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A Reverse *Morris Trust* Ruling

LTR 201542004 at first seems to involve a standard spinoff for the purpose of pursuing a reverse *Morris Trust* combination of Controlled with a Merger Partner, with the "significant issue" for ruling being a proposed swap of Controlled debt for Distributing debt, which has been bought up by an investment banker. But the facts are quite odd and more seems to be going on.

Reverse *Morris Trust*

After the spin, a Merger Sub of Merger Partner will merge into Controlled, and evidently Controlled shareholders will get the majority of the stock of Merger Partner. However, the transfer agent will hold the Controlled stock and Distributing's shareholders will never receive it; they will just get Merger Partner stock. The IRS ruled that the Controlled stock would be deemed distributed and then exchanged.

Debt Securities

Distributing may receive new debt securities of Controlled in the D reorganization creating Controlled. Distributing plans to have an investment banker buy up Distributing debt, hold it for at least five days, and then agree to swap it for Controlled debt at least 14 days after the bankers bought the Distributing debt. This 5/14 day arrangement has been treated as a safe harbor by the IRS in earlier rulings to qualify the investment bankers as true holders of the Distributing debt. This ruling shows that taxpayers still feel uncomfortable in proceeding on this basis without a ruling and that rulings can be obtained.

Liabilities Assumed

Inevitably in a D reorganization preceding a spinoff, Controlled will assume some liabilities. Such assumptions are treated like cash distributions, reducing the basis in the stock of Controlled. The basis of the Controlled stock is

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important to Distributing, because it often wants to pull actual cash out of Controlled, but in certain cases that cash will be taxable to the extent the cash exceeds the basis of the stock.

So the IRS ruled that liabilities assumed that had not yet been deducted or entered into basis did not count to reduce the basis in the stock of Controlled. This should not have been in doubt under Section 358(d)(2). But the taxpayer wanted to be assured that Controlled could deduct those items when they accrued in the future and the IRS so ruled.

Taxable Boot

Generally cash received from Controlled by Distributing can be paid to Distributing's creditors without causing Distributing to recognize gain on the D reorganization, with one exception: not if the cash or other boot exceeds the basis of the stock of Controlled. The excess is taxable under Section 361(b)(3). Because Distributing expected to receive cash in excess of stock basis (basis that was larger because those contingent assumed liabilities had not yet matured), it admitted it might recognize gain.

This is an interesting example of wanting so badly to extract cash from a corporation to be spun off that Distributing is willing to pay tax for the privilege; or maybe Distributing has lots of net operating losses.

The Continuing Relationships

The ruling described an unusual amount of post-spin continuing relationships between Distributing and Controlled. Initially Distributing is Controlled's main customer. The two corporations will share facilities and buy and sell from each other for an "undetermined long-term period." These are not transitional services. If the business purpose for the spin had been "fit and focus," such arrangements would not be allowed, at least not if there were a significant common shareholder. Evidently the *Morris Trust* business purpose was controlling.

Pension Plan

The most unusual part of the plan relates to the pension liabilities of the Distributing group to be assumed in the *Morris Trust* merger by the Merger Partner group. Distributing contemplated transferring assets and liabilities of the Controlled pension plan to the Merger Partner, but contemplated the possibility that it transferred too much assets. If so, Merger Partner would have to pay back the excess. Distributing represented that it would treat such pay back as if it had been paid for Controlled stock in a taxable sale, but it would be less than 20 percent of the value of Controlled stock.

It is curious that such repayment could not have been treated as a price adjustment. Introducing the construct of Distributing selling stock it did not sell seems to introduce many uncertainties.

Conclusion

The Chief Counsel issued this spin-off ruling because it still will rule on significant issues. This taxpayer's issues do not seem all that significant, but perhaps its related issues were. The point for other taxpayers is to continue to evaluate the possibility of rulings on spinoffs, even though they are issued less frequently.

For additional information, call Jack Cummings at 919.862.2302.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie E. Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew Moseley
202.239.3828
matthew.moseley@alston.com

Danny Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

ALSTON & BIRD

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333