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Federal Tax ADVISORY ■

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Hook Stock Split Down

LTR 201404002

Rev. Proc. 2014-3 provides that the IRS won't issue rulings on "the treatment or effects of hook equity, including as a result of its issuance, ownership, or redemption." It defines hook equity as "an ownership interest in a business entity (such as stock in a corporation) that is held by another business entity in which at least 50 percent of the interests (by vote or value) in such latter entity are held directly or indirectly by the former entity."

But a recent ruling involved hook stock and predated the no-rule. LTR 201404002 involved a surprising but somewhat common use of Section 355 to eliminate hook stock. It requires the invention of yet another spinoff term—this time, the split-down. The split-down refers to the fact that the stock of the Controlled corporation will be exchanged (split) with a subsidiary of the Distributing corporation that happens to be a shareholder of Distributing, meaning it holds hook stock.

Facts

D-2, a foreign corporation, owns Controlled (U.S.) and it also owns D-1 (foreign), which owns D-4 (U.S.), which owns stock of D-2 (the hook stock). D-2 exchanges the stock of Controlled for the hook stock held by D-4. As a result, the hook stock is eliminated and two U.S. subsidiaries of this foreign group are combined. It is highly likely that D-4 acquired the hook stock in preparation for this very result.

D-4 also spun off another U.S. subsidiary, C-3. The business purpose for the split-down was to facilitate that spinoff. The IRS ruled that the split-down qualified under Section 355.

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Issue

This ruling is the first to use the term split-down. It is not clear, but the likely purpose for eliminating the hook stock was to make certain that D-2 was in the affiliated group of its parent, D-5, which was also to make a spinoff in the combined transactions. Being in an affiliated group means a corporation's active trade or business can be counted for purposes of Section 355, thus easing that requirement for a spinoff.

If the hook stock were 30 percent of the stock of the corporation immediately below D-5, it might not be affiliated with D-5, because D-5 did not own 80 percent control of one member of the group. The IRS should not have had much trouble issuing the ruling to the extent the issue was affiliated because the corporations could not avoid being affiliated.

It also is not surprising that the IRS allowed a corporate subsidiary to be moved down another chain of corporation by way of a Section 355 transaction. Section 355 transactions have become the go-to vehicle for subsidiary relocation in internal spins.

Reg. Section 1.355-2(b)(3) provides: "If a corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and which is neither impractical nor unduly expensive, then, for purposes of paragraph (b)(1) of this section, the separation is not carried out for that corporate business purpose."

The stock of Controlled could have been moved into D-4 tax free through capital contributions. But that would not have eliminated the hook stock. The taxpayer did not represent that there was no nontaxable alternative. Taxpayers seldom give that representation, but sometimes they do.

Conclusion

Hook stock, including hook equity of a partnership, can arise for "innocent" reasons and tax-motivated reasons. An innocent reason would be an acquisitive reorganization in which the target had some of the acquirer's stock. A high–profile, tax-motivated reason is the Killer B transaction, where the parent stock is bought from the parent, but then spent in another transaction, so it does not remain as hook stock.

The circular ownership issues should be manageable, as shown by this last ruling on hook stock.

For more information, contact Jack Cummings at (919) 862-2302.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333