# I.R.S. BREAKS THE SILENCE WITH REV. RUL. 2017-09, ISSUES GUIDANCE ON "NORTH-SOUTH" TRANSACTIONS

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On May 3, 2017, the I.R.S. issued Rev. Rul. 2017-09, 2017-21 I.R.B. 1244, which clarifies "north-south" transactions in two factual situations. This ruling reverses the I.R.S. no ruling position on north-south transactions that was issued in 2013.[1] A north-south transaction involves to a transfer of stock, money, or other property by a person to a corporation and a transfer of stock, money, or property by that corporation to that person (or a person related to such person) in what are ostensibly two separate transactions, at least one of which is a distribution with respect to the corporation's stock, a contribution to the corporation's capital, or an acquisition of stock.

## BACKGROUND

Generally, a dividend distribution made by a corporation to a shareholder with respect to its stock is includible in the gross income of the shareholder.[2] The portion of the distribution that is not a dividend is applied against and reduces the adjusted basis of the stock,[3] while the portion of the distribution that is not a dividend, to the extent that it exceeds the adjusted basis of the stock, is treated as gain from the sale or exchange of property.[4] If a corporation distributes appreciated property to a shareholder in a distribution to which Code §301 applies, gain (but not loss) is recognized to the distributing corporation as if it had sold the property to the shareholder at fair market value.[5]

No gain or loss is recognized when property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.[6] Furthermore, if certain requirements are met, a corporation may distribute stock and securities of a controlled corporation to its shareholders and security holders without recognizing gain or loss ("nonrecognition treatment") or income to the recipient shareholders or security holders.[7]

For a distribution to qualify for nonrecognition treatment, the distributing corporation must distribute stock or securities of a corporation it controls before the distribution.[8] A distribution will qualify for non-recognition treatment only if the distributing

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1 Rev. Proc. 2013-3, 2013-1 I.R.B. 113.

2 Code §301(c)(1).

3 Code §301(c)(2).

4 Code §301(c)(3)

5 Code §311(b)

6 Code §351(a)

7 Code §355(a)(1)

8 Code §355(a)(1)(A)

corporation distributes an amount of stock in the controlled corporation constituting control within the meaning of Code §368(c).[9] "Control" is defined as ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.[10] The distributing corporation and the controlled corporation each must be engaged in the active conduct of a trade or business immediately after the distribution.[11]

No gain or loss is recognized to a corporation that is a party to a reorganization upon exchange of property in pursuance of a plan of reorganization solely for stock or securities in another corporation that is also a party to the reorganization.[12] The definition of "reorganization" includes a transfer by a corporation of part of its assets to another corporation if, immediately after the transfer, the transferor is in control of the corporation to which the assets are transferred and the transferor distributes the stock in a transaction that qualifies under Code §§354, 355, or 356.[13] If property received in an exchange consists not only of stock or securities of the acquiring corporation but also other property or money (*i.e.*, "boot") and it is received in pursuance of a plan of reorganization, the corporation does not recognize gain from the exchange. However, if the corporation receiving the boot does not distribute it in pursuance of a plan of reorganization, any gain that the corporation realizes on the exchange of its property is recognized up to the amount and the fair market value of the boot that is not distributed.[14] If the acquiring corporation distributes property other than qualified property and the fair market value of such property exceeds its adjusted basis, then gain will be recognized as if such property were sold to the distributee at its fair market value.[15]

The gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in Code §1011 for determining gain, and the loss is the excess of the adjusted basis for determining loss over the amount realized.[16] Unless an exception applies, the entire amount of the gain or loss that was determined under Code §1001 is recognized on the sale or exchange of the property.[17]

No gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.[18] The underlying assumptions of these exceptions to the recognition of gain or loss under Code §1001 are that the new property is substantially a continuation of the old, still unliquidated investment or, in the case of a reorganization, that the new enterprise, the new corporate structure, and the new property are substantially continuations of

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9 Code §355(a)(1)(D)

10 Code §368(c).

11 Code §355(b)(1)(A)

12 Code §361(a)

13 Code §368(a)(1)(D).

14 Code §361(b)

15 Code §361(c)(2)(A).

16 Code §1001(a).

17 Code §1001(c).

18 Code §1232(a).

the old, still unliquidated structure.[19]

In prior rulings, the I.R.S. held that the requirement under Code §355(b)(1)(A) that the distributing corporation be engaged in an active trade or business was satisfied where the distributing corporation was (i) an inactive holding company and (ii) a subsidiary of the distributing corporation engaged in a Code §332 liquidation for the purpose of transferring its active trade or business to the distributing corporation.[20]

In 2013, the I.R.S. issued a ruling where a person (the "Transferor") transferred assets to a corporation (the "First Corporation") in exchange for an amount of stock in the First Corporation constituting control (the "First Transfer").[21] Pursuant to a binding agreement entered into by the Transferor with a third party prior to the First Transfer, (i) the Transferor transferred the stock of the First Corporation (the "Second Transfer") to another corporation (the "Second Corporation"); (ii) the third party transferred money to the Second Corporation (the "Third Transfer"); and (iii) the Second Corporation transferred the money it received from the third party to its wholly owned subsidiary, the First Corporation. Immediately after these transactions, the Transferor and the third party were in control of the Second Corporation and the Second Corporation was in control of the First Corporation. The I.R.S. ruled that the First Transfer satisfied the control requirement of Code §351(a), notwithstanding the Second Transfer. The I.R.S. concluded that the Second Transfer, a nontaxable disposition of the stock received in the First Transfer, was not inconsistent with the purposes of Code §351 because the transaction lacked the characteristics of a sale and the Transferor retained beneficial ownership in the assets transferred to the First Corporation.

In *Estates of Bell*, the Tax Court explained that sales of assets between a taxpayer's wholly owned subsidiaries followed by liquidating distributions "literally comply with the provisions of the Code dealing with complete liquidations . . . but in substance accomplish a reorganization coupled with the distribution of a dividend."[22] The court went on to state that, because Code §356 is "the exclusive measure of dividend income provided by Congress where money is distributed to shareholders as an incident of a reorganization," Code §§301 and 1.3011(l) were not applicable to the acquisitive reorganization under Code §368(a)(1)(D).

## NEW GUIDANCE

The I.R.S. raised two issues in the Rev. Proc. 2007-09:

- If a parent corporation ("P") transfers property (including property constituting an active trade or business that is transferred for the purpose of meeting the requirements of Code §355(b)(1)(A)) to its subsidiary ("D") and, pursuant to the same overall plan, this transfer is followed by a distribution by D of the stock of its controlled subsidiary ("C") to P, are the transactions treated, for Federal income tax purposes, as an exchange under Code §351 followed by a distribution under Code §355?

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[19] Treas. Reg. §1.1002-1(c).

[20] Rev. Rul. 74-79, 1974-1 CB 81.

[21] Rev. Rul. 200351, 2003-1 C.B. 938,

[22] *Estates of Bell v. Commr.*, [1971 PH TC Memo ¶71,285] T.C. Memo 1971285

- Is a transfer of money or other property by C to D, made in pursuance of a plan of reorganization under Code §368(a)(1)(D) and Code §355, governed by Code §§301 or 361?

To answer these issues, Rev. Proc. 2017-9 provides two explanatory scenarios.

**Situation 1 Facts**

P owns all the stock of D, which owns all the stock of C. The fair market value of the C stock is $100X. P has been engaged in Business A for more than five years, and C has been engaged in Business B for more than five years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of Code §355(b). D is not engaged in the active conduct of a trade or business, directly or through any member of its separate affiliated group (within the meaning of Code §355(b)(3)) other than C.

On Date 1, P transfers the property and activities constituting Business A, having a fair market value of $25X, to D in exchange for additional shares of D stock. On Date 2, pursuant to a dividend declaration, D transfers all the C stock to P for a valid corporate business purpose. D retains the Business A property and continues the active conduct of Business A after the distribution. The purpose of P's transfer of the property and activities of Business A to D is to allow D to satisfy the active trade or business requirement of Code §355(b)(1)(A).

**Situation 1 Analysis**

The Federal income tax consequences to P and D in Situation 1 depend on whether the Date 1 and Date 2 transfers are treated as separate transactions. Because they are undertaken pursuant to the same overall plan, a question arises as to whether the two transactions are part of a single reciprocal transfer of property – an exchange.

If the Date 1 and Date 2 transfers are respected as separate transactions for Federal income tax purposes, P would be treated as transferring property to D on Date 1 for D stock, in an exchange to which Code §351 applies, and D would be treated as distributing all the stock of C to P on Date 2, in a distribution to which Code §355 applies (assuming the requirements under those Code sections are otherwise satisfied).

If the Date 1 and Date 2 transfers are integrated into a single exchange for Federal income tax purposes, P would be treated as transferring its Business A property to D in exchange for a portion of the C stock, in an exchange to which Code §1001 applies. In such an exchange, gain or loss would be recognized to P on the transfer of its property to D; gain or loss would be recognized to D, under Code §1001(a), upon its transfer of 25% of the C stock to P in exchange for the property transferred to it. In addition, Code §355 would not apply to any part of the distribution of C stock because D would not have distributed stock constituting Code §368(c) control of C. Gain would be recognized to D, under Code §311(b), upon the distribution of the remaining 75% of the C stock with respect to P's stock in D to which Code §301 would apply.

The determination of whether steps of a transaction should be integrated requires a review of the scope and intent underlying each of the implicated provisions of the Code. The tax treatment of a transaction generally follows the taxpayer's chosen

form unless (i) there is a compelling alternative policy, (ii) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise applicable Code provisions, or (iii) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions.[23] Code §§355(b)(2)(C) and (D) permit the direct and indirect acquisition of an active trade or business by a corporation within the five-year period ending on the date of a distribution in transactions in which no gain or loss was recognized. The intent of Code §§355(b)(2)(C) and (D) is to prevent the acquisition of a trade or business by the distributing corporation or the controlled corporation from an outside party in a taxable transaction within the five-year pre-distribution period.[24] These provisions ensure that transfers of assets in transactions eligible for nonrecognition treatment (nonrecognition transactions) throughout the five-year period will not adversely impact an otherwise qualifying Code §355 distribution. This principle is illustrated in Rev. Rul. 74-79 in which an active trade or business was transferred to a distributing corporation in a Code §332 liquidation to satisfy the requirements of Code §355(b).

The transfer of property permitted to be received by D in a nonrecognition transaction has independent significance when undertaken in contemplation of a distribution by D of stock and securities described in Code §355(a)(1)(A). The transfer thus is respected as a separate transaction, regardless of whether the purpose of the transfer is to qualify the distribution under Code §355(b).[25] Back-to-back nonrecognition transfers are generally respected when they are consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy.[26]

***"Back-to-back nonrecognition transfers are generally respected when they are consistent with the underlying intent of the applicable Code provisions and there is no compelling alternative policy."***

P's transfer on Date 1 is the type of transaction to which Code §351 is intended to apply. Analysis of the transaction as a whole does not indicate that P's transfer should be properly treated other than in accordance with its form. Each step provides for continued ownership in modified corporate form. Additionally, the steps do not resemble a sale, and none of the interests are liquidated or otherwise redeemed. On these facts, nonrecognition treatment under Code §§351 and 355 is not inconsistent with the congressional intent of these Code provisions. The effect of the steps in Situation 1 is consistent with the policies underlying Code §§351 and 355. Accordingly, the Date 1 and Date 2 transfers described in Situation 1 are respected as separate transactions for Federal income tax purposes. Therefore, Code §351 applies to P's transfer on Date 1, and Code §355 applies to D's transfer on Date 2.

The Federal income tax consequences would be the same (qualification under Code §355) if, instead of acquiring an active trade or business in a Code §351 transfer from P to D, D acquired an active trade or business from a subsidiary of P in a

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[23] *H.B. Zachry Co. v. Commr.*, 49 T.C. 73 (1967); *Makover v. Commr.*, T.C. Memo 196753 [¶67,053 P.H. Memo T.C.]; Rev. Rul. 78330, 19782 C.B. 147. Code §§351, 355, and 368 generally allow continued ownership of property in modified corporate form without recognition of gain. See *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655 [13 AFTR 1052] (5 Cir. 1934), cert. denied, 293 U.S. 607 (1934); Treas. Reg. §1.10021(c); Rev. Rul. 2003-51.

[24] Rev. Rul. 78442, 19782 C.B. 143 (holding that Code §357(c) gain arising from a Code §351 transfer of an active trade or business does not violate Code §355(b)(2)(C)).

[25] Rev. Rul. 78330; Treas. Reg. §1.3556(d)(3)(v)(B), Example 1; and *Athanasios v. Commr.*, T.C. Memo 199572 [1995 RIA T.C. Memo ¶95,072].

[26] Rev. Rul. 20159, 201521 I.R.B. 972; Rev. Rul. 201510, 201521 I.R.B. 973.

cross-chain reorganization under Code §368(a)(1).[27]

**Situation 2 Facts**

P owns all the stock of D, which owns all the stock of C. D has been engaged in Business A for more than five years. C has been engaged in Business B for more than five years. Business A and Business B each constitutes the active conduct of a trade or business within the meaning of Code §355(b).

On Date 1, C transfers funds amounting to $15X and property having a fair market value of $10X to D, pursuant to a dividend declaration, and D retains the money and property. On Date 2, D transfers property having a basis of $20X and a fair market value of $100X to C, and D distributes all the C stock to P in a transaction qualifying as reorganization under Code §§368(a)(1)(D) and 355. C and D planned and executed the Date 1 transfer in pursuance of a plan of reorganization.

**Situation 2 Analysis**

If the distribution by C of money and other property on Date 1 is treated as separate from the distribution of C stock, Code §301 would apply to D's receipt of the money and other property from C, and no gain would be recognized to D upon the transfer of property to C. However, if the Date 1 distribution is treated as occurring in pursuance of a plan of reorganization under Code §§368(a)(1)(D) and 355 that includes the Date 2 distribution of C stock, the money and other property distributed by C to D would constitute boot to D, and under Code §361(b)(1)(B), gain would be recognized to D on its transfer of property to C to the extent of the amount of the funds and the fair market value of the property. Code §361(b) requires gain recognition to D if boot is distributed to D and not further distributed by D to its shareholders or creditors in pursuance of a plan of reorganization unless the facts establish that the distribution is in substance a separate transaction.[28]

As noted above, in *Estates of Bell* the Tax Court explained that the boot rules are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization." Code §361 broadly looks to whether transfers of money or other property occur "in pursuance of the plan of reorganization" or "in connection with the reorganization." Here, the distribution is made in pursuance of the plan of reorganization. A distribution of money and other property in pursuance of a plan of reorganization will be treated as boot subject to recognition of gain, consistent with the congressional intent underlying Code §361. Therefore, the Federal income tax treatment of the transaction will follow its substance, and the distribution of money and property by C to D will constitute a distribution of boot under Code §361(b).

## CONCLUSION

In Situation 1, the taxpayer's form was respected. The transfer by P to its subsidiary, D, of property immediately followed by the distribution by D to P of the stock of its controlled subsidiary, C, is treated as an exchange to which Code §351 applies,

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[27] See Rev. Rul. 74-79

[28] Cf., Rev. Rul. 71364, 19712 C.B. 182 (finding that a distribution of money declared and paid following a reorganization exchange is treated as boot in the reorganization).

followed by a distribution of C stock to which Code §355 applies. Conversely, in Situation 2, the taxpayer's form was not respected. Code §361, and not Code §301, applies to the transfer of money or other property by C to D made in pursuance of a plan of reorganization under Code §§368(a)(1)(D) and 355.

According to Rev. Proc. 2017-9, the taxpayer first must determine, under existing Code provisins and case law, whether the two transactions occur pursuant to one plan. Once it is determined, the tax treatment of a transaction will follow the taxpayer's chosen form unless (i) there is a compelling alternative policy, (ii) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise applicable Code provisions, or (iii) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions. This clarification provides useful guidance for a taxpayer planning to execute a north-south transaction and perhaps other multi-step transactions, as well.

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