Strangers in the Night?†
North-South Transactions

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† “Strangers in the night exchanging glances; Wond’ring in the night what were the chances; We’d be sharing love before the night was through…” Immortalized in song by F. Sinatra (1966).

* I would like to express my gratitude to my associates, Teddy McGehee and Stephen Severo, for their invaluable assistance in the research for, and preparation of, these slides. My thanks also go to Michael Schler, Steve Gordon, Alyssa Wolpin and Jeff Preston for their helpful contributions.
## Agenda

<table>
<thead>
<tr>
<th>Part I: N/S Issues: The Fundamentals</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part II: Cash Heads North; Assets Head South</td>
<td>27</td>
</tr>
<tr>
<td>Part III: Cash Heads North; Stock Heads South</td>
<td>35</td>
</tr>
<tr>
<td>Part IV: Stock Heads North; Assets Head South</td>
<td>40</td>
</tr>
</tbody>
</table>
Basic North-South Premise

- **Basic fact pattern**
  - Corporation P owns all of the stock of corporation S
  - In the “southbound” transfer, P contributes property to S
  - In the “northbound” transfer, S distributes property to P

- **There are innumerable variations**
  - Reasons for transfers
  - Nature of property
  - Relative values of property
  - Form of documentation
  - Timing and order of steps
  - Status of S and P

- **No matter the specific facts, the fundamental question remains the same**

  *Are the two transfers separate, or is there an exchange?*

- **The tax consequences of separate v. exchange treatment vary based on the situation**
  - Policy considerations also depend on the context
In January 2013, the IRS issued a no-rule policy covering north-south transactions

- The IRS will no longer address “whether transfers of stock, money, or property by a person to a corporation and transfers of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions (so-called ‘north-south’ transactions), at least one of which is a distribution with respect to the corporation’s stock, a contribution to the corporation’s capital, or an acquisition of stock, are respected as separate transactions for Federal income tax purposes”

Treasury announced a related project to study the issue and provide published guidance

- Treasury seeks guidance “regarding when a transfer by a person to a corporation and a transfer by that corporation to that person, ostensibly in two separate transactions, should be respected as two separate transactions for Federal income tax purposes”

Both the No-Rule and the Guidance Project are broadly drafted and cover north-south transactions generally

- The No-Rule also covers certain related-party transactions not typically thought of as raising north-south issues
The Many Flavors of North-South Issues

- Spin-off-related north-south concerns may be the most-discussed among practitioners, but the issue can arise in many different contexts

- Can we conceptualize north-south transactions in a comprehensive, coherent manner?
Overview

- In this Part I, we first consider the difference between a distribution and an exchange
  - Understanding this distinction is critical to evaluating the proper treatment of north-south transactions
  - But, as demonstrated by the *Baan-Gordon* and *Boulware* cases, this distinction is less clear than one might expect
  - In the related-party context, it is particularly difficult to determine whether a distribution or an exchange has occurred

- We then consider the role of form, particularly in situations where a taxpayer’s chosen form is granted some deference
  - Policy considerations may affect the weight given to form, particularly where a transaction is not the product of arm’s-length negotiation

- Next we review the step transaction doctrine, which permits formally separate transactions to be integrated in certain circumstances
  - The doctrine has different forms and its application by courts is highly dependent on the relevant facts and circumstances
  - The IRS’s application of the step transaction doctrine in recent rulings is instructive, demonstrating the importance of policy considerations in determining whether to integrate separate steps

- We then turn to situations in which the opposite result applies, with an integrated transaction being bifurcated

- Finally, we identify the key factors for analyzing north-south issues and outline some possible approaches for determining when two separate transactions should be treated as one

- In Parts II, III and IV, we consider specific variations of the north-south fact pattern
“Distribution”

- Sections 301 and 355 both require *a distribution* by a corporation *to a shareholder, with respect to its stock*
  - This concept generally implies a lack of consideration for the distributed property
    - A distribution requires property to be “paid to the shareholder in his or her capacity as such”

- However, a distribution may sometimes include a transfer in exchange for stock…
  - Section 355 permits split-offs, consistent with the policy underlying that section
    - The need for a specific provision permitting split-offs arguably reinforces the natural meaning of the phrase “distributes to a shareholder, with respect to its stock” as a transfer without consideration
  - Section 302 treats certain redemptions of stock as “distributions…in exchange for the stock”

- …Or in exchange for other property
  - Sections 355 and 361 both permit “distributions” to creditors, who must forfeit the right to be repaid
  - “[A] sale of corporate assets to stockholders is, in a literal sense, a distribution of its property”

- This very issue arose in the *Baan* and *Gordon* cases decided in the mid-1960s

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(1) Reg. § 1.301-1(c); (2) see also Prior Reg. § 1.311-1(a)(1954 Code) (“The term ‘distributions with respect to its stock’ includes distributions made in redemption of stock (other than distributions in complete or partial liquidations)”; (3) see §§ 355(a)(1)(A)(ii) and 361(b)(3); (4) Palmer v. Commissioner, 302 U.S. 63, 69 (1937).
The Baan-Gordon Cases

**Facts**
1. Pacific created Northwest, contributing certain business assets and cash.
2. Pacific then distributed to its shareholders rights to purchase ~57% of the Northwest stock at a discount. Gordon and Baan sold/exercised their rights in the year of receipt.
3. Approximately two years later, Pacific distributed to its shareholders rights to purchase the remaining ~43% of the Northwest stock at a discount. Gordon and Baan exercised their additional rights.

**Pacific obtained a PLR that the distributions would be taxable dividends, but two shareholders challenged this determination, creating two separate cases — Baan and Gordon**

- The shareholders argued that the distributions of the rights and the later exercise of those rights should be viewed as a single, unified tax-free spin-off (of the Northwest stock) and a separate contribution to capital (of the cash exercise price).
  - The shareholders thus sought to integrate the two distributions and separate out the cash purchase price!
- The IRS argued that the distributions of stock rights were not distributions of stock for purposes of Section 355 and thus did not qualify for tax-free treatment.
  - The IRS did not appear to challenge the integration of the two distributions of stock rights for purposes of assessing whether “control” had been distributed.

**The Tax Court, in a consolidated case, held that the transaction qualified as a tax-free spin-off**

- “The Government’s position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve.”

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1. Comm’r v. Gordon, 382 F.2d 499 (2nd Cir. 1967) (“Gordon I”); Comm’r v. Gordon, 391 U.S. 83 (1968) (“Gordon II”); Comm’r v. Baan, 382 F.2d 485 (9th Cir. 1967) (“Baan II”); (2) The exercise price ($16/share) was more than 20% of the value of the Northwest stock (~$27/share, based on its trading price); (3) The Tax Court also noted that, under then-current law, an issuance of stock rights was not a distribution until the rights were exercised. Baan, 45 T.C. 71, 91 (1965) (“Baan I”) (noting that *Palmer v. Commissioner*, 302 U.S. 63, makes it clear that issuance of the rights, even though they may be valuable, may not be considered as a distribution of corporate earnings and profits’); (4) Baan I at 90.
The *Baan-Gordon* Cases

- **The Circuit Courts split — the shareholder won in *Gordon*, but lost in *Baan***
  - *Gordon* — The Second Circuit sided with the shareholder, noting that nothing specifically prevents there being a distribution when consideration is received
    - Even though “the Code does not [specifically] contemplate the receipt of cash by a corporation in connection with a distribution with respect to its stock…it scarcely follows that the Code prohibits the receipt of cash”1
    - The Second Circuit quoted the Tax Court with approval
      - “If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the [shareholders] where they paid out money in connection with receiving such stock.”2
  - *Baan* — The Ninth Circuit sided with the IRS and found that the distribution was not “with respect to…stock”
    - The “basis for non-recognition…under Section 355 is that the same people continue to own the same businesses with only formal changes in the business organization”; however, “it could well be that a substantial number of [Pacific’s] shareholders would…choose to sell their stock rights rather than to themselves make the [required] cash payment”3

- **The Supreme Court treated the two distributions as separate and found for the IRS**
  - Since Pacific was under *no obligation* to complete the second distribution of Northwest stock rights at the time of the first distribution, Pacific did not distribute “control” (80%) of Northwest for purposes of Section 355 (binding commitment test)

- **It did not address whether a distribution “with respect to…stock” can involve consideration**

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1. Gordon I at 505; (2) *ibid.* quoting Baan I at 90; (3) Baan II at 496.
Over forty years later, in *Boulware*, the Supreme Court again declined to explore the meaning of the phrase “with respect to…stock”

- Boulware had diverted over $10 million from a closely held corporation and was accused of criminal tax evasion, an essential element of which was the existence of a tax deficiency
- In his defense, Boulware argued that the diverted funds were really returns of capital under Section 301, and thus there was no tax deficiency (and thus no tax evasion)

The Ninth Circuit held that Boulware must affirmatively show that he intended his diversion of funds to be a return of capital

The Supreme Court, reversing the Ninth Circuit, held that the applicability of Section 301 did not depend upon whether Boulware intended the diversion to be a return of capital

- “As [Sections 301 and 316(a)] are written, the tax consequences of a ‘distribution by a corporation with respect to its stock’ depend, not on anyone’s purpose to return capital or to get it back, but on facts wholly independent of intent”
- The Supreme Court declined to take up the question of “whether an unlawful diversion may ever be deemed a ‘distribution…with respect to [a corporation’s] stock’”

On remand, the Ninth Circuit noted that the Supreme Court did not affirmatively address the “with respect to…stock” requirement

- “It suffices, however, to say that at the very least a taxpayer must tender some evidence of nexus between the corporate distribution and stock ownership, or show that there were no other alternate explanations.”

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1. *U.S. v. Boulware*, 470 F.3d 931 (9th Cir. 2006)
3. Id. at 423
4. *U.S. v. Boulware*, 558 F.3d 971, 977 (9th Cir. 2009) (quoting Sir Arthur Conan Doyle from *Tales of Sherlock Holmes*: “[W]hen you have eliminated the impossible, whatever remains, however improbable, must be the truth.”)
Both Sections 351 and 721 contemplate an exchange

- Likewise, Section 304 applies to the acquisition by a corporation of an affiliated corporation’s stock “in return for” property

Unlike a distribution, an exchange appears to require some consideration for the transferred property — one thing is given in return for another

- There is an element of interdependence or reciprocity — a quid pro quo, a tit-for-tat, a sense that one transfer is functionally related to the other
- This suggests that intent may play a role in establishing whether and how the transfers are related

So how do we determine whether an exchange has occurred?
Identifying an Exchange

Where unrelated parties are involved, it is easier to identify the consideration (if any) for a transfer of property by examining how the transaction changes the parties’ relationship

- A pro rata distribution of cash or other property may suggest it is not consideration
- Stated intent is often instructive

In the case of a wholly owned corporation, however, it is more difficult to determine whether there has been an exchange because the relationship between the parties may not change

- Whether additional stock is issued may not be relevant if such an issuance would be a “meaningless gesture”
- The stated intent is less reliable where related parties are involved

In the latter case, we must look at the reasons for the property transfers and whether they are interrelated

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(1) Of course, this also looks like a sale of property for cash followed by a cash/stock election dividend; (2) Lessinger v. Comm’r, 872 F.2d 519, 522 (2nd Cir. 1989).
The disguised sale regulations govern when certain transfers to and from a partnership will be treated as an exchange\(^1\)

- If the contribution and distribution occur within two years, they are presumed to be a sale unless the facts and circumstances clearly establish otherwise; likewise, transfers more than two years apart are presumed *not* to be a sale

A facts-and-circumstances test effectively assesses whether X’s right to the distribution, viewed at the time of the contribution, is more equity- or debt-like

- Test focuses on certainty of the distribution and whether it is subject to the entrepreneurial risks of P’s business
- It also considers whether the partnership distributions, allocations or control of partnership operations are designed to effect an exchange of the benefits and burdens of ownership of property

The rules contain important safe harbors protecting certain common situations from sale treatment

- The assumption of qualified liabilities and reimbursement of preformation capital expenditures\(^2\)
- Guaranteed payments for the use of capital and reasonable preferred returns\(^3\)
- Distributions of operating cash flow and debt-financed distributions\(^4\)

There is a presumption of exchange, except where abuse concerns are minimal

- Presumption is relaxed for transactions that present limited opportunity for abuse or that are reasonably necessary

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1 § 707(a); Reg. § 1.707-3; When Subchapter K was added in 1954, the rules were designed to prevent purported sales to controlled partnerships that were really disguised contributions and in which the partner would seek to either (i) recognize gain at lower, individual rates while providing the partnership with a greater asset basis for depreciation or (ii) recognize a loss. (1954 House and Senate Reports). The disguised sale rules are similarly designed in response to perceived tax arbitrage opportunities. (1984 House and Senate Reports); (2) Reg. §§ 1.707-4(d), 1.707-5(a), Notice of Proposed Rulemaking, Fed. Reg. Vol. 56, No. 80, p. 19055. 4/25/91; (3) Reg. § 1.707-4(a); (4) Reg. §§ 1.707-4(b), 1.707-5(b).
The Role of Form

- **In certain cases, courts and the IRS have shown deference to the form chosen by taxpayers**
  - A distribution of assets can be an isolated Section 301 distribution even where the sole shareholder of the distributing company intended, at the time of the distribution, to sell its stock in the distributing company.
  - In the Section 351 context, courts have respected the separateness of certain transfers, effectively permitting them to occur outside the Section 351 exchange.
  - The IRS has ruled that a dividend made freely available to the recipient should be respected even if there is a subsequent contribution back to Distributing.

- **IRS and Treasury have also shown a willingness to respect the timing chosen by taxpayers**
  - A distribution is includible in income only when the property is made unqualifiedly subject to the demands of the shareholder.
    - In the context of a wholly owned corporation, the sole shareholder may have the ability to determine when this standard of unqualified dominion is met.

- **A taxpayer faces strong headwinds and a high burden when arguing against its own form**
  - For instance, courts generally will not integrate a distribution by a corporation to its controlling shareholders, followed by the termination of those shareholders’ interests, into a single Section 302 redemption, unless shares are actually redeemed.
    - This result holds even if the distribution is non-pro rata, so long as the distribution was made “under terms intended to further [all of the shareholders’] mutual advantage” and thus effectively controlled the form of the distribution.
  - In some cases, however, courts and the IRS have permitted taxpayers to invoke the step transaction doctrine.

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(1) See Litton Industries v. Comm’r, 89 T.C. 1086 (1987); (2) see H. B. Zachry Co., 49 T.C. 94 (1967) (Slide 29) and Sylvan Makover, 26 T.C.M. 288 (1967) (Slide 30); but see, e.g., D’Angelo Associates, Inc. v. Comm, 70 T.C. 121 (1978) (Slide 31); (3) see Rev. Rul. 80-154, 1980-1 CB 68; (4) see Reg. § 1.301-1(b); (5) see Danielson v. Comm’r, 378 F.2d. 771 (1967); (6) see Percy A. Reitz, 61 T.C. 443 (1974) and Rosen, Matthew A. and Jeffrey D. Conway, Leveraged Restructurings: Treatment of the Cash, 66 Taxes 987 (Dec. 1988); (7) see Estate of Durkin v. Comm’r, 99 T.C. 571 (1992); (8) See, e.g., Rev. Rul. 78-130, 1978-1 CB 114 (treating an acquisition of target stock followed by a liquidation of target as an asset acquisition qualifying as a C reorganization, rather than a stock acquisition qualifying as a Section 351 exchange) and Rev. Rul. 67-274, 167-2 CB 141 (treating an acquisition of target stock followed by a liquidation of target as an asset acquisition, rather than a stock acquisition qualifying as a B reorganization).
Where Form is Respected

- **In a taxable sale of stock, a taxpayer may specify which shares it is selling by making an “adequate identification”**¹
  - “Under this rule, a shareholder has greater flexibility in planning the tax consequences of the sale by specifically identifying the shares sold.”²

- **Similarly, in a reorganization, shareholders may identify which shares are exchanged for “boot”, as long as the designation is “economically reasonable”**³
  - But, if boot is properly characterized as a dividend, this right of designation may not be available to shareholders (and, under proposed regulations, it would not be)⁴

- **Treatment as an F reorganization is generally respected, no matter what comes before or after**
  - Proposed regulations and Revenue Ruling 96-29 provide taxpayers with comfort that a purported F reorganization will not be recharacterized or integrated with another transaction, so long as relatively formulaic requirements are satisfied
    - “[R]elated events preceding or following the transaction or series of transactions that constitute a mere change do not cause that transaction or series of transactions to fail to qualify as an F reorganization”⁵
  - This permissive approach may be influenced by the fact that an F reorganization is an economic “nothing”

- **In “Check and sell” and “sell and check” transactions, taxpayers have control over the tax treatment of certain sales, even where it significantly affects tax liability**⁶
  - Would a recast of taxpayers’ chosen form be inconsistent with the broad electivity taxpayers have under the check-the-box rules?⁷

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¹ Reg. § 1.1012-1(c)(1)(i); (2) Notice of Proposed Rulemaking, Fed. Reg. Vol. 69, No. 85, p. 24107. 5/3/2004 Determination of Basis of Stock or Securities Received In Exchange for, or With Respect to, Stock or Securities in Certain Transactions; (3) Reg. § 1.356-1(b), (d), Ex. 4; (4) see Johnson v. U.S., 435 F.2d 1257 (4th Cir. 1971) (holding that, because “the tax laws...command assessment on [a § 301 distribution] as a pro rata distribution”, a recipient shareholder cannot aggregate its stock basis for purposes of §§ 301(c)(2) and 301(c)(3)), REG-143686-07, 2009-8 IRB (Jan. 21, 2009) (explicitly adopting Johnson and not allowing shareholders to identify the shares that are exchanged for dividend-equivalent boot in order to “ensure similar tax treatment of dividend equivalent reorganization exchanges and dividend equivalent redemptions”); (5) REG-106889-04, 2004-38 IRB (Sept. 20, 2004), see also Rev. Rul. 96-29, 1996-1 CB 50; (6) Dover Corp. v. Comm., 122 T.C. 324 (2004); (7) see Reg. § 301.7701-3(c).
Step Transaction Doctrine

- The step transaction doctrine permits form to be disregarded in certain cases

- In particular, it allows a series of separate steps to be linked together or recharacterized for tax purposes if they are closely related and focused on a common end
  - When applied, the doctrine may disallow the taxpayer’s purported treatment by linking two formally separate steps, thus preventing what is in substance a unified transaction from being segmented
    - For instance, the doctrine may prevent control from being satisfied in a Section 351 transaction and, under old law, could prevent shareholder continuity of interest from being satisfied in a reorganization
  - Alternatively, the doctrine may recharacterize a transaction by disregarding unnecessary steps or possibly reordering the steps in a multi-step transaction

- The step transaction doctrine comes in three basic forms
  - **End Result Test**: Looks to whether there is a “unitary plan to achieve an intended result”
  - **Mutual Interdependence Test**: Looks to whether “the steps are so interdependent that the legal relations created by one transaction would be fruitless without a completion of the series”
  - **Binding Commitment Test**: Looks to whether, at the time the first step is taken, the taxpayer has committed itself to the remaining steps

- Thus, the step transaction doctrine would seem to be a useful tool to determine whether a north-south transaction should be treated as an exchange

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(1) See, e.g., S. Klein on the Square Inc. v. Comm’r, 188 F.2d 127 (2nd Cir. 1951) and Hazeltine Corp. v. Comm’r, 89 F.2d 513 (3rd Cir. 1937); (2) McDonald’s v. Comm’r, 688 F.2d 520 (7th Cir. 1982). After McDonald’s, the regulations were changed to allow for shareholder sales to third parties, even where there is a binding contract in advance. The regulations now limit the step transaction doctrine’s applicability to the situation where the issuer (or a related party) has a plan to buy back the newly issued stock. Reg. § 1.368-1(e); (3) A “given result at the end of a straight path is not made a different result because reached by following a devious path.” Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938); (4) Kanawha Gas & Util. Co. v. Comm’r, 214 F.2d 685, 691 (5th Cir. 1954); (5) Redding v. Comm’r, 630 F.2d 1169, 1177 (1980); (6) Comm’r v. Gordon 391 U.S. 83 (1968).
**Step Transaction Doctrine**

- **In practice, however, the doctrine is flexible enough to allow for nearly any result**
  - It is often unclear which of the three primary tests will apply
  - Even after the applicable test is determined, each test may be articulated differently in differing contexts
    - For instance, the binding commitment test — perhaps the most formalistic of the primary step transaction tests — has been held to be satisfied in “spirit” even where no legally binding agreement has been executed
    - Moreover, different courts in the same litigation define the “same” test differently
- **Though often not explicitly acknowledged, courts appear to apply the doctrine in a results-oriented manner**
  - “[T]he doctrine is not a rule of law to be applied whenever certain formal criteria are satisfied, but rather is an ‘extremely useful judicial device’ dependent for its application on underlying considerations of substantive tax policy or Code structure.”
  - “Legal doctrines are not, and by their nature cannot be, devices for determining reality. They do not add to our ability to discern the facts. Rather, legal doctrines, including the step transaction doctrine, are means of determining legal consequences. A necessary corollary of this observation is that the proper scope and limits of the doctrine must ultimately be grounded in the policy the law seeks to implement.”
- **Perhaps the key guidance provided by the step transaction doctrine is that policy should inform the determination of whether two transactions should be integrated**
  - The doctrine is a tool for thwarting specific evils, not a means of defining “economic reality”
- **In applying step transaction in certain published rulings, the IRS appears to have been influenced by policy considerations**

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(1) For an excellent review of the step transaction doctrine, see the forthcoming NYSBA report. New York State Bar Association Tax Section (“NYSBA”), *Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions (pending);* (2) See McDonald’s, *supra* (finding that the “the spirit, if not the letter, of the ‘binding commitment’ test” was satisfied); (3) “[T]he Tax Court purported to apply [the mutual interdependence test], 76 T.C. at 997-999, although its version of the test is indistinguishable from yet another formulation, the ‘binding commitment’ test.” *Id.;* (4) see Chirelstein, Marvin A. and Benjamin B. Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 Taxes 970 (1982); see also Martin D. Ginsburg and Jack S. Levin, *Mergers, Acquisitions, and Buyouts,* ¶ 608.3 (Sept. 2013 ed.) ("While the courts nominally apply one or more of the three tests ...a careful reading of the relevant cases indicates that the courts, as a preliminary matter, in deciding whether to apply the step-transaction doctrine tend to focus on two key factors: intent and temporal proximity."); (5) Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions under Section 351*, 11 Va. Tax Rev. 349, 372 (1991-1992).
Integration is Policy-Dependent

One basic fact pattern...

Step 1
- Parent
- Merger Sub
- Consideration
- Shareholders
- Merger

Step 2
- Parent
- Target
- Merger

Final Structure
- Parent
- Target Assets

...Two different outcomes

Consideration is cash\textsuperscript{1}
- Treated as two separate steps
  - Qualified stock purchase of Target
  - Section 332 liquidation of Target into Parent
- Merger Sub is still disregarded as transitory

Consideration is Parent stock\textsuperscript{2}
- Treated as single, integrated transaction
  - Section 368(a)(1)(A) merger of Target into Parent

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(1) Rev. Rul. 90-95, 1990-2 CB 67; see also Rev. Rul. 2008-25, 2008-1 CB 986. This result is consistent with § 338, which was intended to replace the treatment of a stock deal as an asset deal in the taxable context under Kimbell-Diamond; (2) Rev. Rul. 2001-46, 2001-2 CB 321.
Integration is Policy-Dependent

Pursuant to a binding agreement...

In general, the “control” requirement in a Section 351 transaction is not satisfied where the transferor, pursuant to a binding commitment, loses control of the transferee.

However, the IRS ruled that the control test was met here (and the step transaction doctrine did not apply) because Section 351 treatment was not inconsistent with the purposes of that section.

- The IRS noted that Congress enacted Section 351 “to facilitate the rearrangement of the transferor’s interest in its property.”
- This ruling is consistent with the principle that the IRS should not be overly formalistic where the same end result can be achieved (albeit with certain non-tax consequences) in a tax-free manner via a different path (here, by a Section 351 contribution of assets to Y prior to the creation of Z).

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(1) See, e.g., *S. Klein on the Square Inc. v. Comm’n*, 188 F.2d 127 (2nd Cir. 1951) and *Hazeltine Corp. v. Comm’n*, 89 F.2d 513 (3rd Cir. 1937); (2) Rev. Rul. 2003-51, 2003-1 CB 938.
Bifurcation under *Bazley*¹

- **In certain cases, policy demands that a single transaction be split in two**
  - Unlike with integration (for which there exists step transaction), there is no particular doctrine that requires bifurcation (except perhaps the general principle that a transaction should be taxed in accordance with its substance, not its form)

- **Bazley, a closely held corporation with significant E&P, distributed shares of its common stock and bonds to its shareholders in exchange for all of its then-outstanding common stock**

- **The transfers were structured as a tax-free recapitalization under Section 368(a)(1)(E)²**
  - However, the IRS argued the bonds were in substance a separate, taxable distribution of E&P under Section 301

  ![Chosen Form: Recapitalization](image1)
  ![Recast: Separate 301 Distribution](image2)

- **The Supreme Court found for the IRS, bifurcating the purported recapitalization and subjecting the distribution of bonds to Section 301³**
  - The bonds had, “for all practical purposes, the same result as a distribution of cash earnings of equivalent value”
  - A transaction that is “merely a vehicle, however elaborate or elegant, for conveying [E&P] to the stockholders” is not in substance a tax-free reorganization
    - Although the Court did not explicitly rest its holding on the lack of business purpose underlying the transaction, it did note that the transaction structure was chosen on account of tax considerations⁴

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1. *Bazley v. Comm.*, 331 U.S. 737 (1947), *Bazley v. Comm.*, 155 F.2d 237 (3rd Cir. 1946); (2) Under then-applicable pre-1954 Code, securities could be received tax-free in a recapitalization. By contrast, any cash boot would have been taxable as a dividend to the extent of the shareholder’s gain on the exchange; (3) Even though they had a ten-year term, the bonds were “virtually cash” because they were “callable at the will of the corporation which in this case was the will of [its shareholders]”. The Court seemed to imply that the bonds did not qualify as securities, though this was not made explicit and was not central to the Court’s holding; (4) The Court noted that “[o]ne does not have to pursue the motives behind actions…to find…that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income” and separately cited the Tax Court’s finding that “the recapitalization had ‘no legitimate corporate business purpose’ and was therefore not a ‘reorganization’ within the statute”.

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Cravath, Swaine & Moore LLP
Bazley’s Legacy: Reg. 1.301-1(l)

- Treasury subsequently promulgated Reg. 1.301-1(l), incorporating Bazley into the Regulations
  - “A distribution to shareholders with respect to their stock is within the terms of [S]ection 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense.”\(^1\)

- Since Bazley, Reg. 1.301-1(l) is most often cited in IRS rulings as not being applicable to the situation in question
  - For instance, the IRS has referenced — and then ruled out — Reg. 1.301-1(l) when respecting the separateness of distributions not structured as part and parcel of related reorganizations (usually E or F reorganizations)\(^2\)
  - In respecting the form of distributions structured as integrated parts of related reorganizations, the IRS has noted that the independent business purpose justifying the chosen form overrode Reg. 1.301-1(l)\(^3\)

- In the few court cases where the IRS sought to bifurcate using Reg. 1.301-1(l), it has generally lost\(^4\)
  - These cases were predominantly early liquidation-reincorporation cases from a time when the IRS lacked many of the modern tools now available (e.g., the 50% control definition for D reorganizations)

- However, the IRS bifurcated a recapitalization and distribution (formally boot) in Revenue Ruling 61-156, where the two halves of the transaction were not “functionally related”
  - The “dominant purpose” of the transaction was a recapitalization; the distribution in question was “not needed to implement [that] dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it”\(^5\)

- In practice, Reg. 1.301-1(l) is most likely to apply and bifurcate a transaction if the distribution does not share the same business purpose as the related reorganization
  - This is in contrast to Reg. 1.1502-13(f)(3), which automatically bifurcates any distribution from a related reorganization in an intercompany transaction

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\(^1\) Reg. § 1.301-1(l) (emphasis added); (2) see e.g., PLR 200752014; (3) see e.g., Rev. Rul. 86-25, 1986-1 CB 202; (4) see e.g., Kind v. Comm’r, 54 T.C. 600 (1970); (5) Rev. Rul. 61-156, 1961-2 CB 62.
Where Does This Leave Us?

- A taxpayer’s chosen form deserves some deference, but not always
- There is no clear test to determine when two formally separate steps are integrated or when a single, integrated transaction is bifurcated into two steps
- The step transaction doctrine provides some possible approaches, as do other authorities
- In addition, the authorities suggest that policy considerations must play an important role
  - “Often, application of the [step transaction] doctrine hinges on whether a court finds that a particular series of transactions runs counter to a significant tax policy.”¹
  - Primary authorities rarely articulate the importance of specific policy considerations when determining whether to integrate multiple transactions; policy’s presence is often felt — but seldom seen
  - IRS revenue rulings reflect the importance of policy

¹ Ginsburg and Levin, supra ¶ 608.3.
Key Factors for Analyzing North-South Issues

- Thus, in considering whether two purportedly separate transfers should be integrated into an exchange, we should consider three key factors:

  1. The “economic reality”
     - There is no clear test for ascertaining whether, in substance, there have been two separate transfers (typically, a contribution and a distribution) or a single integrated exchange
       - It is not clear whether economic reality depends on objective criteria, subjective intent or both
       - Indeed, it is unclear whether a “true” economic reality even exists in all cases
     - At the least, taxpayers advocating separate treatment should be required to show that it is consistent with a reasonable theory as to the underlying economic reality (even if integrated treatment might also be reasonable)

  2. Policies in support of integration
     - Separate transactions should be integrated if doing so would protect or advance an important tax policy
       - But one overarching tax policy is that economically similar transactions should be treated similarly — put differently, tax consequences generally should not be elective
     - Failure to integrate may mean that, in practice, taxpayers may elect their tax treatment — which itself is potentially troubling as a policy matter
     - The specific policies implicated will depend on the facts of the particular transaction and the applicable Code sections
     - In some cases, the policy at issue may be unarticulated or ambiguous; in other cases, conflicting policies may be at play

  3. Policies in support of respecting separate treatment
     - The relevant policies may favor respecting separate treatment
       - Where the desired tax result may be obtained through a complicated structure, the rules should not be applied so formally as to prevent the same result from being achieved in a simpler and more efficient manner
     - Indeed, policy objectives sometimes mandate bifurcation — splitting apart the pieces of an integrated transaction
Possible Standards for Integration

- **Did the steps occur pursuant to a common plan?**
  - Variations (relating to how definitive that plan must be)
    - Were the transfers part of a unitary plan? (End result test)
    - Were the transfers a result of “an agreement, understanding, arrangement, or substantial negotiations”? (Section 355(e)) — *Note: highly elective in a related-party context*
    - Were the transfers part of a “firm and fixed” plan?¹
    - At the time of the first transfer, was the taxpayer under a binding commitment to make the second transfer? (Binding commitment test) — *Note: highly elective in a related-party context*

- **Would each step have happened regardless of the other?**
  - Variations (generally looking at both subjective motivations and objective consequences)
    - Would each transfer have occurred “but for” the other? (But-for test)
      - That the “value of [Distributing] will decrease as a result of [the distribution] was not a consideration in the decision to contribute property”² and the distribution “is not contingent on there being contributed to [Distributing] assets having a specified (or roughly specified) value”³
      - The contributions “were planned without regard to the [spin-off] and would have occurred or will occur whether or not the [spin-off] occurs”⁴
    - Would either transfer would have been “fruitless” without the other? (Mutual interdependence test)

- **Could each step have happened regardless of the other?**
  - Was one transfer necessary to enable the other? (Compulsion test)
    - “There was no regulatory, legal, contractual or economic compulsion or requirement” that the contribution be made as a condition of the distribution⁵

- **Taxpayer’s election**
  - Alternatively, form controls (often the taxpayer will have ability to choose the form)

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¹ Merrill Lynch v. Comm’r, 120 T.C. 12 (2003); (2) PLR 201007050; (3) see e.g., PLR 201033007; (4) see PLR 201007050 (note that this was not a formal representation); (5) see e.g., PLR 201229002.
Possible Standards — Observations

- **Did the steps occur pursuant to a common plan?**
  - Can capture separate transfers effected in pursuit of a single end goal
    - In its broadest form, the common plan standard could integrate transfers that are not directly related to one another
  - Binding commitment version (the narrow version of this question) is not appropriate in related-party context and would result in significant taxpayer electivity

- **Would each step have happened regardless of the other?**
  - Difficult to apply
  - Goes to taxpayer’s motivations, but those motivations must be determined taking into account objective facts
  - May need to consider whether each transfer had an independent business purpose

- **Could each step have happened regardless of the other?**
  - It is not clear what level of potential harm constitutes “compulsion”
    - Should a taxpayer’s subjective “pain-threshold” matter?
    - Is this a windfall for companies with greater financial flexibility?
  - Does it matter whether any compulsion stems from a need to satisfy the tax requirements under Section 355 or to otherwise address Federal income tax considerations?
  - This approach might alleviate adverse consequences where taxpayers could have taken an alternative path to achieve an end goal (albeit with a slightly different economic result), but chose not to

- **Taxpayer’s election**
  - Taxpayers arguably should not have such broad discretion to determine tax consequences of economically similar transactions, unless policy considerations so require
  - May create a trap for taxpayers who are not well-advised, putting them in a worse position than those with tax counsel
Potentially Relevant Facts

- **Reasons for Transfers**
  - Did the steps occur for independent reasons?
  - Was the decision to take one step made independently of the decision to take the other step?

- **Relationship of Properties Transferred**
  - Were the properties transferred similar in nature?
  - Were they similar in value?
  - Was one a replacement for the other?

- **Form of Documentation**
  - Were the steps documented in a single agreement or separate agreements?
  - Were they characterized as an exchange?
  - Were there non-US tax reasons for the form chosen?

- **Timing and Order of Steps**
  - Did the steps occur substantially contemporaneously?
  - If not, how far apart did they occur?

- **Status of S and P**
  - Are the parties US or foreign, individuals or corporations, consolidated or not?
  - Did the chosen form result in some US tax benefit?
Agenda

Part I: N/S Issues: The Fundamentals 2

Part II: Cash Heads North; Assets Head South 27

Part III: Cash Heads North; Stock Heads South 35

Part IV: Stock Heads North; Assets Head South 40
Contribution of Assets

- **Facts**
  1. P contributes Property A to S
  2. S distributes cash to P

- **Consequences**
  - Separate: Capital contribution under Section 351 followed by a Section 301 distribution to P
  - Exchange: P recognizes gain on Property A

- **Courts have respected the taxpayer’s separate form in some cases but not others**
  - The historic concern was with contributions disguised as sales, which would have allowed taxpayers to recognize gain at lower, individual rates while providing the corporation with a greater asset basis for depreciation
    - Section 351 “[prevents] taxpayers from taking colorable losses in wash sales and other fictitious exchanges”

(1) S may or may not issue additional stock to P; (2) see H. B. Zachry Co., 49 T.C. 94 (1967) (Slide 29) and Sylvan Makover, 26 T.C.M. 288 (1967) (Slide 30), but see, e.g., D'Angelo Associates, Inc. v. Comm., 70 T.C. 121 (1978) (Slide 31); (3) 1921 Senate Report.
H. B. Zachry

- **H. B. Zachry Co. wanted to remove a short-term liability from its balance sheet**
  - To do so, it effectuated a series of transactions that transformed that liability into a “liability in the form of preferred stock”

- **The IRS sought to integrate Zachry’s contribution of oil payments with the cash payment made by Minerals for Zachry’s preferred stock**
  - **After considering the parties’ intent and applying the mutual interdependence test, the Court refused to treat the two transfers as an exchange**
    - Zachry admitted that the transactions were interrelated, and that First City would not have made the loan to Minerals without the endorsement of Zachry’s controlling owner
    - However, because the value of the carved-out oil payments could have financed “at least a substantial portion” of the loan, the transfer of the oil payment “was not a prerequisite” to Zachry’s sale of the preferred stock
      - “[T]he only asset which [Zachry] … had to transfer to Minerals to enable Minerals to carry out its corporate function was the oil payment. The purchase by Minerals of [Zachry’s] preferred stock was a separate investment”

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Makover’s partners contended that the initial contribution of property to TMS Inc. and the subsequent issuance of Note 1 by TMS Inc. to Makover were two separate transactions

- The IRS sought to integrate the two transactions, such that Note 1 would be taxed as “boot” in a Section 351 exchange

Siding with the taxpayer, the Tax Court concluded that the two transactions were separate because the distribution of Note 1 “was [not] a part of the plan for incorporating the partnership”

- “If [the borrowing from Makover] was independent of the exchange it would make no difference whether the money was borrowed from the bank or from the partnership”
- The Court found it important that the parties had originally intended for TMS Inc. to borrow only from Fulton National
- Only after TMS Inc. was formed did Makover’s controlling partner unilaterally decide that 50% of the borrowing should come from Makover, which unexpectedly had excess cash available

The Court rejected the IRS’s argument that the step transaction doctrine should apply

- The mutual interdependence test was not met, since “[i]f cash was needed to permit the corporation to continue the business, it is clear from the evidence that the corporation could have borrowed whatever it needed from Fulton National”

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1 Sylvan Makover, 26 T.C.M. 288 (1967).
**D’Angelo**

**Facts**

1. D contributed cash to a newly formed corporation (“D’Angelo”) in exchange for stock, ~83% of which D directed be given to his family.
2. D sold property to D’Angelo in exchange for cash, an assumption of related liabilities and a demand note.

**D sought sale treatment for the property transfer so as to utilize his preexisting capital losses**

- The IRS argued that the entire transaction was a Section 351 contribution with boot; D attempted to counter this argument by establishing that he did not have control of D’Angelo at any point, and thus Section 351 was inapplicable.

**The Tax Court determined that the steps were part of a common plan**

- “The evidence demonstrates that these steps were integral parts of a plan designed by [D] to transfer the assets…from individual to corporate ownership.”
- D chose to have D’Angelo issue stock to his family, in his “absolute right”; therefore Section 351 was applicable.
  - Applicability of Section 351 does not “turn on whether the tune [D] called was written in two-four time, but on his power to call the tune.”

**The court, looking to the end result, held that the transaction was a unified Section 351 contribution, with boot**

- There was no substance or business purpose to the initial incorporation, absent the subsequent contribution of property.
  - “Any reason for [D’Angelo’s] existence would have vanished absent the transfer of the rental property in accordance with the overall plan.”
- Since no payments had been made on the demand note for over a decade, the court indicated the note was equity-like — thus D’s interest in D’Angelo was effectively retained, notwithstanding his having directed stock to his family.

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(1) *D’Angelo Associates, Inc. v. Comm.*, 70 T.C. 121 (1978); (2) The amount of cash contributed by D in Step 1 was exactly equal to the amount of cash distributed to D in Step 2; (3) Id. at 130; (4) Id. at 133; (5) Id. at 130; (6) The court also found that demand note was treated as a security of D’Angelo, and therefore not boot under then-§ 351, which allowed for distribution of stock or securities.
Basis Allocation in Section 351 Transactions

- In a single transaction, P contributed both high-basis and low-basis property to S in exchange for S stock and securities
  - P claimed the securities (taxable consideration) were received in exchange for the high-basis property, while the stock was received (tax-free) in exchange for the low-basis property
- The IRS ruled that P cannot cherry-pick which consideration is received for which property
  - P’s basis in the S stock and S securities is determined by allocating its historic, combined basis in Property A and Property B between the stock and securities, in proportion to their relative FMVs
  - Thus, “boot” in a Section 351 is received *pro rata* in exchange for all property contributed
    - This follows from Section 357(c) (recognition of gain where liabilities assumed exceed basis of contributed assets), which applies on an aggregate basis
- The ruling arguably does not address the parameters of the exchange, however, and therefore does not speak to the north-south issue
  - “This holding would be unaffected if [P] were to make a transfer in exchange for securities at separate times, and the transfers were part of a single integrated transaction”

Section 351 Examples

- Consider the consequences if we vary two key facts in the above scenarios: P’s built-in gain in the truck ($10 or $0) and the subsidiary’s E&P ($10 or $0)

In all cases, P’s basis in S/F stock exceeds $10

<table>
<thead>
<tr>
<th>Scenario</th>
<th>B-I-G but no E&amp;P</th>
<th>B-I-G and E&amp;P</th>
<th>No B-I-G or E&amp;P</th>
<th>E&amp;P but no B-I-G</th>
</tr>
</thead>
<tbody>
<tr>
<td>If Separate</td>
<td>No gain on truck (but see §367 if outbound); $10 is return of capital</td>
<td>No gain on truck under §351 (but see §367); $10 is dividend</td>
<td>No gain on truck under §351 (but see §367); $10 is return of capital</td>
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</tr>
<tr>
<td>If Exchange</td>
<td>$10 gain on truck</td>
<td>$10 gain on truck</td>
<td>No gain on truck</td>
<td>No gain on truck</td>
</tr>
</tbody>
</table>

- Separate treatment may result in income on the distribution if S/F has E&P
  - In the Foreign Subsidiary and Individual Shareholder scenarios, any dividend is taxable
  - But in the Domestic Subsidiary scenario, a dividend does not result in a net income inclusion because of either the 100% DRD or the consolidated return rules
  - If the subsidiary is foreign, any dividend income to P would generally be foreign-source and may carry foreign tax credits

- Exchange treatment may result in gain on the truck
  - Gain may be capital or ordinary, depending on whether the truck is held as a capital asset
  - S/F takes a cost basis in the truck (carryover basis if separate)

- If separate treatment is respected, should the order of the steps be respected, too?
  - If the contribution occurs first, this will increase the basis in the S stock, effectively permitting P to recover the basis in the truck (not only the historic basis in the S stock) before recognizing any built-in gain
  - Section 351 requires gain to be recognized first
Under CCA 201334037, S may not deduct interest payments on the preexisting note

- Under Section 267(a)(3), accrued interest on the notes is not deductible until actually paid
- Taxpayer contended that it was impossible to “trace” its interest payments on the preexisting note to the new notes because all amounts were paid into/from its general account
  - However, the IRS found that tracing the proceeds from the new notes to S’s purported interest payments is “reflected in and evidenced by” the specific facts and circumstances
- When the “economic substance of the transaction is to capitalize and postpone…through the device of ‘paying’ interest now owed using newly-borrowed principal from the same lender”, the deduction should not be allowed
- The amount of the new note was significantly greater than the interest payments required under the preexisting note
  - IRS concluded that “significant portions of [the] advances funded bona fide Taxpayer operating expenses”, even though S did not need the proceeds of the new note to make interest payments on the preexisting note

Arguably, this is a special form of north-south transaction, involving a circular flow of cash

- Is this CCA in tension with Revenue Ruling 80-154, in which a dividend made freely available to the recipient should be respected even if there is a subsequent contribution back to Distributing?

Facts

1. US Sub (S) has an outstanding note payable to Foreign Parent (P)
2. P loans additional money to S and receives a new note in return
3. S pays interest on the preexisting note
Agenda

Part I: N/S Issues: The Fundamentals  2
Part II: Cash Heads North; Assets Head South  27
**Part III: Cash Heads North; Stock Heads South**  35
Part IV: Stock Heads North; Assets Head South  40
Mechanics of Section 304

- **Under Section 304(a)**, the purchase by one corporation (Buyer) of stock of another corporation (Target) from their common parent (Seller) will be recharacterized as a Section 351 contribution followed by a Section 302 redemption:
  - If Seller’s ownership in Target is not sufficiently reduced, the deemed redemption is treated as a Section 301 distribution.

\begin{itemize}
  \item Sales between members of a consolidated group
  \item Transactions that qualify as Section 368 reorganizations
  \item When the parent buys the stock of a lower-tier subsidiary from a higher-tier entity in the same direct chain of ownership
\end{itemize}

(1) In addition to brother-sister sales, § 304 can also apply to certain parent-subsidiary sales; (2) Reg. § 1.1502-80(c); (3) § 304(b)(3)(A); (4) Rev. Rul. 74-605, 1974-2 CB 97.
Section 304 History

- **Section 304 was intended to prevent bailouts of E&P**
  - The policy undergirding it has remained the same since its inception, but the section has been amended over time to address newly discovered “loopholes”\(^1\)

- **Wanamaker v. Commissioner\(^2\) (1948)**
  - **Facts** — Wanamaker was the sole shareholder of a corporation (Philadelphia), which was the sole shareholder of New York. Wanamaker sold his Philadelphia stock to New York and claimed a small capital loss on the sale, even though New York had significant E&P.
  - **Holding** — The court upheld sale treatment, rejecting the IRS’s argument that the stock purchase was essentially equivalent to a dividend from New York to Wanamaker.
  - **Result** — Wanamaker was effectively able to “bail-out” New York’s E&P.

- **Key Legislative History**
  - 1950 — Noting its displeasure with the *Wanamaker* result, Congress adopted the first precursor to Section 304; it responded narrowly to the *Wanamaker* facts, only covering stock sales between a subsidiary and shareholders of its parent.
  - 1954 — Congress extended the predecessor to Section 304 to cover brother-sister related-party stock sales.
  - 1982 — Under a section entitled “Use of holding companies to bail out earnings”, Congress provided that Section 351 generally would not apply to Section 304 transactions, and that Target’s E&P (in addition to the buyer’s) would be taken into account for purposes of applying Section 301 to the deemed distribution of proceeds to Seller\(^3\).
  - 1984 — Congress amended Section 304 to clarify that it did not override Section 368 and the related reorganization provisions of the Code (although it continues to override Section 351).

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\(^1\) 1950 House Report; \(^2\) *Wanamaker v. Comm’r*, 11 T.C. 365 (1948) aff’d 178 F.2d 10 (3rd Cir. 1949); \(^3\) 1982 House Report.
### Contribution of Stock

**Actual Transaction**
- **1** Parent contributes F2 stock to F1
- **2** F1 distributes cash to P

**Deemed Transaction**
(if exchange treatment applies)
- **1** Parent contributes F2 stock to F1
- **2** F1 distributes cash to P

### Facts
- **1** Parent contributes F2 stock to F1
- **2** F1 distributes cash to P

### Consequences
- **Separate**: Capital contribution of F2 stock by Parent (may require a GRA under Section 367); Section 301 distribution to Parent (dividend to the extent of F1’s E&P, then basis recovery on F1 stock, which includes basis of F2 stock, and capital gain on any value in excess of basis)
- **Exchange**: Section 301 distribution to Parent (dividend to the extent of F1’s E&P and then F2’s E&P, then basis recovery to the extent of its combined historic basis in the F2 stock exchanged and the F1 stock, and then capital gain on any value in excess of basis)

  - But, where Parent is domestic and F1 is not, Parent will recognize gain under 367(a)(1) on any “old-and-cold” F1 stock basis that it attempts to recover in the transaction, and it will also be required to enter into a GRA

### Should the parties’ status and attributes affect the analysis?

(1) The ability to recover “old-and-cold” basis in F1 shares upon the deemed redemption of newly issued F1 shares is subject to some uncertainty. See, e.g., Skinner, William R., *A Primer on the Use of § 304 Transactions and Cash D Reorganizations to Effect Internal Restructurings* (Jan. 18, 2013), available at http://www.fenwick.com/fenwickdocuments/outline_of_304_and_cash_d_reorgs_in_international_restructuring.pdf (citing TD 9250, 2006-1 CB 588, which states that “[the IRS and the Treasury believe…that current law does not provide for the recovery of the basis of any shares other than those exchanged”); (2) Reg. § 1.367(a)-3(a)(1), Temp. Reg. § 1.367(a)-9T(b), Notice 2012-15, 2012-9 IRB. 495 (Feb. 27, 2012), Reg. § 1.367(a)-3(b).
**Contribution of Stock — Examples**

- **Domestic Parent**
  - F2 Stock 
  - USP

- **Individual**
  - S2 Stock

- **Foreign Parent**
  - S2 Stock

### Consider the consequences if we vary two key facts in the above scenarios: S1/F1’s stock basis ($20 or $0) and S1/F1’s E&P ($5 or $0)

- In all cases, S2/F2 has $5 of E&P and USP/P/FP has a $10 basis in the S2/F2 stock

<table>
<thead>
<tr>
<th></th>
<th>Stock basis but no E&amp;P</th>
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<tr>
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<td>No gain on F2 stock under § 351 (but see § 367); $5 is dividend, $15 is return of capital</td>
<td>No gain on F2 stock under § 351 (but see § 367); $10 is gain on S1/F1 stock¹</td>
<td>No gain on F2 stock under § 351 (but see § 367); $5 is dividend, $10 is return of capital, $5 is gain on S1/F1 stock¹</td>
</tr>
<tr>
<td><strong>If Exchange</strong></td>
<td>$5 is dividend, $15 is return of capital (but for Domestic Parent: $5 dividend, $10 RoC, $5 gain)¹</td>
<td>$10 is dividend, $15 is return of capital</td>
<td>$5 is dividend, $15 is return of capital (but for Domestic Parent: $5 dividend, $10 RoC, $5 gain)¹</td>
<td>$10 is dividend, $10 is return of capital</td>
</tr>
</tbody>
</table>

- In the Domestic Parent and Individual scenarios, dividend results in income since no DRD/consolidated return relief, but FTCs may apply (application of Section 304 may affect amount of FTCs); in the Foreign Parent scenario, dividend subject to 30% withholding²
- In the Domestic Parent scenario, GRA is required to avoid gain
  - In addition, with exchange treatment, Section 367(a) prevents tax-free recovery of “old-and-cold” basis in F1 stock
- General observations
  - Effect that Section 304 has on dividend/gain recognized by USP/P/FP generally correlates with the size of S2’s/F2’s E&P
  - If the transferred subsidiary is foreign and there is Section 301(c)(3) gain, Section 304 may have either a beneficial or detrimental effect, depending on specific tax attributes of the group (due to the application of Section 1248(a))

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¹ If there is gain on the exchange, § 1248(a) may convert all or a portion of that gain into a dividend; (2) see §§ 881(a)(1) and 1442, Rev. Rul. 92-85, 1992-2 CB 69.
# Agenda

<table>
<thead>
<tr>
<th>Part I: N/S Issues: The Fundamentals</th>
<th>2</th>
</tr>
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<tbody>
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</tbody>
</table>
Spin-Off — Base Case

### Facts
1. Parent contributes Property A to Distributing
2. Distributing distributes Controlled stock to Parent in a Section 355 spin-off
3. Parent distributes Controlled stock to its shareholders in a Section 355 spin-off

### Consequences
- **Separate**: Tax-free Section 351 transaction and Section 355 spin-off
- **Exchange**: Parent recognizes gain on Property A and Distributing has capital gain on the portion of Controlled stock deemed exchanged for Property A
  - If the value of Property A > 20% of the value of Controlled, the deemed exchange would prevent Distributing from distributing "control" of Controlled and Distributing would recognize gain on all of the Controlled stock
  - Even if the value of Property A ≤ 20% of the value of Controlled, the deemed exchange *might* cause the entire distribution of Controlled stock to fail Section 355 if Distributing relies on the contributed assets to satisfy its Active Trade or Business (“ATB”) requirement of Section 355¹

¹ But see Notice 2007-60, Reg. § 1.355-3(b)(4)(iii). In all events, this assumes the Controlled stock is worth more than Property A. If the reverse were true, then the exchange scenario would involve a § 351 transaction with boot.
Spins Often Raise North-South Issues

- **Spin-offs are particularly likely to raise north-south issues**
  - Aligning the business operations of Distributing and Controlled in advance of the spin-off — or otherwise achieving the relevant business purpose of the distribution — may require transfers of assets.
  - Likewise, satisfying the ATB requirement of Section 355 may necessitate transfers of assets, although the 2006 amendments to Section 355(b)(3) (treating the members of a separate affiliated group as one corporation) alleviated the need to restructure in many cases.
  - Since a spin-off is itself a northbound transaction, even a functionally unrelated (but contemporaneous) southbound transaction may create a concern that the purported Section 355 distribution is part of an exchange.

- **A northbound and a southbound transfer occurring in the context of a spin-off may be susceptible to exchange treatment under various possible standards of evaluation**
  - The transfers generally are executed as part of a common plan, though typically not pursuant to a binding agreement.
  - Often one transfer would not be effected without the other, even if neither represents consideration for the other in the classic sense.
  - In many cases, however, there is no compulsion or requirement to effect one transfer in order to effect the other, except for the need to satisfy the tax requirements themselves.
Instructive Prior PLRs

- Given the uncertainty in this area of the law and the high stakes often involved, prior to the “No-Rule” taxpayers routinely sought IRS guidance on north-south issues in the context of spin-offs

- The IRS issued numerous favorable Private Letter Rulings addressing these issues

- These PLRs contain various representations addressing the separateness of the two transactions
  - Historically, Revenue Procedure 96-30 required the following generic representation
    - “No part of the consideration to be distributed by [Distributing] will be received by a shareholder as a creditor, employee or in any capacity other than as a shareholder of [Distributing].”
    - But, in a north-south situation, this is exactly the question!
  - In more recent PLRs, representations address whether each step *could* have happened regardless of the other
    - “There was no regulatory, legal, contractual or economic compulsion or requirement” that the contribution is made as a condition of the distribution
  - And some address whether each step *would* have happened regardless of the other
    - That the “value of [Distributing] will decrease as a result of [the distribution] was not a consideration in the decision to contribute property” and the distribution “is not contingent on there being contributed to [Distributing] assets having a specified (or roughly specified) value”
    - The contributions “were planned without regard to the [spin-off] and would have occurred or will occur whether or not the [spin-off] occurs”

- The IRS has been flexible in allowing non-exchange treatment where that treatment is economically plausible, generally adopting a “no compulsion” test in most recent PLRs leading up to the No-Rule

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(1) We have not found any spin-off-related rulings in which the IRS integrated two purportedly separate transactions. Given that ruling requests on which the IRS is not inclined to rule favorably are typically withdrawn prior to completion, this is not surprising; (2) Rev. Proc. 96-30, 1996-1 CB 696; (3) see, e.g., PLR 201033007; (4) see, e.g., PLR 201229002; (5) PLR 201007050 (note that this was not a formal representation).
Two Ships Passing in the Night?*

**Did the steps occur pursuant to a common plan?**
- Variations (relating to how definitive that plan must be)
  - Were the transfers part of a unitary plan? (End result test)
  - Were the transfers a result of “an agreement, understanding, arrangement, or substantial negotiations”? (Section 355(e)) — *Note: highly elective in a related-party context*
  - Were the transfers part of a “firm and fixed” plan?¹
  - At the time of the first transfer, was the taxpayer under a binding commitment to make the second transfer? (Binding commitment test) — *Note: highly elective in a related-party context*

**Would each step have happened regardless of the other?**
- Variations (generally looking at both subjective motivations and objective consequences)
  - Would each transfer have occurred “but for” the other? (But-for test)
    - That the “value of [Distributing] will decrease as a result of [the distribution] was not a consideration in the decision to contribute property”² and the distribution “is not contingent on there being contributed to [Distributing] assets having a specified (or roughly specified) value”³
    - The contributions “were planned without regard to the [spin-off] and would have occurred or will occur whether or not the [spin-off] occurs”⁴
  - Would either transfer would have been “fruitless” without the other? (Mutual interdependence test)

**Could each step have happened regardless of the other?**
- Was one transfer necessary to enable the other? (Compulsion test)
  - “There was no regulatory, legal, contractual or economic compulsion or requirement” that the contribution be made as a condition of the distribution⁵

**Taxpayer’s election**
- Alternatively, form controls (often the taxpayer will have ability to choose the form)

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*“Ships that pass in the night and speak each other in passing; Only a signal shown and a distant voice in the darkness; So on the ocean of life we pass and speak one another, Only a look and a voice; then darkness again and a silence.” Tales of a Wayside Inn. Part iii. The Theologian’s Tale: Elizabeth. iv. Henry Wadsworth Longfellow. (1807–1882)
(1) Merrill Lynch v. Comm’r, 120 T.C. 12 (2003); (2) PLR 201007050; (3) see e.g., PLR 201033007; (4) see PLR 201007050 (note that this was not a formal representation); (5) see e.g., PLR 201229002.*
When Does Compulsion Exist?

- **Parent’s contribution of Property A to Distributing satisfies certain covenants on Distributing’s third-party debt that would have otherwise been at risk of being breached after taking into account the distribution of Controlled stock**
  - What if Distributing could have repaid or refinanced the debt at a cost that it could have borne, but chose not to?
  - What if Parent could have provided a guarantee instead of contributing assets?
  - What if Distributing could have gotten a waiver of the covenants, but chose not to because it would have been costly, caused a delay or simply diverted Parent’s limited internal resources from other important matters?
  - What if failure to make the contribution would have resulted in a higher interest rate (which Distributing was capable of paying), but not a breach of covenant or default?
  - What if the contributed assets consist of the active trade or business that Distributing relies on to satisfy the ATB requirement under Section 355?
  - Does it matter that Parent might have instead liquidated Distributing (or converted it to an LLC), thus avoiding the potential deemed exchange?
Policy Issues Related to Spin-Offs

- The IRS’s approach appears to have acknowledged the important policy considerations surrounding spin-offs and the protections that already exist under Section 355.

- Non-recognition treatment under Section 355 is premised on the view that a division of one active corporation into two active corporations is essentially a change in form, not substance.
  - Like a reorganization, a spin-off “merely effects a readjustment of the shareholder’s continuing interest in the corporation in modified form and subject to certain statutory and other constraints”.
  - Tax-free spin-offs involving a D reorganization were introduced in the 1920s; tax-free split-ups date back even farther.
  - Congress did away with tax-free D reorg / spin-offs in 1934 in reaction to the lower court’s decision in the Gregory case.
  - A revised, stricter provision for tax-free spin-offs was reintroduced in the early 1950s, and tax-free spin-offs have been part of the Code ever since.

- Post-repeal of General Utilities, Section 355 provides the only way for a corporation to divide without corporate or shareholder-level tax.
  - Prior to the repeal of General Utilities, corporations could distribute appreciated property tax-free by liquidating (though shareholders still would have been subject to tax).
  - The non-recognition treatment afforded by Section 355 is a narrow exception to the general rule that a corporation and its shareholders must recognize any gain if the corporation distributes property to its shareholders.

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Policy Issues Related to Spin-Offs

- Section 355 requires taxpayers to hurdle high statutory barriers that serve to protect the policy concerns related to tax-free corporate distributions
  - Effecting a spin requires a substantial corporate level business purposes
  - Various other requirements must be satisfied (e.g., no device, distribution of control, five-year ATB, continuity of interest, prohibition of “hot stock”)
  - Sections 355(d), (e) and (g) also protect against various transactions that Congress considered abusive

- Should Section 355 have a special “halo” that suspends exchange treatment because its policy goals are uniquely compelling and because it already has sufficiently strong statutory protections?¹
  - If so, how far should that halo extend?

¹ A forthcoming report by the New York State Bar Associate Tax Section addresses this area in greater detail. NYSBA, Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions (pending).
Typical North-South PLRs

- The extant PLRs show some possible fact patterns that may arise
- In the majority of PLRs, the north-south transaction takes place between Parent and Distributing, with the northbound property consisting of Controlled stock
  - The southbound property may take various forms, including assets, cash or even stock in another subsidiary

![Diagram showing north-south transaction between Parent, Distributing, and Controlled.]

- In many others, the north-south transaction occurs between Distributing and Controlled

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(1) See, e.g., PLR 201033007; (2) see, e.g., PLR 9507036; (3) see, e.g., PLR 200245043; (4) see, e.g., PLR 201136009, PLR 9510005.
North-South Between Distributing and Controlled

### Consequences
- Separate: Transfer of Property A as part of a divisive D reorganization, plus a Section 301 cash distribution to Distributing
- Exchange: Transfer of Property A as part of a divisive D reorganization in which the cash is boot

### Key Questions
- Must Distributing purge the cash? With separate treatment, Distributing can retain the cash without recognizing gain (to the extent the cash ≤ its basis in the Controlled stock); with exchange treatment, Distributing must “purge” the boot.
  - Under Section 361(c), Distributing generally will not recognize gain on boot received in a D reorganization if it distributes the boot to its shareholders or transfers it to its creditors (generally, this requirement has been applied to require a payment to Parent’s public shareholders or external creditors)
- Can the north-south issue be avoided by having Controlled distribute cash to Distributing and then having Distributing contribute both Property A and the Controlled stock to a new holding company (Holdco), which Distributing would then spin off (instead of Controlled)?
  - If so, should the formation of such a Holdco be necessary?
  - This variation appears to fall within the scope of the No-Rule

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### Facts
1. Distributing contributes Property A to Controlled
2. Controlled distributes cash to Distributing
3. Distributing distributes Controlled stock to Parent in a Section 355 spin-off
4. Parent distributes Controlled stock to its shareholders in a Section 355 spin-off

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(1) With separate treatment, the cash received by Distributing is treated as a dividend to the extent of the E&P of Controlled.
Unique North-South PLRs

Assumption of Liabilities

1. Parent contributes assets to Distributing
2. Distributing distributes Controlled stock to Parent and assumes Parent’s liabilities (e.g., PLR 200042024)

Downstream Merger

1. Sub merges into Distributing
2. Distributing distributes Controlled stock to Parent (e.g., PLR 200104001)

(1) All facts shown are simplified.
**A Parallel Exchange – PLR 2007010101**

**Facts**

1. Parent contributes Sub stock to Distributing in exchange for a note in a transaction intended to be treated as a taxable exchange; the value of the note exceeded that of the Sub stock.
2. Distributing distributes Controlled stock to Parent in a purported Section 355 spin-off.
3. Parent distributes Distributing stock to its shareholders in a Section 355 spin-off.

**The IRS respected the taxpayer’s characterization of Step 1 as an exchange and a dividend**

- Parent recognized gain on the Sub stock, and Distributing took an FMV basis in the Sub stock.
- The excess note distribution was an intercompany dividend.

**The IRS ruled that the spins would qualify under Section 355**

- The Sub stock sale in Step 1 was respected as separate from the spin-off of Controlled in Step 2.
- Thus, Distributing was not treated as having exchanged Controlled stock for Sub stock.

**Could the note have been treated as boot in a divisive D reorganization?**

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1. All facts shown are simplified; (2) Since the IRS ruled that the dividend is an intercompany distribution (and thus an “intercompany transaction”) for purposes of the consolidated return regulations, it follows that § 304 should not apply to the exchange in Step 1 (i.e., Reg. § 1.1502-80(b) would render § 304 inapplicable). However, this conclusion is not free from uncertainty in all cases. See Reg. § 1.1502-13(b)(1)(i), -80(b) and Dubroff, Andrew J., Federal Income Taxation of Corporations Filing Consolidated Returns (June 2013) at ¶ 31.04[1].
The IRS ruled that the spins would qualify under Section 355

- The IRS noted it was not ruling on Steps 1 and 3
- The Taxpayer represented that the “compulsion” test was satisfied with respect to the contribution and distributions
  - “There is no regulatory, legal, contractual or economic compulsion or requirement” that Step 1 be made as a condition of either Step 2 or Step 3
- The Taxpayer represented that the stock/assets contributed to D1 were not acquired in “a transaction in which gain or loss was recognized…in whole or in part”
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