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Insights into Recent Regulatory, Judicial and Legislative Developments

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The Elusive Upstream "C"

The Upstream C Reorganization

In the late 20th century, the IRS made a combination of unrelated decisions resulting in a proliferation of upstream C reorganizations. First was the repeal of the *Bausch & Lomb* rule, meaning that the equity held by a parent corporation in its subsidiary could count as continuity of interest, thus allowing the liquidation of a subsidiary to be treated as an upstream C reorganization. Second, the invention of the check-the-box regulations made subsidiary liquidations (and hence upstream reorganizations) so much easier.

Problem

However—sort of like the problems caused by the ease with which homeowners could take out home equity loans—the ease with which an upstream C reorganization can occur can cause problems. Most importantly, characterizing a subsidiary's liquidation as a reorganization means that the parent's exchange of stock for assets is not a recognition event. Therefore, if the parent really wanted to liquidate the subsidiary and recognize a loss (subject to various loss denial rules), it can be forced to "enjoy" a tax-free liquidation of its subsidiary.

The Foreign Subsidiary Case

Many U.S. multinationals have foreign operating subsidiaries that are heavily leveraged, often to the parent. In bad times, many of these subsidiaries may become technically insolvent. It has been fairly common practice to "liquidate" such a subsidiary, claim a stock and sometimes a debt loss, and later reincorporate the subsidiary (and sometimes do it all over again after a few years).

Obviously, the invention of the check-the-box liquidation made this technique much easier to carry out. Reg. Section 301.7701-3. At first, the IRS field was suspicious about the liquidation of a foreign subsidiary that appeared to keep operating its manufacturing plant (or whatever its business), without any change.

The Chief Counsel issued Rev. Rul. 2003-125 to underline the fact that a loss could be claimed in those cases. It describes such a liquidation by an entity classification election. The subsidiary's stock is worthless at the time of the liquidation. The ruling rules that the parent could claim a worthless security deduction under Section 165(g)(3)—its only concern was that the intangibles of the subsidiary be properly valued.

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But such a liquidation can look like an upstream C reorganization. Neither this ruling nor any other citing it has ever discussed that possibility. Presumably, the reason is that literally no assets were received with respect to the parent's stock interest, because all of the assets went to curtail the debt owed to the parent.

But what if the parent had held both common and preferred stock of the subsidiary and had received some distribution on the preferred but none on the common, and that lack of distribution on all shares was the reason Section 332 did not apply? That situation could look much more like an upstream C reorganization. And if the debt to the parent were treated as equity (preferred), that could also resemble a C reorganization. The result would be nonrecognition of loss.

The Decontrol Liquidation

Granite Trust Co. v. United States, 238 F. 2d 670 (1st Cir. 1956) approved the technique of a parent selling more than 20 percent of its stock in its wholly owned subsidiary so as to claim a loss upon the subsidiary's liquidation. The sale was intended to prevent Section 332 from applying to the liquidation and it did. Note, however, that *Fid. Int'l Currency Advisor A Fund, LLC v. United States,* 747 F. Supp. 2d 49, 230 (D. Mass. 2010), cast doubt on Granite Trust as continuing authority in the First Circuit.

But if the parent sells only 21 percent of the stock and the subsidiary liquidates and the parent receives 79 percent of all of the subsidiary's assets, has the parent received substantially all of the subsidiary's assets? If it has, then the liquidation can be an upstream C reorganization and the parent cannot recognize the loss on 79 percent of the stock, although it may have recognized loss on the sale of the 21 percent.

Conclusion

The invention of the upstream C reorganization out of what used to be treated as a liquidation is not always welcome. Taxpayers should be wary of a reorganization being forced on them when none is wanted.

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