



Federal Tax ADVISORY ■

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Hook Stock

What Is It?

Hook stock is stock issued by a parent corporation and held by its subsidiary. That does not seem very complicated—at first. We can imagine that occurring when a sub uses parent stock to carry out a triangular reorganization or to compensate employees of the sub. A little more obscure is the fact that hook stock necessarily results from a Section 304(a)(2) purchase by a sub of the parent's stock from its shareholder, resulting in possible treatment of the seller as receiving a dividend.

But hook stock has an aura of confusion, so there must be more to it. There is, though the "more to it" is actually a variety of cases, which adds to the confusion. Hook stock can involve:

- Not stock at all but a partnership interest, as when a corporation is a partner and the partnership owns its stock.
- Stock held by a controlled sub or an uncontrolled sub.
- Hook stock resulting from a purchase from the parent's shareholder, from a contribution by the parent, from a purchase from the parent, and from an inversion; and the purchase could be for cash, property or stock of the sub.

What's the Problem?

The immediate problem with hook stock is that since last year the Chief Counsel has refused to rule on transactions involving it. The no-rule defines hook stock or equity as something held by a 50 percent or more controlled entity. This is the same definition that is used for Section 304(a)(2). The Chief Counsel must think that if an issuer controls a shareholder, then the shareholder may not act independently and so transactions involving the hook stock are suspect.

The no-rule is an extension of several other no-rule areas that basically say the IRS will not assist taxpayers in forming tax shelters. But the fact that the no-rule is limited to controlled entities at least shows that sometimes hook stock is not problematic.

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Of course corporations control other corporations all the time and that does not prevent rulings. What makes hook stock different is two things. First, some of the issues are counting issues: how does hook stock count for purposes of the many Subchapter C rules that depend on a percentage of ownership or change of ownership, like Sections 1504 and 382? Generally, the default approach of the IRS is to treat hook stock like other outstanding stock: that is, it is not deemed to be treasury stock of the parent.

The more serious problem for the IRS is the concern that potentially taxable appreciated property can disappear from corporations without being taxed. This has been the issue with the long-pending "May Dept. Store" proposed regulations.

Prop. Reg. Section 1.337(d)-3

This 1992 proposal is now in the Treasury's business plan and could be finalized soon. The set of transactions at which the regulation aims is odd and the results are counterintuitive. For example, suppose a partnership buys a corporation. This is not an unusual event today. Partnerships are the acquisition vehicle of choice for lots of investors.

Then the partnership gets the idea that it would be nice to hold the corporation's business assets, or particular assets, inside the partnership. So the corporation contributes the assets to the partnership for a partnership interest.

The partnership interest is hook equity in the partnership, from the corporation's viewpoint. Or maybe the stock is hook equity in the corporation from the partnership's viewpoint.

From the Treasury's viewpoint, it can look like the corporation distributed the assets to its shareholder, the partnership. The proposed regulation would tax the corporation on the Section 311 gain in the assets.

Conclusion

Taxpayers can walk into the zone of this proposed regulation without even thinking about it. Maybe without having any tax savings in mind. But the tipoff is that hook equity exists in a controlled entity. That fact should cause taxpayers to come to a full stop and assess the potentials for an IRS recharacterization of their transactions.

For additional information, call [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

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

Matthew Moseley
202.239.3828
matthew.moseley@alston.com

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

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

Danny Reach
704.444.1272
danny.reach@alston.com

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

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

Heather Ripley
212.210.9549
heather.ripley@alston.com

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

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

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

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

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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 ■ 15th 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