

# **CLEANING UP THE ORGANIZATION CHART: TAX OPPORTUNITIES AND PITFALLS**

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- International Tax
- Partnership Tax
- General Tax
- Tax Controversies

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- Colorado
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- Inbound and outbound business operations and investment
- Tax treaties
- Financial instruments, including foreign currency instruments
- Transfer pricing

John has authored a number of articles and regularly speaks on international and other tax topics.

# CLEANING UP THE ORGANIZATION CHART: TAX OPPORTUNITIES AND PITFALLS

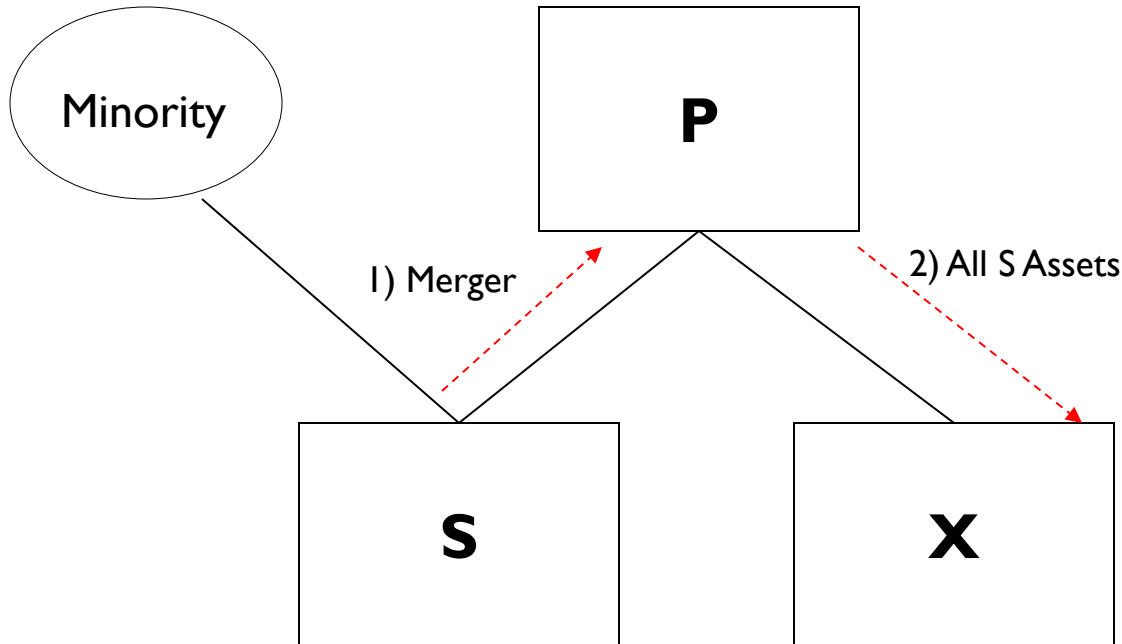
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# **INTRAGROUP REORGANIZATIONS**

# **INTRAGROUP REORGANIZATIONS**

Liquidation/Reincorporation and  
Rev. Rul. 69-617

# REV. RUL. 69-617

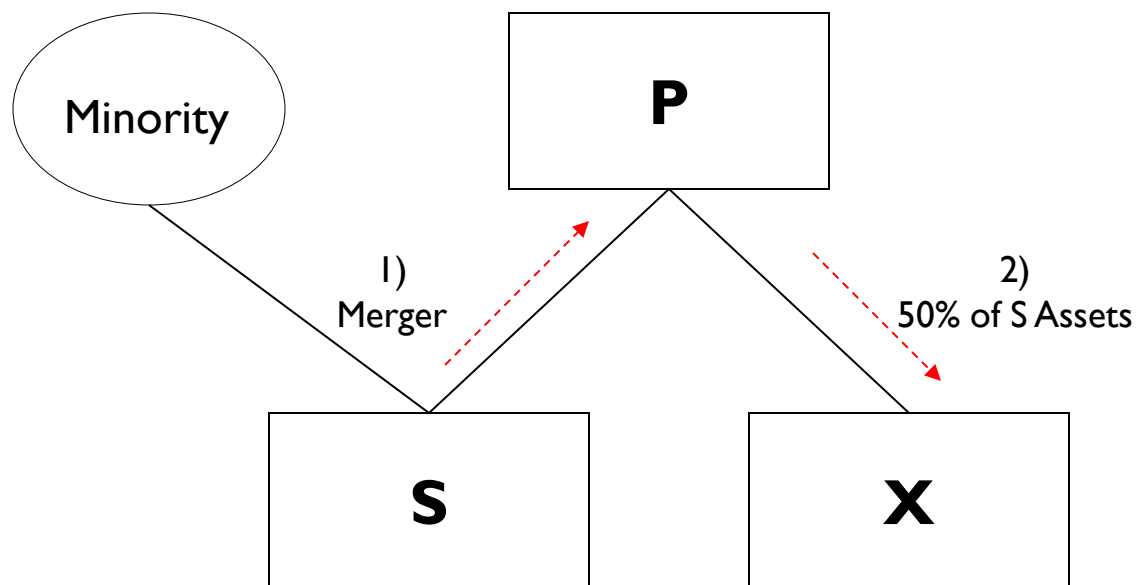


- S merges into P. Minority gets P stock.
- P transfers all of the assets received from S to X.

## Results:

- Merger qualifies as §368(a)(1)(A) reorganization, and Minority gets P stock tax-free.
- Asset transfer to X disqualifies merger as liquidation of S, and does not disqualify merger as a reorganization. §368(a)(2)(C); Reg. §1.368-2(k).

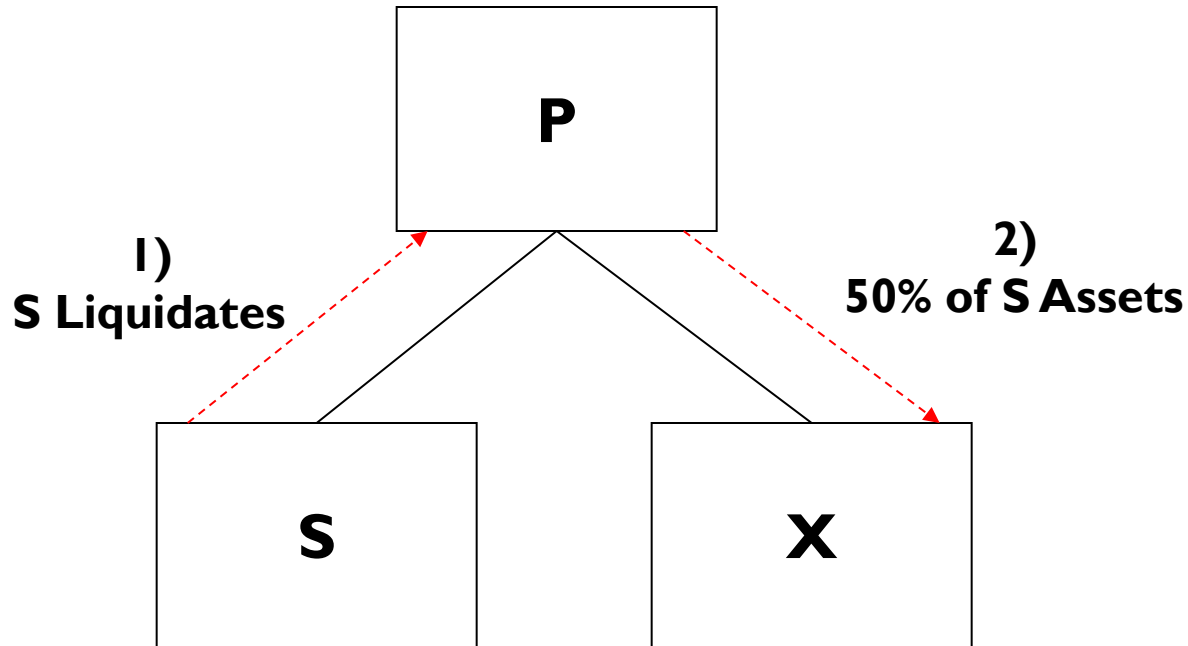
# VARIATION ON REV. RUL. 69-617



- S merges into P.Y's Minority exchange their S stock for P stock..
- P transfers 50% of the assets received from S to X.
- Private rulings rely on Rev. Rul. 69-617 and treat the transactions as A reorganization followed by §368(a)(2)(C) asset drop. PLRs 9222059, 9422057 and 8710067. PLR 9222059 allows double-drop.
- If merger and asset drop were stepped together as asset transfer by S to X, result could be either of two partially taxable cross-chain transactions:
  - Acquisitive D reorganization with 50% of S assets not transferred to X taxed as boot to P.
  - Taxable asset transfer by S to X and §332 liquidation of S.

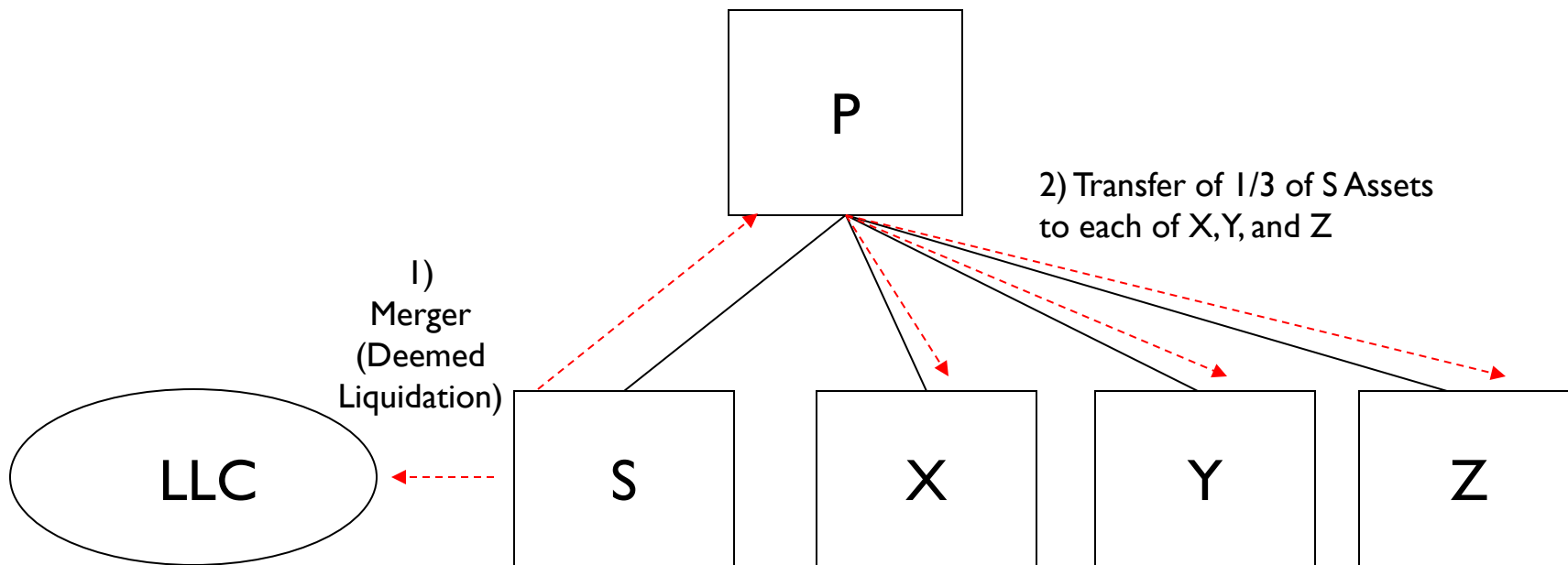


# REV. RUL. 69-617 AND ANTI-BAUSCH & LOMB REGULATIONS



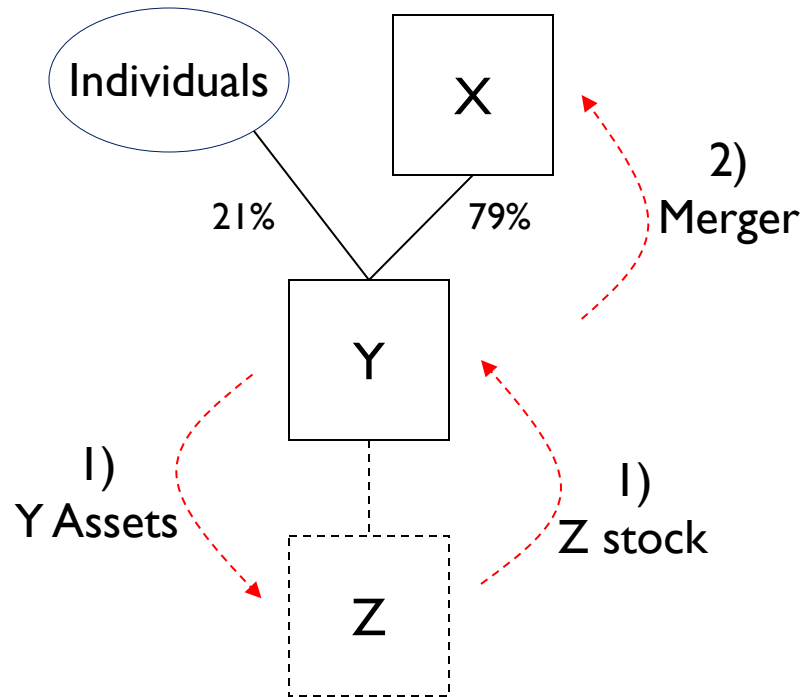
- S liquidates and distributes all of its assets to P. P then transfers 50% of the assets received from S to X.
- Transaction is treated, under Rev. Rul. 69-617, as a C reorganization followed by a drop of assets under §368(a)(2)(C). Reg. §1.368-2(d)(4).
- What if X were a newly formed corporation?

# REV. RUL. 69-617 (VARIATION) AND ANTI-BAUSCH & LOMB REGULATIONS



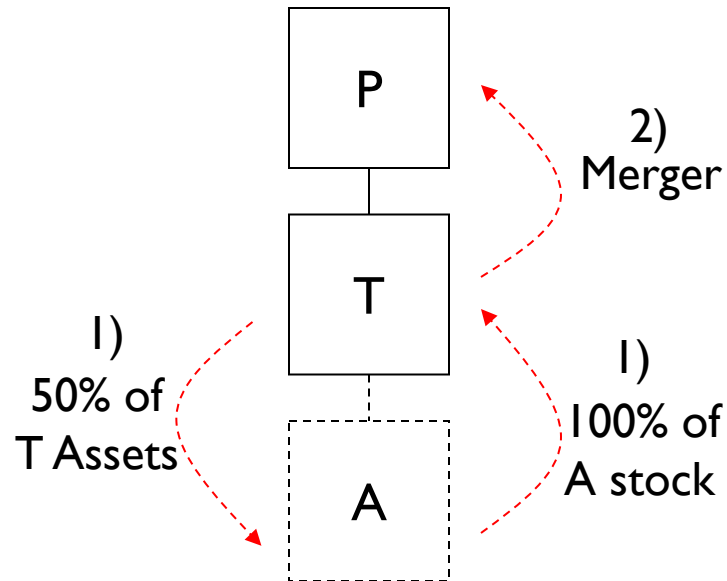
- S converts to LLC causing a deemed liquidation of S for tax purposes.
- LLC transfers 1/3 of S's historic assets to each of X, Y, and Z. (P is treated as transferring such assets to X, Y and Z.)
- Transaction is treated, under Rev. Rul. 69-617, as a C reorganization followed by drops of assets under §368(a)(2)(C). Reg. §1.368-2(d)(4).

# REV. RUL. 58-93



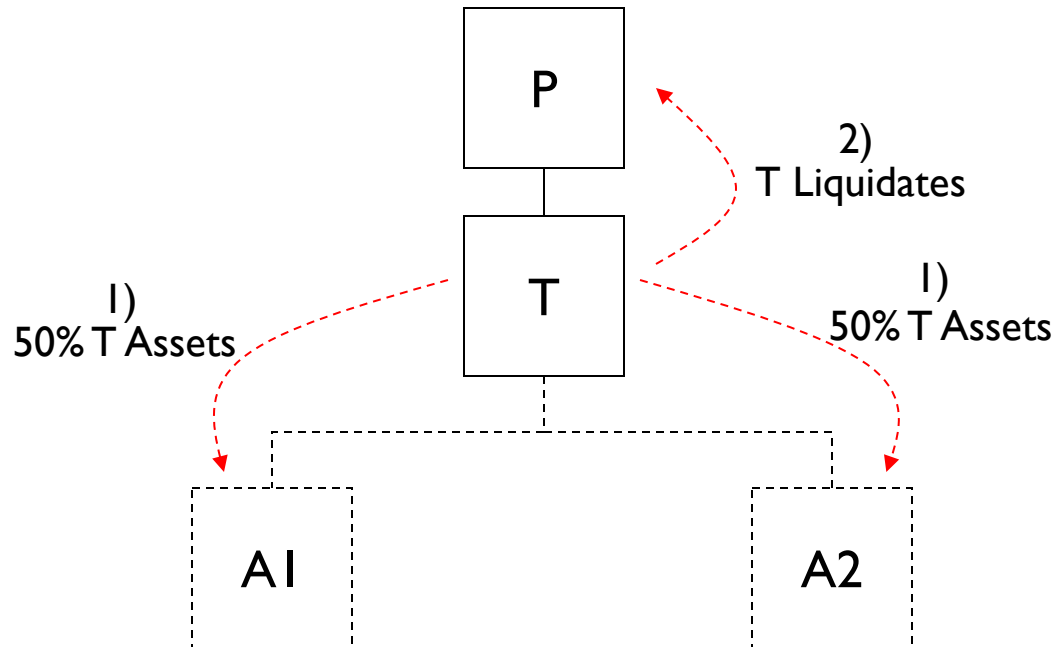
- Y transfers all its assets, subject to its liabilities, to newly-formed Z for all the Z stock.
- Y merges into X. Y's individual shareholders exchange their Y stock for X stock.
- Transactions are re-ordered and treated as if Y merged into X, and then X transferred the Y assets to Z. Thus, as in Rev. Rul. 69-617, transaction constitutes an upstream A reorganization, followed by asset transfer under §368(a)(2)(C).

# PLRs 200733002 AND 201026010



- T drops 50% of its assets into newly-formed A for all the stock of A.
- T merges upstream into P.
- Transactions are treated in accordance with their form (with closing agreement):
  - §351 asset transfer by T to A.
  - §332 liquidation of T.
- Alternative possible treatments:
  - Upstream A reorganization with asset drop under §368(a)(2)(C).
  - Cross-chain acquisitive D reorganization with taxable boot received by P.

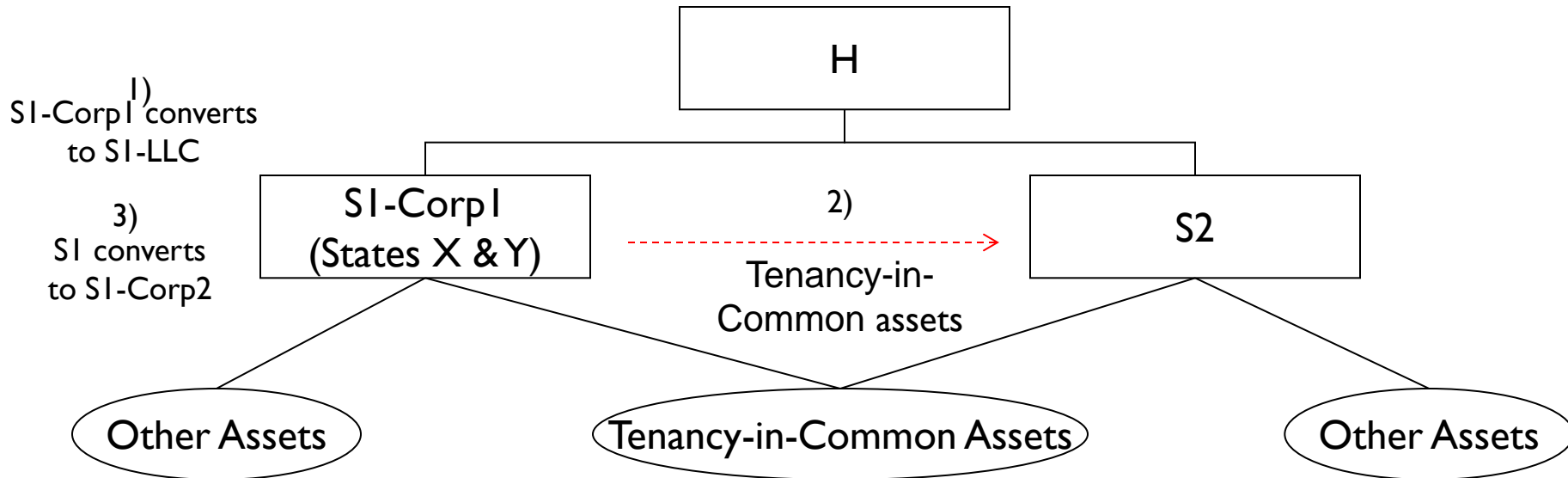
# PLR 200733002 AND 201026010 VARIATION DROP INTO TWO SUBS AND LIQUIDATION



- T drops 50% of its assets into newly formed A1 and 50% into newly-formed A2.
- T liquidates into P (no merger). Requirements of §355 are not satisfied.
- What is this transaction? Can it be two §351 exchanges followed by an upstream C reorganization? What if the §355 requirements are satisfied? What if the A1 transaction satisfies the §355 requirements but not the A2 transaction? What if substantially all of T's assets were transferred in one drop?

# PLR 200952032

## LIQUIDATION-REINCORPORATION-FACTS



- H wants SI-Corp1 to transfer its TIC assets to S2 tax-free and eliminate SI-Corp1's Y charter.
- SI-Corp1 converts to State X SI-LLC, a disregarded entity.
- SI-LLC transfers the TIC assets to S2 for no consideration.
- SI-LLC converts to SI-Corp2, incorporated only in State X.

# PLR 200952032

## LIQUIDATION-REINCORPORATION—ANALYSIS

- IRS rules that conversion of SI-Corp1 to SI-LLC is a transfer of substantially all of SI-Corp1's assets to H in deemed exchange for H stock, followed by deemed distribution of the H stock back to H in liquidation of SI-Corp.
  - Upstream C reorganization with two §§351/368(a)(2)(C) asset drops, as in Rev. Rul. 69-617 (A reorganization).
    - Transfer of SI-Corp1's interest in TIC Assets is a §§351/368(a)(2)(C) transfer by H to S2.
    - Conversion of SI-LLC to SI-Corp2 is a §§351/368(a)(2)(C) transfer of SI-Corp1's Other Assets by H to SI-Corp2.
  - PLR does not state whether SI-Corp's interest in the TIC Assets or its Other Assets constitutes “substantially all” of SI-Corp's assets.
- Why is the transaction not an F reorganization with a distribution? See Reg. §1.368-2(k) (“shall not be recharacterized”); but see *TASCO v. Commissioner*, 63 T.C. 423 (1974), aff'd without opinion, 546 F.2d 423 (4th Cir. 1976).
- What if instead SI-Corp1 had converted to SI-LLC and transferred all its assets to a newco, without reincorporating? See §368(a)(1)(F) (“however effected”); Reg. §1.368-2(k).

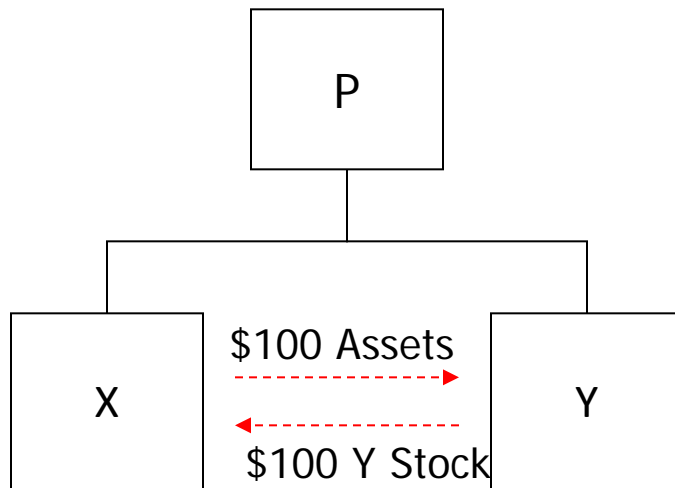
# **INTRAGROUP REORGANIZATIONS**

Acquisitive Type-D Reorganizations

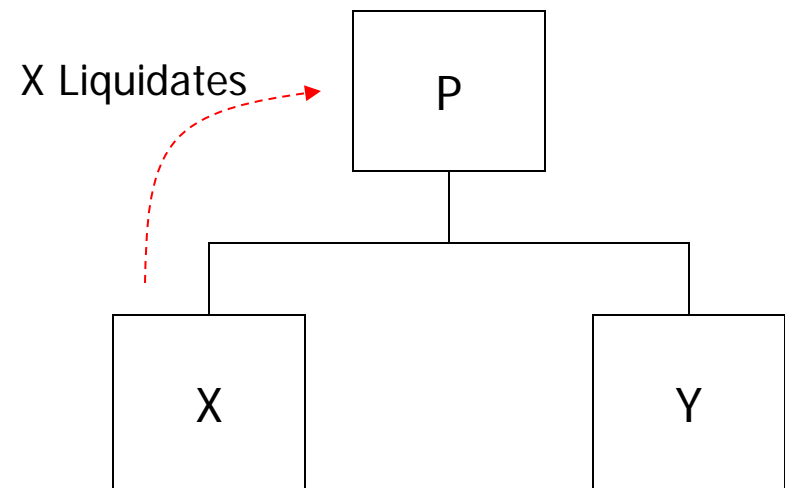


# BASIC ACQUISITIVE D REORGANIZATION

## Step One



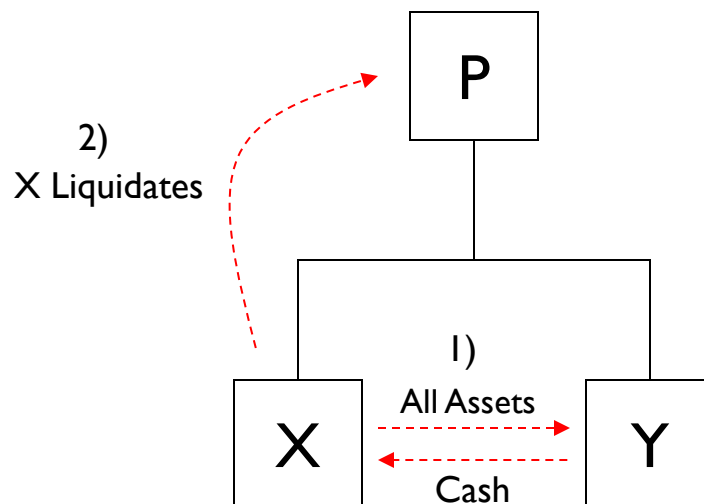
## Step Two



- X transfers all its assets to Y in for \$100 worth of Y stock.
- X then liquidates into P.
- Transactions are a tax-free acquisitive D reorganization:
  - Transfer by X of substantially all of its assets to Y.
  - Immediately after the transfer, P is in control of Y.
  - Y stock is distributed to P under §354. See §354(b)(1).

# D REORGANIZATIONS

## REV. RUL. 70-240



- X transfers all its assets to Y for cash.
- X liquidates into P.
- Transactions are an acquisitive D reorganization.
  - Transfer by X of substantially all of its assets to Y.
  - Immediately after the transfer, P is in control of Y.
- The requirement that stock or securities of the acquiring corporation (Y) be distributed is not technically satisfied. This requirement is treated as satisfied because a distribution of Y stock would be a meaningless gesture, even though the cash represents the full value of the transferred assets. Rev. Rul. 70-240 and Rev. Rul. 2004-83.

# D REORGANIZATIONS

## HISTORY OF REGULATIONS

- On December 18, 2006, Treasury and IRS issued Temp. Reg. §1.368-2T(l), in response to requests for immediate guidance regarding whether certain an all-cash acquisitive transaction can qualify as a D reorganization.
  - The temporary regulations provided that a transaction may be treated as satisfying §§368(a)(1)(D) and 354(b)(1)(B) even if there is no issuance of transferee corporation stock or securities, if the same person or persons own, directly or indirectly, all the stock of the transferor and transferee corporations in identical proportions.
  - In such cases, transferee was deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor's assets.
- On March 1, 2007, Treasury and IRS amended the temporary regulations so that certain related-party triangular reorganizations would not be treated as D reorganizations with boot under the temporary regulations.
- On December 17, 2009, Treasury and IRS issued final regulations on the treatment of transactions as acquisitive D reorganizations where no stock or securities of the transferee is issued and distributed.
  - The final regulations provide for the treatment of all-cash D reorganizations, as well as D reorganizations in which the transferor receives no consideration or consideration with FMV less than the FMV of the assets transferred.
  - The final regulations also confirm the determination of basis in stock of the transferee and the treatment where the reorganization involves consolidated group members.
- In 2011, Treasury and IRS issued temporary regulations to clarify an additional aspect of stock basis. See Slides 37-41.

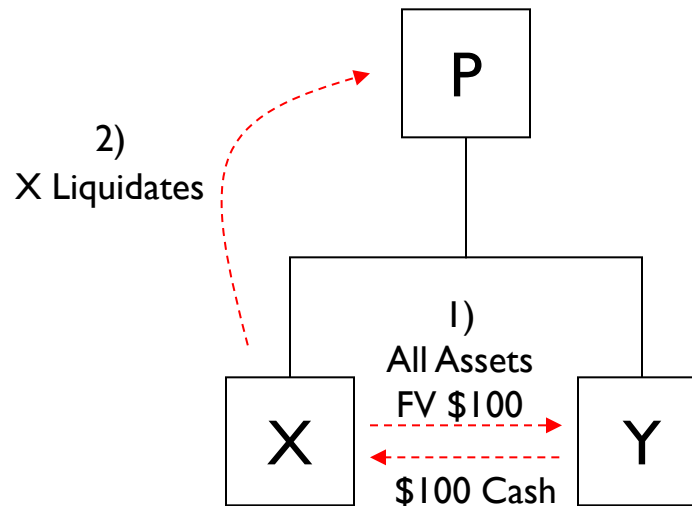
# D REORGANIZATION REGULATIONS

## NOMINAL SHARE AND DEEMED STOCK RULE

- If no stock or securities are issued and distributed in the transaction, and if the same person or persons own, directly or indirectly, all the stock of the transferor and transferee in identical proportions, the regulations deem an issuance of stock.
- The transferee corporation is deemed to issue a nominal share of its stock only if the transferor receives full consideration in exchange for its assets.
- If the transferor receives no consideration, or if the FMV of the consideration received is less than the FMV of the transferor's assets, the transferee is treated as issuing stock with FMV equal to the excess of the value of the assets over the value of the consideration received.
- The nominal share or the deemed stock is deemed to be distributed by the transferor corporation in satisfaction of the distribution requirement of §354(b)(1)(B), and then further transferred through chains of ownership to reflect actual ownership of the stock of the transferor and transferee.

# D REORGANIZATION REGULATIONS

## NOMINAL SHARE AND DEEMED STOCK RULE



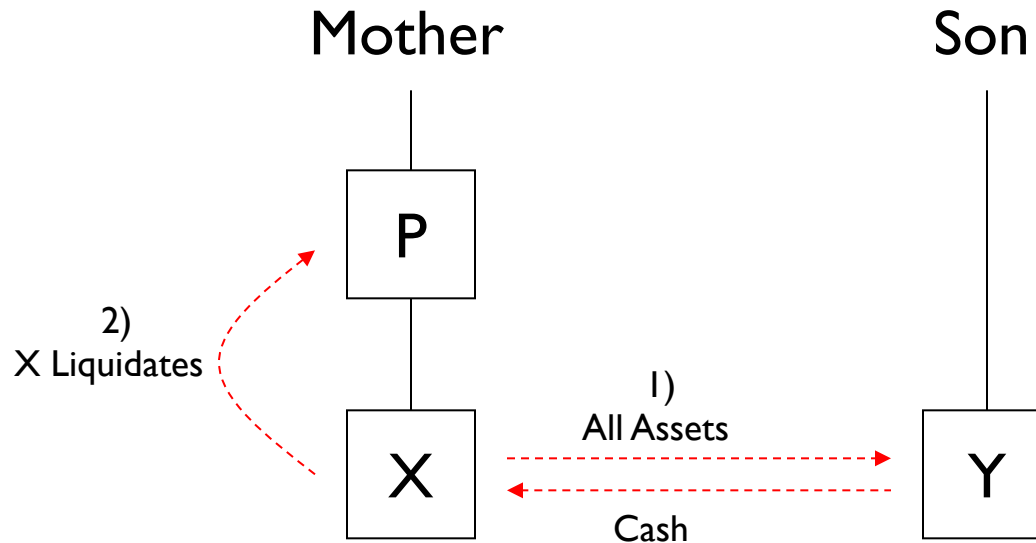
- X transfers all its assets to Y for cash equal in amount to the FMV of X's assets.
- X immediately liquidates into P.
- Transaction is a D reorganization, because there is complete shareholder identity and proportionality of ownership in X and Y. Reg. §§1.368-2(l)(2) and 1.368-2(l)(3), ex. 1.
- Y is deemed to issue a nominal share of Y stock to X in addition to the cash, and X is deemed to distribute the nominal share and the cash to P.
- What if Y transferred only \$50 cash to X?

# D REORGANIZATION REGULATIONS

## SHAREHOLDER IDENTITY/PROPORTIONALITY

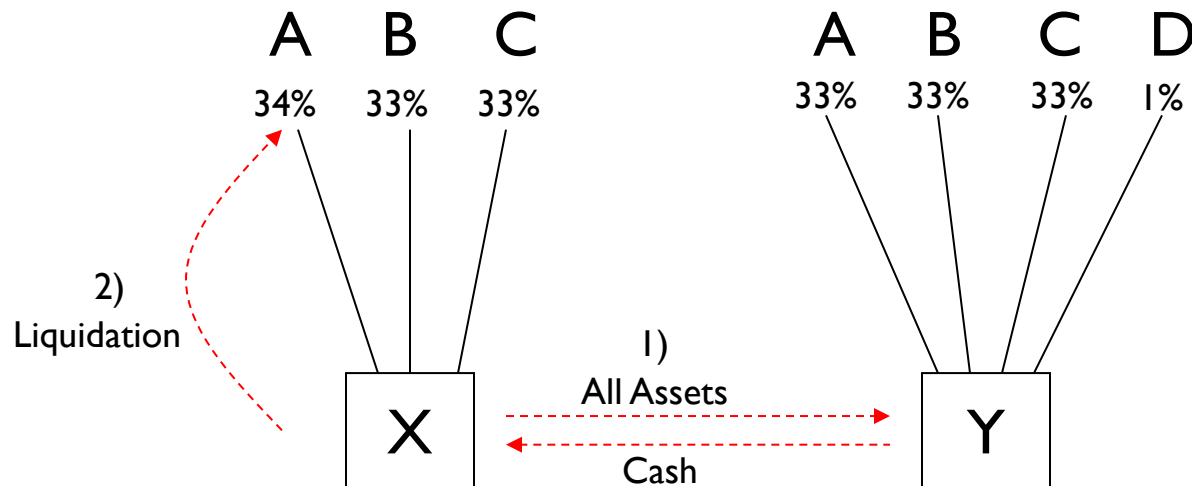
- The constructive ownership rules of §318 apply with modification.
  - Section 318(a)(1) applies such that an individual and all members of his or her family described in §318(a)(1) will be treated as one individual.
  - Section 318(a)(2) applies without regard to the 50-percent limitation in §318(a)(2)(C).
- De minimis variation in shareholder identity or proportionality of ownership is permitted.
  - The regulations do not define what level of variation is de minimis.
  - Reg. §1.368-2(l)(3), ex. 4 states that there is a de minimis variation in identity and proportionality where an individual owns no transferor stock and owns 1% of the transferee stock, and three shareholders own 34%, 33% and 33% of the transferor stock and 33%, 33% and 33% of the transferee stock.
- Section 1504(a)(4) stock is not taken into account.

# D REORGANIZATION REGULATIONS CONSTRUCTIVE OWNERSHIP



- X transfers all its assets to Y for cash equal in amount to the FMV of X's assets.
- X immediately liquidates into P.
- The regulations adopt the constructive ownership rules of §318(a)(1) to treat Mother and Son as one person. Thus, there is complete shareholder identity and proportional ownership in X and Y.
- The transactions are a D reorganization.
  - X is deemed to distribute the nominal Y share to P.
  - P in turn, is deemed to transfer the nominal Y share to Son. Reg. §1.368-2(l)(3), ex. 2; see also PLR 9111055.

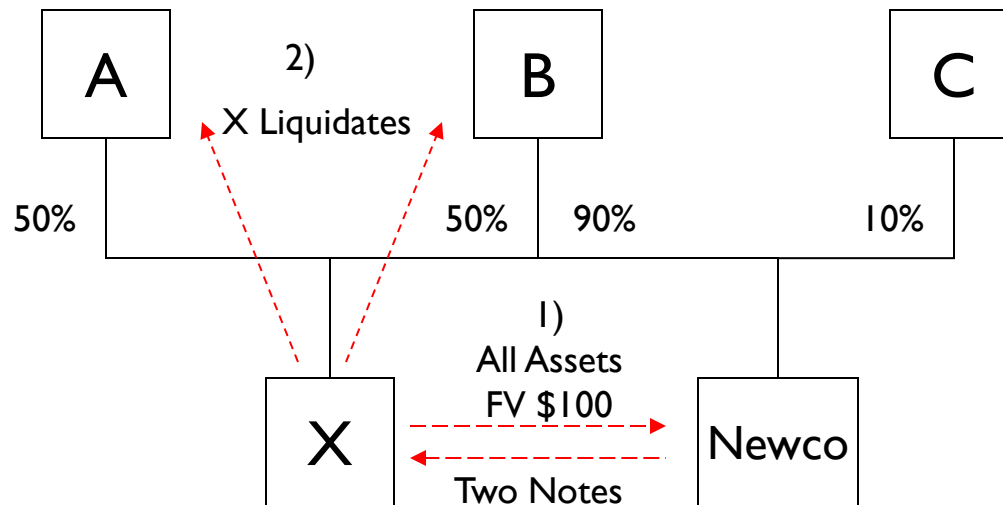
# D REORGANIZATION REGULATIONS DE MINIMIS VARIATION IN OWNERSHIP



- X transfers all its assets to Y for cash equal in amount to the FMV of X's assets
- X immediately liquidates.
- D's ownership of 1% of Y stock is considered de minimis and, thus, there is complete shareholder identity and proportional ownership in X and Y. The transaction is a D reorganization.
  - X is deemed to distribute the nominal Y share to A, B, and C in liquidation.
  - The nominal share is deemed transferred among the Y shareholders to the extent necessary to reflect their actual ownership of Y. Reg. §1.368-2(l)(3), ex. 4.
- What if D owned preferred stock of Y in addition to its common stock?



# D REORGANIZATION REGULATIONS LACK OF SHAREHOLDER IDENTITY/PROPORTIONALITY



- X transfers all \$100 of its assets to Newco in exchange for two notes. Immediately thereafter, X liquidates, distributing one note to A and one note to B.
- There is no shareholder identity and proportionality of ownership in X and Newco.
- Thus, the transaction is not a D reorganization. Reg. §1.368-2(l)(3), ex. 6; see also PLR 200551018.

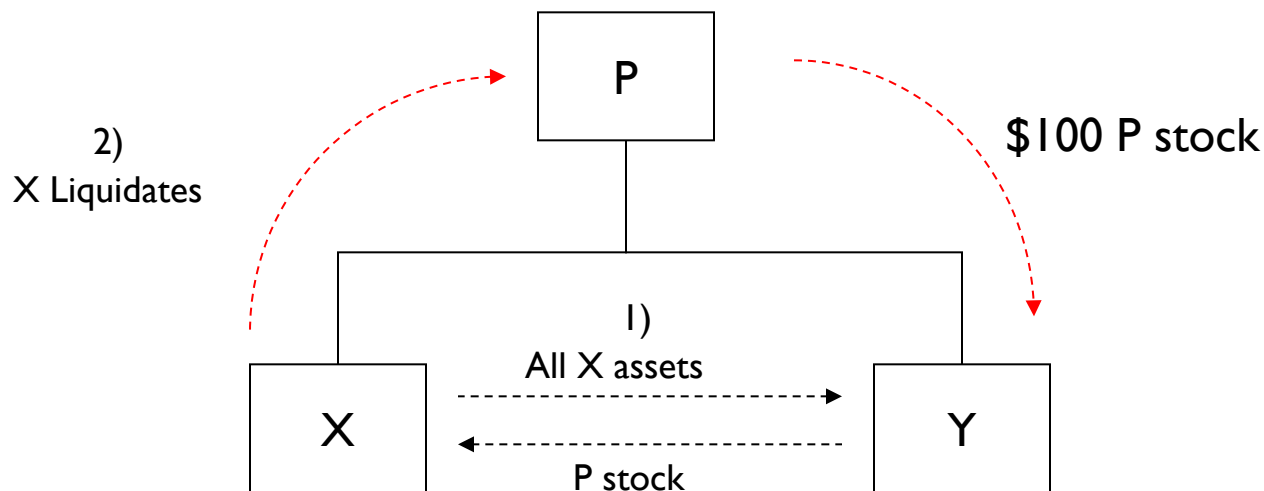
# D REORGANIZATION REGULATIONS

## TRIANGULAR REORGANIZATIONS

- The nominal share and deemed stock rules do not apply to triangular reorganizations described in Reg. §1.358-6(b)(2) or §368(a)(1)(G) by reason of §368(a)(2)(D).
- Without such an exception, related-party tax-free triangular reorganizations would be treated as D reorganizations with the parent stock being treated as boot.
  - If a transaction is described in both §§368(a)(1)(D) and 368(a)(1)(C), D character trumps the C character. §368(a)(2)(A).
  - In a forward triangular merger, the deemed issuance of a nominal share of acquiring corporation stock would violate §368(a)(2)(D)(i).

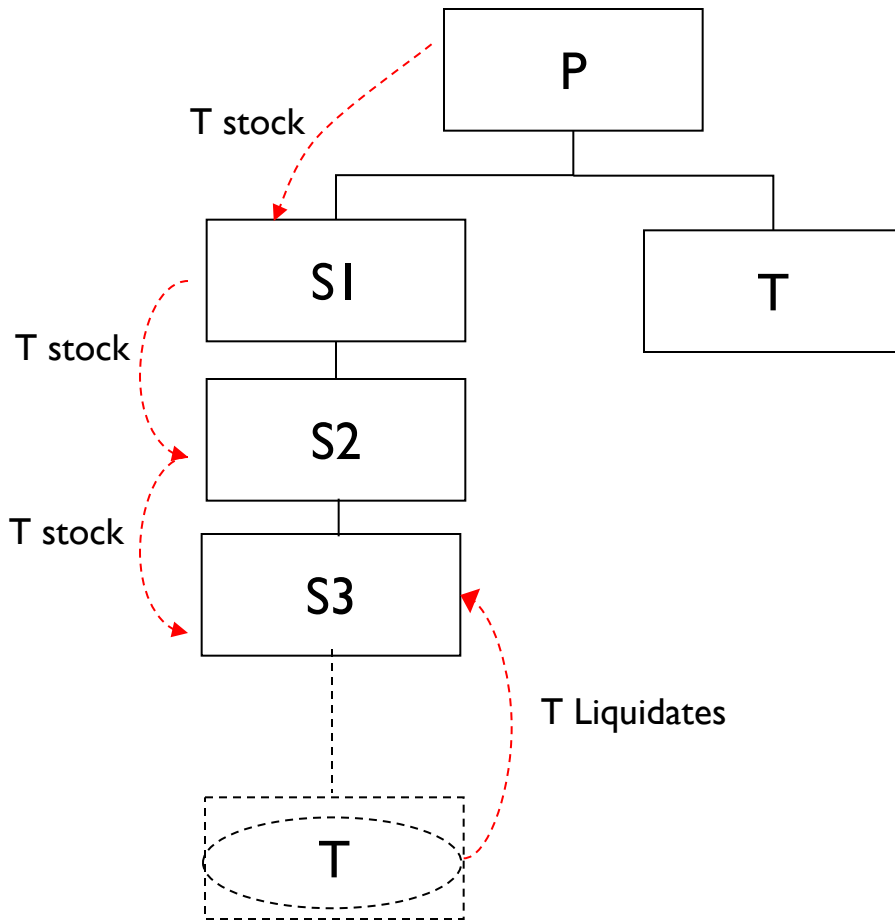
# D REORGANIZATION REGULATIONS

## TRIANGULAR REORGANIZATION



- X transfers all its assets to Y solely in exchange for P stock with FMV the same as the FMV of the X assets.
- X immediately liquidates.
- Transaction satisfies requirements of a C reorganization and is not a D reorganization.
  - The nominal share and deemed stock rules do not apply.
  - Until the March 2007 amendment to the temporary regulations, the transaction could have been a D reorganization with the P stock being boot. See §368(a)(2)(A); Reg. §1.368-2(l)(2)(iv).

# TRIPLE DROP AND CHECK ALTERNATIVE CHARACTERIZATIONS



## Facts:

- To achieve business synergies, P desires the T assets to be transferred to S3. T is solvent.
- P contributes the T stock to S1.
- S1 contributes the T stock to S2.
- S2 contributes the T stock to S3.
- T liquidates or is deemed to liquidate by making a check-the-box election.

## Alternative Characterizations:

- 1) Three §351 contributions followed by a §332 liquidation.
- 2) Two §351 contributions followed by a D reorganization.
- 3) One §351 contribution followed by a triangular C reorganization.
- 4) All-boot D reorganization.

PLR 201150021 (characterization 2)

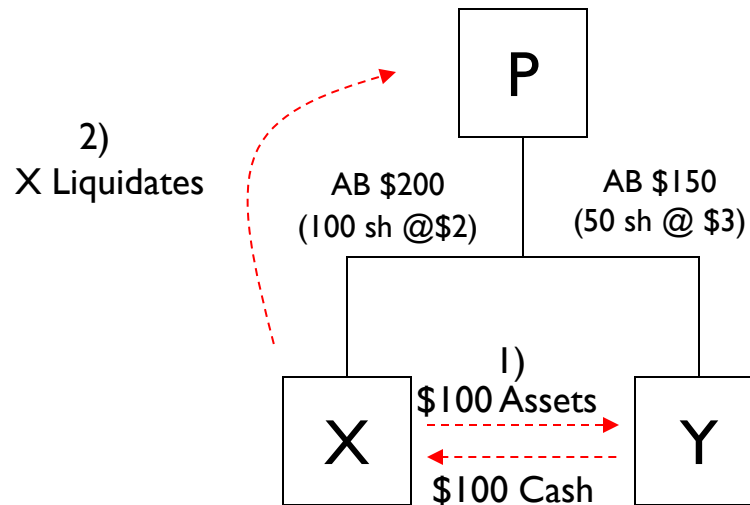
# D REORGANIZATION REGULATIONS

## BASIS CONSEQUENCES

- Treasury and IRS did not agree with comments that recommended treating the nominal share as having tax significance solely to satisfy the distribution requirement in §354(b)(1)(B). TD 9475; TD 9558.
- Instead, the regulations treat the nominal share as property for purposes of basis allocation and future stock gain or loss recognition.
- Reg. §1.358-2T(a)(2)(iii) provides that if a shareholder or security holder surrenders a share of stock or a security and receives no property or property with a value that is less than the FMV of the stock or securities surrendered:
  - The shareholder or security holder is deemed to receive stock equal to the value of stock or securities actually surrendered.
  - Such stock receives a substituted basis.
  - There is a deemed recapitalization for the shares actually held by the shareholder or security holder immediately after the reorganization.
- The regulations clarify that the approach in Reg. §1.358-2T(a)(2)(iii) applies to determine the basis consequences in a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred (as well as the nominal share).
  - The shareholder or security holder may designate the share of stock of the transferee to which basis, if any, of the stock or securities surrendered will attach.
  - Query when this designation must be made—before or after the deemed transfers of the nominal share.

# D REORGANIZATION REGULATIONS

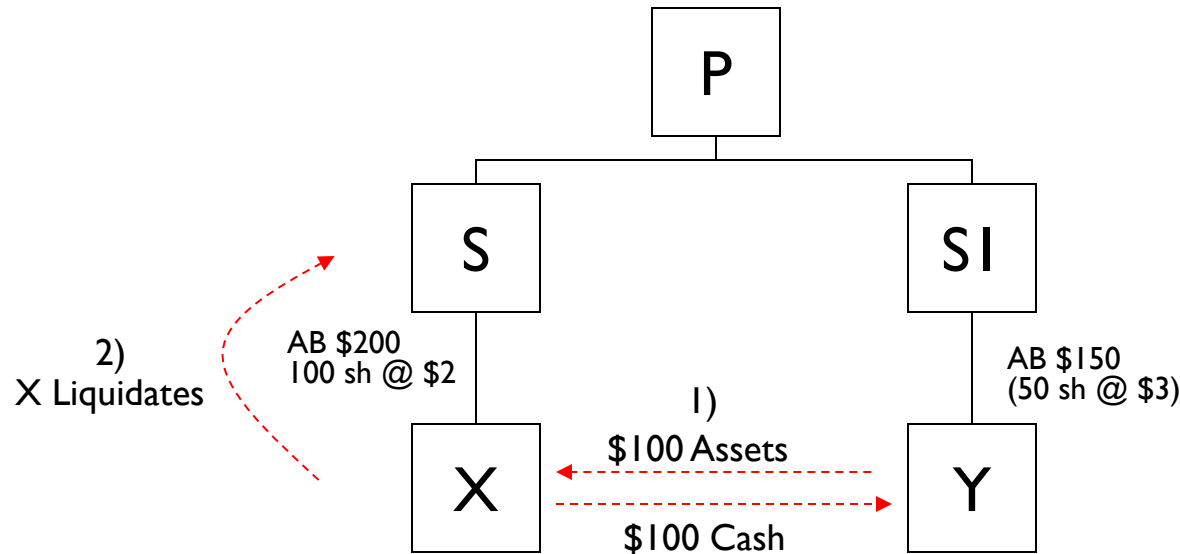
## BASIS OF NOMINAL SHARE



- X transfers all \$100 of its assets to Y for \$100 cash.
- X immediately liquidates into S.
- P's basis in the Y nominal share is \$100 (\$200 basis in X stock less \$100 cash received).
- P is deemed to recapitalize its Y shares, including the nominal share (51 shares), into the Y stock P actually owns (50 shares). P may designate the share(s) of Y stock to which the basis of the nominal share attaches. Assuming P designates the basis as attaching to a single share, P should have 49 shares with a basis of \$3/share and 1 share with a basis of \$103.
- What if P owns both common and preferred stock of Y. Can it designate the basis as attaching only to the preferred stock?

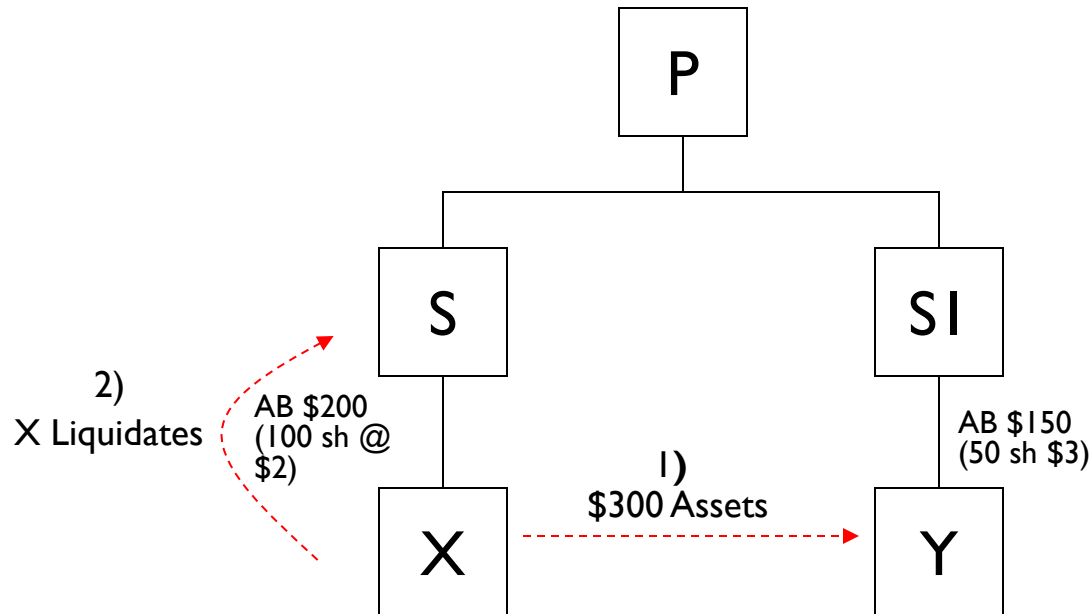
# D REORGANIZATION REGULATIONS

## BASIS OF NOMINAL SHARE IN LOWER TIER SUBSIDIARY



- X transfers all \$100 of its assets to Y for \$100 cash.
- X immediately liquidates into S.
- S's basis in the Y nominal share is \$100 (\$200 basis in X stock less \$100 cash received). The nominal share of Y stock is treated as going up to P and back down to SI.
- Is S's loss on the nominal share (\$1.96 FMV - \$100 AB = \$98.04 loss) disallowed under §311(a), with P's basis in the nominal share reduced to \$1.96.
- When does the deemed recapitalization by SI of its Y shares occur?
- If before the deemed distribution of the nominal share by S, the \$1.96 basis in the nominal Y share is spread among all of SI's 50 shares.
- If after the nominal share is deemed transferred to SI, then SI may designate one or more of its SI shares to which the basis of the nominal share attaches

# D REORGANIZATION REGULATIONS BASIS OF DEEMED STOCK IN LOWER TIER SUBSIDIARY



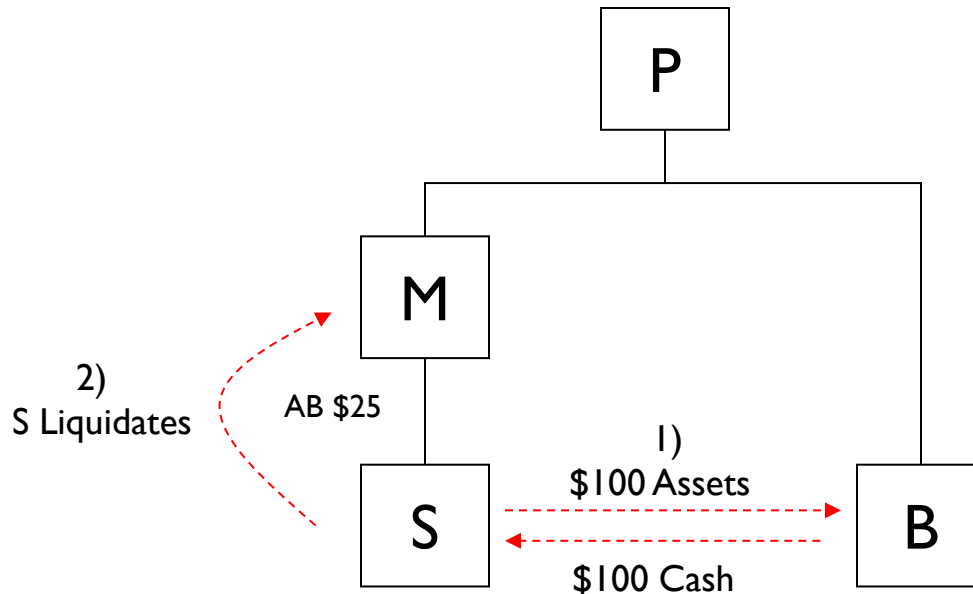
- X transfers all \$300 of its assets to Y for no consideration.
- X immediately liquidates into S.
- The deemed Y stock should have a basis of \$200 and a value of \$300 in S's hands.
- The deemed Y stock is treated as going up to P and back down to SI.
- Is S's gain loss on the deemed stock triggered under §311(b)?



# D REORGANIZATION REGULATIONS CONSOLIDATED GROUP

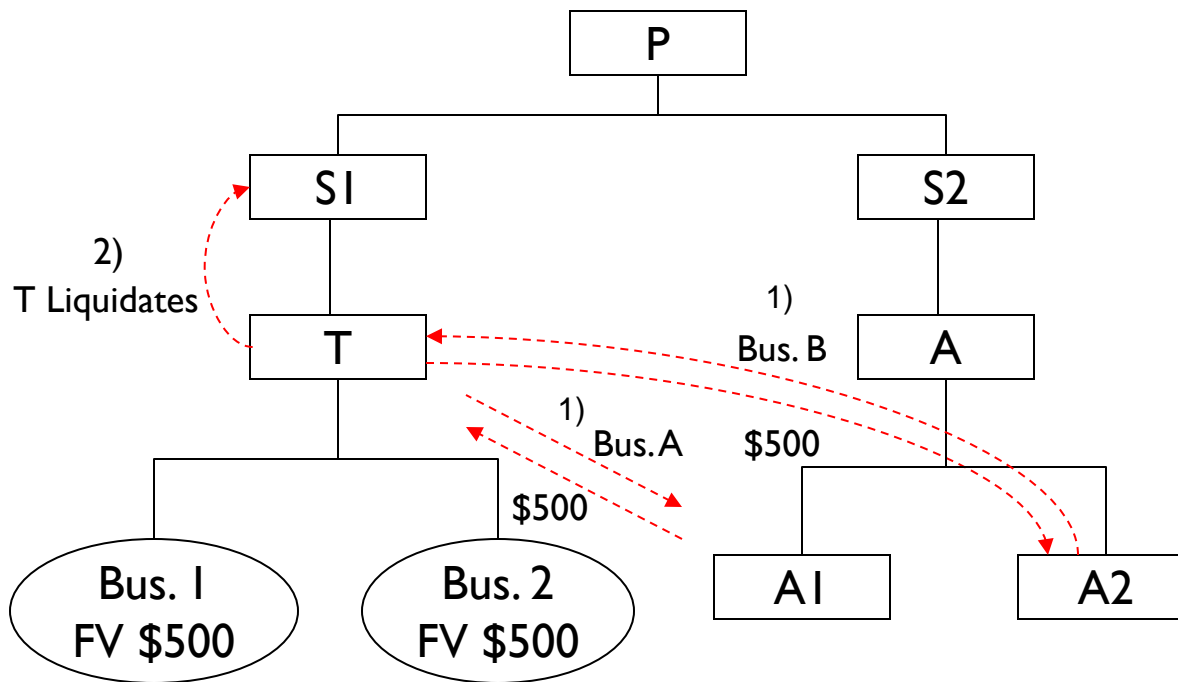
- The regulations confirm that the nominal share is given effect in connection with an all-cash D reorganization involving consolidated group members.
- An all-cash D reorganization involving consolidated group members results in a deemed issuance of stock by the transferee corporation, followed by a redemption of the deemed stock for the consideration actually received in the exchange. Reg. §1.1502-13(f)(3).
- Upon the deemed issuance and redemption, the remaining stock basis or excess loss account ("ELA") shifts to the nominal share.
- Thus, gain or loss inherent in that basis or ELA may be triggered upon the deemed transfer of the nominal share through chains of ownership, subject to Reg. §1.1502-13.

# D REORGANIZATION REGULATIONS CONSOLIDATED GROUP



- P, M, S, and B file a consolidated return.
- S transfers all \$100 of its assets to B for \$100 cash.
- S immediately liquidates into M.
- In the consolidated return context, the following events are deemed to occur:
  - B issues \$100 stock plus a nominal share of B stock;
  - S distributes B stock to M in liquidation. M's basis in this B stock is \$25.
  - B redeems its stock (except the nominal share) from M for \$100 cash.
- M's \$25 basis in the B stock is reduced by the \$100, cash. Result is a \$75 ELA, which attaches to the nominal share.
- M's deemed distribution of the nominal share of B stock to P triggers the ELA, resulting \$75 intercompany §311(b) gain. Reg. §1.1502-13(f) and (f)(7)(i), ex. 4.
- What if B actually issued 1 share of B stock? What if P contributed a share of B stock to M prior to the D reorganization?

# INTERCOMPANY ASSET SALE AND LIQUIDATION “SUBSTANTIALLY ALL” OR DEEMED DOWNSTREAM ASSET TRANSFER?

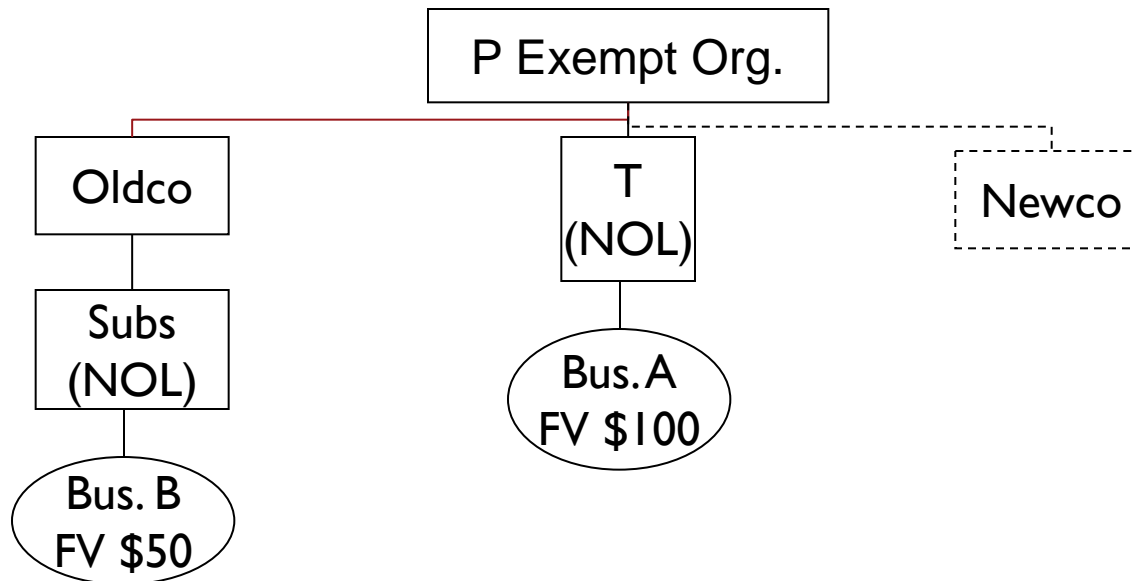


- T sells Business 1 to AI and Business 2 to A2, in each case for \$500 cash.
- T is liquidated and distributes the \$1,000 cash to S1.
- Is the transaction an “all-cash D reorganization,” with A as the acquiring corporation?

# PLR 201003012

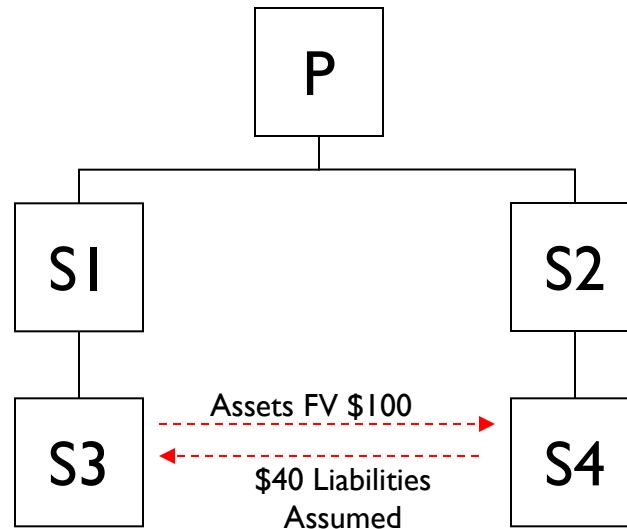
## D AND F REORGANIZATIONS

### INTERNAL CORPORATE COMBINATION



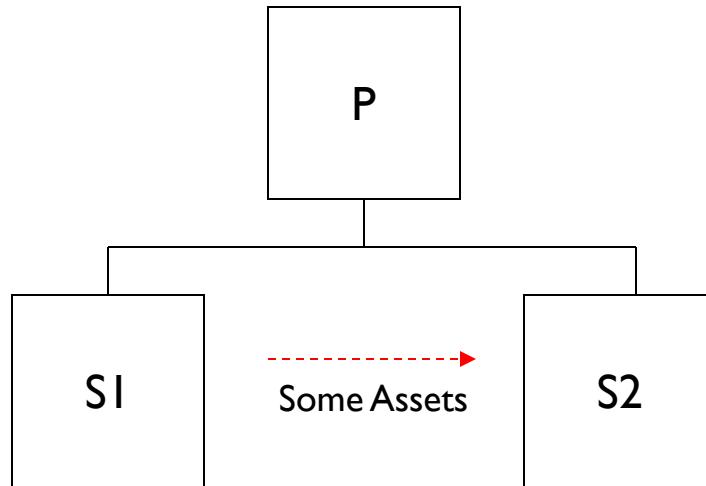
- P forms Newco.
- P contributes the Oldco stock and the T stock to Newco for no consideration.
- Oldco and T each converts to a limited liability company, classified as a disregarded entity.
- Oldco may have disposed of some assets, but these assets were “not critical” to Oldco’s business, and the dispositions were “unrelated to and not dependent on” the transactions. Represented that assets disposed of (other than in ordinary course of business to JVs or under §368(a)(2)(C)) would be <10%.
- Ruled:
  - Transactions involving Oldco constituted an F reorganization.
  - Transactions involving T constituted a D reorganization.

# CROSS-CHAIN SECTION 351 EXCHANGE—1



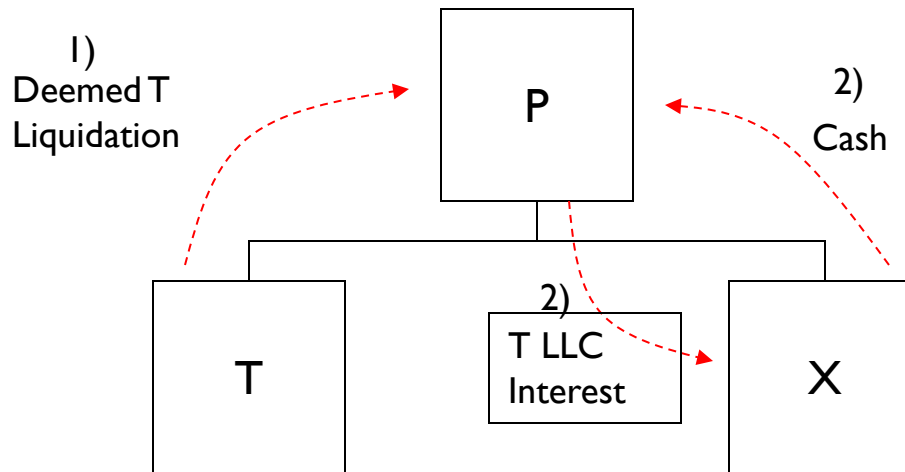
- P, S1, S2, S3, and S4 are a consolidated group.
- S3 transfers Assets with \$100 FMV to S4, and S4 assumes \$40 of liabilities from S3. S4 does not transfer any other consideration to S3.
- Do principles similar to those in the D reorganization regulations cause §351 to apply? If so—
- S4 is treated as issuing a nominal share of its stock to S3.
- Nominal share treated as distributed by S3 to S1 and by S1 to P and then contributed to S2.

# CROSS-CHAIN SECTION 351 EXCHANGE-2



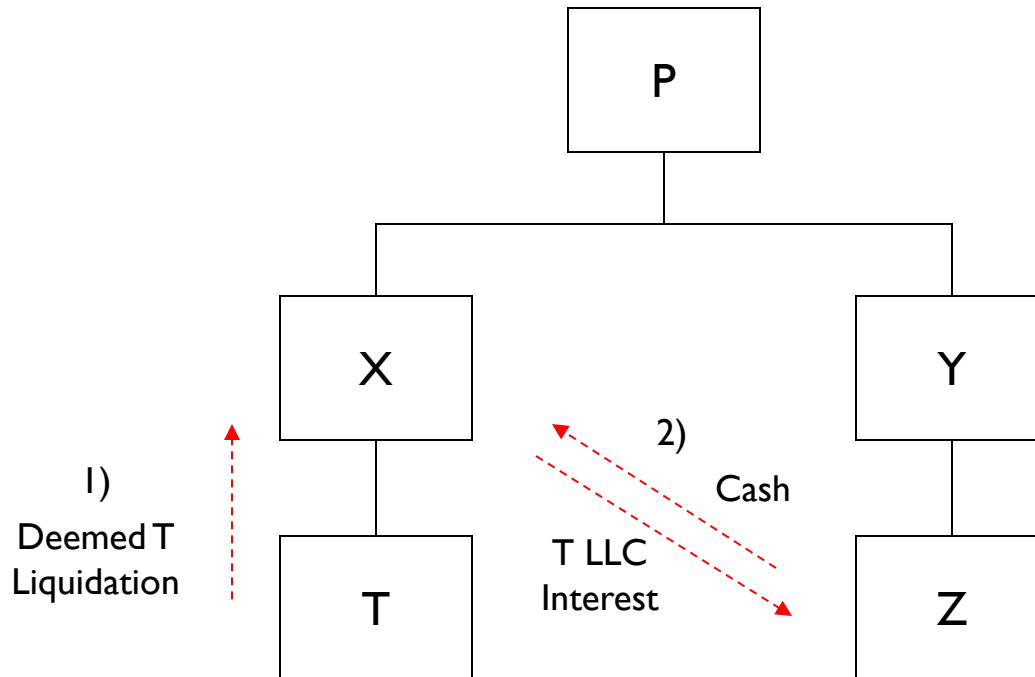
- P and S1 are members of a consolidated group. S2 files a separate return.
- S1 transfers some assets to S2 for no consideration.
- S1 retains other assets.
- To qualify as a §351 exchange, S1 must transfer property to S2 in exchange for stock and be in control of S2 immediately after the exchange.
- S1 satisfies control requirement, because it is treated as owning the S2 stock held by P. Reg. §1.1502-34.
- It is unclear whether S1 satisfies the exchange requirement, because it does not receive S2 stock. Consistent with D reorganization regulations, is S2 deemed to issue stock to S1, with the stock distributed to P?

# CHECK-AND-SELL TRANSACTION



- T converts to an LLC, treated as a disregarded entity.
- P sells the LLC interest to X.
- Is the transfer treated as an asset transfer or a stock transaction? See Rev. Rul. 58-93; *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).

# CHECK-AND-SELL TRANSACTION— INDIRECT OWNERSHIP



- T converts to an LLC, treated as a disregarded entity.
- X sells the T LLC interest to Z.
- Is the transfer treated as a liquidation followed by a sale? See Rev. Rul. 58-93; *Dover Corp. v. Commissioner*.
- What result if X sells only part of its LLC interests in T?



# TEMPORARY REGULATIONS ON ALLOCATION OF STOCK BASIS IN ALL CASH D REORGANIZATIONS – 1

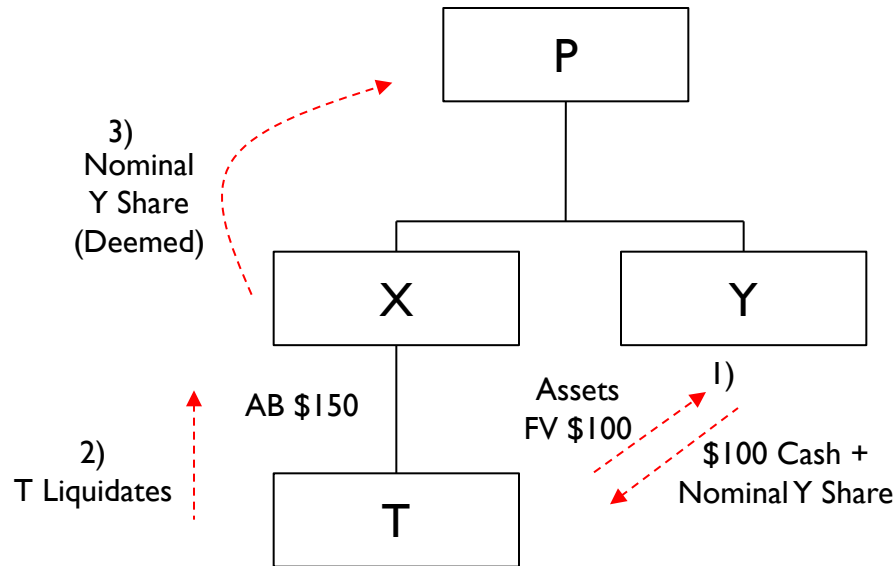
- On November 18, 2011, Treasury and IRS issued temporary regulations to clarify that the ability to designate the share of stock of the issuing corporation to which the basis, if any, of the stock or securities surrendered will attach applies only to a shareholder that owns actual shares in the issuing corporation. TD 9558.
- Treasury and IRS acknowledged that prior rules could allow what they considered to be inappropriate allocation of stock basis.
  - The prior rules could be interpreted to allow persons that do not directly own stock of the issuing corporation to allocate the basis of the nominal share to an actual share of issuing corporation stock directly owned by someone else before the nominal share is deemed to be further transferred through the chains of ownership.
  - Under this interpretation, the actual share to which basis was allocated could be sold to recognize a loss. As a result, a taxpayer would avoid losing the nominal share's basis, which otherwise could be zero following its deemed transfer through chains of ownership to the actual shareholder of the issuing corporation.

## TEMPORARY REGULATIONS ON ALLOCATION OF STOCK BASIS IN ALL CASH D REORGANIZATIONS – 2

The temporary regulations clarify and amend prior Reg. §1.358-2(a)(2)(iii).

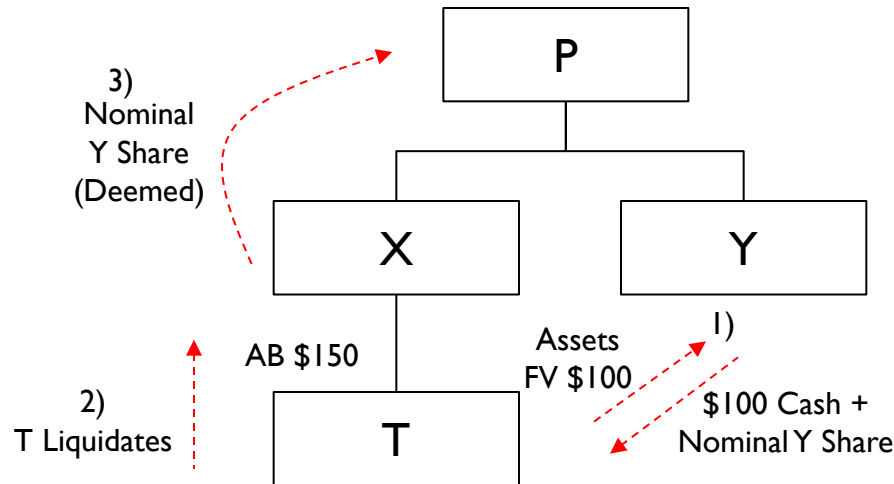
- If an actual shareholder of the issuing (acquiring) corporation is deemed to receive a nominal share of issuing corporation stock, as described in Reg. §1.368-2(l), that shareholder must, after allocating and adjusting the basis of the nominal share and adjusting the basis in the nominal share for any transfers described in Reg. §1.368-2(l), designate the share of stock of the issuing corporation to which the basis, if any, of the nominal share will attach.
- If the shareholder that receives the nominal share is not an actual shareholder of the issuing corporation, that shareholder may not designate any particular share to which the basis of the nominal share will attach.

# TEMPORARY REGULATIONS ON ALLOCATION OF STOCK BASIS IN ALL CASH D REORGANIZATION ACQUISITION OF LOWER-TIER SUBSIDIARY STOCK BY UPPER-TIER SUBSIDIARY—1



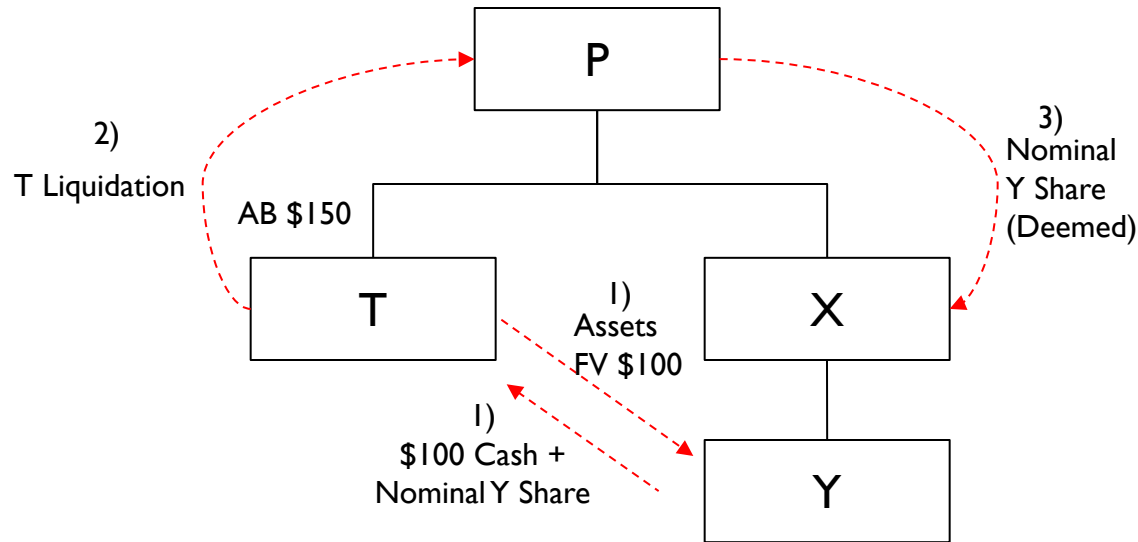
- T sells all its assets to Y for \$100 cash (= FMV). Y is deemed to issue a nominal share of its stock to T. Reg. §1.368-2(l),
- T liquidates. T distributes \$100 and is deemed to distribute the nominal Y share to X.
  - X's basis in nominal Y share = \$50 (X's \$150 basis in its T stock less \$100 cash received).
  - Nominal share FMV = ~\$0.
- X is deemed to distribute the nominal Y share to P.
  - X does not recognize its loss on this deemed distribution. §311(a).
  - P's basis in the nominal Y share = FMV = ~\$0. §301(d).

# TEMPORARY REGULATIONS ON ALLOCATION OF STOCK BASIS IN ALL CASH D REORGANIZATION ACQUISITION OF LOWER-TIER SUBSIDIARY STOCK BY UPPER-TIER SUBSIDIARY-2



- Under prior law: X arguably could allocate the \$50 basis in the nominal Y share to an actual Y share owned by P. If so, P could, e.g., sell this share at a loss, or even recapitalize the share into preferred stock and sell the preferred share at a loss.
- Temporary Regulations eliminate this interpretation:
  - X is deemed to receive the nominal Y share described in Reg. §1.368-2(l).
  - X is not an actual shareholder of Y. Thus, X may not designate a Y share to which the \$50 basis of the nominal Y share attaches. Reg. §1.358-2T(a)(2)(iii)(C),
  - P may not designate a Y share to which basis will attach, because P receives the nominal Y share with basis = ~\$0.
  - Reg. §§1.358-2T(a)(2)(iii),(C), (c) Ex. 16.
  - P is deemed to recapitalize its actual Y stock and the nominal share of Y stock into its actual Y stock, so that basis in the nominal share is spread among the actual shares. Reg. §1.358-2T(a)(2)(iii)(B).

# TEMPORARY REGULATIONS ON ALLOCATION OF STOCK BASIS IN ALL CASH D REORGANIZATION ACQUISITION OF UPPER-TIER SUBSIDIARY BY LOWER-TIER SUBSIDIARY

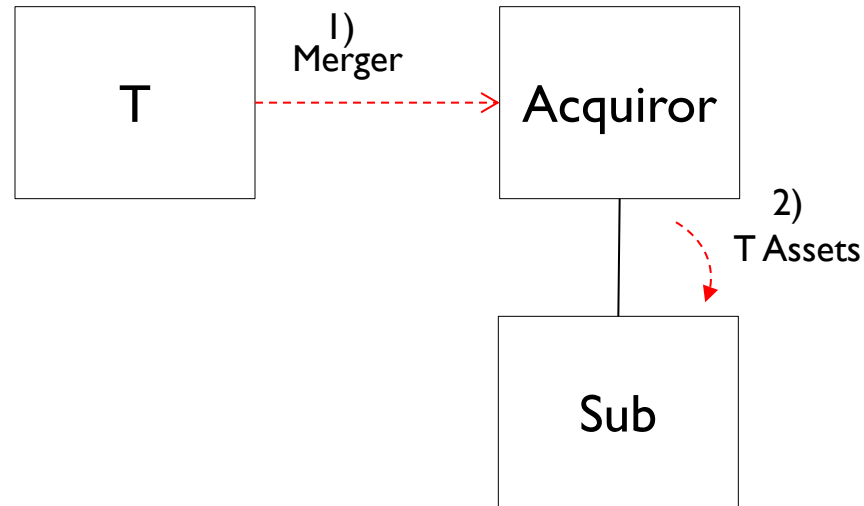


- T sells all of its assets to Y for \$100 cash, their FMV.
    - Y is deemed to issue a nominal share of its stock to T. Reg. §1.368-2(l).
  - T liquidates. T distributes \$100 and is deemed to distribute the nominal Y share to P.
    - P's basis in the nominal Y share = \$50 (P's \$150 basis in its T stock less \$100 cash received).
    - Nominal share FMV = ~\$0.
  - P is deemed to contribute the nominal Y share to X.
    - X's basis in the nominal Y share = \$50. §358(a),
  - Temporary Regulations
    - P is deemed to receive the nominal Y share described in Reg. §1.368-2(l).
    - P is not an actual shareholder of Y. Thus—
      - P may not designate a share of Y stock or X stock to which the \$50 basis of the nominal Y share will attach.
      - X may not designate a share of Y stock to which the \$50 basis of the nominal Y share will attach.
- Reg. §1.358-2T(a)(2)(iii).

# **INTRAGROUP REORGANIZATIONS**

Tax Attributes

# MOVEMENT OF ATTRIBUTES IN ASSET REORGANIZATION



- Acquiror transfers all the T assets to Sub.
- Acquiror retains \$I?
- Acquiror transfers 50% of the T assets to Sub.
- Acquiror transfers the T assets to Sub for cash.

# MOVEMENT OF ATTRIBUTES

- Reg. §1.381(a)-1(b)(1): Section 381(c) tax attributes carry over in a reorganization to the “acquiring corporation.”
- Reg. §1.381(a)-1(b)(2):
  - Only a single corporation can be the acquiring corporation, defined as the corporation that ultimately acquires, directly or indirectly, all the assets pursuant to the plan of reorganization.
  - Also describes a case in which no single corporation ultimately acquires all the assets, so that the one corporation that formally or legally acquires all the assets is the acquiring corporation.
- Reg. §1.381(c)(2)-1(d): When assets are transferred to a subsidiary or subsidiaries in connection with a reorganization –
  - ...then whether any portion of the earnings and profits received by the acquiring corporation under §381(c)(2) is allocable to such controlled corporation or corporations shall be *determined without regard to §381*. See paragraph (a) of §1.312-11[“*proper adjustment and allocation* of the earnings and profits of the transferor shall be made as between the transferor and the transferee.].
- Reg. §1.312-11(a) cross-references §381 regulations for “specific rules as to allocation of earnings and profits in certain reorganizations under §368.”
  - Accordingly, it is generally believed that Reg. §1.312-11(a) does not support an allocation of E&P outside of the “single corporation” rule of Reg. §1.381(a)-1(b). See, e.g., PLR 9231068 (Feb. 3, 1992) and PLR 201026010 (Dec. 18, 2009) (no allocation of E&P permitted for controlled asset transfer pursuant to a plan of reorganization).



# Cases Relating to Movement of E&P

- *Commissioner v. Sansome*, 60 F.2d 931 (2d Cir. 1932), *cert. denied* (transfer of all of a corporation's assets to a new corporation in a reorganization moved the attributes to the successor corporation to ensure the shareholder is appropriately taxed on distributions from the successor).
- *Commissioner v. Phipps*, 336 U.S. 410 (1949), *rev'g* 167 F.2d 117 (10th Cir. 1948) (distributee corporation in a §332 liquidation inherits E&P of liquidating subsidiary, but not E&P deficit: "the *Sansome* rule is grounded not on a theory of continuity of the corporate enterprise but on the necessity to prevent escape of earnings and profits from taxation").
- *Mansfield v. United States*, 141 Ct. Cl. 579 (1958) (transfer by corporation of part of its assets to a newly formed subsidiary in return for all the subsidiary's stock in a §351 exchange did not shift any of parent's E&P to subsidiary where parent remained in existence).
- *Bennett v. United States*, 427 F.2d 1202 (Ct. Cl. 1970) (allocation of E&P in spin-off is necessary to ensure shareholders are appropriately taxed on distributions).

# EXISTING LAW—SECTION 312

- The IRS has historically interpreted the §312 regulations as providing that E&P of the transferor corporation moves in the same manner as other §381 attributes (or in a divisive reorganization, as provided in Reg. §1.312-10).
- Some suggest that E&P could be allocated between the transferor and transferee.
  - Reg. §1.381(c)(2)-1(d) (where some acquired assets are transferred to one or more controlled corporations, or all the acquired assets are transferred to two or more controlled corporations, allocation of E&P is made without regard to §381).
  - Reg. §1.312-11(a) (providing proper adjustment and allocation of E&P with respect to asset transfers in connection with reorganizations, and cross referencing §381 regulations for specific rules).

# PROP. REG. § 1.312-11

- In 2012, Treasury and IRS proposed amending Reg. § 1.312-11. 77 Fed. Reg. 22,515 (Apr. 16, 2012). The proposed regulation would confirm the historical IRS position:
  - E&P remains with the transferor corporation after a §351 exchange.
  - After an acquisitive reorganization or a §332 liquidation, E&P is allocated in the same manner as other §381 attributes.
  - After a divisive reorganization, E&P is allocated pursuant to Reg. § 1.312-10.
- According to Treasury and IRS, the proposed rule is appropriate because—
  - E&P measures a corporation's capacity to pay dividends to its shareholders – the corporation that has an interest (direct or indirect) in all of the target's assets has the dividend-paying capacity most comparable to that of the target.
  - The rules for allocating E&P should conform to the rules for allocating other §381 attributes.
- The proposed rule retains electivity under the IRS historic position.
  - If the initial acquiring corporation drops down all the assets to a single subsidiary, the E&P moves to that subsidiary.
  - If the acquiring corporation retains even \$1 of the target's assets, or transfers even \$1 of target's assets to a separate subsidiary, all the E&P stays with the acquiring corporation.

# LOSSES

# LOSSES

Insolvency And Liabilities

# LOSSES

Insolvency And Liabilities  
Liquidations And Upstream Mergers

# INSOLVENCY AND LIABILITIES

## LIQUIDATIONS AND UPSTREAM MERGERS

### GENERAL

- Section 332
  - A liquidation is not taxable to a corporate shareholder if the shareholder owns at least 80% (by vote and value) of the stock of the liquidating subsidiary.
  - Under §337, the liquidating corporation does not recognize gain or loss.
  - If the requirements of §332 are not satisfied, a liquidation is generally taxable to the corporation (§336) and to its shareholders (§331).
- Reg. §1.332-2(b)
  - Section 332 applies only where the parent receives at least partial payment for its stock.
  - This requirement has been held to apply to §331 liquidations as well. *Braddock Land Co. v. Commissioner*, 75 T.C. 324 (1980); *Jordan v. Commissioner*, 11 T.C. 914 (1948).
  - Section 332 requires a distribution in cancellation or redemption of all of the stock of the liquidating company. Thus, a distribution that is sufficient to redeem only the company's preferred stock is not a liquidation. *Commissioner v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).
- Section 332 does not apply if an insolvent subsidiary, is liquidated. The parent may recognize loss on its subsidiary stock under §165(g). *Iron Fireman Mfg. Co. v. Commissioner*, 5 T.C. 452 (1945); *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941); Rev. Rul. 2003-125, 1970-2 C.B. 53, *amplifying* Rev. Rul. 59-296, 1959-2 C.B. 87.
- IRS position is that a liquidation of an insolvent subsidiary into its creditor-parent does not qualify as a reorganization either. Rev. Rul. 2003-125, *amplifying* Rev. Rul. 59-296. But see *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967) (noting that, unlike the requirement for a liquidation that there be a payment in cancellation or redemption of stock, there is no such requirement for a merger to qualify under §368(a)(1)(A)).

# INSOLVENCY AND LIABILITIES

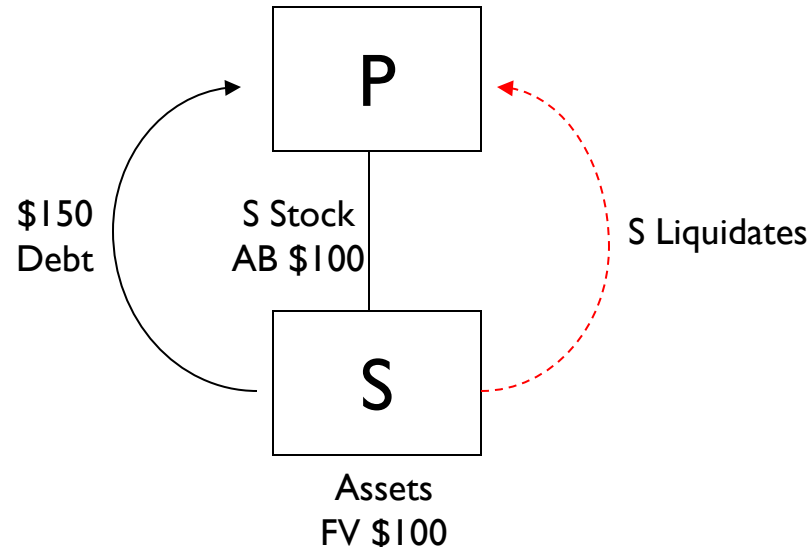
## LIQUIDATIONS AND UPSTREAM MERGERS

### PROPOSED NO NET VALUE REGULATIONS

- In 2005, Treasury and IRS proposed regulations to the effect that §351 and the reorganization provisions, as well as §332, would not apply if stock issued or deemed issued has no net value. 70 Fed. Reg. 11,903 (Mar. 10, 2005).
- The proposed regulations retain the partial payment rule of the current regulations and provide new rules with respect to liquidations involving multiple classes of stock. Prop. Reg. §1.332-2(b).
- If partial payment is not received for every class of stock but is received for at least one class, the proposed regulations look separately to each class of stock to determine the tax consequences.
- With respect to those classes of stock for which no payment is received, the proposed regulations refer to the §165(g) worthless stock deduction.
- With respect to classes of stock for which payment is received, the proposed regulations refer to §368(a)(1) regarding a potential reorganization or to §331 if the distribution does not qualify as a reorganization or a §332 liquidation.

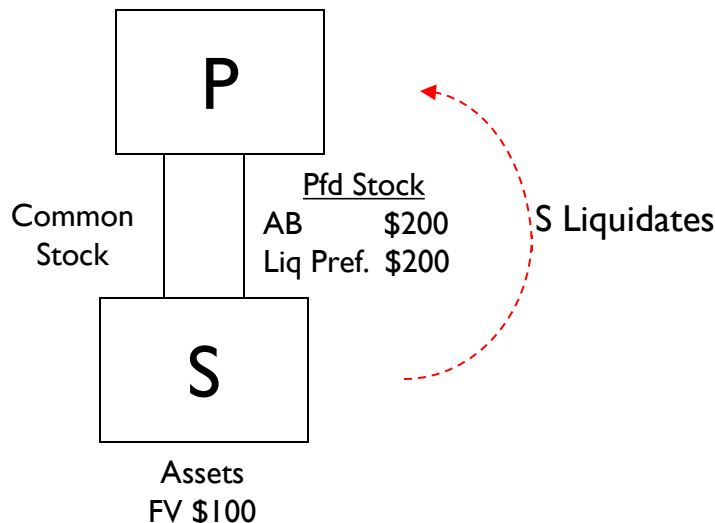


# LIQUIDATION VS. UPSTREAM MERGER



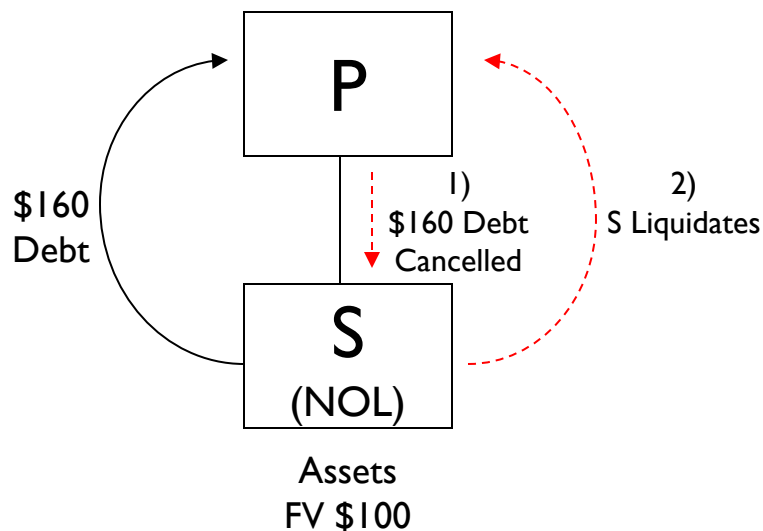
- S liquidates and distributes all its assets to P.
- The transaction does not qualify as a §332 liquidation under current law or the proposed regulations.
- S is treated as transferring its \$100 of assets in satisfaction of its \$150 debt to P.
  - P is entitled to a \$100 worthless stock deduction and a \$50 bad debt deduction.
  - S has \$50 COD income, subject to §108.
  - S's tax attributes, including any loss carryovers, disappear.
  - If P and S are members of a consolidated group—
    - P's bad deduction and S's COD income offset each other, in amount and character. Reg. §1.1502-13(g).
    - P's worthless stock deduction is subject to possible limitation. Reg. §1.1502-36..
- What if S merges upstream into P? See *Norman Scott, Inc. v. Commissioner*. (cross-chain merger of insolvent target qualifies as A reorganization) *But* see Rev. Rul. 2003-125, *amplifying* Rev. Rul. 59-296 (upstream merger of insolvent subsidiary into parent-creditor does not qualify as A reorganization).

# LIQUIDATION WITH NO PAYMENT ON COMMON STOCK



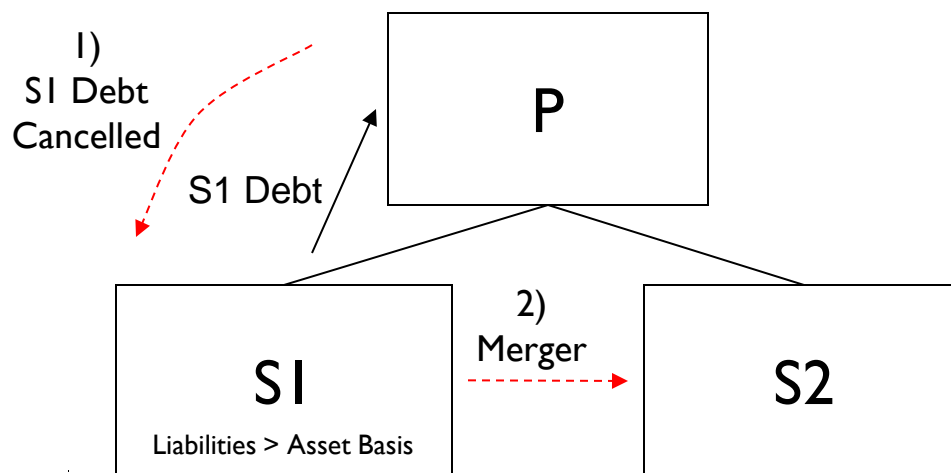
- S liquidates and distributes all its assets to P.
- Transaction does not qualify as a §332 liquidation under current law or proposed regulations, because P did not receive any payment on its common stock. *Commissioner v. Spaulding Bakeries, Inc.*; *H.K. Porter Co. v. Commissioner*; Prop. Reg. §§1.332-2(b), (e), ex. 2.
  - P is entitled to a worthless stock deduction for its common stock. §165(g).
  - P is entitled to a \$100 capital loss on the preferred stock
  - S's tax attributes, including any loss carryovers, disappear.
- Under proposed regulations—
  - Transaction may qualify as a reorganization, since P received partial payment on the S preferred stock.
  - If transaction does not qualify as a reorganization, P recognizes loss on S preferred stock. §331.

# REVENUE RULING 68-602



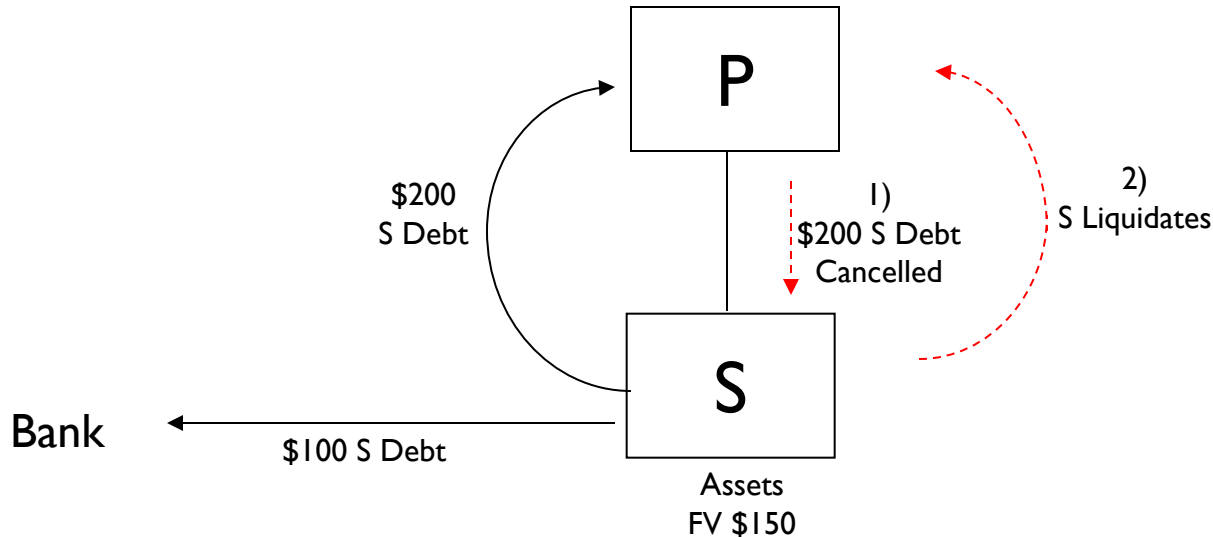
- P cancels the \$160 debt by contributing it to S's capital.
- S liquidates and distributes all its assets to P.
- In Rev. Rul. 68-602, IRS ruled that the debt cancellation was disregarded, because it had no independent significance and no purpose other than to secure the benefit of S's net operating loss carryover.
- As a result, the liquidation of S does not qualify as a §332 liquidation.

# REVENUE RULING 78-330



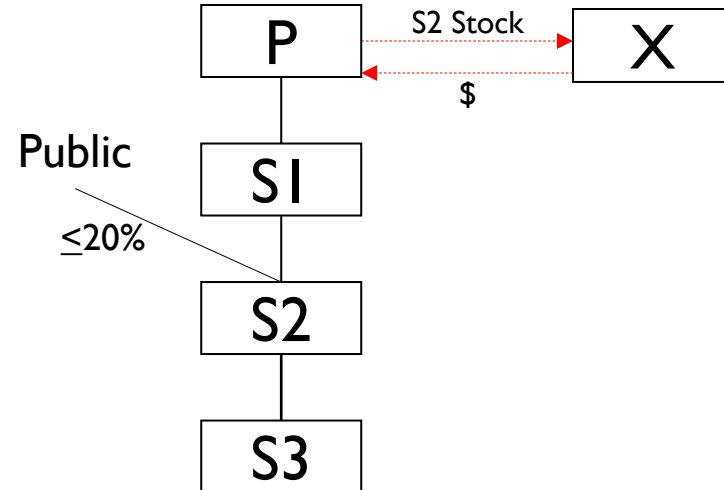
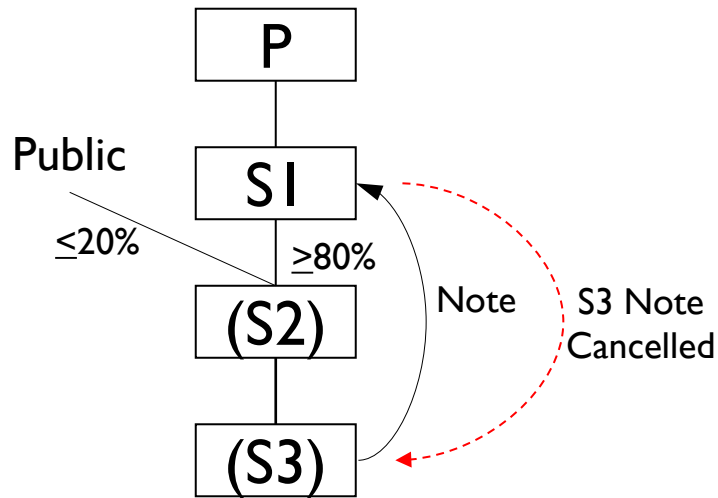
- P gratuitously cancels the debt owed by S1 to P so that the basis of S1's assets exceed its liabilities.
- S1 merges with and into S2.
- In Rev. Rul. 78-330, 1978-2 C.B. 147, IRS ruled that P's cancellation of S1's debt had independent economic significance because it resulted in a genuine alteration of a previous bona fide business relationship.
- Consequently, P's cancellation of the S1 debt was respected, and the merger qualified as an A reorganization.

# REVENUE RULING 68-602—VARIATION



- P cancels its \$200 debt from S by contributing it to S's capital.
- S liquidates, repaying the bank debt in full and distributing the remaining \$50 of assets to P.
- Absent a debt cancellation, 1/3 of S's assets (\$50) would have gone to Bank and 2/3 (\$100) to P.
- Arguably, in these circumstances, the debt cancellation has independent economic significance and Rev. Rul. 78-330, not Rev. Rul. 68-602, should apply.
- Query whether the cancellation has independent economic significance only to the extent of \$150, the value of S's assets available to repay its outstanding debt.

# CCA 200818005



- P, S1, S2 and S3 are members of a consolidated group.
  - S3's liabilities exceed the fair market value of its assets.
  - S2's liabilities exceed the fair market value of its assets.
- As a condition to a sale of the S2 stock, S1 cancelled a portion of the S3 Note. As a result, the value of S3's assets exceeded its liabilities, and the value of S2's assets (including the S3 stock) also exceeded S2's liabilities.
- S1 sold all of its S2 stock to X. P and X made §338(h)(10) elections with respect to the sale of the S2 stock and the deemed sale of the S3 stock.
- National Office disregarded the cancellation of the Note, as in Rev. Rul. 68-602.
- Thus, S1 was not treated as receiving any net value for its S2 stock, and the liquidation did not qualify under §332. The economic significance in cancellation of the Note did not alter the result. The CCA distinguished Rev. Rul. 78-330, because there was no liquidation in the transaction at issue in that ruling.

# LOSSES

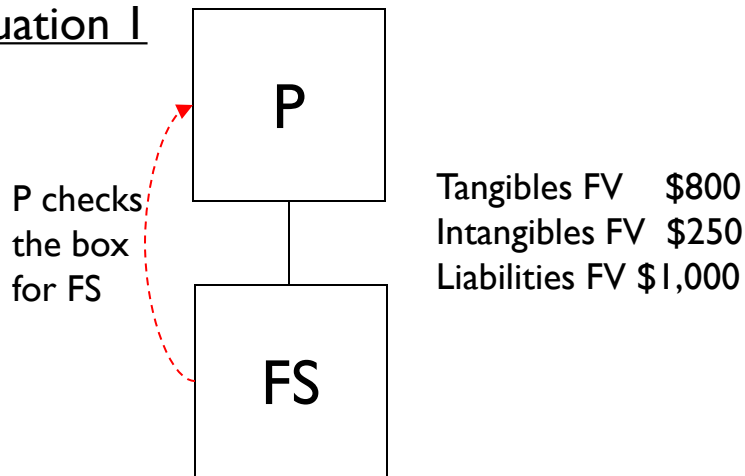
Insolvency and Liabilities

Worthless Stock and Rev. Rul. 2003-125

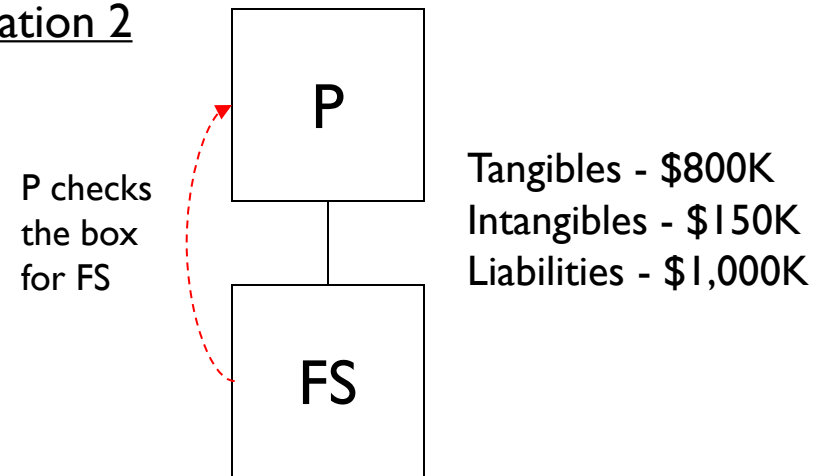
# REV. RUL. 2003-125

## FACTS

### Situation 1



### Situation 2



### Situation 1

- FS, an entity organized under the laws of Country X, operates a manufacturing business. FS is an “eligible entity” under Reg. §301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation under §7701(a)(3). On December 31, 2002, the stock of FS was not worthless.
- On July 1, 2003, P files a check-the-box election for FS, changing the classification of FS to a disregarded entity effective as of that date. At the close of the day before the effective date of the election, the FMV of FS's assets, including intangibles, exceeds its liabilities, but the FMV of FS's tangible assets does not exceed the sum of its liabilities. FS continues its manufacturing operations.

### Situation 2

- Same as Situation 1, except that the FMV of FS's assets, including intangibles, does not exceed its liabilities.



# REV. RUL. 2003-125

## ANALYSIS 1

### Holding

- When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder is allowed a worthless security deduction under §165(g) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that, on the deemed liquidation, the shareholder receives no payment on its stock.

### Situation 1

- Because the FMV of FS's tangible and intangible assets (\$1,050,000) exceeds FS's liabilities (\$1,000,000) immediately before the effective date of the check-the-box election, the FS stock is not worthless.
- P receives partial payment on its FS stock in the deemed liquidation of FS. As a result, §332 applies to the deemed liquidation and no loss is allowable to P.

### Situation 2

- Because FMV of FS's tangible and intangible assets (\$950,000) is less than FS's liabilities (\$1,000,000), the FS stock is worthless.
- Section 332 does not apply, because P does not receive any payment on its FS stock in the deemed liquidation of FS.
  - The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock and P is allowed a worthless security deduction under §165(g) in 2003.
  - FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under §§165 or 166.
  - See *also* Rev. Rul. 59-276 (upstream merger of insolvent subsidiary into creditor parent does not qualify as an A reorganization)

# REV. RUL. 2003-125

## ANALYSIS 2

Rev. Rul. 2003-125 clarifies the following:

- Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholder receives payment for its stock. *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).
- A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the FMV of the corporation's assets does not exceed the corporation's liabilities.
- The value of intangibles, including goodwill and going concern value, is included in determining FMV of the entity's assets immediately before the deemed liquidation.
- Certain facts may suggest that at the time of liquidation the FMV of the liquidating entity's assets exceeded its liabilities, e.g.—
  - Continuation of the corporation's business after a liquidation without a substantial infusion of capital.
  - Revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation.

# REV. RUL. 2003-125

## ANALYSIS 3

Rev. Rul. 2003-125 clarifies the following (continued):

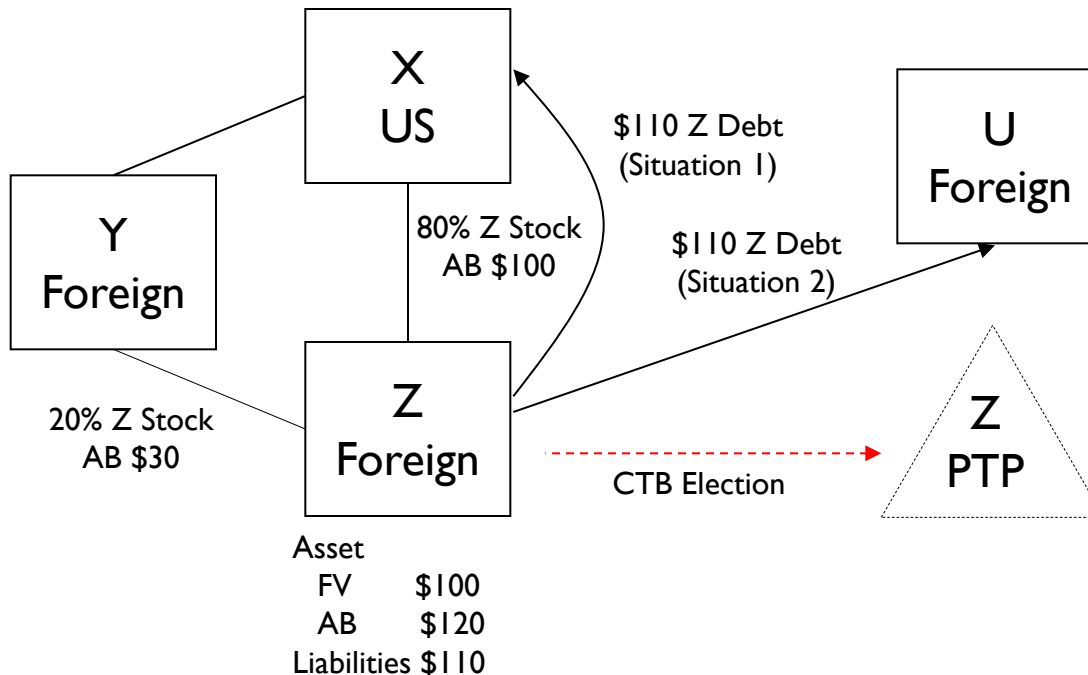
- Nevertheless, a parent can claim a bad debt deduction and a worthless stock deduction, if its subsidiary owes bona fide debt to the parent that exceeds the FMV of its assets, and the subsidiary transfers all its assets to the parent in partial satisfaction of its indebtedness. This may be true even if the parent (through the disregarded entity) continues the business formerly conducted by the subsidiary. Rev. Rul. 2003-125, *amplifying* Rev. Rul. 59-296.
- If a shareholder receives no payment for its stock in a liquidation of the corporation, neither §331 nor §332 applies to the liquidation.
- The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that the stock is worthless.
- The liquidation is an identifiable event that fixes the loss for purposes of a worthless stock deduction under §165(g).

# LOSSES

Insolvency and Liabilities  
GLAM 2011-003

# GLAM 2011-003

## FACTS



### Situation 1

- Z's liabilities are not securities within the meaning of §165(g)(2).
- At the time incurred, Z's liabilities constituted genuine debt that Z expected to repay in full.
- Z is an eligible entity for purposes of the entity classification rules (Reg. §301.7701-3.)
- Z elects to change its classification from corporation to partnership (Z PTP) under Reg. §301.7701-3(c)(1)(i).

### Situation 2

- Same as Situation 1 except that Z's liabilities are owed to U, an unrelated foreign corporation.

# GLAM 2011-003

## ISSUE 1

Is a shareholder of an insolvent corporation that elects to be classified as a partnership allowed a worthless security deduction under §165(g)?

- Under Reg. §301.7701-3(g)(1)(ii), Z is deemed to distribute its assets and liabilities to X and Y in liquidation of Z.
  - Because the FMV of Z's assets (\$100) is less than its liabilities (\$110), the Z shareholders do not receive payment for their stock.
  - Under §165(g), in Situations 1 and 2, X and Y are entitled to worthless security deductions of \$100 and \$30, respectively (basis in the Z stock).
- The GLAM cites Rev. Rul. 2003-125, which reaches the same conclusion in the context of an insolvent foreign corporation that elects to be classified as a disregarded entity.

# GLAM 2011-003

## ISSUES 2 AND 3

### Issue 2

In a transaction deemed to occur under Reg. §301.7701-3(g)(1)(ii), how are Z's liabilities treated?

- The deemed transfer of Z's liabilities followed by the assumption of the liabilities by Z PTP is not a significant modification of the liabilities. Reg. §1001-3.
  - In Situation 1 and Situation 2, Z PTP acquires substantially all of Z's assets. Z is deemed to distribute its assets to X and Y, which also assume Z's liabilities, and X and Y contribute the Z assets to Z PTP, which assumes the Z liabilities.
  - The change in Z's classification from corporation to partnership is not likely to result in a change in payment expectations.
  - No significant alteration occurs as a result of the deemed liquidation. The election by Z does not affect the liabilities of Z with respect to its creditors under local law.
- The tax consequences of Z's debt with respect to its partnership election are the same as if Z had actually liquidated, and X and Y had immediately formed Z PTP as a new partnership.
- Z's debt survives the liquidation and becomes an obligation of Z PTP

### Issue 3

Is a creditor of the insolvent corporation entitled to a bad debt deduction under §166?

- Because the liabilities are treated as surviving Z's deemed liquidation and as being assumed by Z PTP, Z's creditors in Situations 1 (X) and 2 (U) are not entitled to a bad debt deduction under §166.
- Cf. Rev. Rul. 2003-125, which indicates that a foreign subsidiary's creditors, including its parent, may be entitled to a §166 bad debt deduction.

# GLAM 2011-003

## ISSUES 4 AND 5-1

Issue 4: What Z PTP's basis in the assets deemed contributed to it?

Issue 5: What is the basis of each partner's interest in Z PTP?

- Z is deemed to distribute its assets to X and Y in liquidation. Because Z is insolvent, §§331 and 332 are inapplicable, and X's and Y's basis in the assets is determined under §1012 (i.e., the cost of the assets).
  - X is deemed to assume liabilities of \$88 (80% of \$110). Thus, X is deemed to receive assets with \$88 basis.
  - Y is deemed to assume liabilities of \$22 (20% of \$110). Thus, Y is deemed to receive assets with \$22 basis.
- X and Y are deemed to contribute their respective Z assets, pro rata, to Z PTP, and Z PTP is deemed to assume X's and Y's respective liabilities deemed assumed from Z.
  - Under §752(c), the amount of the liabilities treated as assumed by Z PTP is limited to the FMV of the assets at the time of the deemed contribution (\$100).
    - X is deemed to contribute assets with \$88 basis and to have \$80, of liabilities assumed.
    - Y is deemed to contribute assets with \$22 basis and to have \$20 of liabilities assumed.
  - No gain or loss is recognized to Z PTP or to X or Y on the deemed contribution. §721.
  - Z PTP's basis in the assets deemed contributed is \$110 (the basis of the assets to X and Y). §723.
  - Cf. Prop. Reg. §§1.351-1(a)(1)(iii)(A) and (B), which would require a surrender and receipt of net value, respectively, in a §351 transaction.
    - The GLAM takes the position that §721 applies regardless of whether net value is transferred, contrary to the principles in the proposed no net value regulations.
    - Preamble to Proposed No Net Value Regulations (“The IRS and the Treasury Department recognize that the principles in the proposed rules under §351 may be applied by analogy to other Code sections that are somewhat parallel in scope and effect, such as §721 . . .”).



# GLAM 2011-003

## ISSUES 4 AND 5-2

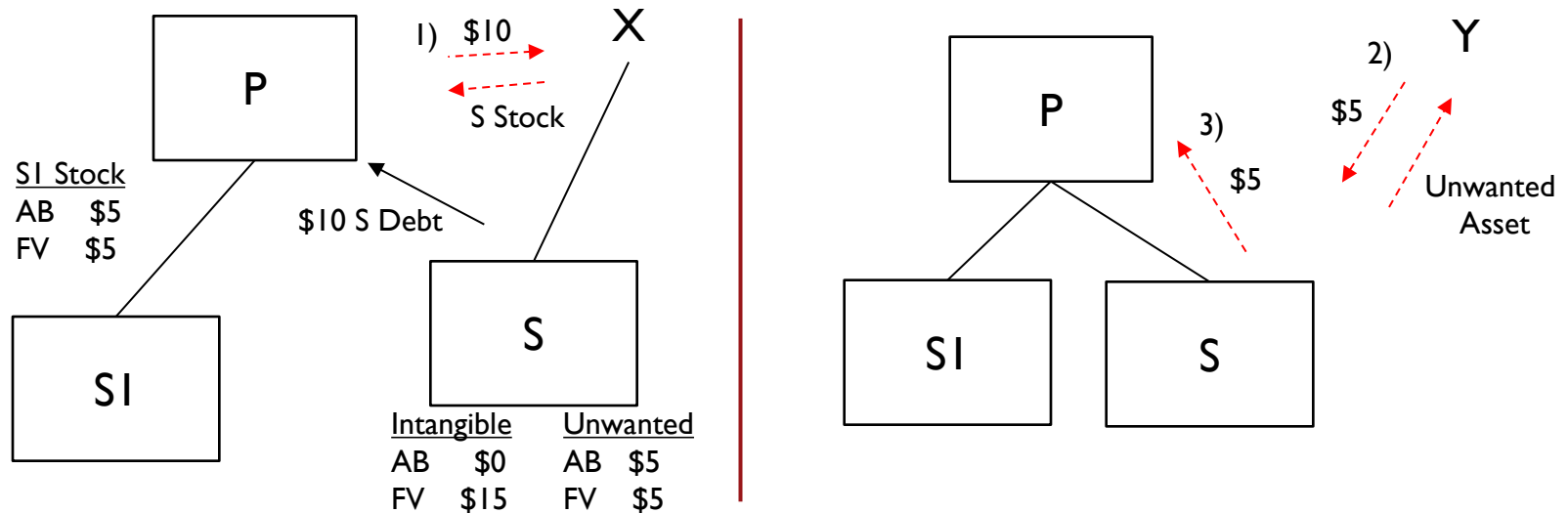
- In Situation 1, X's basis in its partnership interest is \$108, and Y's basis in its partnership interest is \$2.
  - Z PTP is deemed to assume \$100 of the liabilities contributed by X and Y (\$80 and \$20, respectively).
  - But because, as lender, X bears the economic risk of loss for the liability, X's share of the liability is increased by \$100.
  - X's basis in its partnership interest is \$108—\$88 basis in assets deemed contributed (§722), increased by the deemed contribution of \$20 money (§752(a)).
  - Y's basis in its partnership interest is \$2—\$22 basis in assets deemed contributed (§722), decreased by a deemed distribution of \$20 (§752(b)).
- In Situation 2, X's basis in its partnership interest is \$88, and Y's basis in its partnership interest is \$22.
  - Because no partner bears the economic risk of loss with respect to the liabilities contributed to Z PTP, the liability contributed is nonrecourse.
  - There is no net change in the partners' shares of liabilities and thus no deemed contributions or distributions under §752(a) and (b).
  - Z PTP deemed to assume \$100 of liabilities from X and Y (\$80 and \$20, respectively).
  - X's and Y's shares of the liability increases by \$80 and \$20, respectively.
  - X's basis in its partnership interest is \$88 (\$88 basis in assets deemed contributed (§722)).
  - Y's basis in its partnership interest is \$22 (\$22 basis in assets deemed contributed (§722)).

# LOSSES

Insolvency and Liabilities  
GLAM 2012-006

# GLAM 2012-006

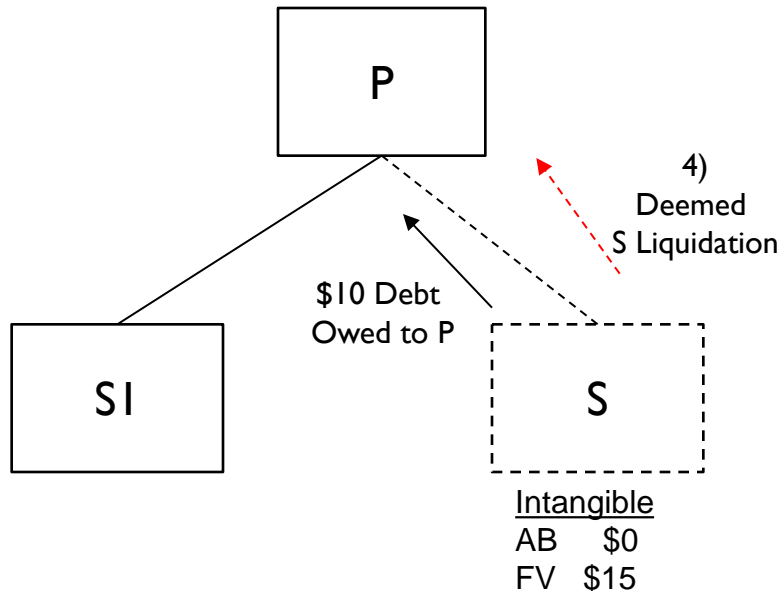
## BASE FACTS



- P and SI are members of a consolidated group.
- 1) P purchases all of the stock of S from X for \$10. P's basis in the S stock is \$10.
- 2) S sells Unwanted Asset to an unrelated person for \$5, with no realized gain or loss.
- 3) S distributes the proceeds to P.
- S's distribution to P is an intercompany distribution, not included in P's income. §301; Reg. §1.1502-13(f)(2)(ii).
- The distribution results in a \$5 reduction to P's basis in its S stock, from \$10 to \$5. Reg. §1.1502-32(b)(2)(iv).

# GLAM 2012-006

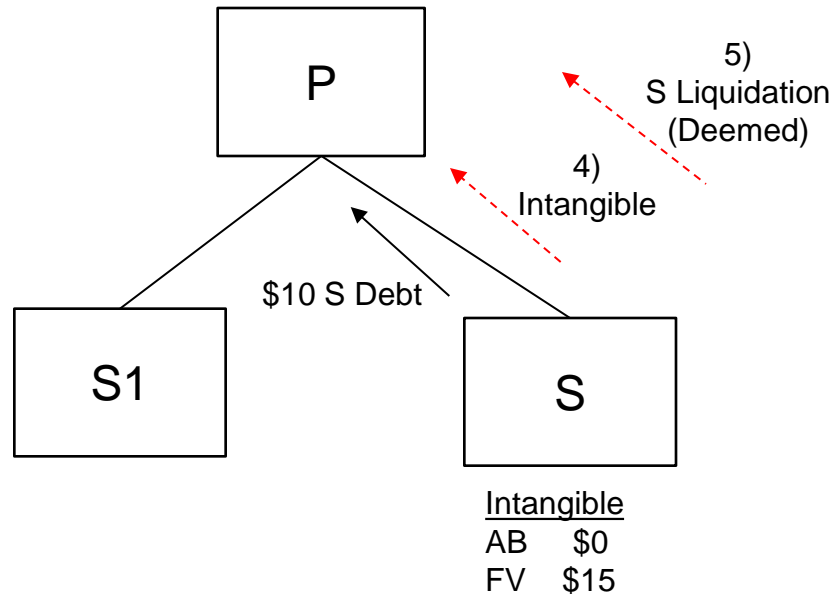
## SITUATION 1



- 4) S converts to an LLC, classified as a disregarded entity. P claims a worthless stock deduction.
- The conversion is treated as a distribution by S of all its assets (Intangible) and liabilities to P in complete liquidation.
  - Because the FMV of Wanted Intangible (\$15) exceeds the amount of S's liabilities (\$10 owed to P), no gain or loss is recognized to P on the receipt of S's property in cancellation of its S stock. §332; Rev. Rul. 2003-125.
  - P's basis in its S stock is eliminated, and P is not entitled to a worthless stock deduction.

# GLAM 2012-006

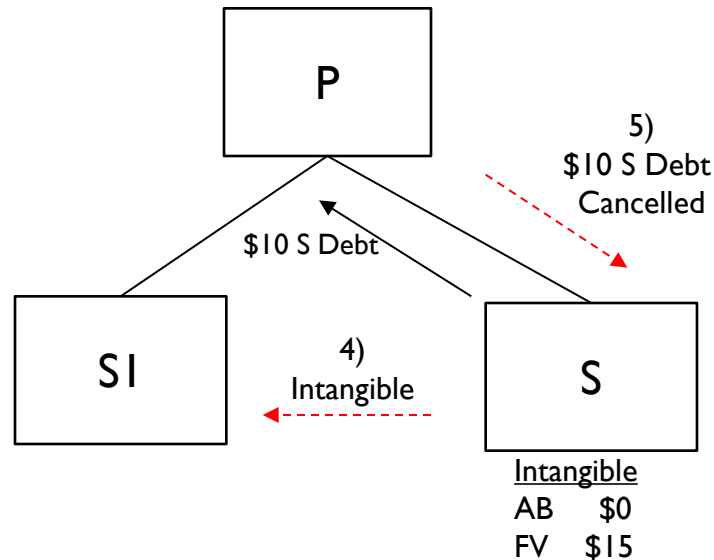
## SITUATION 2



- 4) S distributes Intangible to P.
- 5) S converts to an LLC, classified as a disregarded entity. P claims a worthless stock deduction.
  - S is treated as distributing Intangible in complete liquidation. Rev. Rul. 61-191, 1961-2 C.B. 251.
  - The distribution of Intangible is deemed to satisfy the \$10 debt owed to P and to be in cancellation of the S stock.
  - No gain or loss is recognized to P on the receipt of S's property in cancellation of its S stock. §332.
  - S recognizes no gain or loss on the transfer. Reg. §1.332-7.
  - P's basis in its S stock is eliminated and S is treated as ceasing to exist. Reg. §1.6012-2(a)(2).
  - The conversion by S to a disregarded entity has no federal income tax consequences.

# GLAM 2012-006

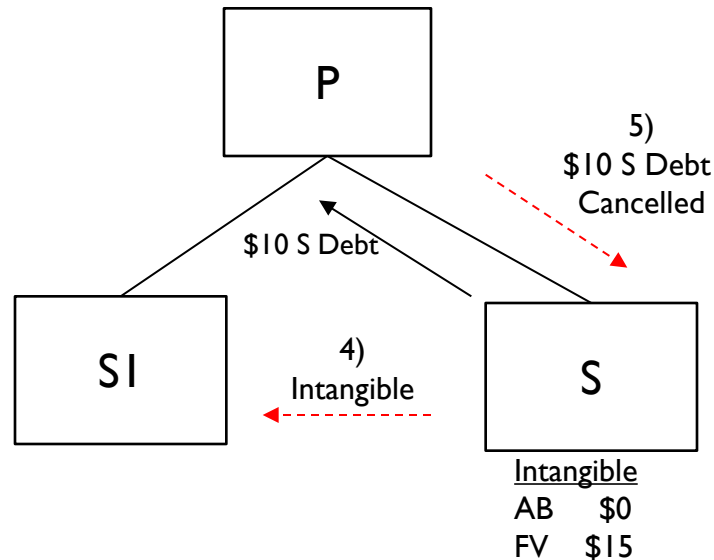
## SITUATION 3-1



- 4) S transfers Intangible to SI for no consideration.
- 5) P cancels S's \$10 Debt.
  - S converts to an LLC, classified as a disregarded entity. P claims a worthless stock deduction.
  - The \$10 S Debt is treated as cancelled before the reorganization (described in Slide 75) with a capital contribution. Rev. Rul. 78-330.
    - The cancellation of the \$10 S Debt is treated by S as if it satisfied the Debt and does not result in COD income. §108(e)(6).
    - P's \$5 basis in its S stock is increased by \$10 to \$15.

# GLAM 2012-006

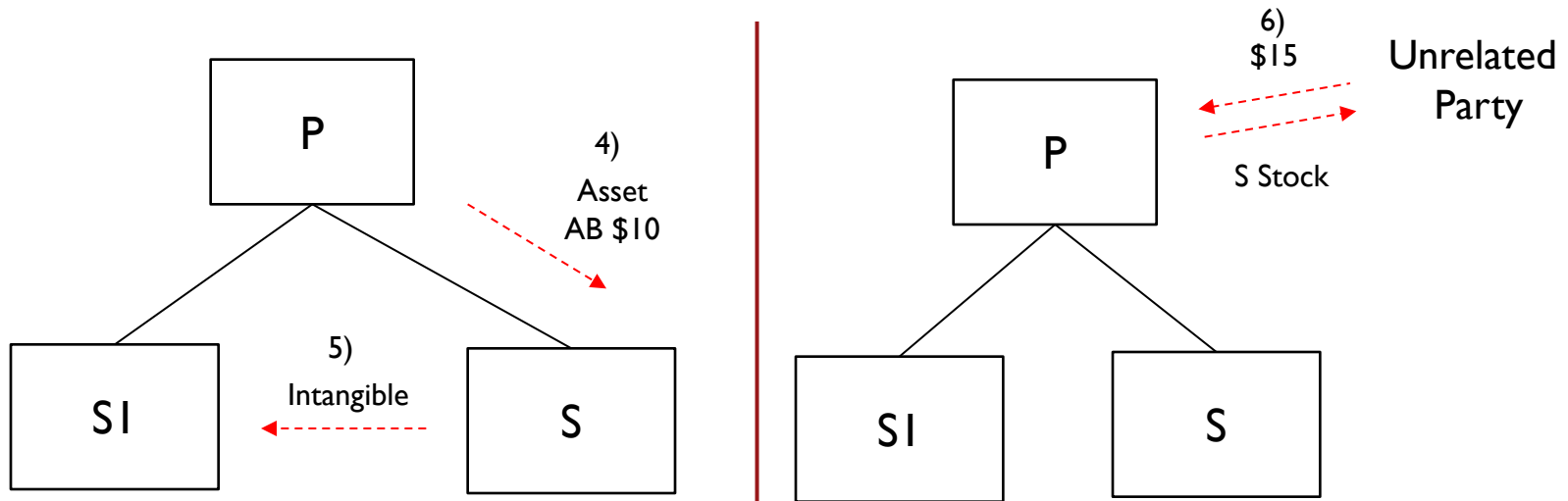
## SITUATION 3-2



- S's transfer of Intangible is an acquisitive reorganization under §368(a)(1)(D).
- S is treated as transferring Intangible to SI for SI stock (FMV = \$15) and distributing the SI stock to P in exchange for its S stock. Reg. §1.368-2(l)(2).
  - P's basis in the SI stock deemed received is \$5, P's basis in its S stock (see Base Facts, Slide 71). §358(a)(1); Reg. §1.358-2(a)(2)(i).
  - P is then treated as surrendering all of its shares in SI, under §368(a)(1)(E), in exchange for the SI shares P actually holds. Reg. §1.358-2T(a)(2)(iii),
  - P does not recognize gain or loss on the deemed exchange of its S stock for SI stock, and the S stock is treated as having been cancelled. §354,
- After the transactions, S ceases to exist for tax purposes. Rev. Rul. 61-191; Reg. §1.6012-2(a)(2). S's conversion to an LLC, treated as a disregarded entity, has no tax consequences.

# GLAM 2012-006

## SITUATION 4—FACTS

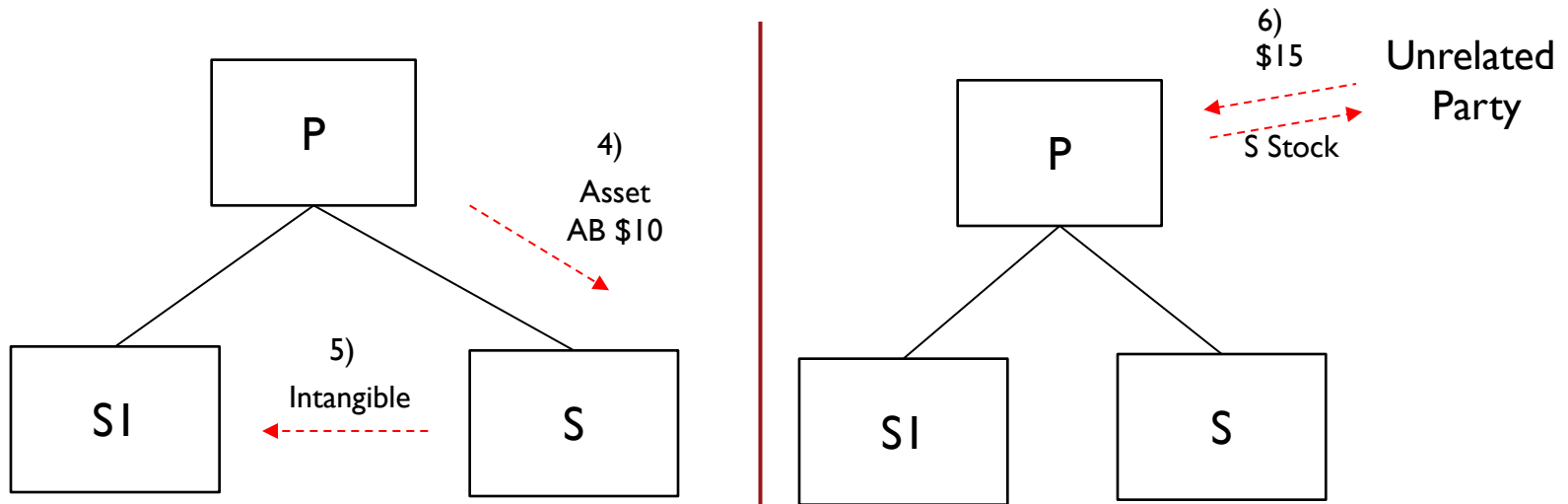


- 4) P contributes Asset to S as a contribution to S's capital. P's basis in the S stock is increased by \$10 to \$15
- 5) S transfers Intangible to SI for no consideration. The P group does not report amortization deductions with respect to Intangible.
- 6) Several years later, P sells the S stock to Unrelated Party for \$15.



# GLAM 2012-006

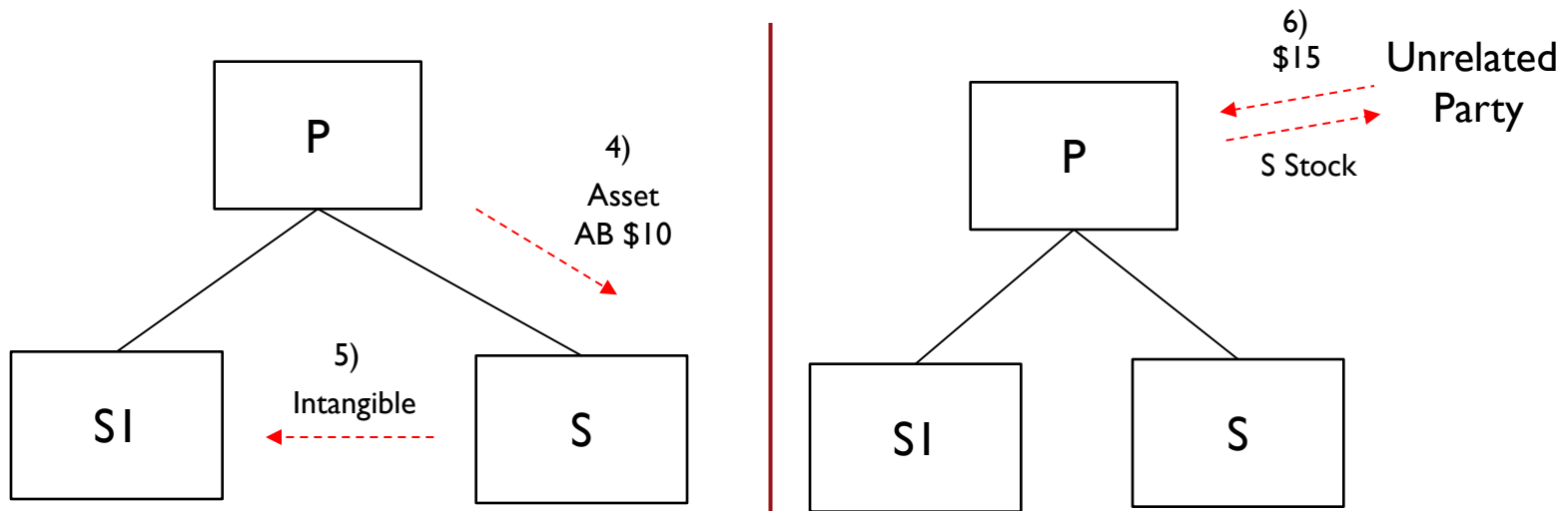
## SITUATION 4—ANALYSIS—1



- S's transfer of Intangible to SI is treated as a distribution of Intangible by S to P and a contribution of Intangible by P to SI. Rev. Rul. 69-630, and §482. (Note: Not treated as a distribution-contribution of \$15 cash.)
  - Because of the contribution of Asset to S, the transfer of Intangible by S to SI does not qualify as a D reorganization ("substantially all").
- The deemed distribution of Intangible by S to P requires S to recognize \$15 gain. §311(b),
- SI's gain is intercompany gain, not taken into account at the time of the deemed distribution. Reg. §1.1502-13(b)(1). S's intercompany gain does not increase P's basis in its S stock until the gain is taken into account.
- The \$15 intercompany distribution is not included in P's gross income (Reg. §1.1502-13(f)(2)(ii)) but results in a \$15 reduction to P's basis in its S stock. Reg. §1.1502-32(b)(2)(iv).
- After steps 1-3 (Base Facts, Slide 71), P's basis in the S stock is \$0 (\$10 original basis, reduced by \$5 distribution following the sale of Unwanted, increased by \$10 due to P's contribution of Asset 1 to S, and reduced by \$15, FMV of Intangible deemed distributed to P).

# GLAM 2012-006

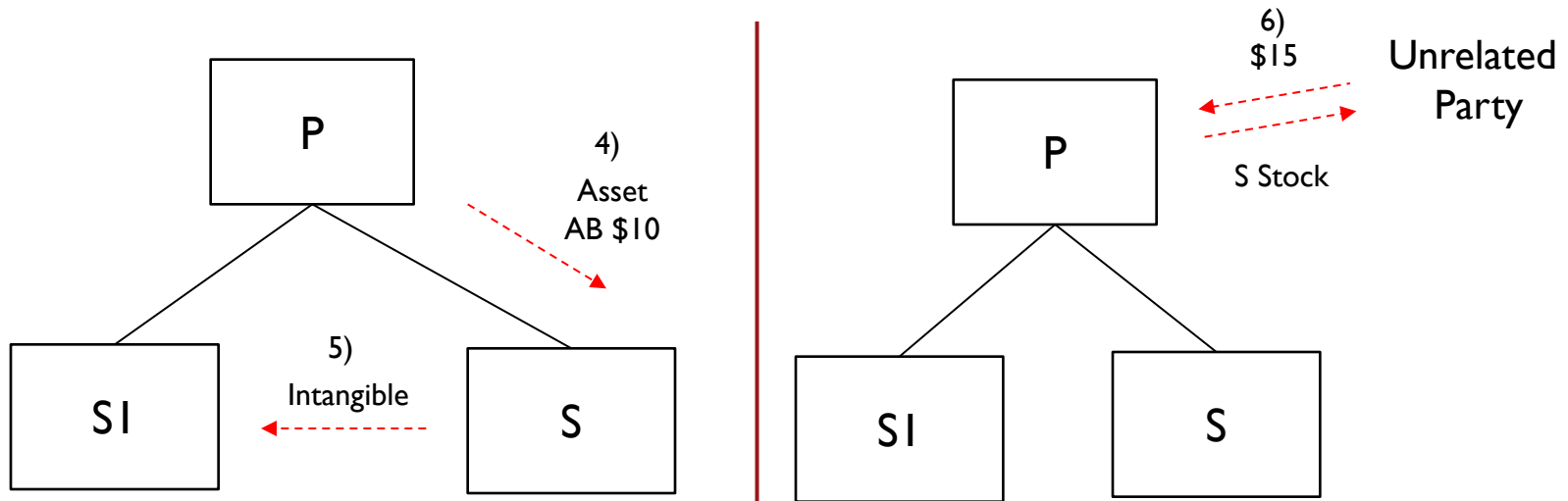
## SITUATION 4—ANALYSIS—2



- P's basis in Intangible is \$15 (= FMV). §301(d).
- On P's deemed contribution—
- SI takes \$15 basis in Intangible. §362(a),
- P's \$5 basis in its SI stock is increased by \$15 to \$20. §358(a).
- When SI receives Intangible with FMV basis (\$15) from P in the deemed contribution, SI may amortize its \$15 basis in Intangible over its 15-year life. Reg. §1.1502-13; §197(f)(2).
  - As SI claims a deduction, S includes in income a corresponding amount of its \$15 intercompany item resulting from its §311(b) gain.

# GLAM 2012-006

## SITUATION 4—ANALYSIS—3

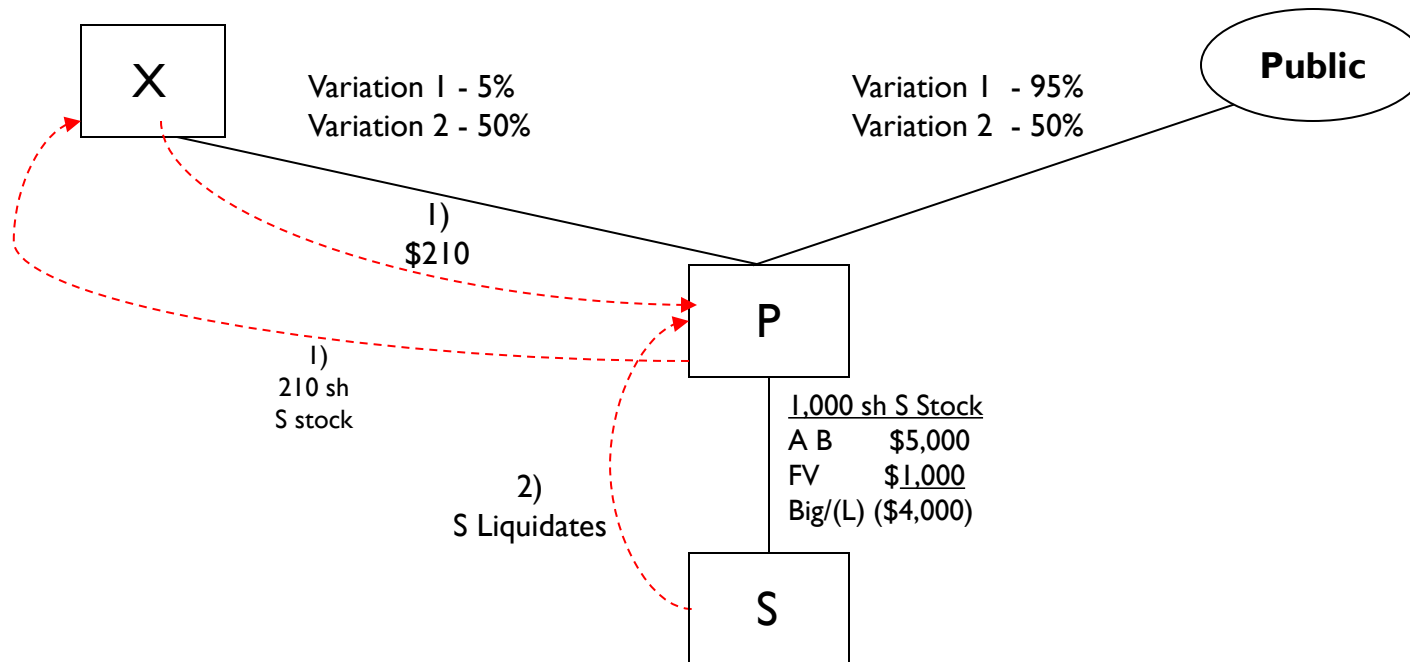


- When P sells the S stock, S ceases to be a member of the P group, and S's intercompany gain is accelerated. Reg. §1.1502-13(d).
- Because adjustments to basis are necessary in determining either the correct basis of a member or gain or loss on a transaction in an open year, S's unreported intercompany items relating to its §311(b) gain should be taken into account in determining P's basis in its S stock and consequently P's gain or loss on the sale of S in Year 7. *Barenholtz v. United States*, 784 F.2d 375 (Fed. Cir. 1986); Rev. Rul. 81-88, 1981-1 C.B. 585.
- SI's unclaimed amortization deductions should be taken into account in determining P's basis in its SI stock.
- SI is treated as if it had deducted amortization each year and S is treated as if it included an equal amount in income resulting from its triggered §311(b) gain each year, and triggered the rest of its intercompany gain in the year of the sale of the S stock.

# LOSSES

*Granite Trust* Transactions  
and the “Super Secret Rule”

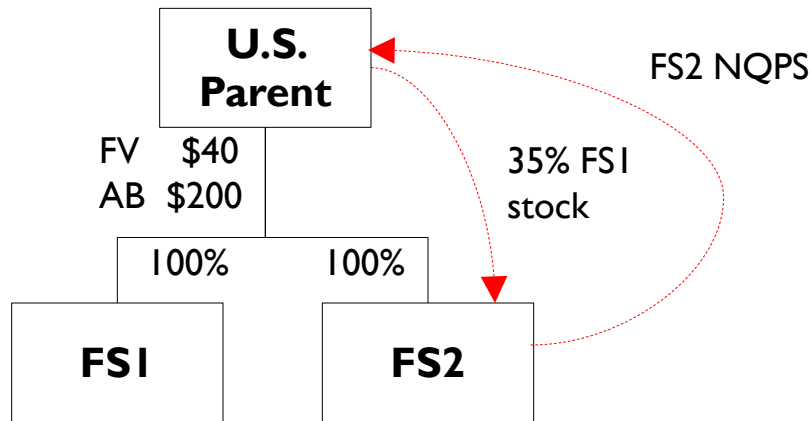
# GRANITE TRUST TRANSACTION



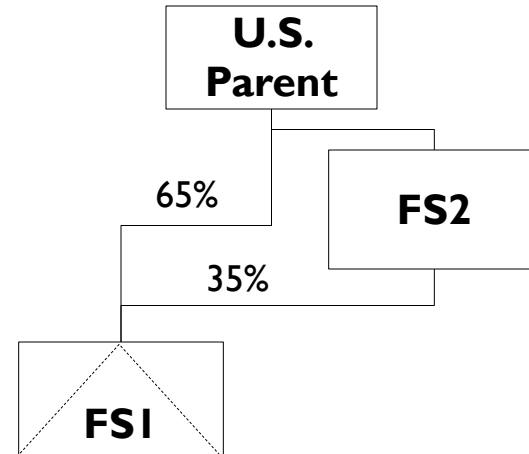
- If S liquidated without prior stock sale, no loss on the S stock would be recognized. To P. §332.
- In Variation 1, P's \$840 loss on sale of 210 shares (21%) of the S stock to X is deductible.
- In Variation 2, P's \$840 loss on sale of 210 shares (21%) of the S stock to X is deductible but deferred until P and X are no longer members of a controlled group. See Slides 83-86 (§267(f) and regulations).
- \$3,160 loss recognized to P on liquidation of S.
- Loss on liquidation not disallowed by step transaction, substance-over-form or economic substance doctrine. *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517 (3d Cir. 1945); *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956). See also TD 9583 (Apr. 13, 2012) (§267(f) regulations "consistent with" *Granite Trust*).

# GRANITE TRUST TRANSACTION WITH FOREIGN SUB

## 1) Transfer of 35% of FSI stock to FS2



## 2) FSI makes CTB election



- U.S. Parent transfers 35% of the stock of wholly-owned foreign subsidiary, FSI, to another wholly-owned foreign subsidiary, FS2, for §351(g)(2) non-qualified preferred stock of FS2.
- FSI then makes an election to be classified as a partnership.
  - Nonqualified preferred stock makes §304 inapplicable to sale of FSI stock (but see legislative proposals).
  - Percentage disposed of addresses 80/80 test as well as upstream C reorganization recast.
- If certain requirements are met, U.S. Parent recognizes capital loss on liquidation of FSI (65% of built-in loss). §331.
- FSI recognizes gain or loss under §336.
- Parent's loss on transfer of the 35% of the FSI stock to FS2 continues to be deferred until U.S. Parent and FS2 are no longer members of the same controlled group.

# FINAL §267(f) REGULATIONS

## BACKGROUND

- Reg. §1.267(f)-1(c)(1)(iv), known as the “supersecret rule,” relates to losses that would have been redetermined to be noncapital, nondeductible amounts if the attribute redetermination rule in Reg. §1.1502-13(c)(1) applied.
- If an intercompany loss between members of a consolidated group would have been redetermined to be a noncapital, nondeductible amount as a result of the attribute redetermination rule applicable to consolidated groups, but the loss is not redetermined because the sale or exchange occurred between members of a controlled group, (not a consolidated group), the loss is deferred and generally is taken into account when the selling and buying members are no longer in a controlled group relationship.

# FINAL §267(f) REGULATIONS

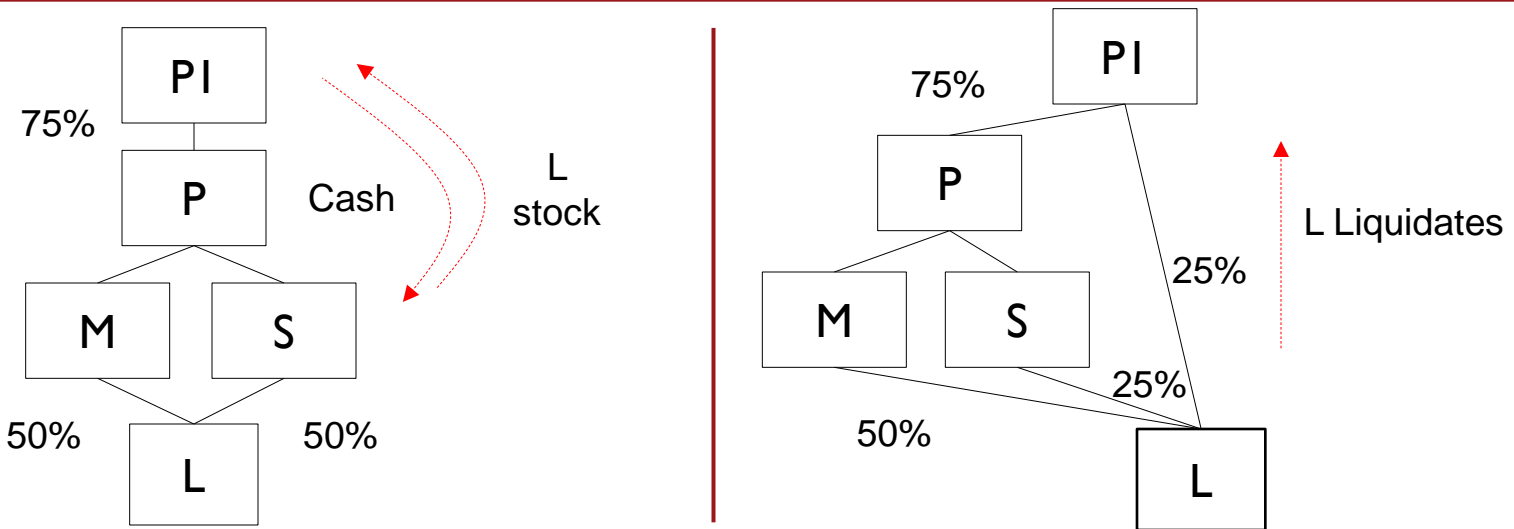
## NEW RULES

- The final regulations adopt a new aggregation rule to prevent triggering of intercompany loss on a sale of stock with a §331 liquidation of the target.
  - For purposes of determining whether a deferred loss is redetermined to be a noncapital, nondeductible amount under the principles of Reg. §1.1502-13, the following are taken into account:
    - Stock held by Seller.
    - Stock held by all members of Seller's consolidated group.
    - Stock held by any member of a controlled group of which Seller is a member that was acquired from a member of Seller's consolidated group.
    - Stock issued by Target to a member of the controlled group.
    - Stock held by the Buyer.
  - Under the new final regulations, stock issued to a member of a controlled group by a target is included. The purpose is to ensure that taxpayers cannot circumvent the regulations through issuances of Target stock to controlled group members, instead of sales of stock.
- The final regulations also clarify the interaction between §267(f) and Reg. §1.1502-13 by removing a provision in the proposed regulations that deferred loss is taken into account to the extent of any corresponding gain that the buying member recognizes with respect to the property, because the timing of taking into account such a loss is provided for under Reg. §1.1502-13.



# REG. § 1.267(f)-1 (j) EXAMPLE 9

## SALE OF STOCK BY CONSOLIDATED GROUP MEMBER TO CONTROLLED GROUP MEMBER



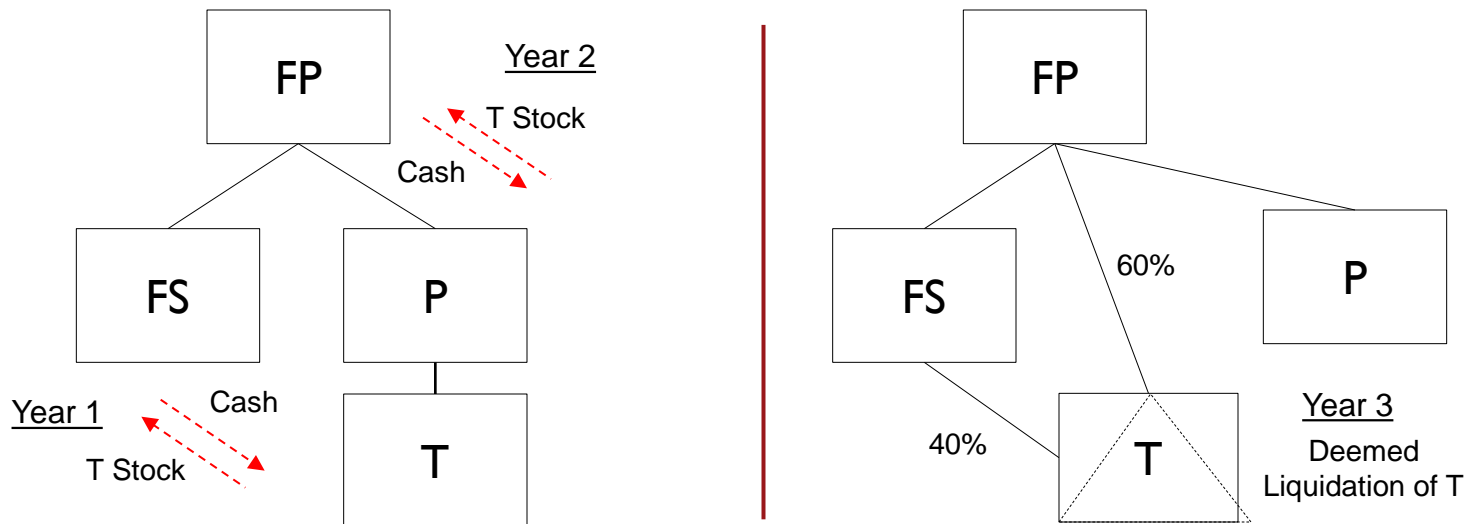
- PI owns 75% of the stock of P, common parent of a consolidated group. M and S (both group members) each owns 50% of the stock of L, a nonmember life insurance company.
- In Year 1, S sells 25% of the L stock to PI for \$50. S's basis in the transferred L stock was \$80, and S recognizes a \$30 loss.
- In Year 2, when the L shares held by PI are worth \$60, L liquidates, with PI recognizing \$10 gain.

### Results

- Under Reg. § 1.267(f)-1(a)(2), S's loss on the sale of the L stock to PI is deferred. Under Reg. § 1.267(f)-1(c)(1)(iv), upon the liquidation of L, to the extent S's loss would be redetermined as a noncapital, nondeductible amount under Reg. § 1.1502-13, S's loss continues to be deferred.
- Under Reg. § 1.1502-13, S's loss is not redetermined to be a noncapital, nondeductible amount to the extent of PI's \$10 of gain recognized. Accordingly, S takes into account \$10 of loss as a result of the liquidation.
- In determining whether the remainder of S's \$20 loss would be redetermined to be a noncapital, nondeductible amount, stock held by PI, M, and S is taken into account. Accordingly, under principles of Reg. § 1.1502-13, the liquidation of L would be treated as a \$332 liquidation, and S's remaining \$20 loss would be redetermined to be a noncapital, nondeductible amount. Thus, such loss continues to be deferred until S and PI are no longer in a controlled group relationship.

# REG. § 1.267(f)-1(j) EXAMPLE 10

## ISSUANCE OF STOCK TO CONTROLLED GROUP MEMBER



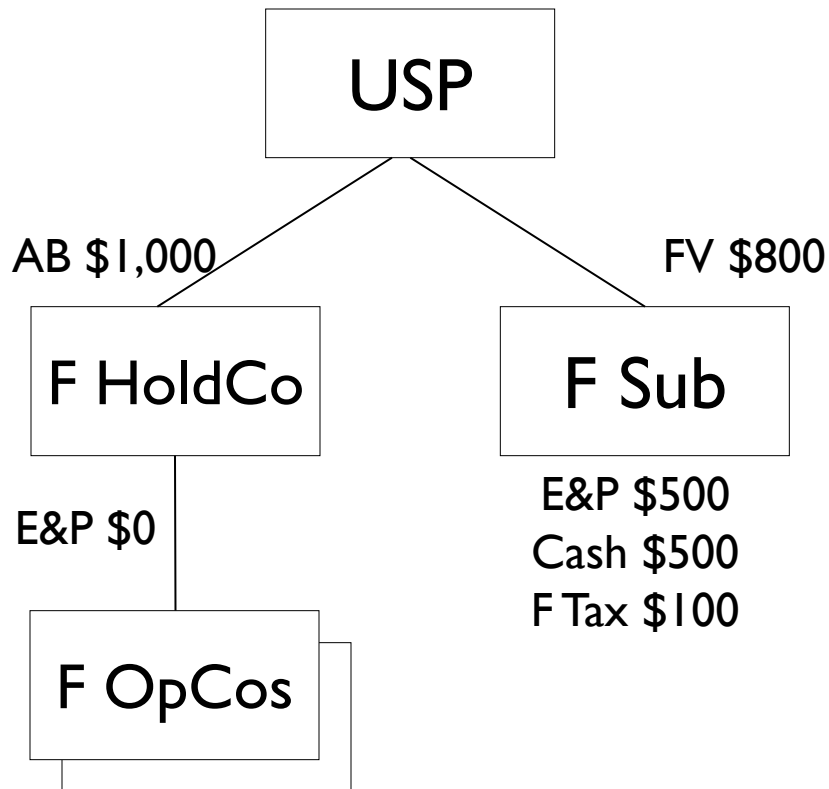
- FP, a foreign corporation, owns all the stock of FS, a foreign corporation, and all the stock of P, a domestic corporation. P owns all the stock of T.
- In Year 1, FS transfers cash to T for newly issued T stock that constitutes 40% of the T stock.
- In Year 2, when the value of the T stock owned by P is less than P's basis, P sells its T stock to FP.
- In Year 3, in an unrelated transaction, T converts into an LLC that is treated as a partnership for federal income tax purposes.

### Results

- P's loss on the sale of its T stock is deferred. Reg. § 1.267(f)-1(a)(2). On T's conversion, to the extent P's loss would be redetermined to be a noncapital, nondeductible amount under Reg. § 1.1502-13 principles, P's loss continues to be deferred. Reg. § 1.267(f)-1(c)(1)(iv). In making this determination, stock held by FS (which was acquired from T) and stock held by FP (the buyer of the T stock from P and a member of P's controlled group) is taken into account.
- Accordingly, under Reg. § 1.1502-13 principles, the deemed liquidation of T resulting from its conversion would be treated as a § 332 liquidation, and P's loss would be redetermined to be a noncapital, nondeductible amount. Thus, under Reg. § 1.267(f)-1(c)(1)(iv), P's loss continues to be deferred until P and FP are no longer in a controlled group relationship.

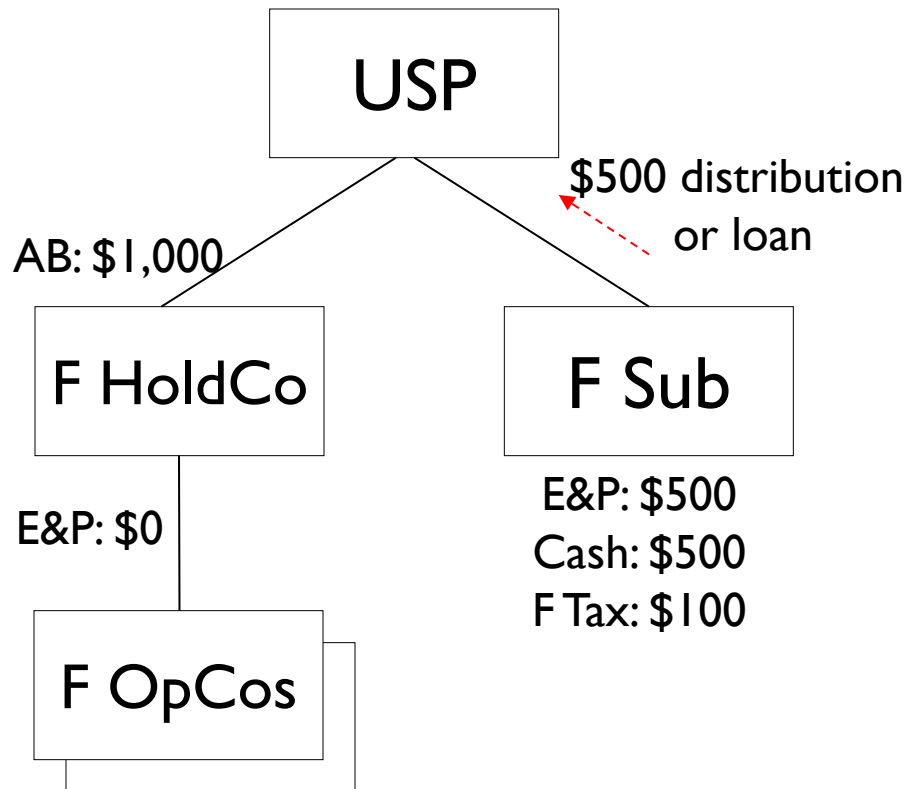
# UTILIZING FOREIGN EARNINGS

# BASIC FACT PATTERN



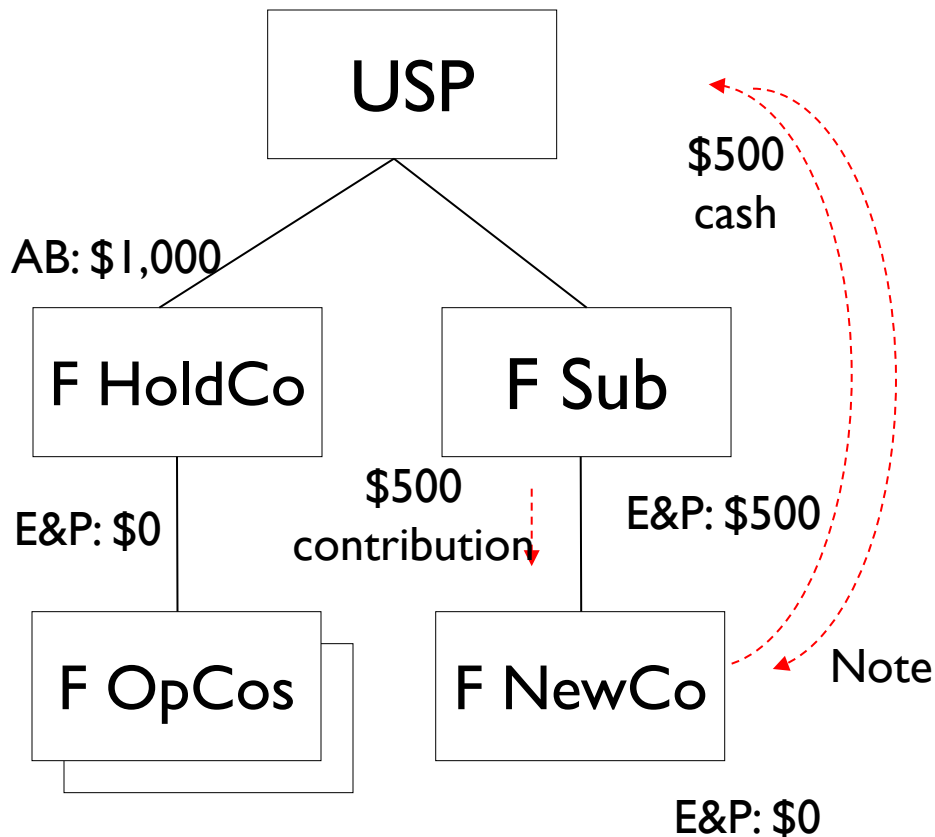
- USP has \$1,000 basis in stock of F HoldCo
- Because F HoldCo does not have its own operations, it has zero E&P
- USP also owns F Sub, which has \$500 E&P and \$500 cash and has \$100 in its foreign tax pools
- The value of the F Sub stock is \$800

# DIRECT REPATRIATION



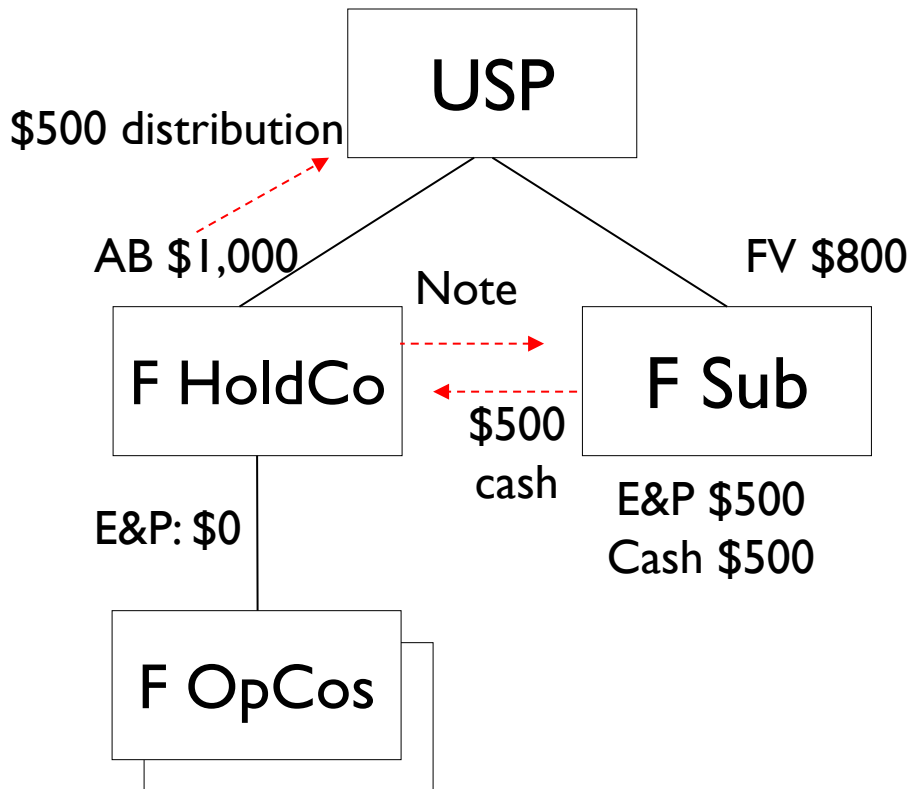
- Distribution of \$500 by F Sub to USP is dividend taxable to USP (carries up \$100 foreign taxes under § 902)
- Loan of \$500 by F Sub to USP is investment in U.S. property within the meaning of §956, giving rise to inclusion under §951(a)(1)(B) (carries up \$100 foreign taxes under §960)

# INDIRECT INVESTMENT IN U.S. PROPERTY



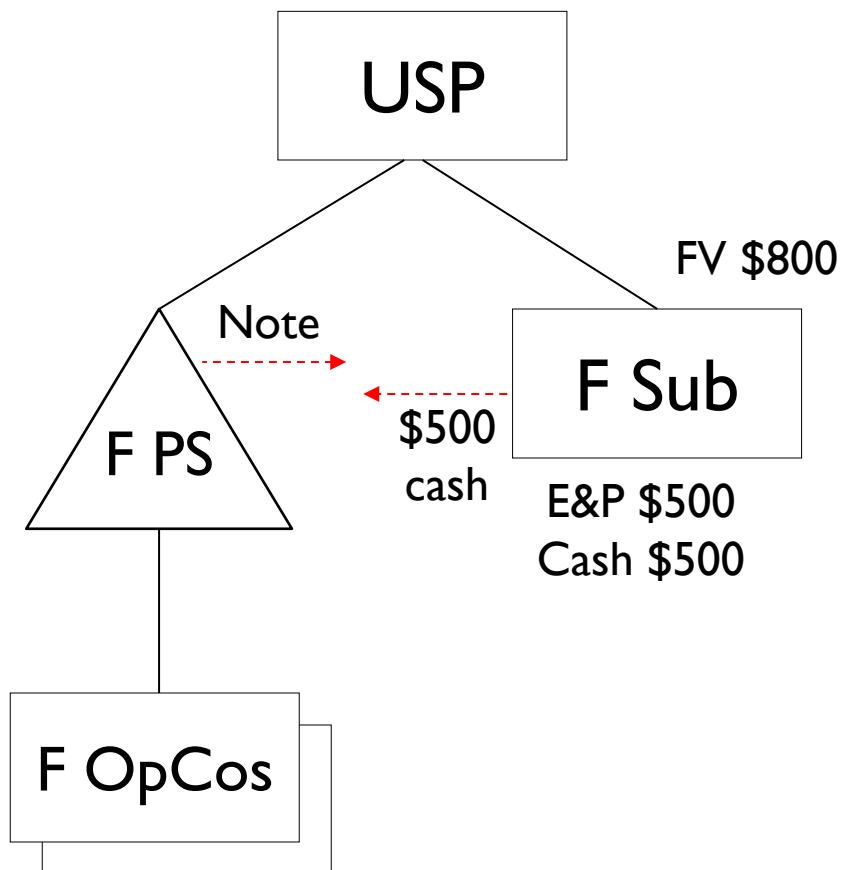
- F Sub contributes \$500 cash to F NewCo
- F NewCo lends \$500 to USP
- F NewCo's §956 amount is zero even though the loan is an investment in U.S. property (because zero E&P)
- F Sub could be treated as indirectly investing in U.S. property, though, under Reg. §1.956-1T(b)(4)

# LOAN TO CFC



- F Sub lends \$500 to F HoldCo
- F HoldCo distributes \$500 to USP
- Distribution is a return of basis
- No §956 investment in U.S. property (CFC-to-CFC loan)
- Administration proposal to trace E&P

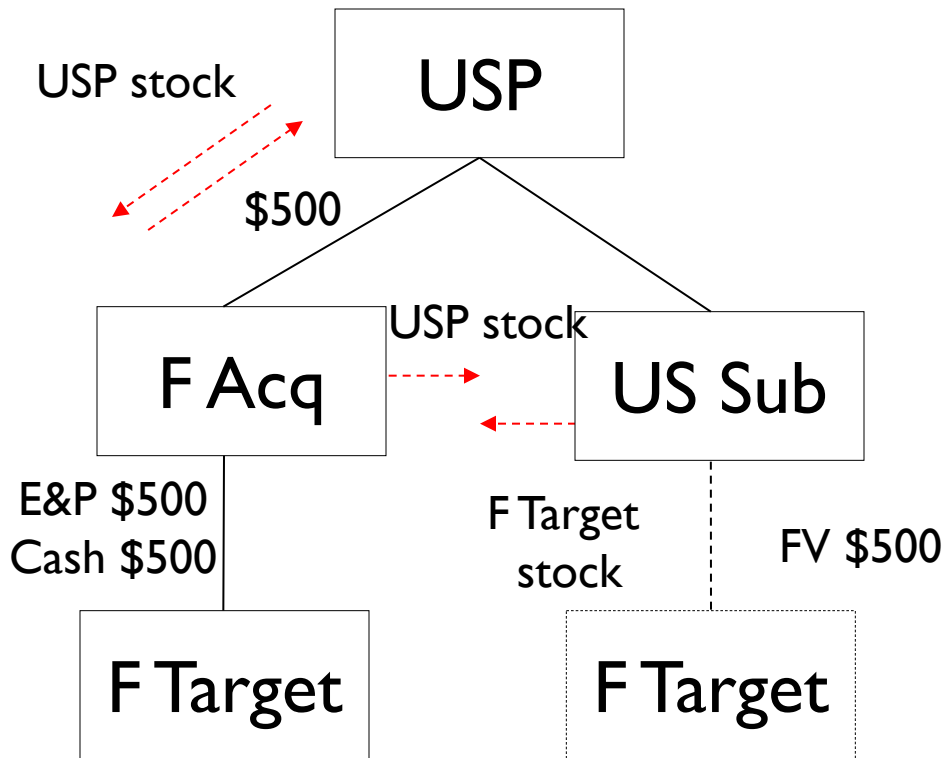
# LOAN TO PARTNERSHIP



- F Sub lends \$500 to F PS
- Is F Sub's loan to F PS treated as an investment in U.S. property under an "aggregate" approach?
- IRS indicated it is developing guidance
- Possible approaches include:
  - Automatic aggregate approach
  - Application of §752 principles
  - More subjective approach
- Should it matter whether the proceeds are distributed or invested in a foreign business, for example?

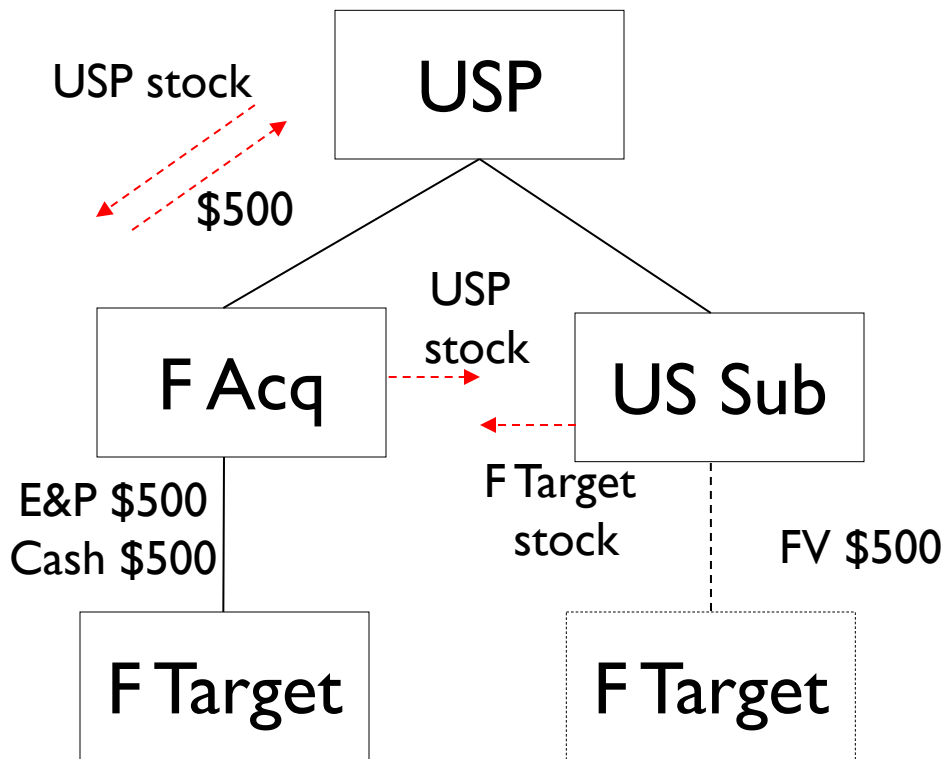


# “OLD” KILLER B TRANSACTIONS – FACTS



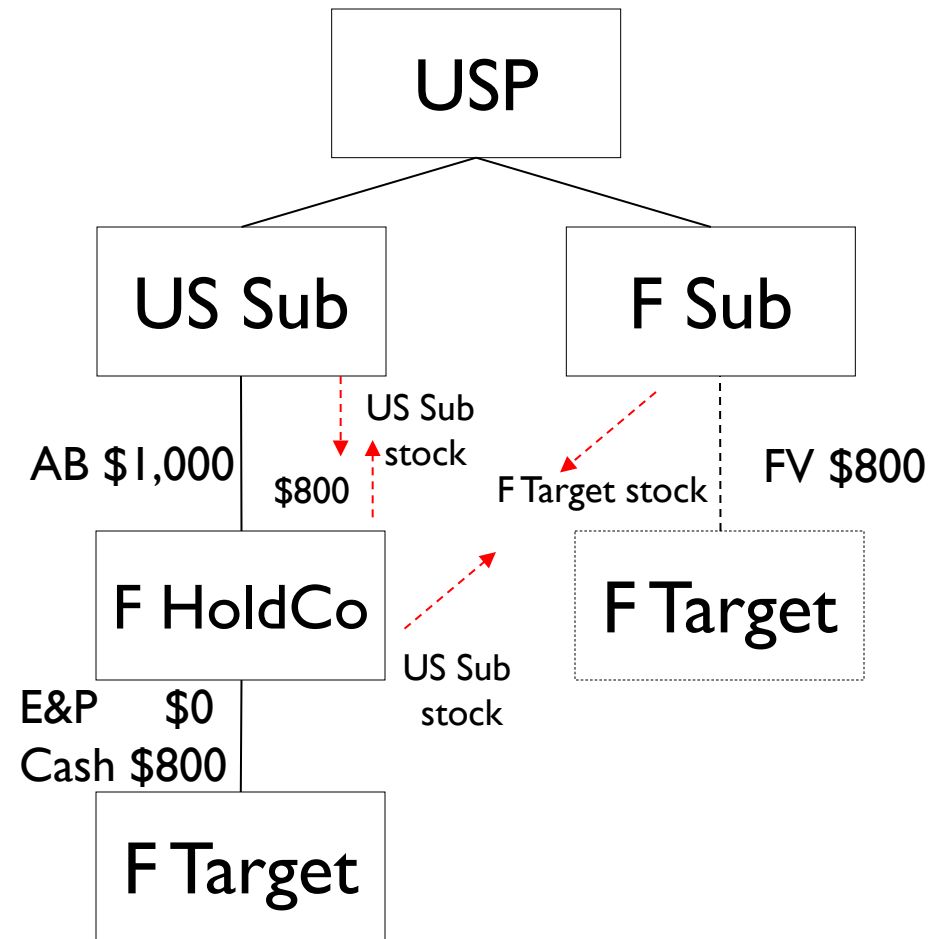
- USP issues voting stock to F Acq for \$500 cash
- F Acq exchanges USP stock for stock of F Target
- Transactions intended to qualify as triangular reorganization under §368(a)(1)(B)

# “OLD” KILLER B TRANSACTIONS – CONSEQUENCES



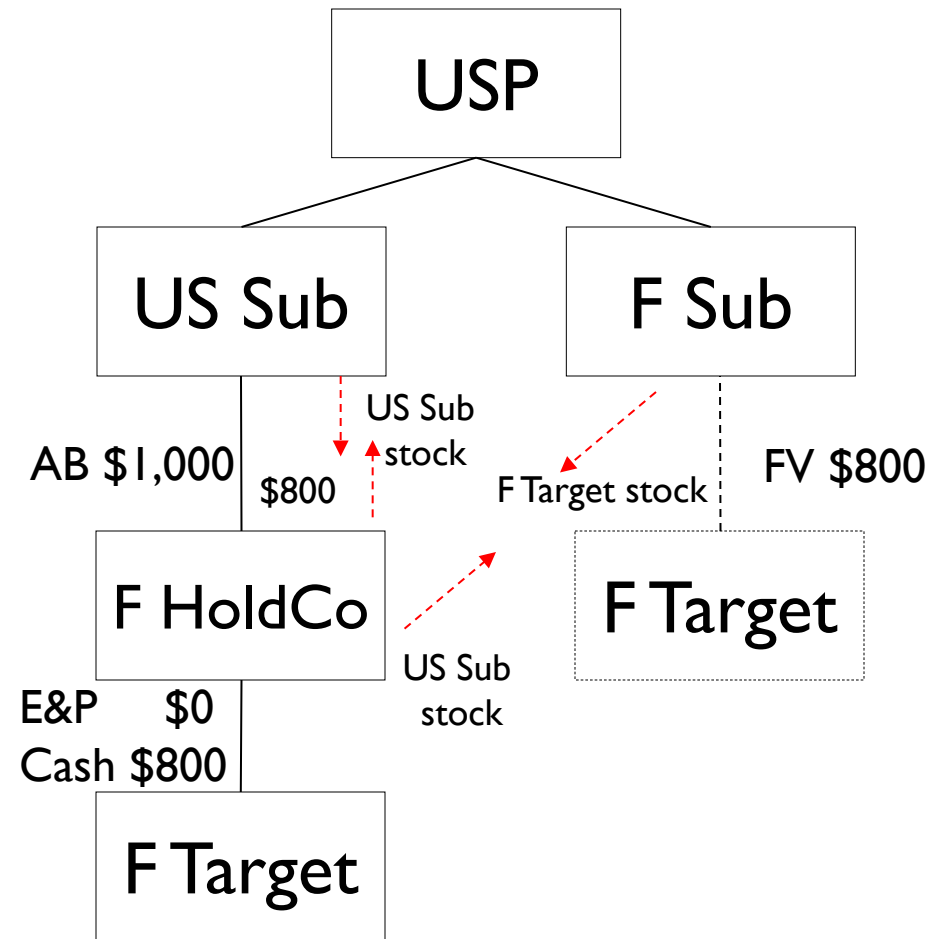
- USP issues voting stock to F Acq for \$500 cash
- F Acq exchanges USP stock for stock
- Formerly asserted treatment
  - No dividend inclusion to USP parent
  - Tax-free reorganization
  - No §956 investment in U.S. property
- Result: cash transfer from F Acq to USP tax-free
- Now governed by Reg. § 1.367(b)-10 (prior guidance included Notice 2006-85; Notice 2007-48; Reg. § 1.367(b)-14T)
  - Initial exchange treated as (1) deemed distribution and (2) deemed contribution
  - Deemed distribution is \$500 taxable dividend

# TRIANGULAR REORGANIZATION – FACTS



- USP seeks to move F Target under its foreign holding company structure
- US Sub issues voting stock to F HoldCo for \$800
- F Sub transfers stock of F Target to F HoldCo in exchange for stock of US Sub
- Transactions intended to qualify as triangular reorganization under §368(a)(1)(B)

# TRIANGULAR REORGANIZATION – CONSEQUENCES



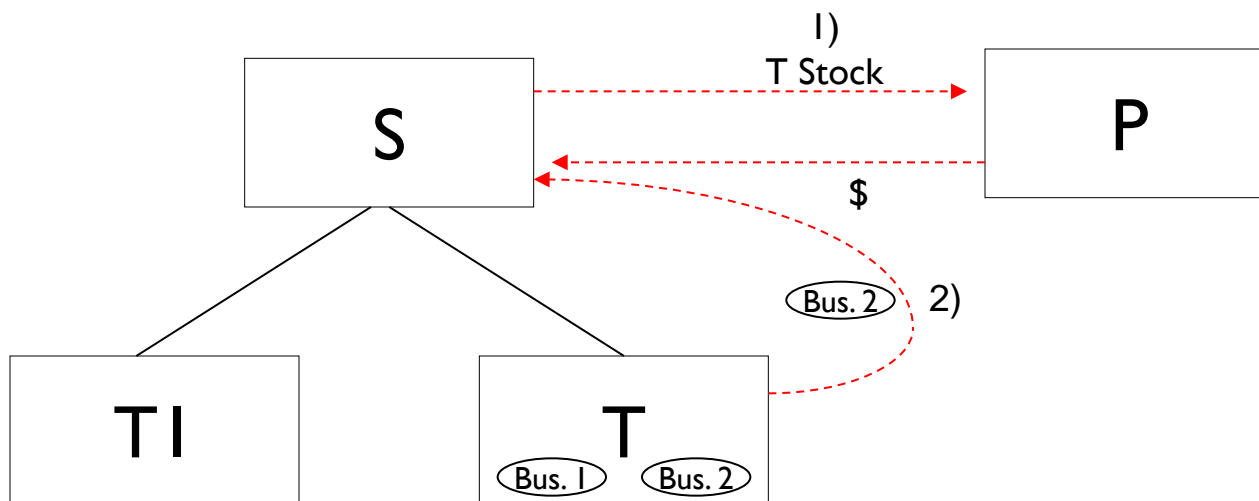
- No gain or loss recognized
- Reg. §1.367(b)-10 applies, imputing constructive distribution and contribution of \$800 used to acquire US Sub stock
  - Deemed distribution by F HoldCo to US Sub of \$800 treated as return of basis
  - Deemed contribution by US Sub to F HoldCo increases F HoldCo basis by \$800

# **SECTIONS 338(h)(10) AND 336(e)**

# **SECTIONS 338(h)(10) AND 336(e)**

Unwanted Assets

# DISTRIBUTION OF UNWANTED ASSETS—1



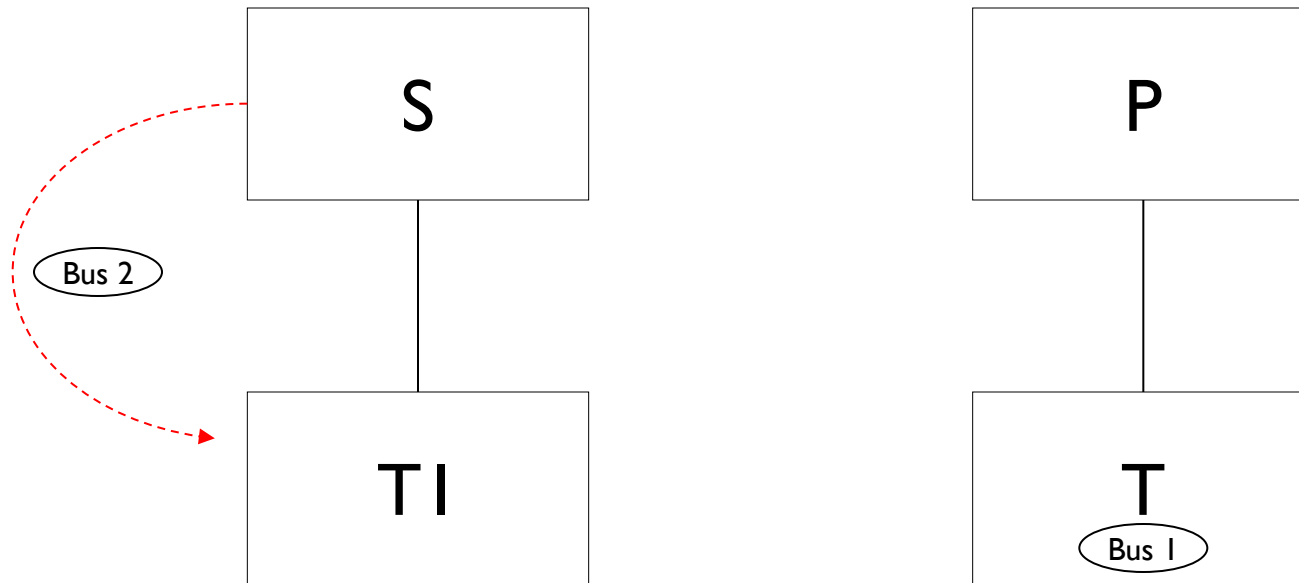
## **Facts**

- P, which is unrelated to S, wishes to acquire Bus. 1 but not the stock or assets of TI or Bus 2.
- 1) T distributes Bus. 2 to S.
- 2) S sells the T stock to P; S and P make a §338(h)(10) election.

## **Questions**

- Does the sale of the T stock qualify for a §338(h)(10) election?
- What are the tax consequences of the distribution of Business 2 to S?

# DISTRIBUTION OF UNWANTED ASSETS-2



- That would be the result if, after the distribution and stock sale, S transferred Business 2 to TI? Would the deemed liquidation under §338(h)(10) be affected?
- What would be the result if it were determined that the deemed liquidation was not in fact a complete liquidation?

## References

*Telephone Answering Service Co. v. Commissioner*, 63 T.C. 423 (1974), *aff'd without opinion*, 546 F.2d 423 (4th Cir. 1976).

Reg. §§1.338(h)(10)-1(d)(4), 1.338(h)(10)-1(e), Ex.2, 1.1502-13(j)(2)

PLR 9738031, PLR 9735038, PLR 9210041, PLR 9137040,

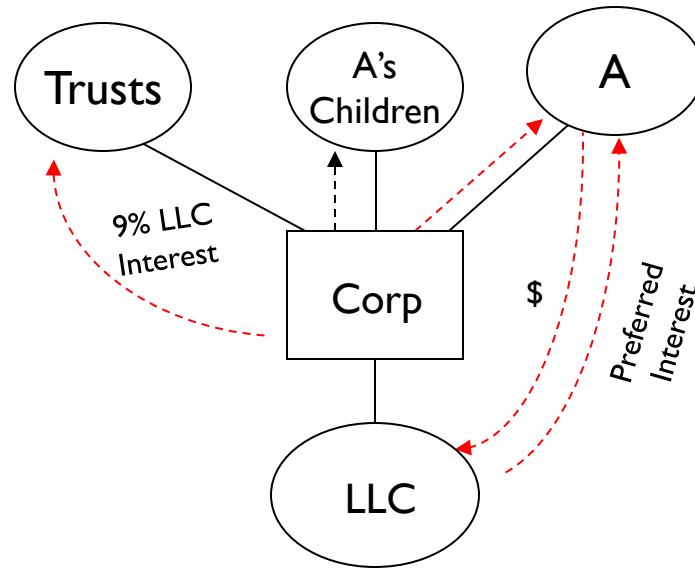
PLR 9044063, PLR 8938036, PLR 8821047

Rev. Proc. 2013-3, §4.01(22)



# PLR 200934013

## VALUATION OF LLC INTEREST—*POPE & TALBOT* FACTS



- A contributes cash to LLC for a preferred interest.
- Corp proposes to distribute 9% of its LLC interests, pro rata, to its shareholders—A, A's children, and trusts for the benefit of A's children and grandchildren.

# PLR 200934013

## VALUATION OF LLC INTEREST—*POPE & TALBOT* ANALYSIS

- Admission of A causes LLC to be classified as a partnership. Rev. Rul. 99-5.
- Corp. is deemed to contribute assets of LLC to the partnership. §721.
- Corp. is deemed to distribute 9% of the LLC interests to its shareholders, recognizing gain. §311(b).
  - IRS rules that Corp's basis in the distributed LLC interests equals their proportionate share of Corp's adjusted basis in its entire LLC interest.
  - Taxpayer represented:
  - For purposes of measuring the §311(b) gain to Corp on the Proposed Transaction,
  - if any, the Distributed LLC interests will be valued as a percentage of the value of
  - the assets held by LLC. *Cf. Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995),
  - *aff'd* 162 F3d 1236 (9th Cir. 1999).
- Is it appropriate to look through the LLC to the assets in valuing the distributed interests, but look to the LLC interest in computing their basis?
- See also *Pierre v. Commissioner*, 133 T.C. 24 (2009) (for gift tax purposes, LLC interests valued directly, not as interests in underlying assets).

# **SECTIONS 338(h)(10) AND 336(e)**

Taxable Stock Distributions

# QSD MECHANICS: §336(e) ELECTION FOR TAXABLE STOCK DISTRIBUTION

- Target is deemed to sell all its assets to an unrelated person for ADADP.
  - Gains are recognized in full.
  - To implement the policy of §311(b), any net loss is disallowed in proportion to the amount of stock distributed vs. sold (retained stock excluded).
  - New Target is deemed to purchase the assets from an unrelated person for AGUB.
- Target is deemed to distribute to Seller the consideration deemed received for its assets.
  - Generally a liquidation subject to §332 and §337.
  - If so, Target's E&P (adjusted to reflect the deemed asset sale) and other tax attributes are transferred to Parent.
- Seller is deemed to purchase the New Target stock from an unrelated person for fair market value. No gain or loss is recognized on this deemed sale to any taxpayer.
- No gain or loss is recognized to Seller on distribution of New Target stock.
- Distributee shareholders are taxed under §301 or §302, as applicable, and take fair market value basis in the stock, as in any other taxable distribution of property.

# PROTECTIVE §336(e) ELECTION

- A protective §336(e) election should be considered in connection with any intended tax-free stock distribution (spin-off or split-off).
  - Such an election would mitigate the tax cost of the distribution becoming taxable under §355(d) or §355(e).
  - The tax sharing agreement could allocate the benefits of any basis step-up to the party that bears the tax cost of the taxable deemed asset sale.
  - The mitigation will be less effective if Target or any Target Sub realizes net loss on a separate basis.
  - Steps to reduce or eliminate net losses in Target Subs should be considered.
  - If a net loss is large enough, a protective election could be counter-productive.
- IRS officials have stated that IRS may be willing to issue an advance ruling that such a protective election is effective.
  - Will the general no-rule for §355 distributions (Rev. Proc. 2013-32) affect IRS's willingness to rule on this issue?
  - Will a “significant” issue regarding the election be required?

# DISALLOWED LOSS: GENERAL

- Some or all of the net loss realized in Target's deemed asset sale is disallowed.
- The proportion of net loss disallowed is determined by the "disallowed loss fraction":
  - Numerator: Value on the Disposition Date of all Target stock distributed during the 12-Month Disposition Period (including stock distributed outside the QSD).
  - Denominator: Sum of—
    - Value on Disposition Date of Target stock sold during 12-Month Disposition Period as part of QSD.
    - Numerator.
- Proportion of net loss attributable to any Target stock sold during 12-Month Disposition Period as part of QSD is allowed.
- Disallowed losses are allocated among assets deemed sold at a loss in proportion to losses realized.
- Disallowed losses are permanently disallowed and do not result in any increase in basis of Target assets.

# DISALLOWED LOSS: CHANGES FROM PROPOSED REGULATIONS

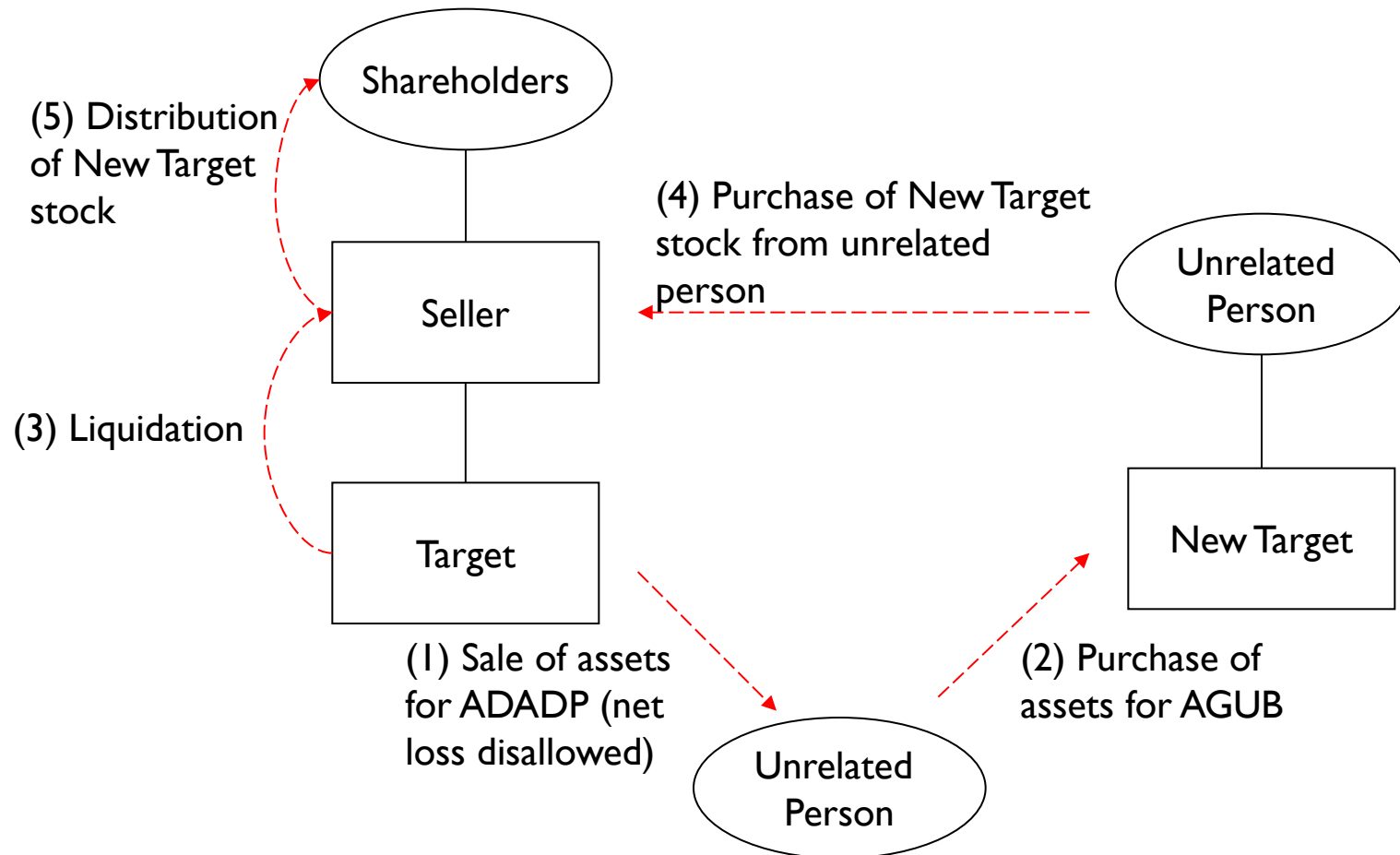
- The final regulations modify the proposed regulations regarding loss disallowance:
  - Target's losses realized in the deemed asset sale are allowed to the extent of Target's "gains realized."
    - How does disallowance of net losses apply to a QSD that involves both stock sales under the installment method and stock distributions?
- Loss disallowance applies to all distributions of Target stock during the 12-Month Disposition Period, including—
  - Stock distributions after the Disposition Date.
  - Stock distributions that are not part of the QSD, e.g., a distribution to a Related Person.

# DISALLOWED LOSSES: TARGET SUBS

- If Target has a Target Sub, and Target stock is distributed in a QSD, with §336(e) elections for both Target and Target Sub, the deemed disposition of the Target Sub stock is a deemed distribution of that stock.
- Loss disallowance, including netting losses against gains, is determined separately for Target (excluding stock of Target Subs for which §336(e) is elected) and for each Target Sub.
- Separate-entity netting reduces the benefit of loss netting.
  - It may be difficult to determine the value of assets held by each Target Sub.
  - Computation of ADADP can complicate the process even further. See Reg. §1.336-2(b)(1)(i)(B)(3) Example 2.
  - Difficulty is similar to that of determining location of goodwill within a corporate group, as required under Prop. Reg. §1.355-3(b)(2)(iii) (§355 active-trade-or business).
  - Can the impact of separate-entity loss netting be reduced with intercompany combinations and the like?

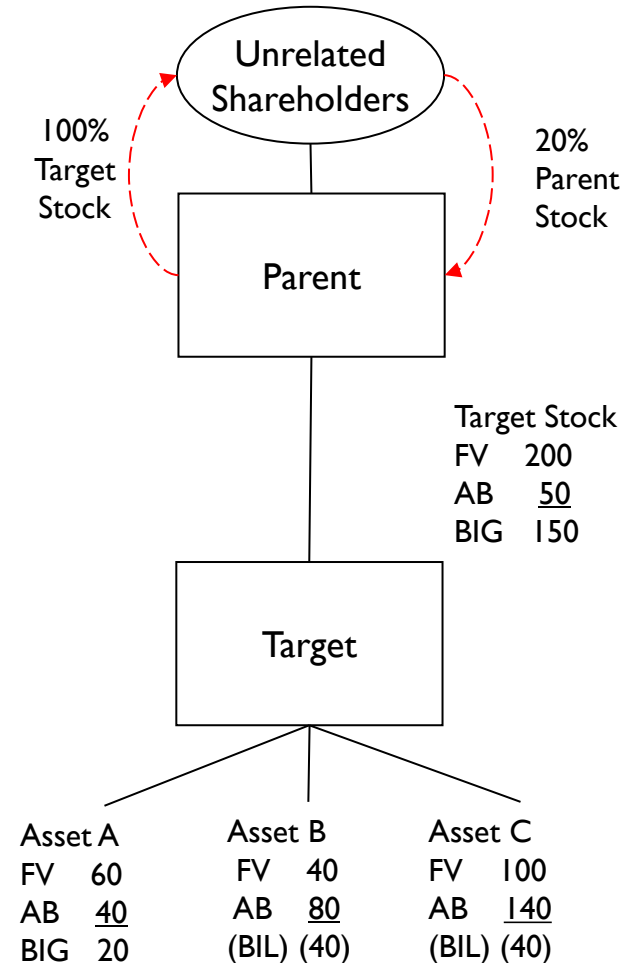


# QSD MECHANICS: §336(e) ELECTION FOR TAXABLE DISTRIBUTION OF TARGET STOCK



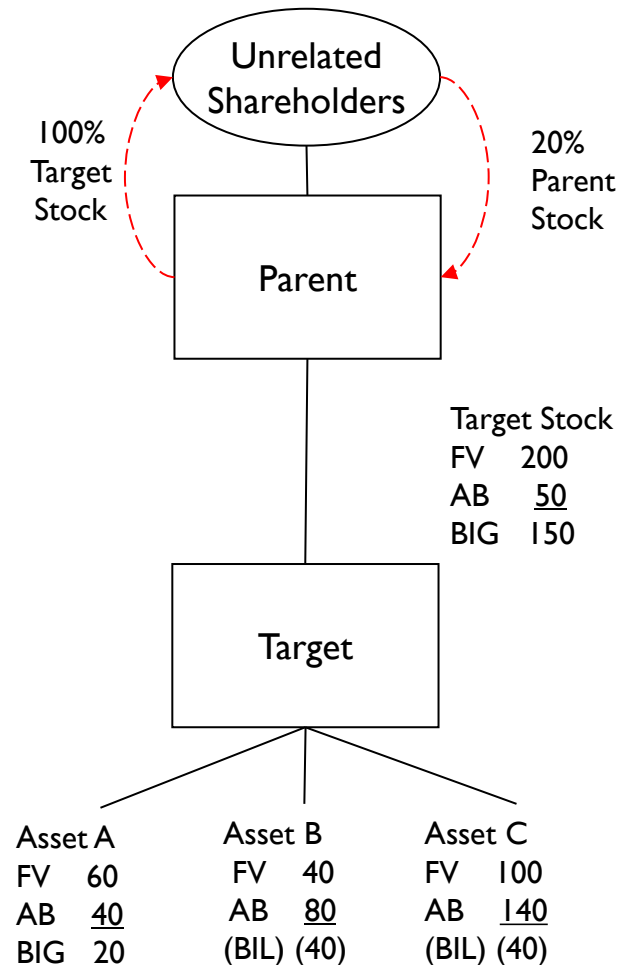
# DISTRIBUTION TO UNRELATED SHAREHOLDERS—1

- Transactions
  - In a tender offer, Parent distributes all the Target stock to Unrelated Shareholders in exchange for 20% of the Parent stock, at a premium.
  - The exchange is intended to qualify under §355, but it does not do so.
  - Parent makes a protective §336(e) election.
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
  - Target realizes \$60 net loss.
  - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
  - Disallowed loss is allocated 50% (\$30) each to Asset B and Asset C.
  - Target recognizes \$20 gain on Asset A, \$10 loss on Asset B and \$10 loss on Asset C.
- Target is deemed to purchase the assets from an unrelated person for AGUB (assume \$200).
  - Are ADADP and AGUB determined by the value of the distributed Target stock or of the redeemed Parent stock?
  - If the Target stock, does *Pope & Talbot, Inc. v. Commissioner*, 162 F.3d 1236 (9th Cir. 1999) control (§311 gain determined by value of distributed property to distributing corporation, not traded price)?
- Target is deemed to liquidate, and its tax attributes are transferred to Parent.



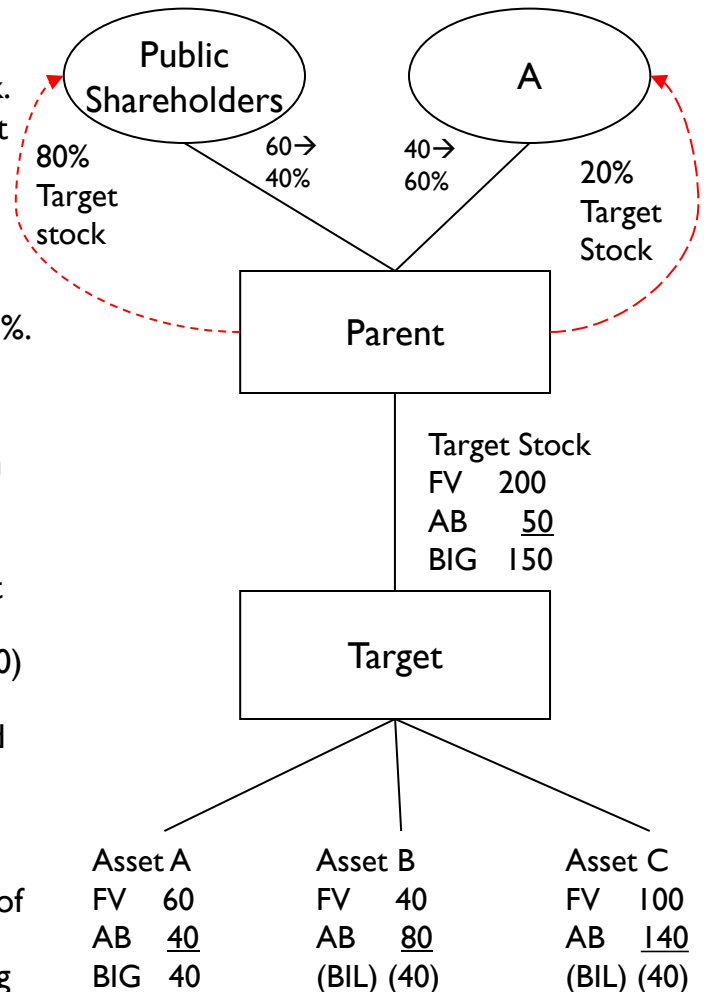
# DISTRIBUTION TO UNRELATED SHAREHOLDERS—2

- Parent distributes the Target stock to Unrelated shareholders, pro rata.
  - No gain is recognized to Parent.
  - Shareholders receive the Target stock as a taxable §301 distribution.
- Target's deemed sale-to-self does not cause the distribution to fail any §355 requirement, including the 5-year active trade or business test.
- If Target is a Newco, is Target treated as the deemed seller of its assets, or is Seller treated as the asset seller under assignment-of-income and step-transaction principles?
  - Other rules of law apply to determine the tax consequences of a §338 election as if the parties had actually engaged in the deemed transactions. Reg. §1.338-1(a)(2).



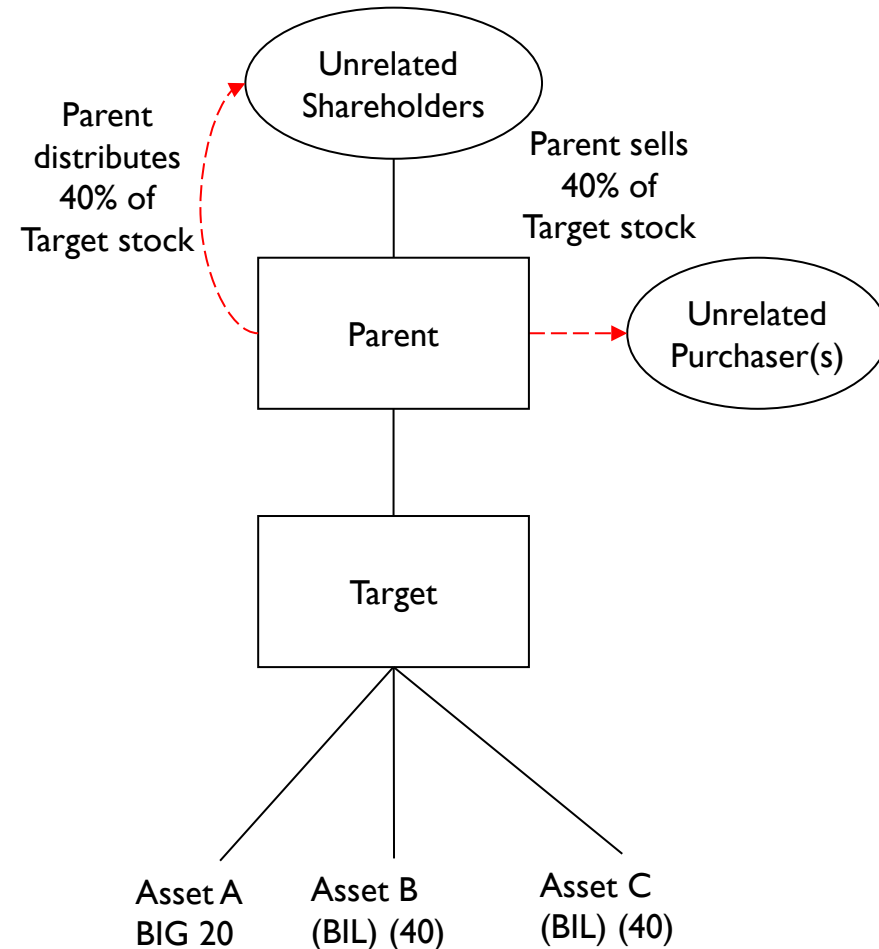
# DISTRIBUTION TO UNRELATED AND RELATED SHAREHOLDERS

- Transactions:
  - In a tender offer, Parent distributes 80% of the Target stock to Public Shareholders and 20% to A in exchange for Parent stock.
  - The exchange is intended to qualify under §355, but it does not do so.
  - Parent makes a protective §336(e) election.
  - As a result of the exchange—
    - A's ownership of Parent stock increases from 40% to 60%.
    - Public's ownership of Parent stock declines from 60% to 40%.
  - Target is acquired as part of a §355(e) "plan."
- The distribution to Public Shareholders is a QSD.
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
  - Target realizes \$60 net loss.
  - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
  - Disallowed loss is allocated 50% (\$30) to Asset B and 50% (\$30) to Asset C.
  - Target recognizes \$20 gain on Asset A, \$10 loss on Asset B, and \$10 loss on Asset C.
- A is a Related Person.
  - The Target stock distributed to A is not part of the QSD.
  - This stock is included as distributed stock in the computation of disallowed loss.
  - The value of this stock is not taken into account in determining ADADP and AGUB.



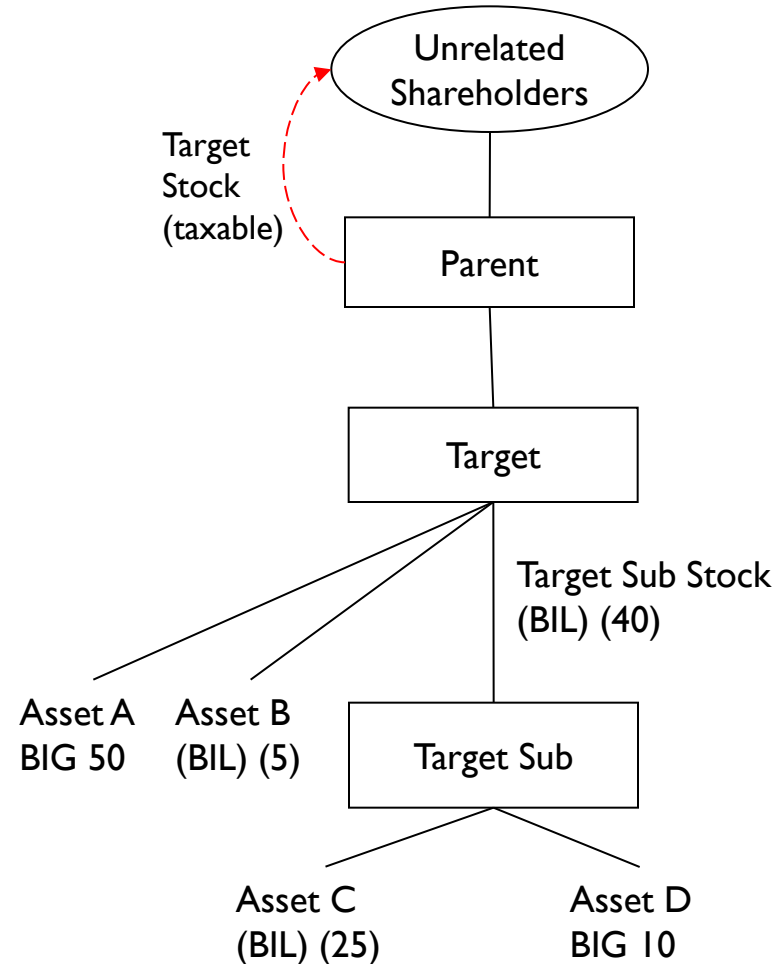
# 40% SALE, 40% DISTRIBUTION, 20% RETENTION

- Target is deemed to sell all its assets to New Target for ADADP (\$200, or  $(\$80 + \$80) / 0.8$ ).
- Target realizes \$60 net loss. Because half of the Target stock disposed of in the QSD (40 / 80 shares) is distributed (as opposed to sold), half of the net loss (\$30) is disallowed. The disallowed loss is allocated 50% (\$15) to Asset B and 50% (\$15) to Asset C. Target recognizes \$20 gain on Asset A, \$25 loss on Asset B, and \$25 loss on Asset C.
- New Target is deemed to purchase Target's assets from an unrelated person for AGUB (\$200).
- Target is deemed to distribute to Parent the consideration deemed received for the assets (\$332 liquidation).
- Parent is deemed to purchase 40% of the New Target stock from an unrelated person and then distribute that stock.
- Parent is deemed to purchase 20% of the New Target stock on the day after the Disposition Date.



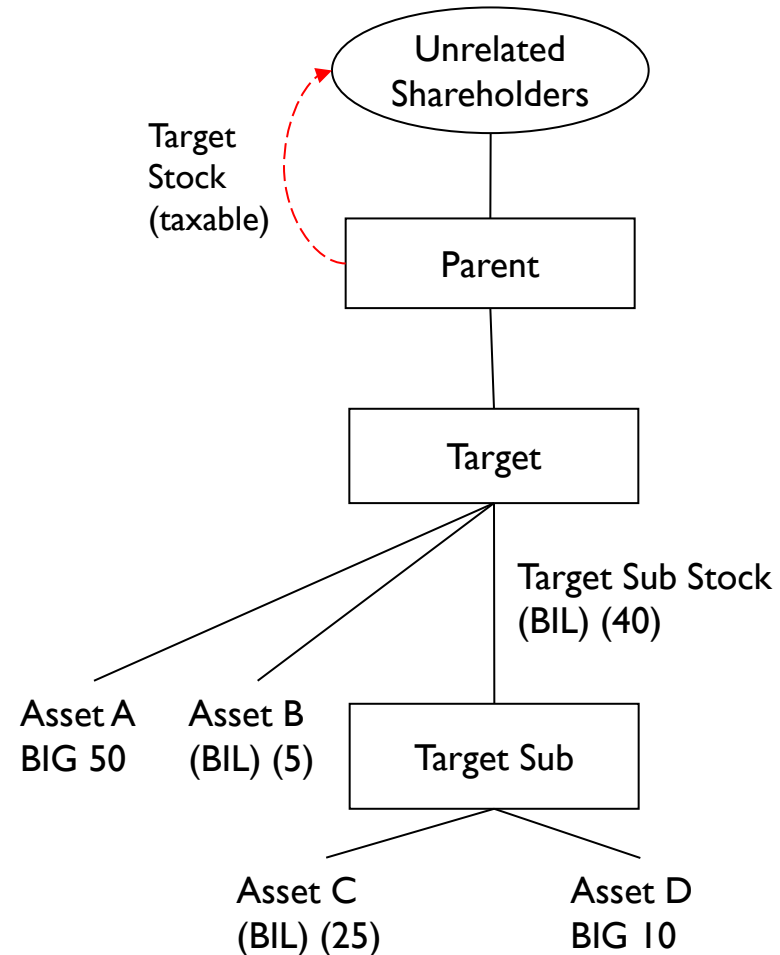
# TAXABLE DISTRIBUTION OF TARGET WITH TARGET SUB-1

- Section 336(e) elections are made for Target and for Target Sub.
- Target Sub deemed sale and liquidation
  - Target Sub is deemed to sell Asset C and Asset D to an unrelated person for ADADP. Target Sub realizes \$15 net loss.
  - Because all the Target stock is distributed, all the Target Sub stock is also deemed distributed.
  - All of Target Sub's net loss is allocated to Asset C and disallowed. Target Sub recognizes \$10 loss on Asset C and \$10 gain on Asset D.
  - Target Sub is deemed to liquidate into Target before Target's liquidation into Parent.
- Target deemed sale and liquidation
  - Target is deemed to sell Asset A and Asset B to an unrelated person for ADADP.
  - Target recognizes \$50 gain on Asset A and \$5 loss on Asset B.
  - Deemed sale of the Target Sub stock is disregarded.
  - Target is deemed to liquidate into Parent after Target Sub's deemed asset sale and liquidation into Target.



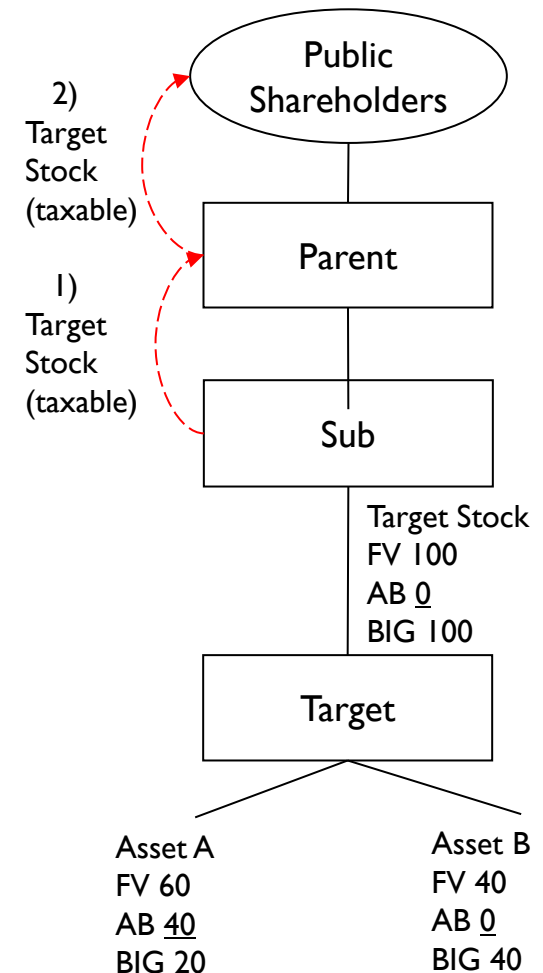
# TAXABLE DISTRIBUTION OF TARGET WITH TARGET SUB-2

- Target as a whole has economic built-in gain, regardless of whether Target Sub stock or Target Sub assets, or neither, is taken into account.
- Nevertheless, if §336(e) elections are made for both Target and Target Sub, \$15 of the loss on Asset C will be disallowed, and the basis of Asset C will be reduced by \$15.
- If Target transfers Asset A to Target Sub under §351, the disallowed loss is reduced from \$15 to \$5.
- If a §336(e) election is made for Target but not for Target Sub—
  - No loss is disallowed.
  - Target Sub retains its full basis in Asset C and Asset D.
  - The consistency rules do not limit New Target's basis in Asset A to carryover basis, because gain on the deemed sale of Target's assets does not increase the basis of the Target Sub stock or allow a dividend from Target Sub subject to a 100% dividends-received deduction.
- If Target Sub is liquidated or converted to a disregarded entity, or if Target is merged downstream into Target Sub, the net loss is absorbed into Target's built-in gain. If §336(e) elections are made for Target and Target Sub, no loss is disallowed.
- Would a §351 transfer, a liquidation or a downstream merger like the above be disregarded or recast under anti-abuse principles? See Reg. §1.338-1(c).
- Would a downstream merger fail to meet the continuity-of-business-enterprise requirement for a tax-free reorganization?



# INTRAGROUP TAXABLE DISTRIBUTION

- Sub's distribution of Target to Parent is not a QSD, because Parent is a Related Person to Sub.
  - Sub recognizes \$100 gain on distribution of Target stock, deferred under Reg. §1.1502-13 (but accelerated by Step 2).
  - Parent takes \$100 cost basis in the Target stock.
- Parent's distribution of Target stock to Public Shareholders is a QSD, because no Public Shareholder is a Related Person to Seller.
  - If Parent makes a §336(e) election, Target is deemed to sell all its assets to New Target for ADADP.
  - Target recognizes \$60 gain on the deemed asset sale.
  - Target's \$60 gain increases Parent's basis in the Target stock from \$100 to \$160.
  - New Target is deemed to purchase the assets from an unrelated person for AGUB.
  - Target is deemed to distribute the consideration deemed received for the assets to Parent (§332/337 liquidation). Gain on Step 1 is triggered.
  - Parent may elect to apply Reg. §1.1502-13(f)(5)(ii)(C), which treats Target's liquidation as a §331 liquidation (solely to cause Parent to recognize loss on the Target stock). If this election is made, Parent recognizes \$60 loss in the deemed liquidation.
  - \$100 net gain to Parent (\$100 gain on Target stock in Step (1), \$60 gain on deemed asset sale and \$60 loss on deemed taxable liquidation in Step 2). Parent's net gain equals its BIG on the Target stock, not on Target's assets.
  - Parent is deemed to purchase the New Target stock from an unrelated person.
  - Parent is deemed to distribute the New Target stock, with no gain or loss.
  - Target's tax attributes are transferred to Seller.
  - New Target takes AGUB basis in its assets.
  - Public Shareholders receive a \$100 §301 distribution and take \$100 basis in the New Target stock.





# **SECTIONS 338(h)(10) AND 336(e)**

Stock Distributions  
Subject to §355(d) or §355(e)

# SALE-TO-SELF MECHANICS

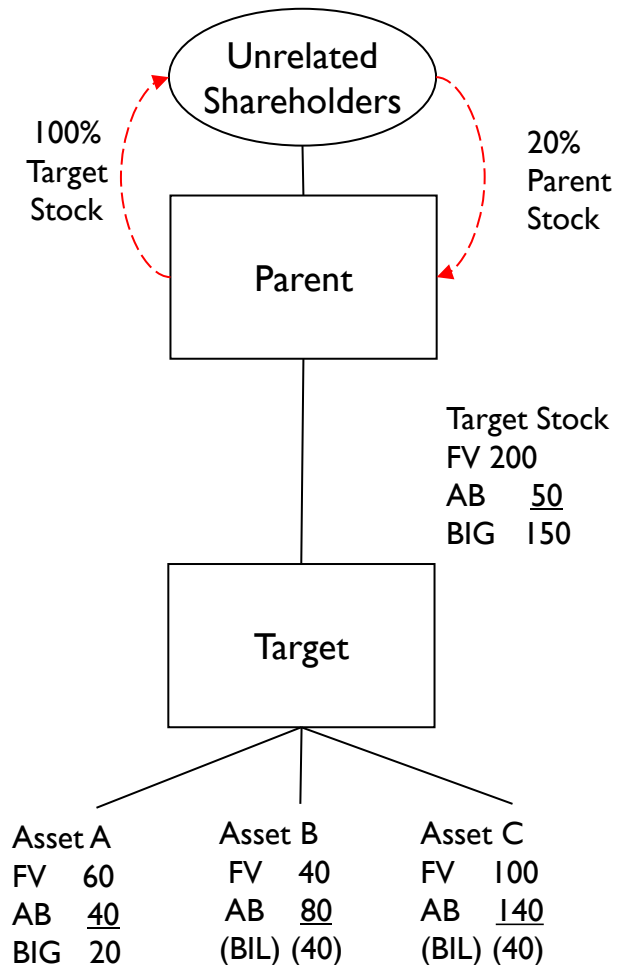
- Target is deemed to sell all its assets to an unrelated person for ADADP.
  - Gains are recognized in full.
  - To implement the policy of §311(b), any net loss is disallowed in proportion to the amount of stock distributed compared with any amount of stock sold as part of the QSD. The rules regarding disallowed losses are the same as those applicable to fully taxable stock distributions. See “Taxable Stock Distributions,” above.
- Target is deemed to re-acquire its assets from an unrelated person for AGUB (sale to self).
- Target is not deemed to liquidate.
- Seller distributes the Target stock.
  - Seller recognizes no gain or loss on the distribution.
  - Target’s tax attributes remain intact with Target.
  - Target’s earnings and profits account is adjusted to reflect gain or loss on the deemed asset sale.
- The distributee shareholders receive the Target stock tax-free under §355 and allocate their basis in their Seller stock between the Seller stock and Target stock, under §358.

# COLLATERAL MATTERS

- **Excess Loss Account.** IRS officials have indicated that any excess loss account (“ELA”) in the stock of Target or Target Sub is triggered, whether or not the ELA was created in connection with the distribution. Reg. §1.336-2(b)(2)(iii) (“No gain or loss is recognized by seller on the distribution.”); Reg. §1.1502-19(b)(1)(i) (“if M is treated under this § as disposing of a share of S's stock, M takes into account its excess loss account in the share as income or gain from the disposition.”)
- Sections 197(f)(9) and 1091.
- For purposes of §197(f)(9) (intangibles amortization anti-churning rule) and §1091 (wash sale), Target in its capacity as deemed seller “shall be treated as a separate and distinct taxpayer from, and unrelated to,” Target in its capacity as deemed buyer in the deemed sale-to-self. Reg. §1.197-2(h)(8).
  - What if Seller spins Target pro rata, and one of Seller’s shareholders owns 30% of Seller’s stock (more than the 20% relatedness threshold under §197(f)(9))? IRS officials have stated that the intention was not to exempt sale-to-self transactions from anti-churning where anti-churning otherwise would apply.

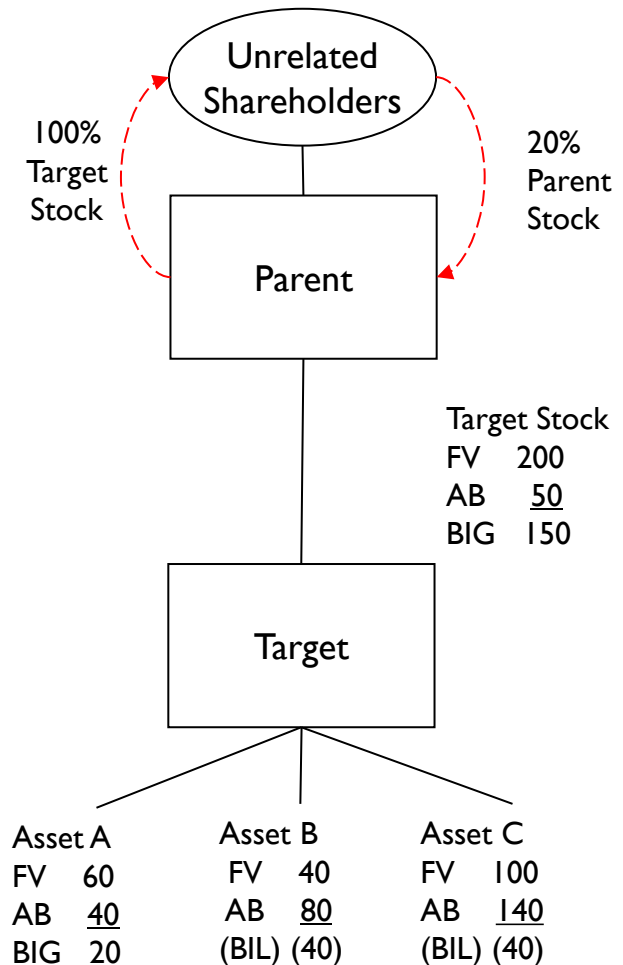
# DISTRIBUTION TO UNRELATED SHAREHOLDERS—1

- Transactions
  - In a tender offer, Parent distributes all the Target stock to Unrelated Shareholders in exchange for 20% of the Parent stock, at a premium
  - Parent makes a protective §336(e) election.
  - Target is acquired as part of a §355(e) “plan.”
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
  - Target realizes \$60 net loss.
  - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
  - Disallowed loss is allocated 50% (\$30) each to Asset B and Asset C. Target recognizes \$20 gain on Asset A, \$10 loss on Asset B and \$10 loss on Asset C.
- Target is deemed to purchase the assets from an unrelated person for AGUB (assume \$200).
- Are ADADP and AGUB determined by the value of the distributed Target stock or of the Parent stock redeemed?
- If the value of the Target stock is determinative, does *Pope & Talbot, Inc. v. Commissioner* (§311(b) gain determined by value of distributed property to distributing corporation, not traded price) control?
- Target is not deemed to liquidate, and it retains its tax attributes.



# DISTRIBUTION TO UNRELATED SHAREHOLDERS-2

- Parent distributes the Target stock.
  - No gain is recognized to Parent.
  - Shareholders receive the Target stock tax-free under §355.
  - Shareholders' basis in Target stock is determined under §358.
- Target's deemed sale-to-self does not cause the distribution to fail any §355 requirement, including the 5-year active trade or business test.
- E&P of Parent and of Target are determined under Reg. §§1.312-10 and 1.1502-33(e). E&P is adjusted to reflect the deemed asset sale before allocation in Reg. §1.312-10.



# INTRAGROUP DISTRIBUTION

- Sub's distribution of Target stock to Parent is not a QSD, because Parent is a Related Person to Sub.
  - Section 355(f) treats Sub's distribution as a taxable distribution.
  - Sub recognizes \$100 gain on distribution of Target stock, deferred under Reg. §1.1502-13 (but accelerated by Step 2).
  - Parent takes \$100 cost basis in Target stock.
- Parent's distribution of Target stock to Shareholders is a QSD.
  - Target is deemed to sell its assets to an unrelated person for ADADP (\$100).
  - Target recognizes \$60 gain.
  - This gain increases Parent's basis in the Target stock from \$100 to \$160.
  - Target is deemed to purchase its assets from an unrelated person for AGUB (\$100) (sale-to-self).
  - Target is not deemed to liquidate, and it retains its own tax attributes.
  - If an election is made to apply Reg. §1.1502-13(f)(5)(ii)(C), then, solely for purposes of that regulation, Target is deemed to liquidate into Parent under §331. Parent recognizes \$60 loss.
  - Net result: \$100 gain to Parent group = Sub's BIG in the Target stock.
  - Parent is deemed to distribute the Target stock at no gain or loss.

