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New IRS Spin on North-South Transfers and Step Transactions

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Acquisitions, dispositions, and restructurings can have a lot of moving parts. Large corporations typically deploy battalions of subsidiaries, drawn up in multiple tiers, as they advance on their assorted business, tax and regulatory objectives. The complexity of these ownership structures means that even simple transactions can lead to a good deal of fiddling with the organizational chart.

The necessary adjustments may involve the movement of assets or shares up the corporate chain, down the chain, or even across to cousins on another chain. Of course, corporate planners strongly prefer that these intra-group transfers not trigger any tax. But when two transfers *cross paths from opposite directions*, that goal can become problematic.

The most immediate concern is that the IRS will treat the reciprocal transfers as an *exchange*. If that happens, one or both parties may be forced to recognize gain pursuant to Code Sec. 1001(c). And even if the exchange is not taxable *per se*, recharacterizing the component transfers can upset the intended tax treatment of some *other* part of the overall transaction.

Revenue Ruling 2017-09: Regime Change?

Evaluating the risk of a recast is a standard part of tax practice, and the IRS rarely goes out of its way to make the task any easier. After all, uncertainty about where the lines are drawn—assuming there even *are* any lines—may deter aggressive tax planning. So, when the IRS issues guidance that resolves practitioners' nagging concerns about some series of transactional steps, it usually comes as a pleasant surprise.

M&A tax professionals were delighted by the issuance of Rev. Rul. 2017-09 [2017-1 IRB 1244], which addresses so-called "north-south transactions." These are reciprocal transfers undertaken so that an intra-group spin-off can qualify for tax-free treatment under Code Sec. 355(a). A few years ago, the IRS ominously designated north-south transactions an "area under study," which meant no more private

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rulings pending further guidance [*see* Rev. Proc. 2013-3, §5.02(2)].

Rev. Rul. 2017-09 lifts the letter-ruling embargo. Even better, the ruling concludes that the principal form of north-south transaction should *not* be recast as an exchange under the step-transaction doctrine. That is good news for practitioners, because recharacterization can torpedo efforts to qualify a spin-off under Code Sec. 355(a).

However, the significance of Rev. Rul. 2017-09 may extend far beyond spin-offs. Under the ruling, the step-transaction doctrine does not come into play unless following the *form* of the transaction would let the taxpayer enjoy tax results that the Code did not intend. If the IRS is serious about applying the step-transaction doctrine only to what we may term "opportunistic" transactions, tax planners should be able to stop worrying that a series of related steps will be collapsed *simply because they can be* under the traditional tests. No opportunism, no foul.

This pragmatic limitation would be useful to taxpayers whose transactions do *not* push the envelope, which is of course the great majority of them. As a theoretical matter, however, Rev. Rul. 2017-09 would be hard to square with a century of judicial decisions insisting on the almost metaphysical primacy of substance over form. But if there really is a new step-transaction regime in town, taxpayers are unlikely to object.

North-South Transactions

The basic north-south transaction involves three members of a corporate group occupying successive positions in an ownership chain. This gang of three can appear anywhere in the group, but it is convenient to assume that one of them is the group's parent.

Setup for a Spin-off

The first corporation (Parent) owns at least an 80-percent interest in the second corporation (Sub1). Sub1 owns an 80-percent interest in the third corporation (Sub2). Parent's stake in Sub1 and Sub1's stake in Sub2 both qualify as "control" under Code Sec. 368(c).

Parent (at the top of the chain) and Sub2 (at the bottom) are both engaged in the active conduct of at least one trade or business. But the corporation in the middle (Sub1) is a holding company. It owns the shares of Sub2 and possibly some other corporations, but it does not itself conduct a trade or business.

Required Parental Contribution

Sub1 would like to distribute the shares of Sub2 to Parent. Parent and Sub1 do not want the distribution to be treated as a dividend to Parent under Code Sec. 301, or to trigger recognition of gain to Sub1 under Code Sec. 311(b). The distribution of the shares of Sub2 needs to qualify as a tax-free spin-off under Code Sec. 355(a).

Under Code Sec. 355(b)(1)(A), however, a distribution cannot qualify unless both the distributing corporation (Sub1) and the controlled corporation (Sub2) are engaged in the active conduct of a trade of business immediately *after* the distribution. Sub2 will still be conducting its trade or business after the spin. But Sub1—a

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holding company—will not be conducting a trade or business before or after the distribution.

Code Sec. 355(b)(3)(A), added to the Code in 2007, sometimes comes to the rescue in these situations. Sub1 is credited with the trades or businesses conducted by the members of its "separate affiliated group" (SAG). Sub1's SAG consists of Sub1 and any corporations that would be considered part of Sub1's affiliated group under Code Sec. 1504(a), if Sub1 were the common parent. For SAG purposes, though, any limitations in Code Sec. 1504(b) on the types of corporations that can be included in an affiliated group are disregarded. [*See* Code Sec. 355(b)(3)(B).]

Sub1 may continue to own stock of other corporations after it spins off Sub2. However, let's assume that it does not own enough shares for any of them to be treated as member of its SAG. In that case, Sub1 will no longer be treated as conducting a trade or business following the distribution. Sub1 will therefore flunk Code Sec. 355(b)(1)(A)'s active-business requirement.

Obviously, this case calls for some pre-spin planning. If the problem is that Sub1 will not be conducting an active trade or business after the spin, why not have Parent contribute a trade or business to Sub1 in exchange for some additional shares of Sub1 before Sub1 distributes the Sub2 shares to Parent? We have assumed that Sub1 is in control of Sub2 within the meaning of Code Sec. 368(c), so Parent's contribution should not trigger recognition of any gain or loss [*see* Code Sec. 351(a)].

Of course, this means that Sub1 will acquire the crucial trade or business during the five-year period preceding its spin-off of Sub2. But this will not pose a problem under Code Sec. 355(b)(2) as long as: (1) the contributed trade of business would have qualified for Code Sec. 355 purposes while still in the hands of Parent; and (2) the contribution does not trigger recognition of gain or loss. Exchanging business assets for stock under Code Sec. 351(a) will do just fine.

Questioning the Spin

Once Sub1 has the contributed trade or business in place, it will distribute the shares of Sub2 to Parent. Will the distribution qualify as a tax-free spin-off under Code Sec. 355(a)? If it is considered on its own, yes. But *will* it be considered on its own?

The problem with our "pre-spin" planning is that it is part of a plan to spin off Sub2. Even without a "binding commitment" linking Parent's contribution of the trade or business to Sub1's distribution of the Sub2 shares [*see, e.g.*, *I. Gordon*, SCt, 68-1 USTC ¶9383, 391 US 83 (1967)], the practical nexus between the two steps could still cause them to be treated as a single transaction [*see, e.g.*, *American Bantam Car Co.*, CA-3, 49-2 USTC ¶9471, 177 F2d 513 (1949), *cert denied*, SCt, 339 US 920 (1950)].

If the reciprocal transfers are integrated, they could be recharacterized as an exchange to the extent that the values moving in each direction overlap. Suppose, for example, (1) that the trade or business contributed down the chain ("south") to Sub1 is worth $100; and (2) that the shares distributed up the chain ("north") to Parent are worth $400.

In a recast, Sub1 would be viewed as exchanging $100 worth of Sub2 shares for the $100 trade or business that Parent thought it was contributing to Sub1. With $100 of Sub2 shares diverted to this exchange, Sub1 would logically be viewed as distributing *only $300* worth of stock up to Parent. This has the potential to throw the tax treatment of the transaction completely out of kilter.

The Shock of Recognition

The first leg of the recast transaction (the exchange) would trigger recognition of gain or loss to both transferors. Sub1 would be taxable on its exchange of Sub2 stock for the $100 trade or business it received from Parent. Parent, in turn, would be taxable on its exchange of the trade or business for $100 worth of Sub2 shares.

Recharacterizing the reciprocal transfers could also have major tax implications for the *second* leg of the transaction. As noted, Sub1 would have only $300 of Sub2 shares to distribute to Parent in the spin-off. The consequences would be dire.

To satisfy Code Sec. 355(a)(1)(D), Sub1 must distribute shares representing "control" of Sub2. Even if we assume that Sub1 starts off owing 100 percent of Sub2, worth $400, its distribution of shares worth only $300 will represent only 75 percent of the total. That will fall short of "control" under Code Sec. 368(c).

Parent and Sub1 would then find themselves in a busted spin-off. Under Code Sec. 311(b), Sub1 would recognize gain on the distribution of the $300 of Sub2 shares. Parent would be taxable on its receipt of those shares in accordance with Code Sec. 301(c)—although Code Sec. 243 or other provisions might soften the blow.

Sub-Regulatory Relief

Rev. Rul. 2017-09 readmitted north-south transactions to polite society. It did so under the shadow of Executive Order 13771 (January 20, 2017), in which the Trump Administration had announced that the promulgation of each new federal regulation should be balanced by the repeal of two existing ones.

EO 13771's definition of "regulation" is broad enough to pick up revenue rulings, so the service proceeded gingerly at first. [*See* Donald P. Board, *Regulatory Freezes and Code Sec. 409A*, THE M&A TAX RERORT 1, 1–2 (May 2017).] Commissioner Koskinen stuck a tentative toe in the water on March 21, 2017. The Commissioner announced that the IRS would resume issuing certain forms of "sub-regulatory" guidance, *e.g.*, revenue procedures. For reasons unknown, however, reporting of the original list did not include revenue rulings.

By May, the IRS had regained its stride. Rev. Rul. 2017-09 laid out a scenario ("Situation 1") largely identical to the case of Parent, Sub1, and Sub2 outlined above. The issue, as the ruling framed it, was whether Parent's contribution of $100 of assets and Sub1's distribution of $100 of Sub2 shares were "part of a single reciprocal transfer of property—an exchange."

At this point, one might have expected Rev. Rul. 2017-09 to roll out one or more of the standard step-transaction tests to determine whether the contribution and distribution were really two faces of a single transaction. Of course, those tests must be applied, as the IRS always insists, based on all the facts and circumstances. That's difficult in a revenue ruling, which typically addresses a generic set of facts.

Rev. Rul. 2017-09 is notable because it resolved the integration issue *without* applying any of the standard step-transaction tests. According to the ruling, the place to start is by reviewing the "scope and intent" of each of the potentially relevant provisions of the Code. This is necessary because the tax treatment of a transaction "generally follows the taxpayer's chosen form" unless one of three conditions is met:

- There is a "compelling alternative policy;"
- The effect of all or part of the taxpayer's separate steps is to *avoid* a result intended by Code provisions that otherwise *would* have applied; or
- The effect of all or part of the taxpayer's separates steps is to *achieve* a result that is inconsistent with the intent of the Code provisions that *do* apply.

If none of these conditions is satisfied, that is the end of the inquiry—the taxpayer's form is accepted at face value. There is no occasion to consider whether any of the formally distinct steps should be integrated under one of the step-transaction tests. The specific facts and circumstances surrounding the taxpayer's steps are therefore irrelevant.

Testing for Code Opportunism

The basic idea in Rev. Rul. 2017-09 is that the tax system should not recast a transaction, unless following the taxpayer's chosen form would let the taxpayer get away with something the Code did not intend. The ruling treats the step-transaction doctrine as a *means* to advance the Code's purposes, not as an end itself. The doctrine should not be considered if its application would simply disrupt the intended tax treatment of an otherwise unobjectionable plan.

Rev. Rul. 2017-09's analysis of north-south transactions therefore begins by asking whether respecting their form would allow the participants to achieve tax objectives that are contrary to the intent of the relevant Code provisions. The ruling observes that, if Sub1 had *already* owned the necessary trade or business, its distribution of the Sub2 shares to Parent would have posed no problem under Code Sec. 355(a). If the parties qualify a spin-off by having Parent contribute a trade or business to Sub1 before the stock distribution, is that Code opportunism?

Policy *Versus* Happenstance

The revenue ruling comes at this question indirectly. It points out that nobody would object if, in a similar situation, Sub1 were to acquire the required trade or business by liquidating another subsidiary. [*See* Rev. Rul.

74-79.] Of course, that case is distinguishable, because the distribution of the liquidating subsidiary's trade or business up to Sub1 does not cross paths with Sub1's distribution of Sub2 shares up to Parent. Without reciprocal transfers, there is nothing to recharacterize as an exchange.

In a north-south transaction, Parent's contribution to Sub1 and Sub1's distribution to Parent are reciprocal transfers. Hence, it is at least *possible* to recharacterize the transaction as an exchange. But does that provide a *justification* for recasting the transaction? Under Rev. 2017-09, possibility is not enough.

The ruling requires us first to determine whether the transaction involves some form of Code opportunism. Parent is contributing a trade or business to Sub1 so that Sub1 can satisfy the active-business requirement of Code Sec. 355(b)(1)(A). Where is the abuse?

According to Rev. Rul. 2017-09, Code Sec. 355(b)(2)(C) and (D) are intended to prevent the active-business requirement from begin satisfied by a trade or business transferred by "an outside party" in a taxable transaction within the five-year pre-distribution period. Allowing an *inside* party (Parent) to contribute a qualifying trade or business to its controlled subsidiary in a *tax-free* transaction is consistent with the intent of those Code provisions.

What about Sub1's simultaneous distribution of Sub2 shares up to Parent? The ruling says that the purpose of Code Sec. 355 is to allow tax-free treatment of certain distributions that result in the continued ownership of property in modified corporate form. The fact that Sub1's otherwise-qualifying distribution of Sub2 shares to Parent happens to cross paths with Parent's contribution of assets to Sub1 does not contradict the intent of Code Sec. 355.

Hence, the taxpayers' chosen form does not involve any Code opportunism. That means there is no reason to consider whether the formally distinct steps of the transaction should be integrated under the step transaction doctrine. Under Rev. Rul. 2017-09, Parent's contribution to Sub1, and Sub1's distribution to Parent, are properly analyzed as *separate* transactions. It does not matter that the reciprocal transfers *could* have been integrated under one or more of the step-transaction tests.

Economic Substance Doctrine Compared

Under Rev. Rul. 2017-09, the step-transaction doctrine is like a power tool that cannot be plugged in unless it is first determined that following the taxpayer's form would produce effects not intended under the Code. It should also be noted that plugging in the doctrine does not mean that the taxpayer's formal steps *will* be integrated. It just means that the taxpayer's form will be *reviewed* to see whether a recast is warranted under the traditional tests.

Here, we can observe a significant parallel to the IRS's approach to the economic substance doctrine. Code Sec. 7701(o) declares that certain transactions will not be treated as having economic substance unless two conditions are met: (1) the transaction must change the taxpayer's economic position in a meaningful way apart from federal income tax effects; and (2) the taxpayer must have substantial purpose, apart from federal income tax effects, for entering into the transaction. [Code Sec. 7701(o)(1)(A) & (B).]

What is sometimes overlooked is the fact that the Code does *not* say that a transaction must have economic substance to be respected for tax purposes. Code Sec. 7701(o)(1) says that its two-pronged test applies only if the transaction is one "to which the economic substance doctrine is relevant." The Code does not say when the doctrine is "relevant." That must be determined as if Code Sec. 7701(o) "had never been enacted." [Code Sec. 7701(o)(5)(C).]

The IRS's limited guidance states that the economic substance doctrine is *not* relevant "when a taxpayer's treatment of an item is consistent with the congressional intent underlying the relevant Code sections." [ILM 201640018.] The IRS's focus on the intent of specific Code provisions—which is not always easy to divine—can be traced to the Joint Committee on Taxation's Technical Explanation of Code Sec. 7701(o). [*See* Robert W. Wood, *Acquiring Economic Substance with No Rudder*, THE M&A TAX REPORT 5, 6 (November 2010).]

Getting caught on the wrong side of the economic substance doctrine can cost the taxpayer a 40-percent penalty [*see* Code Sec. 6662(b)(6)]. So it is understandable that practitioners grouse about the doctrine's recourse to intent. The IRS has now adopted an analogous test as the threshold inquiry for application of the step-transaction doctrine. But practitioners will probably not object to a vague test, so long as it helps keep the doctrine unplugged.

Flight from Reality?

The IRS is free to decide, as a matter of administrative discretion, that it will not apply the step-transaction doctrine when the taxpayer's chosen form is consistent with the underlying intent of the relevant Code provisions. However, anyone who reads the classic step-transaction cases will notice the courts have typically treated the doctrine as more that a tool for blocking unintended results.

Traditional formulations state that a series of interrelated steps in an integrated transaction should be analyzed as a whole, because the legal and tax analysis should be grounded in what is "really" going on. In substance, there is a *single* transaction. For the IRS or the courts to treat the constituent steps separately would be inconsistent with *the fact of the matter*.

Under this conception of the step-transaction doctrine, one could ask whether the doctrine can be "turned off" simply because the results obtained under the taxpayer's form are consistent with the intent of the Code. After all, the facts are the facts. If the courts have a mandate to do substantial justice, how can they ignore substantial reality?

Suppose, for example, that Parent and Sub1 had unwisely entered into a contract *requiring* them to carry out both legs of their planned transaction. Under the "binding commitment" test, that would usually be enough to integrate Parent's contribution with Sub1's distribution. If this means the "reality" of the situation is that Parent is transferring a trade or business worth $100 to Sub1, and Sub1 is transferring $100 of Sub2 stock to Parent, a court could feel some pressure to treat the reciprocal transfers as an exchange.

Of course, if the IRS follows Rev. Rul. 2017-09, it is unlikely that a court will be put in the awkward position of having to "ignore reality." If the taxpayer's form produces a result that the IRS believes is consistent with the intent of the Code, the IRS will not seek to integrate the taxpayer's steps in the first place. An adventurous court might still find an occasion to invoke the step-transaction doctrine *sua sponte*, *e.g.*, to uphold a lower court's decision on appeal. But such rarities will not affect the general course of tax administration.

Conclusion

Rev. Rul. 2017-09 is obviously welcome news to anyone who needs to do a north-south transaction. But the ruling is potentially much more significant for its purpose-based limitation on the application of the step-transaction doctrine. That could be broad relief indeed.

If the IRS hews to the new line, it will not seek to collapse a series of formally distinct steps simply because it would be *possible* for it to do so under one of the traditional step-transaction tests. That will avoid "gotcha" scenarios, in which the intended tax treatment of a transaction would be flipped on its head without advancing any real Code objective. Under Rev. Rul. 2017-09, the fact that a recast would raise some additional revenue is *not* enough.