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On the Subject

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Recent private letter rulings by the IRS illustrate the broad scope of tax planning available with respect to internal restructurings of controlled groups.

Recent IRS "North-South" Rulings

An issue that routinely arises both in corporate tax practice and in the Internal Revenue Service (IRS) private rulings program is whether a transfer of property (including money) from a shareholder to a corporation that occurs in temporal proximity to a distribution of property (including money) from the corporation to the shareholder should be viewed as an exchange. This so-called "North-South" issue often is raised in the context of spin-off transactions, but may arise in reorganizations or incorporations as well. Examples include transfers that are nominally contributions of cash, stock or other property by a shareholder that occur relatively close in time with purported corporate distributions of cash or stock. The tax consequences of such transfers may be changed radically if treated as exchanges. Of course, shareholders and corporations may engage in transactions denominated as sales, the form of which generally is not pulled apart into separate contributions and distributions by the IRS and the courts. Rather, the circumstances that typically cause concern are those in which the parties engage in formally separate transactions (*e.g.*, a spin-off distribution and an asset contribution to the distributing corporation) that occur at approximately the same time, but which the IRS may assert should be treated as in substance an exchange.

There are a number of different lines of IRS authorities addressing North-South issues. For example, Treas. Reg. §1.301-1(l) provides that a distribution is "within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense." The regulation states that this is most likely to occur in the context of a recapitalization or a reorganization under section 368(a)(1)(F). The IRS has applied a "but for" test in applying Treas. Reg. §1.301-1(l) based on a representation like "the separate distributions will take place regardless of whether any other steps of the proposed transaction are consummated" (PLR 9749018 [Sept. 11, 1997]; see also PLR 200752014 [Aug. 22, 2007]).

Historically, in a number of private letter rulings involving spin-off distributions qualifying under sections 355 and 368(a)(1)(D), the IRS has treated contributions of assets to a controlled corporation and temporally proximate cash distributions by the controlled corporation as separate, even though both are part of a planned restructuring in preparation for a spin-off. Following the form chosen by the parties, the rulings hold that the cash distributions are dividends, not boot in the section 368(a)(1)(D) reorganizations (PLR 9737018 [June 13, 1997]; see also PLR 9544004 [Nov. 22, 1994]). A similar issue may be presented when the distributee in a spin-off has contributed assets to the distributing corporation arguably as part of the spin-off plan (PLR 9708012 [Nov. 19, 1996]; PLR 9705018 [Nov. 4, 1996]; PLR 9651007 [Sept. 6, 1996]). These favorable (non-exchange) rulings have been issued even in cases in which assets were transferred to the distributing corporation so that the distributing corporation would satisfy the active trade or business requirement of section 355(b). No special representations were required.

In several spin-off rulings issued in recent months, however, the IRS has required the following representation in order for exchange treatment to be avoided:

> There is no regulatory, legal, contractual, or economic compulsion or requirement that the Contribution be made as a condition to the Internal Distribution. The fact that the value of Distributing will decrease as a result of the Internal Distribution was not a consideration in the decision to contribute property to Distributing. The Internal Distribution is not contingent on there being contributed to Distributing assets having a specified (or roughly specified) value.

See PLR 201033007 (May 21, 2010); PLR 201030005 (Apr. 28, 2010)

These rulings seem to reflect a conclusion that North-South transfers should be treated as made in exchange for each other if the property transferred to the distributing corporation is required to enable the distribution of the spinco (*e.g.*, the distributor's

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creditors require that the value of the spinco be replaced). Thus, the IRS appears to be narrowing somewhat its historic pattern of respecting form in addressing North-South issues, at least in the spin-off context. The test applied reflects a limited iteration of the "mutual interdependence" test that appears to be somewhat less restrictive than the "but for" test that the IRS has used in applying Treas. Reg. §1.301-1(l).

That the version of the step transaction test now being applied by the IRS in the spin-off context still allows substantial room for tax planning is illustrated by the most recent of the IRS's North-South spin-off rulings, PLR 201034005 (May 20, 2010). This ruling involved an extremely complex transaction in which the IRS respected certain exchanges labeled as such, but treated other transfers as separate based on the representation quoted above. This approach would seem to permit taxpayers to achieve optimal results through tax planning except to the extent external factors (*e.g.*, creditors, rating agencies) dictate that the property distributed be replaced. (Compare Rev. Rul. 85-164, 1985-2 C.B. 117, in which the IRS held that the consideration used in a part-sale, part-contribution transaction would be prorated.)

The private letter rulings described above illustrate the broad scope of tax planning available with respect to internal restructurings of controlled groups, even when the ultimate goal of each transfer is a distribution to public shareholders. The rulings also suggest that a ruling from the IRS may be useful in this context because in certain cases it may be difficult to reach a sufficiently high level of comfort in an opinion applying the step transaction tests to a transaction for which the IRS appears to be willing to issue a favorable private letter ruling.

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