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New Step Transaction Rulings

What Is It?

In May, the IRS issued two rulings dealing with the application of the step transaction doctrine to corporate transactions. Their basic message is this: form still controls the treatment of corporate transactions, absent a fairly weighty reason to rule otherwise.

The rulings eased practitioners' concerns about the so-called "triple drop and check," where a holding company drops a subsidiary down a chain of other subsidiaries and the traveling member checks the box and liquidates at the bottom. That is not a busted reorganization, but a series of Section 351 exchanges and a D reorganization.

Rev. Rul. 2015-9

Domestic corporation P transferred all of the stock of foreign subsidiary S-1 (an operating company) to P's wholly owned foreign subsidiary S-2, a holding company, in exchange for additional voting common stock of S-2; S-2 also owns X, Y and Z (all foreign operating companies).

Immediately thereafter, S-1, X, Y and Z transfer substantially all of their assets subject to liabilities to N, a newly organized subsidiary of S-2, in exchange for additional shares of N common stock, and then the four transferors "liquidate" and distribute their N shares to S-2. N will continue the businesses of the four corporations. With respect to the outbound transfer of the stock of S-1, P will enter into a gain recognition agreement and will take into account Reg. Section 1.367(b)-4.

The ruling found an outbound Section 351 transfer and four D reorganizations. Rev. Rul. 78-130 had ruled that the transactions could only be characterized as a foreign to foreign triangular C reorganization of S-1 into N, plus three D reorganizations. The new ruling states two reasons: (1) the form met the requirements of Section 351, and (2) "an analysis of the transaction as a whole does not dictate that P's transfer be treated other than in accordance with its form in order to reflect the substance of the transaction."

The ruling revoked Rev. Rul. 78-130. It had ruled that the same transactions could only be a triangular C reorganization and could not be a Section 351 exchange. It was issued to free the taxpayer from obtaining an approval required by Section 367 at the time. That approval is no longer needed.

The real problem with the prior ruling probably was that it purported to say that there could be only one correct nonrecognition treatment of the transactions. That was probably an overreach and might be the reason it was revoked, although that is not obvious. All the new ruling says is that the transaction is "properly treated" as a Section 351 exchange. Perhaps it could still qualify as both.

Rev. Rul. 2015-10

This ruling has similar facts except the stock is dropped down two more levels. The integrated transactions could not be a triangular C reorganization because P received "grandparent stock." This scenario had worried practitioners, although the Chief Counsel had been ruling for several years privately that Section 351 applied.

The ruling relied primarily on Rev. Rul. 77-449. It involved multiple contributions down a chain of property like a truck. It ruled that Section 351 applied to all such drops. The ruling was really unremarkable because there was no loss of control of the corporation to which the truck was contributed and there is no continuity of business required for Section 351.

Moreover, when the property dropped down is all of the stock of a corporation that subsequently liquidates into a corporation, transferring all of its assets, a completely different rule must be applied: Reg. Section 1.368-1(a), which requires the application of the step transaction doctrine in all cases to test reorganizations.

The ruling did not discuss that regulation but rather followed the same path as Rev. Rul. 2015-9 and said there was nothing to cause the IRS to deviate from the form of the transaction in treating it as first a Section 351 exchange.

Takeaway

As a general matter, practitioners should be happy for small favors. These rulings were not on the business plan, and the IRS did not have to issue them. It could have just made Rev. Rul. 78-130 obsolete without explanation. Now there will be fewer problems to worry about in internal group restructurings…. Until some taxpayer needs for that set of facts to be a triangular C reorganization for reasons we can't now foresee.

For additional information, call Jack Cummings at 919.862.2302.

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