

Successive 351 Transfers Are Ok, Says Ruling

By Robert W. Wood • Wood LLP

Under Code Sec. 351, no gain or loss is recognized on a transfer of property to a corporation solely in exchange for its stock. A key requirement is that immediately thereafter, the transferors must be in control of the corporation. “Control” means 80 percent of the corporation’s total voting power and 80 percent of the total number of shares of all other classes of stock.

The courts have held that this 80-percent control requirement is not satisfied where, under a binding agreement entered into by the transferor before the 351 exchange, the

transferor loses control. Such a loss of control may occur in a taxable sale of all or part of that stock to a third party who does not also transfer property to the corporation in the Code Sec. 351 exchange.

However, some subsequent transfers do not spoil nonrecognition treatment. If the second transfer is a nontaxable disposition, the transferor holds a continuing interest in the property transferred, and the transferor could have taken an alternative path to achieve nonrecognition treatment. [*See Rev. Rul. 2003-51, 2003-21 IRB 938.*]

In the current climate of partnership and limited liability company transactions, such successive transfers are common. LTR 201506008 (Feb. 6, 2015) underscores the tax-free nature of the transaction that is not spoiled by a subsequent disposition. In the ruling, a partnership (#1) was comprised of several insurers who were combining their dental, life and health insurance businesses.

Partnership #1 owned 100 percent of the stock of Corporation A. It wrote and reinsured dental, life and health insurance contracts. Partnership #1 allowed the insurers to pool their risks, to increase their operating efficiencies and to provide broader product offerings to customers. To add additional insurers to the mix, Partnership #1 formed Partnership #2 with nominal cash.

The new insurers who wanted to join would contribute cash to Partnership #1 in exchange for units in Partnership #1. Partnership #2 acquired a dormant insurance company we will call Corporation C. Partnership #1 contributed

cash, and Corporation A and the new insurers contributed a share of their businesses to Corporation C.

This contribution was solely in exchange for Corporation C stock. However, under a preexisting binding plan, Partnership #1, Corporation A and the new insurers then contributed their Corporation C stock to Partnership #2 solely in exchange for units in Partnership #2. The ruling concludes that the transfer of assets by Partnership #1, Corporation A and the new insurers (who ended up as the Corporation C shareholders) was tax-free.

In each case, the IRS was comfortable that the assets were contributed in exchange for Corporation C stock, meeting the requirements of Code Sec. 351. Notably, the subsequent transfer of the Corporation C stock by the Corporation C shareholders to Partnership #2 was also blessed. It did not cause the contributions to Corporation C to fail to run afoul of Code Sec. 351.

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