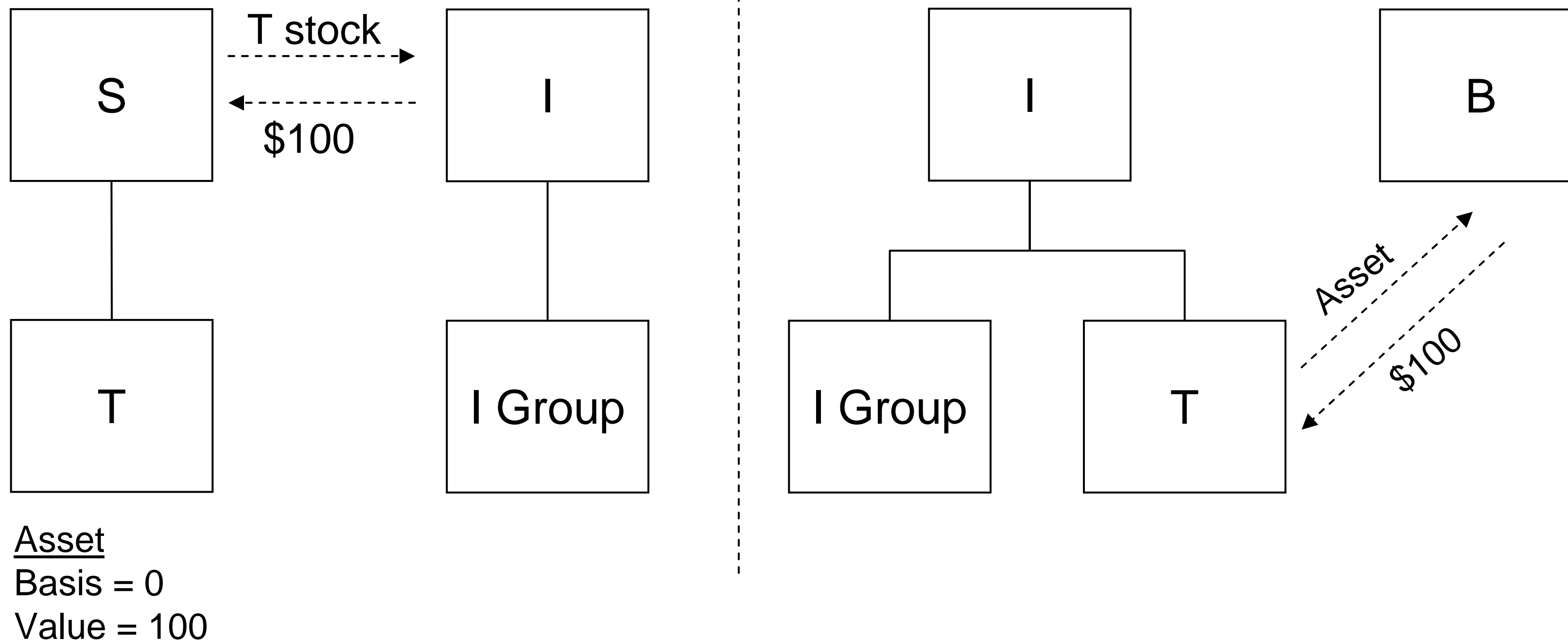
Notice 2008-20 – Overview

- The IRS issued Notice 2008-20 on January 17, 2008, to identify the components of the "Intermediary Tax Shelter" described in Notice 2001-16.
- Notice 2008-20 provides that a transaction that does not satisfy all four of the components listed in the Notice will not be the same or substantially similar to the listed transaction described in Notice 2001-16.
- Notice 2008-20 is effective as of January 17, 2008, and applicable to returns and statements due by taxpayers (under section 6011) and material advisors (under section 6111) after that date.
- The IRS clarifies in Notice 2008-20 that the Notice does not affect whether a transaction was required to be disclosed or registered prior to January 17, 2008.

Notice 2001-16 – Intermediary Tax Shelter

- As described in Notice 2001-16, the Intermediary Tax Shelter generally involves a seller ("S") who desires to sell the stock of a target corporation ("T") to a buyer ("B").
- The buyer in the transaction desires to acquire the assets of T (rather than the T stock).
- Pursuant to a plan, S transfers the T stock to an intermediary ("I") followed by a transfer by T of its assets to B.
- As a result of the transaction, B obtains a cost basis in the T assets it receives.
- Notice 2001-16 identifies certain transactions as an Intermediary Tax Shelter, including the use of an intermediary (i) that is a member of a consolidated group that uses consolidated tax attributes to shelter the gain otherwise resulting from the sale of T assets or (ii) that is an entity not subject to tax.

Intermediary Tax Shelter Example – Consolidated Group



Facts: S owns all of the stock of T. T owns an asset with a value of $100 and a basis of zero ("Asset"). S sells all of its T stock to I for $100 in Year 1. I is a parent of a consolidated group that expects to have a significant loss in Year 1. T transfers Asset to B for $100 in Year 1.

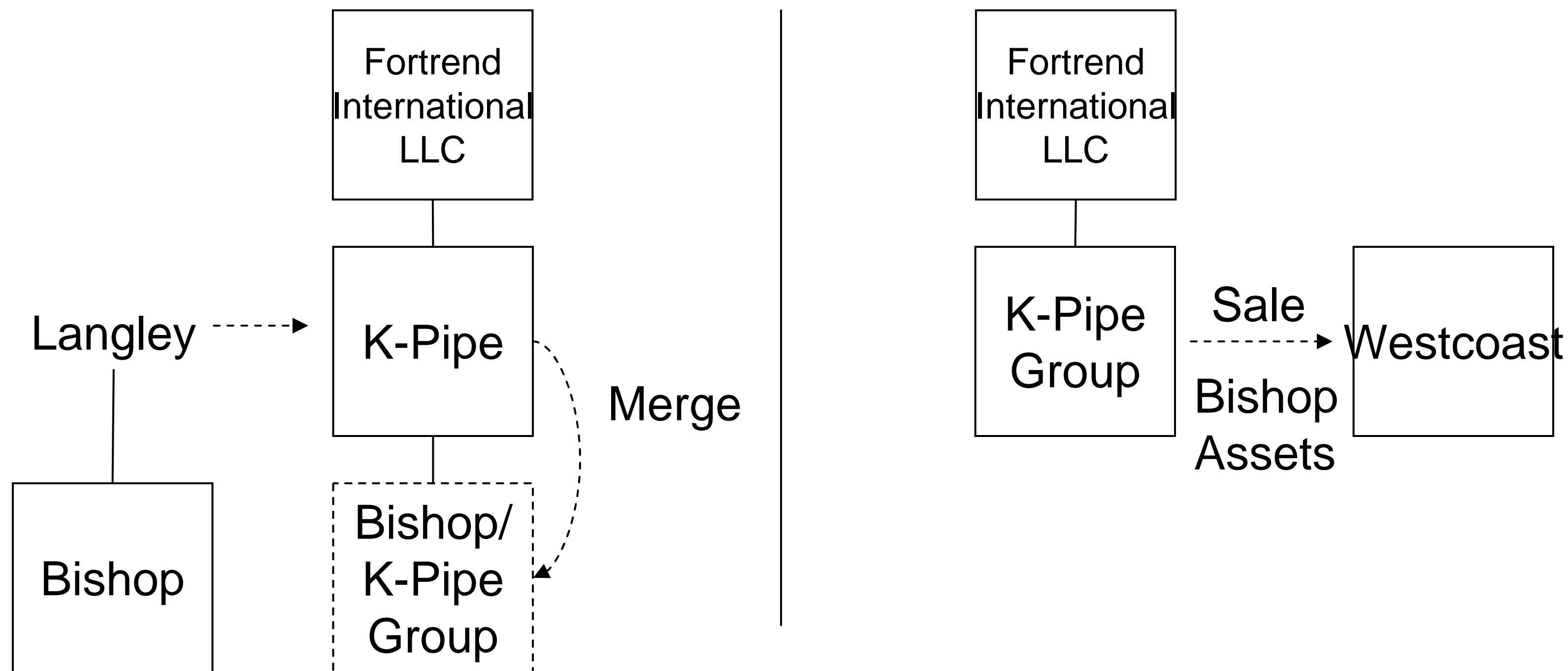
Notice 2008-20 – Four Components

- Component 1 – (Built-in Tax) -- A corporation ("T") directly or indirectly (*e.g.,* through a pass-through entity or a member of a consolidated group of which T is a member) owns assets the sale of which would result in taxable gain and, at the time of the stock disposition described in Component 2 (below), T (or the consolidated group of which T is a member) has insufficient tax benefits to eliminate or offset such taxable gain (or the tax) in whole or in part. The tax that would result from such sale is hereinafter referred to as T's Built-in Tax.
- Component 2 – (Sale of Stock) -- At least 50 percent of the T stock (by vote or value) is disposed of by T's shareholder(s) ("S"), other than in liquidation of T, in one or more related transactions within a 12-month period.
- Component 3 – (Sale of Assets) -- Either within 12 months before, simultaneously, or within 12 months after the date on which S has disposed of at least 50 percent of the T stock (by vote or value), all or most of T's assets are disposed of (Sold T Assets) to one or more buyers (B) in one or more transactions in which gain is recognized with respect to the Sold T Assets.
- Component 4 – (Offset of Built-in Tax) All or most of T's Built-in Tax described in Component 1 that would otherwise result from the disposition of the Sold T Assets described in Component 3 is purportedly offset, avoided, or not paid.

Notice 2008-20 – Issues in Application

- Issues Relating to Disclosure and Circular 230
  - Taxpayers and their tax advisors may not be in a position to determine whether a transaction satisfies the four components of Notice 2008-20 at the time of the sale of target company stock (or at the time they are required to discharge their obligations related to listed transactions).
  - In fact, taxpayers and their tax advisors may never be in a position to know the status of the transaction.
    - A seller of stock may have no knowledge of the intention of the buyer regarding asset dispositions during the 12-month period following the stock sale.
    - A purchaser of stock may not have knowledge of asset dispositions for 12-month period preceding the stock sale.
    - Must sellers and purchasers rely on representations?
  - Tax advisors may be required to comply with Circular 230 with respect to written advice and their own disclosure obligations shortly after the transaction is completed.
- Issues Relating to Components in Notice 2008-20
  - Meaning of "all or most"
  - Treatment of cross-chain transactions under Component 2
  - Treatment of subsidiary stock held by T
  - Identification of Sold T Assets under an aggregate or asset-by-asset approach
  - *De minimis* amount of Built-in Tax attributable to Sold T Assets

Enbridge Energy Co. v. United States



- In *Enbridge Energy Co. v. United States*, 553 F.Supp.2d 716 (S.D. Texas 2008), the court determined an intermediary company to be a sham.
- In *Enbridge*, the taxpayer, Langley, wanted to sell his solely owned pipeline business, The Bishop Group, Ltd. ("Bishop"). Langley sold the stock of Bishop to an intermediary, K-Pipe Merger Corporation ("K-Pipe"). K-Pipe then merged into Bishop, with Bishop surviving. Bishop changed its name to K-Pipe Group. K-Pipe Group then sold all of the Bishop assets to Midcoast Energy Resources, Inc. ("Midcoast").

Enbridge Energy Co. v. United States District Court Decision

- The district court disregarded the involvement of K-Pipe as a mere conduit and treated the transaction as a purchase of the Bishop stock by Westcoast, followed by a liquidation of Bishop. The court treated the transaction as a stock sale and liquidation rather than a straight asset purchase because the court determined that it was clear from the facts that Langley would not consider a straight asset sale. Therefore, the court determined that in substance the transaction was a direct sale of stock in Bishop from Langley to Westcoast, followed by a 332 liquidation of Bishop. Thus, Westcoast did not receive a cost basis in Bishop's assets.
- The court disregarded the intermediary company or "midco" as a conduit based on an analysis of the following factors:
  - Whether there was an agreement between the principals to do a transaction before the intermediary participated;
  - Whether the intermediary was an independent actor;
  - Whether the intermediary assumed any risk;
  - Whether the intermediary was brought into the transaction at the behest of the taxpayer; and
  - Whether there was a non tax-avoidance business purpose to the intermediary's participation.
- Although there was no formal agreement between Bishop and Midcoast, the court found that the facts indicated that Midcoast's tax advisors identified Fortrend as an intermediary and that there was no nontax business purpose for Fortrend's participation. Moreover, the entity formed for the transaction, K-Pipe, was a mere shell and did not have any other business activities.

Section 355 Updates

Proposed Section 361(d) Legislation

Proposed Section 361(d)

- Section 357(c)(1) provides that Distributing must recognize gain if the liabilities assumed in a section 351 exchange or a divisive ‘D’ reorganization exceed the total adjusted basis of the property transferred.
- Section 361(b)(1)(A) and (b)(3) provides that Distributing does not recognize gain if it receives money or other property in a ‘D’ reorganization and distributes that money or other property to its shareholders or creditors.
  - However, the amount of money plus the FMV of other property that Distributing can distribute to its creditors without gain recognition is limited to the amount of the basis of the assets contributed to Controlled in the divisive ‘D’ reorganization. Section 361(b)(3).
- Congressman Charles Rangel (D-NY) introduced H.R. 3970, the Tax Reduction and Reform Act of 2007 in the House on October 29, 2007, which would add section 361(d) to treat Controlled securities or nonqualified preferred stock similar to cash and the assumption of liabilities.

Proposed Section 361(d)

- Proposed section 361(d) would provide:

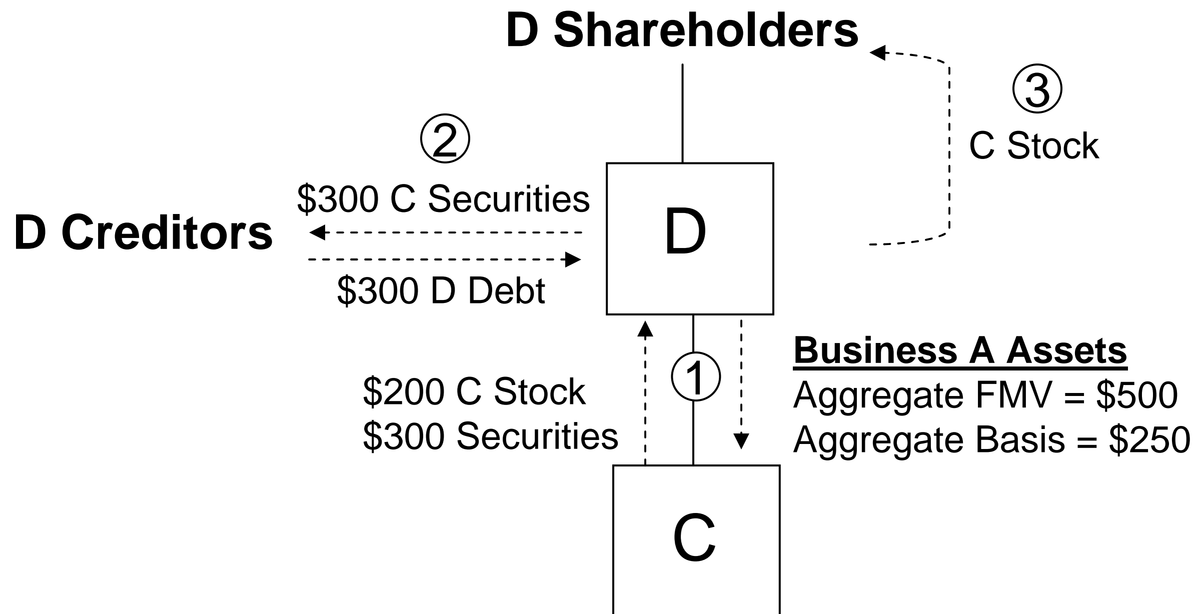
(d) Receipt of Securities, etc., in Exchange for Assets in Certain Reorganizations – If--

(1) property is transferred to a corporation (hereinafter in this subsection referred to as the controlled corporation) pursuant to a plan of reorganization described in section 368(a)(1)(D), and

(2) pursuant to such plan of reorganization, stock or securities in the controlled corporation are distributed in a transaction which qualifies under section 355,

then any securities and nonqualified preferred stock (as defined in section 351(g)(2)) of the controlled corporation shall be treated as other property for purposes of subsections (a) and (b).

Proposed Section 361(d) - Example



Facts: D owns all of the stock of C in which it has a basis of $100. D contributes its business A assets, which have an aggregate fair market value of $500 and an adjusted basis of $250, to C in exchange for $200 of C stock and $300 of C securities. D exchanges its securities for currently outstanding D debt. D then distributes all of its C stock pro rata to its shareholders. Assume that the spin-off qualifies under section 355.

Result: Under current law, the receipt of C securities and their transfer to D's creditors should not trigger any gain. Section 361(a), (c)(3). However, if section 361(d) is enacted, the C securities would be treated as boot under section 361(b) and, therefore, limited to the total adjusted basis of the properties transferred by D to C. *See* section 361(b)(3); *cf.* section 357(c)(1).

What if C transferred $200 of C stock and $300 of cash to D? $200 of C stock and $300 of nonqualified preferred stock?

What if D distributed the $300 C securities to its shareholders instead of its creditors?

Notice 2007-60

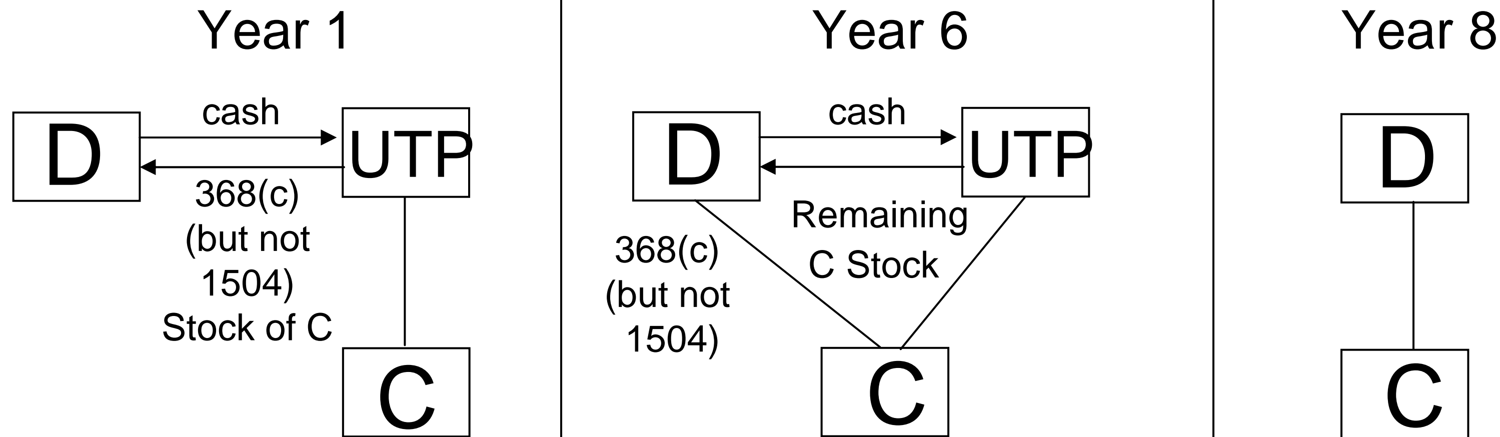
Section 355(b)(3) – The SAG Rules

- Section 355(b)(3) provides that, for purposes of determining whether a corporation is engaged in the active conduct of a trade or business, all members of such corporation's separate affiliated group ("SAG") are treated as one corporation.
  - A SAG is defined as the affiliated group which would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply.
- Section 355(b)(2)(C) provides that the ATB must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part, during the 5-year pre-distribution period.
- Section 355(b)(2)(D) provides that control of a corporation which (at the time of acquisition) was conducting an ATB must not have been directly or indirectly acquired by any distributee corporation or distributing corporation during the pre-distribution period in a transaction in which gain or loss was recognized, in whole or in part.
  - Control means control under section 368(c) (*i.e.*, 80% of voting power of all classes of stock entitled to vote and 80% of each other class of stock).

Section 355(b)(2)(C) & (b)(2)(D) Post-Section 355(b)(3)

- Regulations proposed on May 8, 2007 provide guidance on the application of the SAG rule to the acquisition rules of sections 355(b)(2)(C) and (D).
- The proposed regulations disregard asset transfers between SAG members for purposes of determining whether there has been an impermissible acquisition under section 355(b)(2)(C).
- The proposed regulations generally treat stock acquisitions that result in the acquired corporation becoming a SAG member as asset acquisitions.
  - Thus, the applicable Code provision is section 355(b)(2)(C), and the effect of section 355(b)(2)(D) is thereby limited.

Section 355(b)(2)(C)



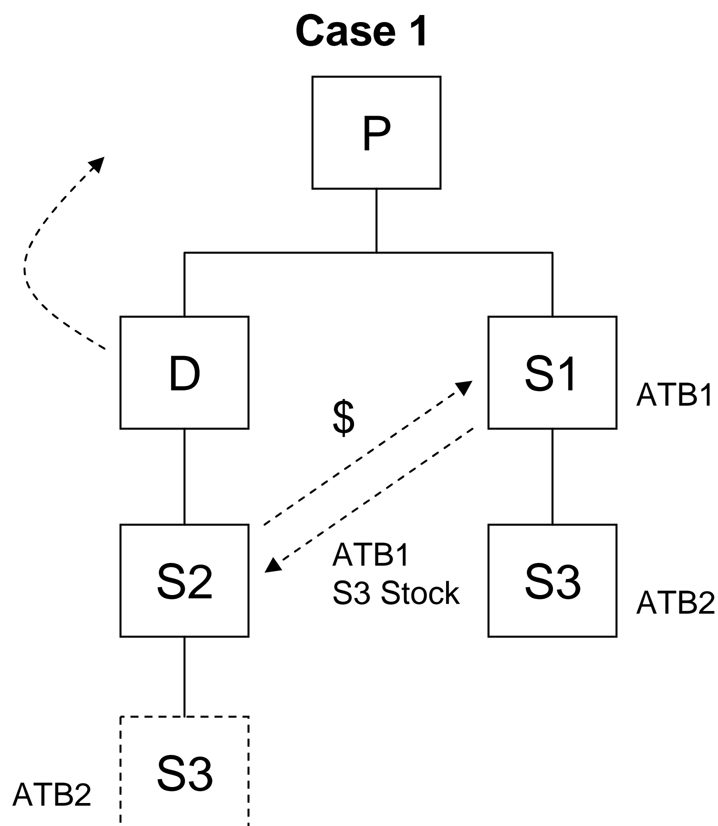
Facts: In Year 1, D acquired stock of C constituting control within the meaning of section 368(c), but C did not become a member of the DSAG. At that time and at all times since the acquisition, D and C have been directly engaged in different ATBs. In Year 6, D acquired all of the remaining C stock and C became a member of the DSAG. In Year 8, D distributed the stock of C to its shareholders.

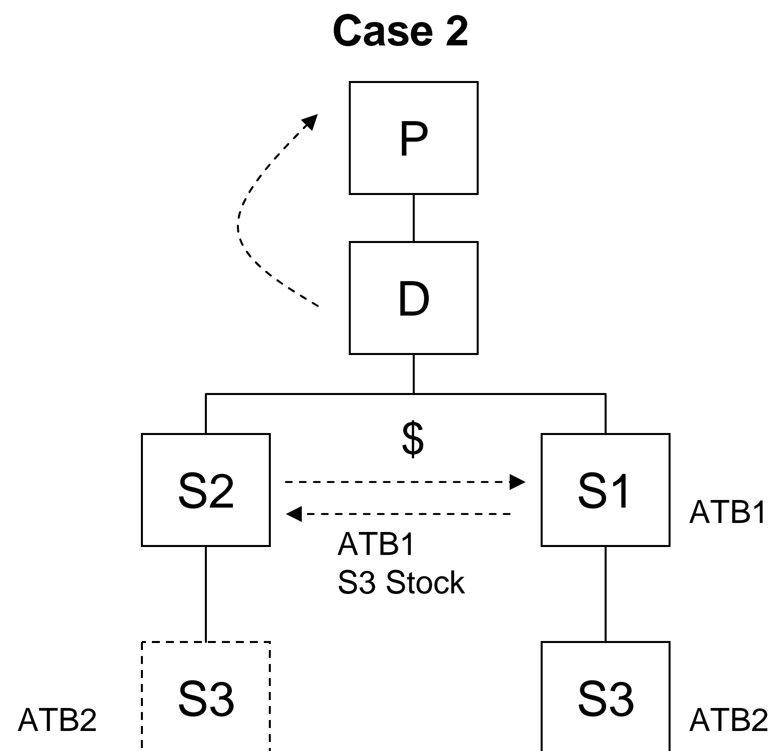
Results: The proposed regulations treat the acquisition of the remaining C stock in Year 6 as an asset acquisition subject to section 355(B)(2)(C), notwithstanding that D already controlled C and thus a stock acquisition would not have violated section 355(b)(2)(D). *See* Prop. Treas. Reg. § 1.355-3(d), Ex. 42. Notice 2007-60 provides that the IRS will not challenge D's acquisition of additional C stock as a violation of section 355(b)(2)(C) in the case of distributions on or before the proposed regulations become final.

Affiliate Exception

- Treas. Reg. §1.355-3(b)(4)(iii) provides that a direct or indirect acquisition of a trade or business by one member of an affiliated group from another member of the group is disregarded in applying section 355(b)(2)(C) and (D).
  - Section 355(b)(2)(C) and (D) were intended to prevent the direct or indirect acquisition of a trade or business by a corporation in anticipation of a spin-off.
  - Acquisitions from affiliates, even if taxable, are not the type of transactions to which these provisions were intended to apply.
- Although, by its terms, the affiliate exception only applies to acquisitions before December 15, 1987, the IRS has continued to apply the exception administratively. *See, e.g.,* PLRs 200452003; 9621030; 9416008; 9224016.
- The proposed regulations apply the affiliate exception only to transfers between SAG members. Prop. Treas. Reg. §1.355-3(b)(4)(iii).
- The IRS has indicated, however, that it will not challenge the applicability of the affiliate exception to distributions occurring on or before the date the proposed regulations become final. *See* Notice 2007-60.

Affiliate Exception – Example





Facts: For five years, the P consolidated group has consisted of P, D, S1, S2, and S3. During this period, S1 and S3 have conducted ATB1 and ATB2, respectively. In Year 6, S2 purchases ATB1 and the stock of S3 from S1. In Year 8, D spins-off S2. In Case 1, S1 is a brother-sister corporation of D. In Case 2, S1 is a wholly-owned subsidiary of D.

Result: In Case 1, S1 is not a member of the DSAG. Therefore, the acquisition of ATB1 and ATB2 violates section 355(b)(2)(C), and D cannot rely on ATB1 or ATB2 to satisfy the ATB requirement for the Year 8 spin-off. In Case 2, S1 is a member of the DSAG. Accordingly, the acquisitions of ATB1 and ATB2 are disregarded. *See* Prop. Treas. Reg. §1.355-3(b)(1)(ii), -3(d)(2), Ex. 26.