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Focus on Tax Strategies & Developments

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Distinguishing Between Captive Insurance and Related Party Derivatives: Chief Counsel Advice Memorandum 201511021

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Overview

In Chief Counsel Advice (CCA) memorandum 201511021, the Internal Revenue Service (IRS) considered whether a contractual arrangement transferring foreign currency (FX) risk to a captive insurance company resulted in insurance for federal income tax purposes. After considering the tax definition of insurance, the IRS concluded that the arrangement should be taxed as a foreign currency derivative—rather than insurance—based largely on its view that the FX risk at issue did not qualify as an "insurance risk."

The FX Arrangement

The Taxpayer Group in the CCA is described as a group of related entities engaged in the design, manufacture, etc., of products and services in the environmental and life sciences sectors. The Taxpayer Group includes a regulated state law captive insurance company ("Captive") that provides coverage to the Taxpayer Group for a variety of risks.

Members of the Taxpayer Group engaged in sales and purchases in multiple currencies and were therefore exposed to risk of exchange rate fluctuations relative to the US Dollar (USD) that could adversely impact their results of operations and financial condition. To manage their FX risks, members of the Taxpayer Group entered into two types of contracts with Captive ("Contracts"). In exchange for a premium, Captive agreed to indemnify participating members for the "loss of earnings" resulting from a decrease ("Contract 1"), or an increase ("Contract 2"), as the case may be, in the rate of exchange of the USD against the specified foreign currency during the term of the contract up to the stated coverage limit. The loss of

earnings provision did not measure the actual loss suffered by a participating member as a result of exchange rate fluctuations, but rather provided a reasonable approximation of the participating member's actual loss. The CCA notes that no individual participant was expected to account for more than 15 percent of the premiums paid to Captive with respect to the Contracts.

The CCA indicates that the Contracts included many features commonly found in insurance policies. The Contracts excluded any loss otherwise covered under property insurance or business interruption insurance. There is no mention of any parental guarantee, premium loan back, or any other aspect of the arrangement that could be viewed as inconsistent with a bona fide insurance arrangement. The Contracts included an endorsement pursuant to which coverage was extended monthly. This monthly endorsement apparently operated to stagger coverage for twelve separate annual policies, which provided protection against a trend of a strengthening or weakening dollar (depending on which side the coverage related to).

Participating members of the Taxpayer Group paid deposit premiums to Captive upon entering into the Contracts. Deposit premiums were determined by multiplying the "rate of premium" by the coverage limit, with the rate of premium being set at twice the amount of the premium, as quoted by Bloomberg on the effective date, as a percentage of "notional" for a 12-month call option contract to purchase USD against the specified foreign currency. The actual premium was calculated after the Contract expired, based on the actual loss experience, as the lower of the "retrospective adjusted premium" (determined by reference to a specified percentage of the deposit premium less paid losses in excess of a specified percentage of the deposit premium) and the deposit premium. If the retrospective adjusted premium was less than the deposit premium, Captive refunded the difference to the participant; if the retrospective adjusted premium was greater than the deposit premium, however, the participant was not required to pay an additional premium to Captive.

Tax Definition of Insurance

The CCA summarizes existing guidance for determining whether an arrangement can be classified as insurance for federal income tax purposes, which has largely been developed by the courts due to the absence of an insurance definition in the Internal Revenue Code or the Treasury regulations. The courts have generally defined insurance as an arrangement involving (1) an insurance risk; (2) risk shifting and risk distribution; and (3) insurance in its commonly accepted sense.

Under the relevant authorities, the existence of an *insurance risk* is a prerequisite to classifying an arrangement as insurance for tax purposes. An insurance risk requires an element of fortuity or hazard, as opposed to a "risk of another nature, such as investment, or perhaps synonymously, 'business risk.'" The CCA notes that failure to achieve a desired investment return is "investment risk," not "insurance risk."

In evaluating the character of the underlying risk in a purported business insurance arrangement, all of the facts and circumstances associated with the parties and the context within which the arrangement was constructed are to be taken into account. This includes the nature of activities considered typically attendant to the operation of the business, what activities are in control of the parties, whether the risk at issue is a market risk, whether the insured is required by law to pay for the covered claim, and whether the action is willful or inevitable.

Classification of the Contracts

The IRS concluded that the Contracts did not satisfy the tax definition of "insurance" as established by the courts, based on its determinations that the Contracts lacked an insurance risk and failed to constitute insurance within the commonly accepted meaning.

LACK OF INSURANCE RISK

Noting generally that contracts that transfer risk are not automatically classified as insurance for tax purposes, the CCA concludes that the Contracts transferred investment (or business) risk, as opposed to insurance risk, as the FX risk underlying the Contracts "is solely the manifestation of fiat currency valuation." It noted that while Statement of Statutory Accounting No. 60, Financial Guaranty Insurance, describes protection against currency exchange rate risk as insurance, FX insurance does not appear to be commonly available from major carriers, and FX risks are typically managed with

derivative contracts. The CCA states that the Contracts resemble notional principal contracts or other section 988 transactions rather than insurance contracts. The CCA cites for support the fact that Contract premiums were determined by reference to commercially available pricing information for currency options (derivatives) and that the Contracts were “layered” through endorsements that expired monthly, producing periodic monthly settlements based on the trailing 12 months’ results. The CCA also notes that retrospective rating is common but observed that it was not clear that the formula in the Contracts was consistent with common retrospective rating methodologies. It appears that the IRS was influenced by the fact that the taxpayer represented that the Contract’s loss of earnings provision did not measure actual losses suffered by participating members as a result of changes in FX exchange rates, but rather provides a reasonable approximation” of actual losses.

The IRS also was influenced by its belief that the participants were primarily interested in making a profit, noting that failing to achieve a profit is an investment risk and the purchase of FX protection does not change the underlying nature of the risk but rather “only reduces or eliminates that risk.”

COMMONLY ACCEPTED DEFINITION OF INSURANCE

In addition to concluding that the Contracts lacked insurance risk, the CCA also concludes that the Contracts were not insurance in its commonly accepted sense. While the CCA acknowledges that the Contracts had many features typically found in insurance policies, according to the CCA, the Contracts did not contemplate a casualty (fortuitous) event, but instead indemnified participants for loss of earnings due to changes in FX exchange rates. The IRS’s analysis of whether the Contracts constituted insurance within the commonly accepted definition was largely limited, however, to a discussion of its views on whether the underlying risk was an insurance risk.

Observations on the CCA’s Analysis of Insurance

The CCA should be taken for what it’s worth, which is a one-sided expression of the IRS’s views as to the proper tax characterization of particular transactions. Nevertheless, the CCA is important in that it reflects the IRS’s current thinking on the issue of whether contractual protection can give rise to insurance risk rather than business or investment risk. This issue currently is being addressed in *R.V.I. Guaranty Co., Ltd. v. Comm’r* (Docket No. 27319-12) (*RVI*). The primary issue in *RVI* is whether residual value insurance policies issued to unrelated insureds result in insurance for federal income tax purposes. Residual value insurance is generally purchased by the owner of leased property and protects against decline in value of such property at the end of the lease term. The IRS’s position in *RVI* is that the policies are not insurance because, among other things, they do not cover insurance risk but rather merely operate to protect policyholders against market risk and as a result lack the element of fortuity. In other words, the loss protected by the policies is not a casualty loss but rather is an economic loss arising at the end of the lease itself. In contrast, the taxpayer in *RVI* argues that the policies relate to an insurance risk because the requisite fortuity is present and the lease agreements give rise to more than mere speculative or investment risk. The taxpayer finds fortuity in the multitude of events potentially leading to the end of the lease agreement. *RVI* was tried before the Tax Court in September 2014. As of the date of this article, the Tax Court had not issued its opinion.

The CCA’s insurance classification analysis is also important in that it appears to be the first administrative guidance relating to the definition of insurance for tax purposes following the Tax Court’s decisions in *Rent-A-Center*, 142 T.C. No. 1 (January 14, 2014), and *Securitas*, T.C. Memo 2014-225. In considering whether the arrangements at issue resulted in insurance for federal income tax purposes, in both cases the Tax Court viewed risk distribution from the perspective of the insurer rather than the insured. The question was whether the captive insurer was exposed to a sufficiently large pool of risks and whether the risks were statistically independent (rather than focusing on the number of insured affiliates). Although neither of these cases was appealed by the IRS, to date the IRS has not acquiesced to the decisions.

The CCA reflects the IRS’s litigating position with respect to insurance risk versus investment or business risk. Whether the CCA will influence the market for contracts such as those considered in the CCA may depend in large part on the Tax Court’s decision in *RVI* and any subsequent appeal.

Classification Implications

Beyond the insurance classification issues addressed by the CCA, it is important to consider the impact of these issues on the parties' resulting tax consequences. If the Contracts are properly classified as insurance, participating members would be entitled to claim expense deductions for premiums paid to Captive, typically deducted over the life of the contract, and payouts received by participating members of the Taxpayer Group from Captive would be classified as tax-free insurance proceeds.

By contrast, characterizing the Contracts as FX derivatives would mean that participating members would take payouts received from Captive into account in determining whether any such Contracts result in taxable income or loss (with such gain or loss equaling the difference between any payouts received by a participating member and premiums paid to Captive). The Contracts likely would be characterized, for tax purposes, either as options or potentially as currency swaps (due to the monthly endorsements potentially resulting in periodic settlements). It would be expected that any such FX "derivatives" would be classified as "section 988 transactions," resulting in ordinary gain or loss under section 988 and the regulations thereunder.

From Captive's perspective, if the Contracts are properly classified as insurance, Captive would generally take premiums received into income over the life of the Contracts, and would take an actuarially determined deduction for payouts. By contrast, classifying the Contracts as FX derivatives would result in ordinary gains or losses to Captive under section 988, with income or loss being taken into account under the general timing rules for the type of derivative (which as noted above, would likely result in the Contracts being classified as either options or currency swaps).

Derivative classification also raises an additional question of whether Captive could be considered a dealer in securities under section 475 and the regulations thereunder, which provide that a taxpayer may be considered a dealer in securities even if its only customers are related parties, to the extent such customers include related entities that are not part of the taxpayer's U.S. consolidated federal income tax group. Securities dealer classification would subject Captive to mark to market accounting under section 475, which could have potential consequences to Captive beyond the Contracts themselves.

Achieving Tax-Free 'Rollover' Treatment for Certain Shareholders in Acquisition of Publicly Traded Target Company

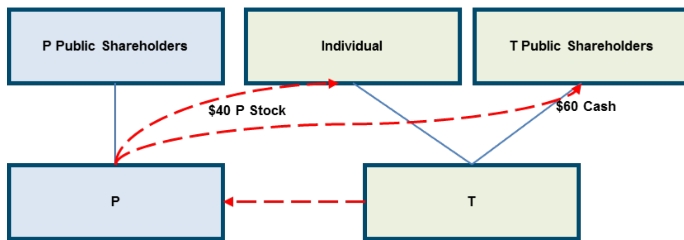
Michael J. Wilder and Britt Haxton

Introduction

A common issue that arises when structuring a corporate acquisition of a public company is that a tax-sensitive shareholder of the target corporation (T) requires tax-free treatment while the remaining shareholders do not. For example, assume that an acquiring corporation (P) seeks to purchase T (which has fair market value of $100), that 60 percent of the T stock is widely held by the public and that 40 percent of T is owned by a single family or individual (Individual). P would prefer to acquire all of T for cash, and the public shareholders may generally be indifferent to tax considerations (*e.g.*, where T stock is held primarily by tax-exempt pension funds), but Individual demands tax-free rollover treatment of his/her T shares. This article addresses four methods for structuring P's acquisition of T to achieve taxable treatment for the public and tax-free treatment for Individual. In the discussion below, P and T are domestic corporations, but a similar analysis frequently applies when P and T are foreign.

Reorganization Under Section 368(a)(1)(A)

The simplest structure from a U.S. federal tax perspective for providing Individual with tax-free rollover treatment under the scenario presented above is a reorganization under section 368(a)(1)(A) (an "A" reorganization) of the Internal Revenue Code. The A reorganization can be accomplished through a direct statutory merger of T into P or a merger of T into a disregarded entity or subsidiary of P. In order for the reorganization to be tax-free, at least 40 percent of the value of the total consideration paid to T shareholders must be in the form of P stock (the "continuity of interest" requirement). Thus, T can merge directly into P, with the T shareholders collectively receiving a total of $40 of P stock and $60 of cash.



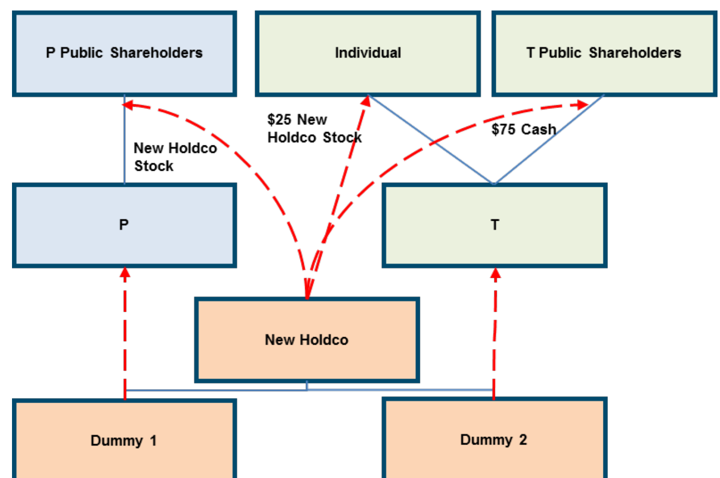
In the example above, all tax objectives will be achieved if the $40 of P stock can be directed to Individual (who will receive tax-free rollover treatment on the exchange of T stock for P stock) and the $60 cash can be directed to the public T shareholders. Depending on the jurisdiction, securities and corporate law may or may not prevent P from effectively ensuring that the public receives solely cash and Individual receives solely the P stock. For example, certain states permit the P stock to be offered to shareholders that tender the most T stock (*i.e.,* Individual). Other jurisdictions impose stricter protections for public shareholders, which may necessitate P offering potentially costly financial incentives to obtain the necessary cooperation from the T shareholders.

Meeting the 40 percent continuity of interest requirement can also pose practical issues. The parties will typically want to negotiate the major economic terms of the reorganization, but fluctuations in the value of T or P before closing can impact whether the amount of P stock and cash intended to be delivered at closing will actually meet the 40/60 ratio on that date. Treasury regulations provide a helpful "signing date" rule for measuring continuity of interest that allows the parties to agree to an exchange ratio that satisfies the 40/60 test when the original merger agreement is signed (so that subsequent value fluctuations do not disqualify the merger on the closing date). However, the signing date rule can prove difficult to satisfy, particularly where disparate consideration must be offered to different groups of T shareholders (as described above).

The 'Double Dummy' Structure

A second structure for combining P and T with tax-free rollover treatment is known as the "double dummy" structure. In a double dummy structure, P may acquire T using a larger percentage of cash consideration than 60 percent because the transaction is not geared to satisfy the requirements of an A reorganization, but rather the more flexible requirements for a tax-free section 351 exchange. Note that section 351(a) provides that a transfer of property (including stock) to a corporation in exchange for stock will be tax-free if one or more transferors own at least 80 percent of the stock (within the meaning of section 368(c) of the transferee corporation immediately after the exchange (the "control" requirement). The double dummy structure thus commonly is used when P seeks to issue more than 60 percent cash in the exchange (*e.g.*, where Individual owns only 25 percent of T and P wants to purchase the remaining 75 percent of T for cash).

A double dummy structure involves P or T forming a new holding corporation (New Holdco), which in turn forms two wholly owned merger subsidiaries (the "double dummy" corporations). Dummy One merges into P (the P merger) and Dummy Two merges into T (the T merger), with P and T each surviving the merger as wholly owned subsidiaries of New Holdco. In the P merger, the P shareholders receive solely New Holdco stock in exchange for their P stock; in the T merger, Individual receives $25 of New Holdco stock and the T public shareholders receive $75 cash in exchange for their T stock.



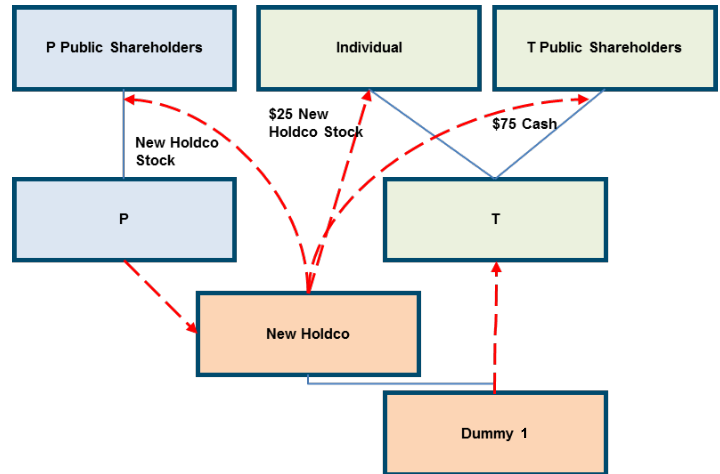
Because T and P survive the reverse mergers, the transitory existence of the dummy corporations is disregarded for federal tax purposes and the transaction is treated as if the P and T shareholders transferred their stock to New Holdco in exchange for New Holdco stock (or $75 cash in the case of the T public). Treating the reverse mergers as stock transfers ensures that there is no risk of a corporate level tax on the assets of P and T. In addition, the P and T stock exchanges are designed to qualify for tax-free treatment at the

shareholder level under section 351. That is, the shareholders of P and Individual constitute a section 351 "control group" who own in the aggregate 100 percent of the stock of New Holdco following the exchanges. Thus, the P shareholders and Individual should each obtain tax-free treatment under section 351(a).

As stated above, this structure is frequently useful for a merger of equals where Individual owns less than 40 percent of T or the continuity of interest requirement is otherwise difficult to satisfy. Drawbacks of this structure include the fact that the P shareholders generally must participate in and vote for the exchanges (although under Delaware law, the vote by P shareholders can sometimes be avoided) and that P, which may be a much larger publicly traded company than T, will end up as a subsidiary of a new public holding company. If it is undesirable for P to become a subsidiary of New Holdco, the "single dummy" structure (discussed below) is a viable alternative.

The 'Single Dummy' Structure

A single dummy structure is a variation of the double dummy structure where P merges directly into New Holdco rather than becoming a subsidiary of New Holdco, thus enabling P's business to continue in the top-tier public company. In a single dummy structure, P forms New Holdco and New Holdco, in turn, forms a single new subsidiary (Dummy One). Dummy One then merges into T, with T surviving as a wholly owned subsidiary of New Holdco. Here, the T public receives $75 of cash and Individual receives $25 of New Holdco stock. Immediately after T's merger, P merges into New Holdco, with New Holdco surviving and the P shareholders receiving New Holdco stock. Once again, the combination of T and P into New Holdco is designed to qualify as an overall section 351 exchange, so that Individual can obtain rollover treatment, but the technical tax analysis differs slightly. Specifically, Individual and P will be considered co-transferors in a section 351 exchange, with Individual obtaining section 351 treatment and the P shareholders obtaining tax-free reorganization treatment under section 354.

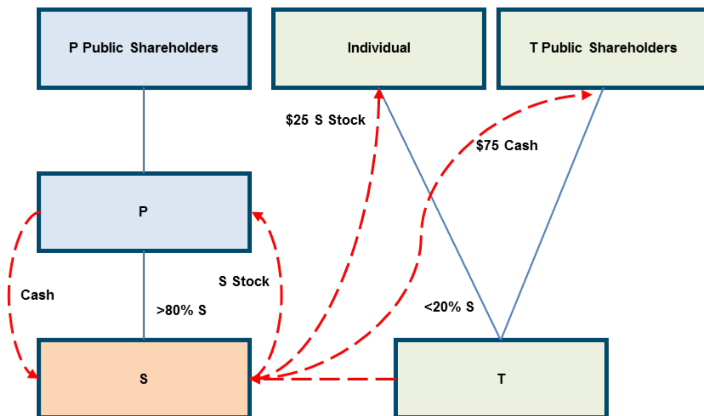


To reach a good comfort level for a single dummy acquisition, it is important that (i) the transaction be structured so that the merger of P into New Holdco cannot qualify as a reorganization under section 368(a)(1)(F) (which is achieved by completing the T merger before the P merger), and (ii) the incorporation of New Holdco or the P merger achieves some business objective beyond satisfying section 351 (which is usually the case).

Convertible Stock

A fourth alternative is for P to form a new subsidiary (S) with cash and cause S to acquire the T stock. In this alternative, S buys out the T public shareholders with the cash and acquires Individual's T stock in exchange for S stock; P and Individual are treated as co-transferors in the section 351 exchanges with S, with Individual obtaining tax-free treatment. Although Individual will initially hold a less liquid minority interest in S stock, Individual will also be given a conversion right so that he/she can exchange the S stock for a more liquid interest in P's publicly traded common stock after a period of time (*e.g.*, one year after the acquisition).

Due to the issues presented by the conversion feature, this structure is less desirable, but it has been used when the alternatives listed above are not workable (for example, News Corporation acquired all of the shares of Dow Jones & Company using this structure in 2007).



Crucially, the subsequent conversion of S stock into P stock will be a taxable exchange for Individual. Other planning considerations also should be kept in mind when structuring the transaction (*e.g.,* the S stock should participate to some extent in corporate growth to avoid potential concerns under section 351(g)) in order to successfully defer the recognition of Individual's gain until the time of conversion.

Thus, while this structure has the advantage that P does not have to merge or be contributed to a holding company, the additional tax complexities of the conversion arrangement mean that the tax treatment is somewhat less assured.

German Real Estate Transfer Tax: A Trap for the Unwary Multinational

Annette Keller and Nina Siewart

German Real Estate Transfer Tax (RETT) is an important cost factor in mergers and acquisitions, real estate transactions in Germany and intra-group restructurings. Despite the German legislature's widely advertised intentions to enable RETT-neutral intra-group restructurings, recent developments have increased the scope of the tax's application. Based on the wide range of transactions that trigger RETT and the steady increase of the applicable tax rates in recent years, the application of exemption rules and anti-abuse provisions in the RETT is among the key structuring considerations for many transactions.

What Kinds of Transactions Trigger RETT?

German RETT is triggered by the following transactions in particular:

- Transfer of ownership in German real estate to another legal entity, *e.g.*, by way of a sale. The rule also applies to transfer of real estate in corporate restructurings, such as mergers, spin-offs, split-ups or contributions of assets.
- Transfer of at least 95 percent of the interests of a real estate holding partnership to new partners within a period of five years (New Partner Rule).
- Acquisition of at least 95 percent of the shares or interests of a real estate holding corporation or partnership by one acquirer or a group of related acquirers (not necessarily in one transaction) (Unification Rule).

The New Partner Rule and the Unification Rule refer to direct and indirect changes in the holding structure of a German or foreign entity that holds German real estate. Therefore, a multinational's engagement in an M&A transaction or a corporate restructuring could also trigger German RETT, even if various intermediary holding levels are interposed, since all indirect changes to the shareholding structure must be taken into account..

Which Tax Rate Applies?

The RETT rate depends on the German federal state in which the real estate is located. Since the federal states have been able to determine the rates, rates have been on the rise and now vary between 3.5 percent (Bavaria and Saxonia) and 6.5 percent (North Rhine-Westphalia, Saarland and Schleswig-Holstein). In light of the precarious financial situation in which many federal states find themselves, a further increase in tax rates is to be expected.

The tax base is generally the purchase price of the real estate or, where no such purchase price exists, the specially determined real estate value, which in most cases is slightly below the market value.

When a RETT rate increase is imminent, notaries observe a marked increase in purchase notarizations, as parties aim to trigger RETT at the old rate by signing the purchase agreement prior to the change in law. The old rate remains applicable if the purchase agreement as a whole is subject to conditions precedent (*e.g.*, the approval of the tenants regarding amended lease agreements), provided the conditions are outside of the discretion of the parties. A condition precedent has the benefit that RETT only arises once the condition is fulfilled. Otherwise, the signing of the agreement triggers RETT, and the purchaser might have to fund its payment shortly after the signing, before the acquisition financing is available.

What Exemptions Are Available for Intra-Group Restructurings?

Certain transfers of real estate from a partnership to its partners, and vice versa, are tax exempt provided the applicable five-year holding periods are observed. Prior to December 31, 2009, no other exemption was available for intra-group restructurings, meaning that any *direct* or *indirect* transfer of real estate or real estate holding companies between related companies was subject to RETT. As a result, the RETT burden was considered one of the main obstacles to corporate restructurings. Another hindrance to group restructurings was the forfeiture of tax losses as a consequence of a share transfer, even where transferor and transferee were members of the same group of companies.

On December 31, 2009, the so-called intra-group restructuring exemption clause was introduced (together with group restructuring relief and the hidden reserves exemption rules for the preservation of tax losses) in order to facilitate economically reasonable restructurings. Although the exemption rule has been amended three times since its implementation, it still has limited relevance in practice, partly because the German tax authorities have published binding administrative guidelines that limit the scope of the exemption rule even further.

The exemption rule for intra-group restructurings is only applicable to mergers, spin-offs, split-ups or contributions of assets under German restructuring law or comparable rules of a Member State of the European Union or the European Economic Area. Restructurings under U.S. law are not within the ambit of the exemption. The exemption rule further requires that the entities involved in the restructuring be part of the same group. A group only exists if there is a controlling entity that holds at least 95 percent of the shares in all controlled entities involved for a period of five years before the restructuring and five years after the restructuring. Even a holding structure that has been in place for considerable time might not be eligible for the exemption rule, however, because the German tax authorities also require that the controlling entity conduct an active business, *i.e.*, be more than a mere holding entity.

What Structuring Scenarios Are Available, and Which Anti-Abuse Provisions Should Be Taken into Account?

Based on the New Partner Rule and the Unification Rule applicable to real estate holding entities, certain structuring scenarios allow for the sale of all or almost all of the shares or partnership interests without triggering RETT. The common denominator of such scenarios is that they require the participation of a party unrelated to the purchaser, which may be undesirable for a number of reasons.

RETT is not triggered if one person or group of related persons purchases less than 95 percent of the shares. Two joint venture partners may therefore purchase a real estate holding entity that is a corporation; each may acquire 50 percent of the shares without any RETT (provided the joint venture partners are not considered to be related persons for RETT purposes). However, such involvement of an unrelated person is rare in a group restructuring.

In the past, it was common to find so-called RETT-blocker structures that at least economically minimized third-party participation. If an acquirer directly purchased 94 percent of the shares of a real estate corporation and also acquired 94 percent of interest in the partnership that held the remaining 6 percent of the shares of the real estate corporation, the acquirer economically held more than 99 percent of the shares in the corporation (94 percent + 94 percent x 6 percent). This did not trigger RETT under the Unification Rule because, based on the formal understanding of the concept of partnership interests, the shares indirectly held through the

partnership were not taken into account for the calculation of the 95 percent threshold of the Unification Rule.

The so-called Anti-RETT-Blocker Rule, applicable since June 7, 2013, introduced a substance-over-form approach for calculating the 95 percent threshold. Under this anti-abuse rule, RETT becomes due if a person or entity directly or indirectly acquires an economic participation of at least 95 percent in a real estate holding partnership or corporation. All direct or indirect shareholdings of a person or entity in a real estate entity are now taken into account, including any and all indirect minority shareholdings.

As a result, RETT-blocker structures with an economic 99 percent participation are now effectively prevented. Under the new rules, the involvement of a "real" minority shareholder will be the price for not triggering RETT, which may make blocker structures less attractive to both investors and financing institutions.

What Developments Are to Be Expected?

RETT rates are expected to increase to meet the federal states' funding needs. The German legislature is currently planning to amend the RETT Act in order to broaden the scope of the application of the New Partner Rule. It will most likely be several years until the fiscal courts decide whether the German tax authorities' narrow interpretation of the applicability of the intra-group restructuring exemption clause is legitimate. Taking all these factors into account, diligent RETT planning and structuring will become even more important in the future.

New IRS Rulings Should Provide Greater Certainty for Corporate Restructurings

Philip J. Levine and Timothy S. Shuman

On May 5, 2015, the Internal Revenue Service (IRS) issued two long-awaited rulings, Rev. Rul. 2015-09 and Rev. Rul. 2015-10, that should alleviate some of the uncertainties in corporate tax planning. The rulings address increasingly common transaction structures—the "drop and sideways merger" and the "triple drop and check"—that had provoked frequent corporate tax panel debates and some uncertainty for tax practitioners and taxpayers.

In Rev. Rul. 2015-09, revoking Rev. Rul. 78-130, the IRS departed from a 37-year-old application of the step transaction doctrine to a stock transfer followed by an asset reorganization, or a "drop and sideways merger" transaction. The facts presented in Rev. Rul. 2015-09 are identical to those in Rev. Rul. 78-130. P, a domestic corporation, owns all of the stock of S1 and S2, both of which are incorporated in foreign country R. S1 is an operating company, and S2 is a holding company that owns all of the stock of corporations X, Y and Z, all of which are country R operating companies. Pursuant to a plan to combine the four operating companies into a new subsidiary, S-2 forms corporation N, and P transfers all of the stock of S-1 to S-2 in exchange for additional shares of S-2 voting common stock. Immediately after P's transfer, X, Y and Z, as well as S-1, transfer all of their assets (subject to liabilities) to N, in exchange for additional shares of N common stock. Each of X, Y, Z and S-1 then liquidates and distributes all of its N stock to S-2. Following the transaction, N continues to conduct the businesses formerly conducted by S-1, X, Y and Z.

Rev. Rul. 78-130 described the tax treatment of the transaction as follows:

> Since the two steps of P's transfer of the stock of S-1 to S-2 immediately followed by N's acquisition of S-1's assets are part of a prearranged, integrated plan which has as its objective the consolidation of all of the operating companies in N, the two steps should not be viewed independently of each other for Federal income tax purposes.
>
> Accordingly, the transfer by P of the stock of S-1 to S-2 will not constitute an exchange within the meaning of section 351 of the Code. Instead, N will be viewed as directly acquiring substantially all of the assets of S-1 in exchange for stock of S-2. This recast transaction does not meet the definitional requirements of a section 368(a)(1)(D) reorganization because neither S-1 nor P (the transferor or its shareholder) will be in control of N, within the meaning of section 368(c), immediately after the transaction. (Citations omitted.)

Rev. Rul. 78-130 concludes, however, that the acquisition of the S-1 assets (subject to liabilities) "in exchange for stock of S-2 by N, as recast," may be properly characterized as a triangular reorganization under section 368(a)(1)(C)—that is, a transaction in which a corporation (N) acquires, solely in exchange for voting stock of a corporation in control of the acquiring corporation (S-2), substantially all of the properties of the target corporation (S-1).

Much has changed in the corporate reorganization landscape since Rev. Rul. 78-130 was issued. In 1984, the definition of "control" for a section 368(a)(1)(D) reorganization was amended to conform with section 304. In addition, the IRS issued "all-cash D reorganization" guidance in Treasury regulations section 1.368-2(l), which deems stock of nominal value to have been issued in such transactions for purposes of qualifying the transaction under section 368(a)(1)(D) (namely, to satisfy the requirement of section 354(b)(1)(B) that the target corporation distribute stock of the acquiring corporation in the target's liquidation). This change confirms that an all-cash cross-chain reorganization can qualify under section 368(a)(1)(D) even if the target and acquiring corporations are not directly owned by the same person. The regulations include a priority rule, in section 1.368-2(l)(2)(iv), that provides that the nominal share rule will not apply if the transaction is described as a triangular reorganization in section 1.358-6(b)(2) (*i.e.*, a transaction that otherwise would qualify as a triangular reorganization will not be treated as an all-boot D reorganization).

In recent years, the IRS had issued two private letter rulings, PLR 201252002 and PLR 201150021, that arguably are inconsistent with Rev. Rul. 78-130 in treating a triple drop down of stock of a company (*e.g.*, P to S1 to S2 to S3), followed by a deemed liquidation of the company (into S3), as two successive section 351 transactions followed by a reorganization under section 368(a)(1)(D). Rev. Rul. 2015-09 reaches a similar conclusion as these private letter rulings, holding that P's transfer of S-1 to S-2 satisfies section 351, and that S-1's transfer of all of its assets (subject to liabilities) to N followed by S-1's liquidation qualifies as a D reorganization. The IRS reasons as follows:

> A transfer of property may be respected as a § 351 exchange even if it is followed by subsequent transfers of the property as part of a prearranged integrated plan. However, a transfer of property in an exchange otherwise described in § 351 will not qualify as a § 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a whole.
>
> Under the facts of this revenue ruling, P's transfer satisfies the formal requirements of § 351, including the requirement that P control S-2 within the meaning of § 368(c)
>
> immediately after the exchange. Moreover, even though P's transfer and S-1's transfer and liquidation are steps in a prearranged, integrated plan that has as its objective the consolidation of S-1 and the other operating companies in N, an analysis of the transaction as a whole does not dictate that P's transfer be treated other than in accordance with its form in order to reflect the substance of the transaction. Accordingly, P's transfer is respected as a § 351 exchange, and no gain or loss is recognized by P on the transfer of all of the stock of S-1 to S-2.
>
> S-1's transfer followed by S-1's liquidation is a reorganization under § 368(a)(1)(D). (Citations omitted.)

Rev. Rul. 2015-10 applies the same approach as Rev. Rul. 2015-09 to a "triple drop and check" transaction, similar to that addressed in PLR 201252002 and PLR 201150021. In the revenue ruling, a corporation transfers a limited liability company taxable as a corporation down a chain of three subsidiaries, immediately after which the transferred company elects pursuant to Treasury regulations section 301.7701-3(c) to become a disregarded entity. Rev. Rul. 2015-10 treats the transaction as two successive section 351 stock transfers followed by a D reorganization.

Rev. Ruls. 2015-09 and 2015-10 are welcome additions to the IRS's body of law under Subchapter C, providing certainty of treatment in an area that reasonably could be viewed as needlessly uncertain. The key difference in the analytical underpinnings of Rev. Rul. 78-130 versus the 2015 revenue rulings appears to be the application of the step transaction doctrine. Rev. Rul. 78-130 applies what appears to be the "end result" test (the broadest version of the step transaction doctrine) in concluding that the relevant target shareholder is P, and in finding that the fact that the steps constitute an integrated plan requires the interim stock transfer to be ignored. On that basis, Rev. Rul. 78-130 concludes that the

transaction cannot qualify as a section 351 transfer followed by a section 368(a)(1)(D) reorganization but instead must be characterized based on where the assets of the target company, S-1, end up within the corporate group. The 2015 revenue rulings stay closer to the form of the transaction and conclude that, in effect, there are two separate transactions—the section 351 transfer (or transfers) and then a D reorganization.

Rev. Rul. 2015-09 relies on a 1977 ruling (Rev. Rul. 77-449) not even cited in Rev. Rul. 78-130 that illustrates that a transfer of property may be respected as a section 351 exchange even if the property transferred is further transferred as part of a prearranged plan. Under Rev. Ruls. 2015-09 and 2015-10, a section 351 transfer that is not immediately followed by a liquidation or upstream merger generally will be respected, provided that the transferor does not surrender control of the transferee as a result of a transfer of the stock of the transferee corporation in a related transaction. The IRS could have taken a similar approach to the application of the step transaction doctrine in its analysis in Rev. Rul. 78-130 and reached the conclusion now embodied in Rev. Rul. 2015-09 and Rev. Rul. 2015-10 under the law in effect at that time. That is, although corporate reorganization law has changed since 1978, none of the changes has necessarily rendered the analysis or conclusion in Rev. Rul. 78-130 obsolete. Thus, the difference between Rev. Rul. 78-130 and the new rulings appears to be the result of a change in the IRS's view of how the step transaction doctrine should apply rather than the result of a change in substantive law.

Rev. Ruls. 2015-09 and 2015-10 are consistent with a trend in IRS guidance over the past 15 years or so to apply the step transaction doctrine in a somewhat less aggressive fashion than it had been applied previously. This approach increases taxpayers' certainty that the form that they choose will be respected notwithstanding planned future steps. However, Rev. Rul. 2015-09 does caution taxpayers not to get too comfortable, observing that "a transfer of property in an exchange otherwise described in section 351 will not qualify as a section 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a whole." For better or worse, this indicates that the potential for uncertainty has not been eliminated completely, and that issues remain for taxpayers, tax practitioners and the government to debate in the years to come.

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