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Tax Section

Report on Revenue Ruling 2017-09 and "North-South" Transactions

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This Report[1] of the New York State Bar Association Tax Section provides comments on Revenue Ruling 2017-09 (the "**Ruling**")[2] and on related aspects of so-called "north-south" transactions. In 2013, the Treasury Department (the "**Treasury**") and the Internal Revenue Service (the "**Service**") identified these transactions as an "area under study" that the Service would not address in private letter rulings until further guidance was issued.[3]

The adoption of the no-rule policy, particularly given the lack of guidance in the area, introduced significant uncertainty into common transactions. Consequently, the issuance of the Ruling was welcomed by taxpayers and practitioners. We commend the Treasury and the Service for allocating resources to address these issues and for the overall analytical framework of the Ruling. In addition to providing helpful guidance on a "north-south" fact pattern that commonly recurs in corporate separations, the Ruling marks the end of the no-rule policy. This Report suggests a modification to the Ruling to

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[2] 2017-21 I.R.B. 1244.

[3] Rev. Proc. 2013-3, 2013-1 I.R.B. 113. For a previous discussion of "north-south" issues and the no-rule policy, see New York State Bar Association Tax Section, *Report on the Role of the Step Transaction Doctrine in Section 355 Stock Distributions: Control Requirement and North-South Transactions* (Report No. 1292, Nov. 5, 2013) (the "**2013 Report**").

more clearly reflect what we believe was intended by the Treasury and the Service. This Report also provides comments on related fact patterns that are not directly addressed by the Ruling and may be appropriate subjects for future guidance. Part I of this Report presents a brief summary of the background regarding "north-south" transactions and the Ruling. Part II sets out our comments and recommendations.[4]

I. OVERVIEW OF "NORTH-SOUTH" TRANSACTIONS AND THE RULING

A. Background

The principal tax issue relating to a "north-south" transaction is described in Revenue Procedure 2013-3: "[w]hether 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."[5] Although "north-south" transactions can occur in several different contexts, they are frequently implicated by corporate separation transactions (that is, Section 355 distributions). In those situations, there is typically no question that the "north" leg (the

4 This Report, for simplicity, only addresses issues within the scope of the Ruling or other "north-south" issues in transactions intended to be subject to Section 355 of the Internal Revenue Code of 1986, as amended (the "**Code**"). However, we would welcome the Treasury and the Service indicating if, as the Ruling suggests, its analysis is limited to the Section 355 context, or if it is intended to have broader applicability. We would also be happy to analyze "north-south" issues arising outside the Section 355 context if Treasury and the Service would find it useful. Unless otherwise indicated, all references herein to "Section" or "§" refer to the Code. References to the Treasury Regulations are to those in effect as of the date of this Report.

5 Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

distribution of controlled stock by a distributing corporation) and the “south” leg (the contribution of assets to the distributing corporation) are part of an overall plan. For example, these transfers are often undertaken within corporate groups to ensure that group assets are held by the appropriate entities prior to a spin-off, to eliminate or rationalize intercompany debt, to satisfy debt covenants, or to satisfy the active trade or business requirement under Section 355(b). However, if the “north” and “south” legs of such a transaction are combined under the step transaction doctrine[6] into a single, integrated transaction, the original contribution of assets from a parent to a distributing subsidiary corporation could be recast as a sale or exchange, and may even disqualify the entire spin-off or reorganization from tax-free treatment.[7]

Prior to 2013, the Service issued a series of private letter rulings in which it respected “north-south” transactions in the context of spin-off transactions as separate where the taxpayer represented that there was no “regulatory, legal, contractual or economic compulsion or requirement” that the contribution be made as a condition of the

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[6] The step transaction doctrine is a judicially created doctrine that integrates into a single transaction nominally separate steps that, in substance, are part of a larger, interdependent transaction. The step transaction doctrine has often been invoked by the Service to recharacterize transactions purporting to qualify as tax-free reorganizations as taxable transactions. On the other hand, the doctrine has also been used to recast steps that would otherwise constitute a taxable transaction into a tax-free reorganization by combining them with later steps. For a detailed discussion of the doctrine, see the 2013 Report at 4-12.

[7] If, in the context of a spin-off, the contribution of assets from a parent to the distributing corporation, and the subsequent distribution of the controlled corporation to parent were recharacterized as a single transaction, then the original contribution could be treated as a taxable exchange of the contributed assets for all or a portion of the subsequently distributed shares of controlled. Furthermore, if parent is deemed to receive more than 20% of the controlled shares in exchange for the contributed assets, then the entire transaction would fail to qualify for tax-free treatment because 80% of the stock of controlled would not have been distributed with respect to stock as required by Section 355(a)(1)(D).

subsequent distribution (the "**compulsion test**").[8] The compulsion test permitted a contribution and a distribution to be respected as separate transactions even if they occurred as part of a plan and with little time between them. Although the compulsion test has generally been applied narrowly,[9] it created uncertainties where, for example, contributions were made to maintain compliance with debt covenants or other contractual provisions that could be breached by consummation of the separation transaction, as determining the existence of economic compulsion in any particular case can raise difficult factual and line-drawing issues that may result in similar transactions being treated differently.

B. The Ruling

In May 2017, the Service issued the Ruling, which announced that the Service would once again issue private letter rulings with respect to "north-south" transactions and provided guidance regarding the tax treatment of two fact patterns raising "north-south" concerns.[10]

The Ruling describes two situations. In each situation, a parent corporation ("P") owns a wholly owned subsidiary ("D"), which in turn owns 100% of a second subsidiary ("C"). In Situation 1, P and C operate separate businesses, each of which constitutes a

[8] *See*, *e.g.*, Priv. Ltr. Rul. 201136009 (May 23, 2011); Priv. Ltr. Rul. 201202007 (Sept. 30, 2011); Priv. Ltr. Rul. 201149012 (Sept. 9, 2011); Priv. Ltr. Rul. 201123022 (Mar. 14, 2011).

[9] For example, in Private Letter Ruling 201030005 (Apr. 28, 2010), a spin-off was expected to cause the distributing corporation ("D") to repurchase certain outstanding notes. To "assist [D] in satisfying its repurchase obligations", D's parent contributed cash to D prior to the spin-off. The Service accepted the taxpayer's representation that the contribution to D was not economically compelled and ruled that the transactions were not an integrated exchange.

[10] Rev. Rul. 2017-09, 2017-21 I.R.B. 1244.

five-year active trade or business for purposes of Section 355(b). D is not engaged in any business. Pursuant to an overall plan, P transfers its business to D in exchange for additional D stock, in order to allow D to satisfy the active trade or business requirement. Thereafter, D distributes all of the stock of C to P. The Ruling held that the two transactions in Situation 1 will be respected as separate transactions, even though they were part of a single plan. As a result, the contribution to D is treated as an exchange to which Section 351 applies, and the distribution of C stock is treated as a distribution to which Section 355 applies, instead of as a single, integrated sale or exchange.[11]

The Ruling's analysis is based on the premise that the taxpayer's chosen form generally controls its tax treatment unless "(1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions." The Ruling concludes that the transfer of property to D in a nonrecognition transaction has independent significance, and should be respected as separate, given that Section 355 permits the receipt of an active trade or business in a nonrecognition transaction within the five-year period ending on the date of the spin-off. Further, it notes that no assets left corporate solution, and so the steps do not otherwise resemble a sale—so that according the two legs of the transaction independent significance (and in this case, nonrecognition treatment) is consistent with the congressional intent of Section

[11] Situation 1 presents the quintessential "north-south" case, which frequently recurs in corporate separations. Both the 2013 Report and a 2008 report from the Tax Section specifically sought guidance on this fact pattern. *See* New York State Bar Association Tax Section, *Formal Guidance for Stock Buybacks and "North South" Transactions* (Report No. 1162, Aug. 18, 2008).

351 and Section 355. It also noted that this holding would apply even if D acquired its business from a different subsidiary of P in a cross-chain reorganization under Section 368(a)(1) instead of via a contribution from P.

In Situation 2, D and C operate separate businesses, each of which constitutes a five-year active trade or business for purposes of Section 355(b). On Date 1, C pays a dividend of cash and property to D. On Date 2, D transfers appreciated property to C and then distributes all of the stock of C to P. The Ruling states that the Date 1 distribution was made "in pursuance of the plan of reorganization." The Ruling held that the distribution of cash and property by C on Date 1 is properly treated as part of the overall reorganization, and the "boot" rules of Section 361 apply. The Ruling does not list any facts that establish that the distribution of cash and property by C on Date 1 is in substance a separate transaction. Therefore, the Date 1 dividend will not be treated as a Section 301 distribution, and instead D will be required to recognize gain on its transfer of appreciated property to C to the extent of the "boot" received.

II. RECOMMENDATIONS AND COMMENTS

A. Clarify that the Holding of Situation 1 of the Ruling Applies Whether or Not the Contributed Assets Constitute an Active Trade or Business

Situation 1 of the Ruling describes a set of facts where the "north" and "south" legs of the transaction are not integrated. As noted above, this fact pattern is very common, and the analytical approach taken in the Ruling to respect the contribution and distribution as separate steps is sensible and constructive. One element of the stated facts, however, has attracted some notice. Specifically, in Situation 1, the assets contributed by parent to its subsidiary constitute an active trade or business, transferred for the purpose of enabling the subsidiary to satisfy Section 355(b). This has prompted some commentators to wonder whether the fact that the contributed assets were an active trade or business was somehow determinative of the holding, and if a different conclusion would apply if the contribution were of other assets.

We do not believe that the Ruling intended to premise the holding of Situation 1 on the fact that the contribution was made to enable the subsidiary to meet the active trade or business requirement. We note that the Ruling provides that "[t]he transfer thus is respected as a separate transaction*, regardless of whether the purpose of the transfer is to qualify the distribution under § 355(b).*"[12] Furthermore, the framework used by the Ruling to analyze Situation 1 should apply equally to contributions of property (including cash) not required to satisfy Section 355(b). We also note that public statements from representatives of the Treasury and the Service are consistent with this reading, and suggest that the reference to a contribution of an active trade or business was intended to provide comfort on the most difficult case for treating the contribution as separate.[13]

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[12] Emphasis added. We also note that the holding itself supports this interpretation by using the word "including": "[t]he transfer by P to its subsidiary, D, of property (including a transfer of property constituting an active trade or business for the purpose of meeting the requirements of § 355(b)(1)(A)), immediately followed by the distribution by D to P of the stock of its controlled subsidiary, C, is treated as an exchange to which § 351 applies, followed by a distribution of C stock to which § 355 applies."

[13] *See* Emily L. Foster, *Reverse Morris Trust Variations Still A Concern, No Action Taken*, TNT 141-4 (July 25, 2017) (relating statements made by Robert Wellen, Associate Chief Counsel (Corporate), concerning the scope of the Ruling, noting that "if practitioners think cash, for example, is the tougher case, the IRS will consider a ruling request, although he doesn't view it as a significant issue."). *But see* Emily L. Foster, *IRS Clarifies Spinoff Guidance, Welcomes Pre-Ruling Calls*, 2017 TNT 93-1 (May 16, 2017) (relating statements made by Susan Massey, assistant to the Branch 4 Chief, Office of Associate Chief Counsel (Corporate), noting that if D transfers cash or other property, instead of an active trade or business, taxpayers can pursue a north-south letter ruling as such cases would not be considered "comfort rulings[.]")

However, given that the amount of tax at stake in these cases is often very large, certainty is paramount to taxpayers. As a result, we suggest that the Treasury and the Service modify the Ruling to make this clear. For example, the last sentence of the analysis section of Situation 1 could be slightly reworded to say (new language in italics): "The federal income tax consequences would be the same (qualification under § 355) if, instead of acquiring an active trade or business in a § 351 transfer from P to D, D acquired an active trade or business from a subsidiary of P in a cross-chain reorganization under § 368(a)(1), *or D received cash or other assets not constituting an active trade or business from P in a § 351 transfer*."

We understand that the Service may have concerns about expending resources to amend the Ruling and we sympathize with those concerns. However, given the importance of certainty on this issue to taxpayers, making the relatively simple clarification proposed above is likely to conserve administrative resources by avoiding the need for the Service to consider private letter ruling requests from taxpayers to the same effect.

The Ruling does not refer to the compulsion test discussed above. We believe that the Ruling intended to articulate a new and controlling analytical framework for the "north-south" issues posed by Situation 1 and similar situations and that the compulsion test is no longer relevant in that context. We also believe that the Ruling's framework provides a better and more flexible construct for resolving "north-south" questions than the compulsion test, for the reasons discussed above.

The Ruling notes that the Service may decline to issue a letter ruling addressing "north-south" issues when appropriate in the interests of sound tax administration or when warranted by the facts of a particular case. The Ruling also notes that rulings are not issued in some areas because the issues are "inherently factual." These grounds for not issuing a ruling are customary and not specific to "north-south" issues. However, to the extent that the Service determines that it is unlikely to rule on particular "north-south" patterns, it would be useful for the Service to identify those cases. This would allow taxpayers greater ability to reflect that in their planning and, where appropriate, allow for the tax community to provide input and commentary on those fact patterns for the Service's further consideration.

B. Application of the Ruling's Principles to Situations Involving Multiple Entities

As discussed in the 2013 Report, the analysis of "north-south" fact patterns becomes even more complex when multiple parties are involved.[14] For example, the person that receives the distribution may not be the same person that makes the contribution. Similarly, the person that makes the distribution may not be the same person that receives the contribution. The 2013 no-rule policy implicated multi-party transactions, as it applied to cases where distributions were made to persons related to the person making the contribution.[15]

The Ruling notes that the result in Situation 1 would be the same if D acquired an active trade or business in a cross-chain reorganization. The Ruling does not address whether the result in Situation 2 would be the same if the distribution were made to a

[14] See the 2013 Report at 50-52 (Case 4).

[15] Rev. Proc. 2013-3, section 5.02(2) ("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). . . .") (emphasis added).

different party from the party making the contribution. Multiple-party fact patterns may be an interesting topic for future guidance, and we present the following scenarios as potential subjects of such guidance for consideration:

Scenario 1: Split-off with Debt Contribution.

> P and A (an affiliate of P) own all of the stock of D, which owns all of the stock of C. Pursuant to a single, integrated plan, (1) D splits off C to P in exchange for D shares and (2) A contributes intercompany debt to D.

As described in the 2013 Report, we believe this scenario represents a fairly common set of facts in which assets and liabilities are transferred among related entities in connection with a corporate separation or restructuring. Applying the analytical framework of Situation 1 of the Ruling to these facts produces a compelling case for treating the two legs of the transaction as independent. The fact that P, the receiving party in the "north" leg of the transaction, is different from the contributing party in the "south" leg, strengthens the case that the two legs of this transaction have independent significance and should be respected as separate.

Scenario 2: Distribution to Non-Contributing Entity.

> P owns D. A (an affiliate of P) owns historic voting preferred stock of C (representing less than 20% of C's voting power) and D owns all the voting common stock of C. C distributes cash to A as a regular dividend with respect to the preferred stock. D contributes appreciated property to C and then distributes the stock of C to P.

This scenario presents a variation on Situation 2 of the Ruling, except that the pre-spin dividend is not paid to D, but to an affiliate. We believe that the result in Situation 2 of the Ruling should not apply to this case, as the pre-spin dividend is not paid to a person that is a party to the reorganization between D and C. We do not think that dividends should be viewed as distributed in pursuance of a plan of reorganization merely because they are paid to a person that is related to a party to the reorganization. Indeed, we believe that the fact that the recipient of a distribution is not a party to the reorganization (or prospective reorganization that the distribution might be integrated with) is a significant fact that may establish that the distribution is a separate transaction.[16] Thus, absent other facts that argue for integrating the dividend and the reorganization, the dividend to A should be treated as a Section 301 distribution.[17]

Scenario 3: Distribution to Contributing Entity by Affiliate of Contributee.

> P owns D, and D owns C and S. S distributes property to D. D contributes property (including property received from S) to C and distributes the stock of C to P.

This Scenario is a variation on Situation 2 of the Ruling, as the contributing entity (D) receives a distribution from S, an affiliate of the entity (C) receiving the contribution. We believe that the "north" and "south" legs of the transaction in Scenario 3 should not be integrated. The "north" and "south" legs of the transaction are with different parties, and there does not appear to be any compelling policy reason to treat the distribution of property by S as made pursuant to the reorganization. As the transaction does not, when viewed properly, involve a distribution by C, the "boot" rules that control Situation 2 of the Ruling should not apply. Instead, the distribution by S, and the subsequent

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16 This is not in our view an absolute rule—there could be facts that indicate that a distribution by a corporation to one person should be integrated with a reorganization between the corporation and another person.

17 We believe that the conclusion of Situation 2 of the Ruling should not apply in this scenario, even if the preferred stock were owned by D. Although D is the same party making the contribution, the fact that the dividend is a regular dividend on historic preferred stock supports the treatment of the distribution as a separate transaction from the contribution. *See, e.g.*, Treas. Reg. § 1.301-1(l); Rev. Rul. 69-443, 1969-2 C.B. 54.

contribution to C and spin-off, should be respected as separate transactions.[18] We believe this is a relatively common fact pattern, as assets are often reallocated among group members in anticipation of a spin-off.

[18] *See* I.R.S. Adm. Mem. 2012-006 (Jul. 27, 2012) (transfer of an asset from a brother corporation to a sister corporation for no consideration was properly recast as a distribution of the asset by the brother corporation to the common parent, followed by a contribution to the sister corporation). The distribution could be viewed as a Section 368(a)(1)(C) reorganization if S liquidated into D and D then contributed some of the assets to C. Section 368(a)(2)(C), Treas. Reg. §§ 1.368-2(k), 1.368-2(m)(4) (Example 12). However, even in that case, the distribution of assets should not be viewed as having been made by C as a "boot" distribution governed by § 361.