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Federal Tax ADVISORY ■

MARCH 1, 2014

An Unusual F/D(?) Reorganization

LTR 201406005 evidently blessed as an F or D reorganization the transfer by a subsidiary of all of its assets to its parent corporation, despite the fact that the parent had previously bought an asset from its parent by assuming a liability greater than the value of the asset. We normally think that the one unmovable requirement of an F reorganization is that the acquiring corporation be "virgin," but it turns out that it may just need not to have different shareholders. The ruling did not specify what kind of Section 368 reorganization occurred, and it could have been a non-divisive D reorganization into a new corporation.

Facts: A U.S. person indirectly owns a CFC, Sub 2, that owns a DRE, Sub 3, that owns a CFC, Sub 5. Sub 2 contributes an asset to Sub 3, which assumes a liability greater than the value of the asset. Then Sub 3 checks the box to be regarded as a corporation. One day later, Sub 5 will merge sideways into a DRE owned by Sub 3. Therefore, Sub 3 will exist as a corporation before Sub 5 indirectly merges into it in exchange for what the ruling describes as 100 percent of the Sub 3 stock. Sub 2 will receive stock in Sub 3 solely in exchange for its stock in Sub 5, and otherwise does not own Sub 3 stock.

Ruling: The deemed incorporation of Sub 3 and the merger will be treated as a reorganization of Sub 5 into Sub 3. The ruling does not state what sort of reorganization it is. Sub 2's transfer of assets to Sub 3 for the debt assumption will be treated as a Section 1001 sale for the assets' fair market value, and the excess assumption is a Section 301 distribution by Sub 3. The E&P of Sub 3 will include the E&P of Sub 5, citing Rev. Rul. 70-240.

Representation: The taxpayer represented that "the Debt Assumption in excess of the value of the Additional Assets will be assumed by Sub 3 in recognition of Sub 2's capacity as a shareholder of Sub 3." Of course, Sub 2 was not a shareholder of Sub 3 as a corporation until after the merger, which occurred later.

Discussion: There are several unusual features about this ruling, including why the taxpayer wanted to do these transactions. It wound up putting an asset subject to a larger liability into Sub 5. It could have done that by pushing the asset and liability down through the DRE Sub 3 into Sub 5. Instead, it arranged a transaction that the IRS ruled to be an "upstream" reorganization of sorts—with the surviving corporation getting a cost basis in the asset pushed down, Sub 2 might recognize subpart F income on the Section 1001 exchange, but the liability assumption in excess of basis will be a separate dividend from Sub 5, rather than gain in a Section 351/357 exchange.

Perhaps achieving the dividend treatment was what the taxpayer wanted. The ruling was quite accommodating to reach that result, doing the following unusual things:

- allowing Sub 3 to check the box to be a corporation without acquiring any shareholder;
- treating all of the stock of Sub 3 as issued in the merger; and
- finessing whether the transaction was an F or D reorganization by just not saying.

Also, there is the interesting issue whether Sub 3 was solvent. Of course, if it owned Sub 5, it could have been solvent for that reason. However, Sub 2 was treated as owning Sub 5, so it looked like Sub 3 only owned the contributed asset and owed the larger debt. The other corporations were represented to be solvent, but not Sub 3. If Sub 3 were insolvent, that means a check-the-box incorporation can be done both to create an insolvent corporation and a corporation for the purpose of obtaining preferential dividend treatment.

Takeaway: The takeaway from this ruling is that Chief Counsel is willing to rule that boot of sorts, or maybe just liability assumption, is a dividend and not a gain item, if the transaction can be recast as a reorganization. Also, the Chief Counsel is willing to help taxpayers engineer pretty much any related corporation transaction into a reorganization. So—particularly in the CFC cases—taxpayers can get a dividend if they want one.

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