This Month in M&A / Issue 2 / February 2014

M&A tax recent guidance

This month features:

- Proposed regulations address the determination of partners' shares of liabilities under Section 752 and certain deficiencies and technical ambiguities under Section 707 regulations (REG-119305-11)
- Proposed regulations subject tiered partnerships to mandatory basis adjustment rules, modify basis adjustment allocations, disallow Section 734 adjustments to corporate partner stock, adopt Sections 743(e) and 743(f), provide guidance for Section 704(c)(1)(C) application, and mandate Section 704(c) layers (REG-144468-05)
- Temporary regulations identify some stock of a foreign corporation that is disregarded in calculating ownership of the corporation when determing whether it is a surrogate foreign corporation under Section 7874 (TD 9654)
- Revenue procedures governing letter rulings updated (Rev. Procs. 2014-1, 2014-2, 2014-3)
- IRS applies discretionary rule to exclude intercompany gain from gross income (PLR 201402001)
- IRS underscores significance of SEC filings for Section 382 purposes (PLR 201403007)
- Redemption of hook stock in split-down transaction qualifies under Section 355 (PLR 201404002)

Did you know…?

Proposed regulations would reinvent the way partnership liabilities are allocated to partners. If finalized, most partnership agreements should be re-evaluated and potentially modified. The proposed regulations (REG-119305-11) would:
(1) fundamentally change the manner in which economic risk of loss is measured for purposes of allocating recourse partnership liabilities under Section 752; (2) reduce flexibility in the allocation of nonrecourse liabilities among partners; (3) clarify or amend a number of rules in the disguised sale regulations under Section 707; and (4) expand the definition of qualified liabilities under the disguised sale regulations.

The proposed amendments are noteworthy because an allocation of a partnership liability provides tax basis, which enables the partner to deduct losses and receive tax-free cash distributions from the partnership. A liability allocation also can allow a partner to receive a debt-financed distribution in connection with a property contribution without recognizing gain under the disguised sale rules to the extent the liability is allocable to the recipient partner under Section 752.

The proposed regulations

Allocation of recourse liabilities under Section 752

Under the existing regulations, a partnership's recourse liabilities are allocated to the partners that bear the economic risk of loss for the debt, which means the debt is allocated to the partner that would be obligated to make a payment if the partnership's assets became worthless and the liability became due and payable. The existing regulations assume that all partners and related persons will actually satisfy their payment obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.

The proposed regulations would replace the presumption that all partners and related persons will satisfy their payment obligations with objective requirements intended to establish commercial reasonableness. Under the proposed regulations, obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) would not be recognized for purposes of Section 752 unless two general requirements are met. First, the payment obligation of the partner or the related person must meet six specific requirements. Second, the partner or related person must satisfy a minimum net value requirement.

The six requirements are:

- the partner or related person must maintain a commercially reasonable net worth for the entire term of the payment obligation or must be subject to commercially reasonable restrictions on transfers of assets for nominal consideration;
- the partner or related person must periodically document its financial condition;
- the term of the payment obligation must not end before the term of the partnership liability;
- the payment obligation must not require that the partnership or any other obligor hold liquid assets that exceed the obligor's reasonable needs;
- the partner or related person must receive arm's-length consideration in exchange for assuming the payment obligation; and
- in the case of a guarantee, the partner or related person must be liable up to the full amount of the payment obligation if any amount of the partnership liability is not satisfied, and in the case of an indemnity, the partner or related person must be liable up to the full amount of the payment obligation if any payment is made by the indemnitee or other benefited party.

The proposed rules further provide that the payment obligation of a partner or related person (other than an individual or decedent's estate) for a partnership recourse liability (other than trade payables) will be recognized only to the extent of the partner's net value on the allocation date, generally determined without regard to any value attributable to the partnership under the rules of Reg. Sec. 1.754-2(k) currently applicable to partnership interests held by disregarded entities. The net value requirement, however, does not apply with respect to payment obligations relating to trade payables of a partnership or to any payment obligations of individuals or decedents' estates under the proposed regulations.

Allocation of nonrecourse liabilities under Section 752

The existing regulations permit a partnership to allocate its excess nonrecourse liabilities to its partners under Section 752 based on the manner in which the deductions attributable to the liabilities are reasonably expected to be allocated or in a manner that's reasonably consistent with the allocation of a significant item of partnership income or gain that has substantial economic effect.

The proposed regulations would replace these alternatives with an approach that permits the partnership to allocate the excess nonrecourse liabilities to its partners based on the partners' relative interests in the liquidation value of the partnership. For this purpose, a partner's liquidation value percentage is generally the amount of cash (expressed as a percentage) the partner would receive if the partnership sold all of its assets for fair market value, paid off its debts, and liquidated.

Disguised sales regulations under Section 707

The disguised sale regulations under Section 707 provide that a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property and, for non-simultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership.

The regulations under Section 707 provide a number of exceptions to disguised sale treatment. The proposed regulations would amend certain widely used exceptions to disguised sale treatment and address other technical ambiguities.

Among other proposals, the proposed regulations would:

- provide that the debt-financed distribution exception to the disguised sale rules applies before any other exceptions to disguised sale treatment under Reg. Sec. 1.704-4
- prevent a partner from 'double-dipping' or receiving reimbursement for pre-formation capital expenditures funded with an otherwise qualified liability
- revise the list of 'qualified liabilities' under the disguised sale rules to include any liability incurred in connection with a trade or business that was not incurred in anticipation of the transfer to the partnership, provided all assets material to the trade or business are contributed to the partnership and
- add a rule that a reduction to a partner's share of a liability assumed by the partnership will not be treated as an 'anticipated reduction' to the partner's share of the liability, provided the subsequent reduction is subject to the entrepreneurial risks of partnership operations.

The proposal described in the fourth bullet also would add a presumption that the reduction is anticipated if a partner's share of a contributed liability is reduced within two years of its contribution due to a decrease in the partner's net value, unless the facts and circumstances clearly establish otherwise. The proposed regulations under Section 707 also would provide specific rules applicable to tiered-partnerships.

Effective dates

The regulations under Section 707 are proposed to apply to transactions with respect to which all transfers occur on or after the date the proposed regulations become final. The proposed regulations regarding the allocation of partnership recourse and nonrecourse liabilities are proposed to apply to liabilities incurred or assumed by a partnership and, in the case of recourse liabilities, to payment obligations imposed or undertaken with respect to a partnership liability on or after the date the proposed regulations become final.

The proposed regulations also provide transitional relief for any partner to the extent that such partner's allocable share of partnership liabilities under Reg. Sec. 1.752-2 exceeds such partner's adjusted basis in such partner's partnership interest on the date the proposed regulations are finalized. The transitional rule generally permits a partnership to continue to apply the existing regulations under Reg. Sec. 1.752-2 for the grandfathered liabilities for a seven-year period from the date the proposed regulations are made final.

Observations

The proposed regulations under Section 707 would add a number of welcome changes and clarifications—generally taxpayer favorable—to the disguised sale regulations.

The proposed regulations under Section 752 are another story. If finalized in their current form, the proposed regulations would fundamentally change the manner in which partnership liabilities are allocated to partners. Many partnership liabilities that are treated as recourse liabilities under the existing rules would become nonrecourse liabilities allocated by reference to partnership profits rather than by reference to a refined concept of economic risk of loss. The 'all-or-nothing' approach to a partner's guarantee of a partnership liability effectively prevents bottom-dollar guarantees from being recognized as payment obligations. Partners would have to guarantee the first dollars of loss for the obligation to be recognized under the proposed regime. Any partnership liability structure relying on bottom-dollar guarantees or other economic risk of loss principles that are effective under current law would have to be revisited and possibly restructured.

The proposed change to the manner in which excess nonrecourse deductions are allocated potentially delinks the manner in which partnership nonrecourse liabilities are allocated from the manner in which related nonrecourse deductions are allocated. The liquidation value percentage method takes into account partners' interests in profits and capital and, consequently, may introduce its own distortions and complexity. Partnerships and partners will have to weigh the benefit of embracing this bright-line alternative against any unexpected repercussions that it may have.

Fortunately, the proposed regulations are not effective until finalized and contain a liberal transition rule with respect to the allocation of partnership recourse liabilities. The IRS and the Treasury Department are encouraging comments on the proposed regulations. Therefore, there is time to plan and comment before having to live with a fundamentally new approach to allocating partnership liabilities.

For additional information, please contact Todd McArthur, Susy Noles, John Schmalz, Elizabeth Amoni, or Megan Stoner.

Proposed and temporary Treasury regulations

IRS issues proposed regulations regarding the disallowance of partnership loss transfers, mandatory basis adjustments, basis reduction in stock of corporate partner, modification of basis allocation rules for substituted basis transactions, and miscellaneous provisions

Proposed regulations would usher in needed and largely anticipated changes to a variety of partnership provisions. Specifically, the proposed regulations would: (1) provide guidance for the application of Section 704(c)(1)(C) to the contribution of built-in loss property to partnerships; (2) apply the mandatory basis adjustment provisions to tiered partnerships; and (3) modify the Section 755 basis adjustment allocation rules applicable to partnerships with built-in loss property.

The proposed regulations also include other changes to Section 704(c) (mandating separate reverse Section 704(c) layers) and Section 734 (disallowing the allocation of a Section 734 adjustment to stock of a corporate partner), and adopt the statutory provisions of Sections 743(e) and 743(f).

The regulations are proposed to apply prospectively when finalized, generally to contributions and transactions occurring on or after the date final regulations are published, except that the rule modifying the allocation of Section 743(b) basis adjustments arising in substituted basis transactions would apply to transfers of partnership interests occurring on or after January 16, 2014.

Contributions of built-in loss property—Under Section 704(c)(1)(C), built-in loss with respect to property contributed to a partnership shall be taken into account only in determining the amount of items allocated to the partner who contributed such property. In determining the amount of items allocated to other partners, the partnership's basis in the property shall be treated as being equal to its fair market value at the time of contribution.

The proposed regulations would adopt a Section 743(b) basis adjustment model. Under that model, a Section 704(c)(1)(C) basis adjustment equal to a property's built-in loss upon contribution is created and recovered in the same manner as the underlying loss property. This adjustment is only for the benefit of the contributing partner. Specific rules address the treatment of the adjustment upon the transfer of the contributing partner's interest and disposal of the Section 704(c)(1)(C) property by sale or distribution to the contributing partner or another partner, and in other situations (eg, like-kind exchanges and installment sales). The Section 704(c)(1)(C) basis adjustment is subject to reporting rules similar to a Section 743 adjustment.

Mandatory basis adjustment provisions—Sections 734(d)(1) and 743(d)(1) require a downward basis adjustment to partnership property if a distribution results in a substantial basis reduction or upon the transfer of a partnership interest there is a substantial built-in loss in partnership property.

The proposed regulations would extend the mandatory downward Section 743(b) or 734(b) adjustment provisions to tiered partnerships. A mandatory downward adjustment resulting from transfers of partnership interests in, or distributions by, an upper-tier partnership that has a substantial built-in loss or substantial basis reduction allocable to an interest in a lower-tier partnership would be allocated to the lower-tier partnership's assets. The proposed regulations also would address exceptions from mandatory basis adjustments available to electing investment partnerships (EIPs) under Section 743(e) and to securitization partnerships under Section 743(f), and incorporate guidance and reporting requirements for EIPs initially provided in Notice 2005-32.

The proposed regulations also provide that:

- downward Section 734(b) adjustments cannot be made to the stock of a corporate partner (or any related person);
- a Section 754 election is deemed to be in effect only with respect to the transfer giving rise to the mandatory Section 734 or 743 adjustment; and
- for purposes of determining whether an upper-tier partnership has a substantial built-in loss in its assets, the fair market value of an interest in a lower-tier partnership is equal to its cash liquidation value plus its share of lower-tier partnership liabilities as determined under Section 752.

Required maintenance of separate Section 704(c) layers—Under current regulations it is unclear how to properly treat multiple Section 704(c) layers. As a result, practitioners commonly have applied one of two approaches: a layering approach, under which multiple Section 704(c) layers were created and maintained on the property, and a netting approach, under which layers were netted and one layer maintained on the property.

The proposed regulations provide that separate Section 704(c) layers must be maintained when a partnership revalues its property under Reg. Sec. 1.704-1(b)(2)(iv). The proposed regulations would expressly disallow the 'netting approach.'

The proper apportionment of the tax basis of Section 704(c) property among the Section 704(c) layers is also unclear under current regulations. The proposed regulations would provide that tax basis on revalued Section 704(c) property can be allocated among the various Section 704(c) layers based on any reasonable method.

Allocation of Section 743(b) adjustments arising from substituted basis transactions—The proposed regulations amend Reg. Sec. 1.755-1(b)(5), applicable to the allocation of a Section 743(b) adjustment arising from a substituted basis transaction. Under the proposed regulations, a positive adjustment is allocated between the classes of ordinary and capital assets in proportion to and to the extent of the transferee's allocable share of gross gain or gross income from a hypothetical sale of all assets in each class following the transfer.

Similarly, a negative adjustment is allocated between the classes of ordinary and capital assets in proportion to and to the extent of the transferee's allocable share of gross loss from a hypothetical sale of all assets in each class following the transfer. This is a change from existing Reg. Sec. 1.755-1(b)(5), under which a positive adjustment was allocated to a class only if there was *overall* net gain or net income in partnership property, and a negative adjustment was allocated to a class only if there was *overall* net loss in partnership property.

Within the classes, the proposed regulations change the method for allocating downward adjustments that exceed the transferee's share of unrealized depreciation in a class by allocating such excess among the *adjusted bases* of all property in the class (not only among the depreciated property in the class).

Observations

The proposed regulations set forth a series of changes to the existing regulations that, while substantial, were largely anticipated by most practitioners. Administrative complexity and hardship may result from certain provisions, but commentators generally agree that the proposed regulations reflect needed changes. One such hardship is the

requirement to push mandatory downward basis adjustments to lower-tier partnerships when the upper-tier partnership holds a small interest in and does not have access to a lower-tier partnership's books and records.

For additional information, please contact Todd McArthur, John Schmalz, or Kristel Glorvigen Pitko.

IRS issues temporary regulations identifying stock of a corporation that is disregarded when determining whether it is a surrogate foreign corporation.

Treasury and the IRS issued temporary regulations clarifying the application of Section 7874 to corporate inversions. The regulations formalize and clarify rules set forth in Notice 2007-98 with three significant modifications: two that expand the reach of Section 7874 and one that limits it. See the October 2009 edition of *This Month in M&A* for a discussion of Notice 2009-78.

Under Section 7874, a foreign corporation generally is treated as a surrogate foreign corporation if, pursuant to a plan, it directly or indirectly acquires substantially all the properties of a domestic corporation or partnership, and the shareholders or partners of the domestic entity own at least 60 percent of the stock (by vote or value) of the foreign corporation after the acquisition. Notice 2009-78 stated that regulations would be issued requiring the denominator (as well as the numerator) of the foreign corporation ownership calculation to exclude foreign corporation stock ('disqualified stock') issued for cash or other 'nonqualified property' in a transaction related to the acquisition of substantially all the domestic entity's properties (the Exclusion Rule). However, the regulations clarify that stock generally is disqualified stock only to the extent the transfer of such stock increases the fair market value of assets of the foreign acquiring corporation. The Exclusion Rule applies to publicly traded and privately held foreign corporations and, as the preamble to the regulations clarifies, applies regardless of the use of the nonqualified property.

The temporary regulations expand the definition of nonqualified property to include obligations of (i) a member of the expanded affiliated group that includes the foreign acquiring corporation; (ii) a former shareholder of the domestic entity, and (iii) any person related to a member of the foreign corporation's expanded affiliated group or to a former shareholder of the domestic entity.

Additionally, the Exclusion Rule applies if pursuant to a plan the foreign corporation stock issued for property is subsequently transferred by the transferee in satisfaction or for the assumption of one or more of the transferee's obligations associated with the transferred property. Also, the temporary regulations provide that disqualified stock cannot be purged by reason of a binding commitment sale to a third party.

A welcome addition in the temporary regulations is a de minimis exception limiting the application of the Exclusion Rule if the former shareholders of the domestic entity own less than five percent of the foreign acquiring corporation after the acquisition and all related transactions have occurred.

The temporary regulations generally are effective for transactions occurring on or after September 17, 2009, for matters addressed in Notice 2009-78, and on or after January 16, 2014, for matters not covered in Notice 2009-78.

Observations

These regulations continue the IRS's trend of expanding the scope of Section 7874, in some ways arguably beyond what Congress intended. Expanding the Exclusion Rule to disregard foreign corporation stock issued for certain obligations may make it more

difficult for foreign acquirers to avoid triggering Section 7874. Fortunately, the de minimis exception allows for some limited founder or management rollover in connection with cash acquisitions—though one can certainly argue that a higher threshold would be more appropriate as a matter of tax policy.

For additional information, please contact Carl Dubert or Timothy Lohnes.

Revenue procedures

Rev. Procs. 2014-1, 2014-2, 2014-3

The IRS published its 2014 revenue procedures for issuing private letter rulings (PLRs). The revenue procedures include a list of tax matters on which the IRS will not issue PLRs and a list of tax matters on which it ordinarily will not issue PLRs. The IRS may issue PLRs with respect to matters on the latter if the taxpayer demonstrates 'unique or compelling reasons' to justify the issuance of a ruling. In Rev. Proc. 2014-3, the IRS made several significant revisions to these lists:

- ***Hook stock***—The IRS ordinarily will not rule on the treatment or effect of 'hook equity,' including as a result of its issuance, ownership, or redemption. For this purpose, hook equity generally means an ownership interest in a business entity (A) held by another business entity (B) if A directly or indirectly owns at least 50 percent of the interests of B by vote or value.
- ***Granite Trust planning***—No rulings will be issued on the treatment of transactions in which stock of a corporation is transferred with a plan or intention that the corporation be liquidated in a transaction intended to qualify under Section 331. *See, eg, Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956).
- ***Rescissions***—No rulings will be issued on whether a completed transaction can be rescinded for US federal income tax purposes. The IRS had listed rescissions as under study in Rev. Proc. 2012-3.

Observations

These revenue procedures continue to reflect an attempt by the IRS Corporate Division to narrow its rulings practice. In the absence of a more robust ruling practice, taxpayers and practitioners remain optimistic that additional guidance on these and many of the other no-rule areas will follow. In the interim, however, taxpayers are left wondering whether the rulings in novel PLRs should be interpreted as a settled area of the law or if the government's views could shift. Speaking at the January ABA Meeting, IRS Associate Chief Counsel (Corporate) Bill Alexander clarified that the updates with respect to hook stock and *Granite Trust* planning in no way signal that the IRS does not believe in the substance of recent PLRs issued in those areas. Instead, he indicated that the IRS simply does not want to expend its time and resources on those issues.

For additional information, please contact Derek Cain, Bruce Decker, or Viraj Patel.

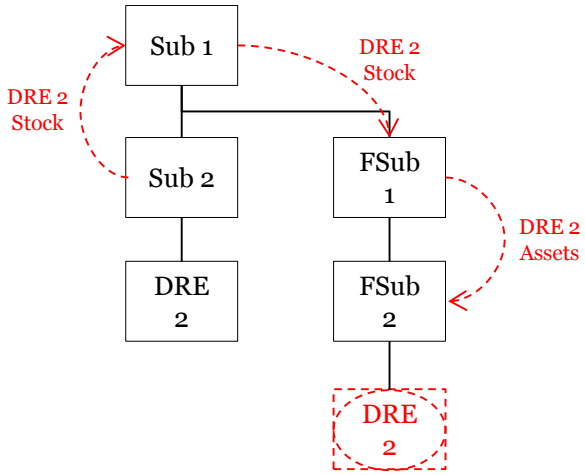
Private letter rulings

PLR 201402001

In this PLR, the IRS used the Commissioner's Discretionary Rule (CDR) in Reg. Sec. 1.1502-13(c)(6)(ii)(D) to exclude a deferred intercompany gain (DIG) created by an intercompany distribution of foreign corporation stock. See the January 2014 edition of *This Month in M&A* for a detailed discussion of the CDR.

Sub 1 was the common parent of a consolidated group (the Sub 1 Group) and wholly owned Sub 2, a member of the Sub 1 Group. Sub 2 owned the stock of DRE 2, a foreign company then treated as a corporation for US federal tax purposes. Sub 2 distributed the

stock of DRE 2 to Sub 1 in a taxable transaction, creating the DIG. DRE 2 then reorganized into a newly formed foreign company (FSub 1) in a drop-and-check transaction (the Reorganization). The taxpayer represented that the Reorganization qualified under Section 368(a)(1)(F) and that Sub 1's FSub 1 stock constituted a successor asset to the DRE 2 stock under Reg. Sec. 1.1502-13(j)(1). In an unrelated transaction, FSub 1 transferred DRE 2 to its wholly owned subsidiary (FSub 2).



The taxpayer proposed a series of transactions in which

1. FSub 2 would sell all the DRE 2 stock to an unrelated third party
2. Sub 2 would either convert to a single-member limited liability company and be treated as a disregarded entity of Sub 1 or merge with and into Sub 1, and
3. each of FSub 1 and FSub 2 would elect to be treated as a disregarded entity.

The IRS ruled that the FSub 1 liquidation would require Sub 1 to take the DIG into account under the matching rule of Reg. Sec. 1.1502-13(c), but that the DIG would be redetermined to be excluded from gross income under the CDR.

Observations

It appears the taxpayer did not qualify for relief under Reg. Sec. 1.1502-13(c)(6)(ii)(C) because the DIG was not created by an intercompany transaction involving member stock (ie, there is no indication in the ruling that DRE 2 was a member of the Sub 1 Group, for example by reason of a Section 1504(d) election). If this is the case, a possible argument for applying the CDR could have been the taxable repatriation of any earnings of FSub 1 and FSub 2 as a result of their liquidations (ie, Reg. Sec. 1.367(b)-3 likely required an inclusion of the all earnings and profits amount on the inbound liquidation).

Separately, FSub 1's role as a successor asset to the DRE 2 stock that created the DIG should not have—in and of itself—required the CDR as it should be viewed as the DRE 2 stock for purposes of the matching rule. This PLR illustrates the value in the retention of the CDR in the final regulations and that the IRS may stretch the CDR to grant relief in sympathetic cases.

For additional information, please contact Bart Stratton, Olivia Ley, or Brian Corrigan.

PLR 201403007

The IRS ruled that the taxpayer could rely on information, and the lack thereof, in SEC filings to identify its five-percent shareholders for Section 382 purposes. Taxpayer was a publicly held loss corporation. Entity A filed a Schedule 13G stating that it beneficially

owned more than five percent of the taxpayer's stock. It identified itself as a holding company and listed various related entities (the Related Entities) as owning a portion of these shares. Entity A stated that various persons had the right to receive or power to direct the receipt of dividends from, or the proceeds from the sale of, the taxpayer's stock, but that none owned more than five percent of the taxpayer's total outstanding shares. Entity A did not affirm the existence of a 'group' under Section 13(d)(3) of the Securities Exchange Act of 1934, and the taxpayer represented that there was no other indication that a group existed. None of the Related Entities filed a separate Schedule 13G stating it beneficially owned more than five percent of the loss corporation's stock.

The IRS ruled that the taxpayer could rely on the fact that Entity A did not affirm the existence of a group, and the absence of any other evidence of a group, to conclude that none of the taxpayer's shareholders were members of a group that constituted an 'entity' under Reg. Sec. 1.382-3(a)(1)(i), even if the Related Entities may have overlapping officers or directors. Additionally, the IRS ruled that the taxpayer will not be deemed to know that any of its shareholders constitute an 'entity' merely because an employee of the taxpayer may know that one or more of the Relevant Entities has overlapping officers or directors.

Observations

This PLR should provide helpful guidance to those attempting to identify a loss corporation's five-percent shareholders for Section 382 purposes, a process commonly defined by its patchwork of actual knowledge, regulatory presumptions, and reverse implications. It may be of particular value in a typical situation in which a mutual fund or private equity firm owns shares of a loss corporation through multiple related entities. Thus, it appears that merely being related may not be sufficient to require such entities to be aggregated, which seems consistent with prior guidance such as PLRs 200747016, 200806008, and 200902007.

The other ruling suggests that actual knowledge must meet some threshold level of materiality or reliability to be relied on for Section 382 purposes. It appears that in this PLR, an employee's potential knowledge of overlapping officers or directors among the loss corporation's shareholders did not cross that threshold.

For additional information, please contact Julie Allen or Neha Prabhakar.

PLR 201404002

As part of an overall public spinoff, an inbound multinational taxpayer used stock of a US corporation to redeem hook stock of one of its foreign corporations in a Section 355 transaction (the split-down). In the PLR, a publicly traded foreign corporation (Distributing 5) spun off one of its lines of business (Business A) (the spinoff). Prior to the spinoff, Distributing 5 and its affiliates first undertook several internal transactions to facilitate the divestiture, including the split-down, which involved Distributing 5's first-tier subsidiary (Distributing 2). Distributing 5 owned all of Distributing 2's class A shares, and several of Distributing 2's indirect US subsidiaries owned all its class B shares (ie, hook stock). In the split-down, Distributing 2 contributed property to a controlled corporation conducting Business B (Controlled 1) and distributed all its Controlled 1 stock to its class B shareholders in redemption of their class B shares. The IRS ruled that the split-down and the subsequent public spinoff each was a tax-free transaction under Sections 368(a)(1)(D) and 355.

Observations

The use of a split-off to redeem hook stock appeared to accomplish multiple objectives for this taxpayer. After the split-down, Distributing 5 wholly owned Distributing 2, which may have made the spinoff easier to accomplish. For example, had the split-down not

occurred, the spinoff may have been structured as a split-off, increasing the relative interests of the US shareholders owning hook stock in Distributing 2. Because the hook stock was foreign stock, query whether a split-off would have adversely affected the status of Distributing 2 as a foreign corporation that does not appear to be a CFC.

In addition, if Distributing 5 were a pure holding company, the split-down may have facilitated the public spinoff by enabling Distributing 5 to rely on a lower-tier entity for its active trade or business. In that regard, by eliminating the class B shares through the split-down, Distributing 2 may have joined Distributing 5's separate affiliated group (SAG), allowing Distributing 5 to rely on Distributing 2 and its fellow SAG members for its active trade or business. Finally, query whether the IRS would address this issue in a future ruling due to the restrictions on its ruling practice under Rev. Proc. 2013-32 and the recent update regarding hook stock on its no-rule list (see Rev. Proc. 2014-3).

For additional information, please contact Derek Cain, Colin Zelmer, or Matt Lamorena.

PwC M&A publications

In the article titled, *Buggy Code: Another Software Glitch in the Consolidated Return Rules,* published in *Corporate Taxation*, January/February 2014 issue, PwC M&A author Wade Sutton points out 'glitches under Section 1504 which the IRS can clarify.'

In the article titled, *Changing Your Mind With Check-the-Box,* published in Tax Notes on January 27, 2014, PwC M&A authors Gabe Gartner and Neha Prabhakar explore taxpayers' ability to use a CTB election to change the tax treatment of a prior stock transfer into that of a reorganization under Section 368(a)(1)(D).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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