

IRS Rulings Clarify Tax Treatment of Multi-Tier Restructuring Transactions

By declaring a controversial ruling obsolete, the IRS removes uncertainty surrounding the tax effects of certain corporate restructuring techniques.

A pair of revenue rulings the US Internal Revenue Service (IRS) issued this week clarify the agency's position on certain multi-step transactions, including a "triple-drop-and-check" transaction.¹ Breaking from an older revenue ruling, but consistent with more recent private guidance, this week's rulings respect the transactions' form, treating the initial component as falling within the rules for tax-free exchanges under Section 351 of the Internal Revenue Code of 1986, as amended (Code),² and the ensuing component (*i.e.*, the final "drop-and-check") within the tax-free "D" reorganization rules. In doing so, the IRS indicated the form of the successive contributions in these types of restructurings would be respected, unless a recast is necessary to reflect the substance of the transaction (*e.g.*, the recast of the final component of the restructuring as a "D" reorganization).

In issuing these welcome rulings, the IRS revoked a 1978 ruling, the continued viability of which had been questioned in recent years by many tax practitioners. These new rulings have eliminated an element of uncertainty and risk regarding the possibility that an intra-group restructuring involving the issuance of nonvoting stock, or those in the nature of a triple-drop-and-check transaction, could have been recast — under the logic of the 1978 ruling — as a taxable transaction by virtue of failing to satisfy the requirements of a triangular "C" reorganization.

The Old View: Revenue Ruling 78-130

In Revenue Ruling 78-130,³ the IRS treated a multi-step restructuring transaction as a triangular "C" reorganization rather than a first-step Section 351 exchange and a subsequent deemed "D" reorganization. A US parent corporation (P) owned all the stock of a non-US operating corporation (S1) and a non-US holding corporation (S2). S2 in turn owned all the stock of non-US corporations X, Y and Z. P wanted to move all its non-US operations into a single new non-US subsidiary. To accomplish this objective, P caused S2 to form a new non-US corporation (N). P transferred all the stock of S1 to S2 in exchange for additional S2 voting shares (that is, it "dropped" S1 into S2). S1, X, Y and Z then transferred substantially all their assets to N in exchange for shares of N stock. In the final step, S1, X, Y and Z liquidated and distributed their N stock up to S2.

The IRS, circa 1978, declined to view P's transfer of S1 to S2 and N's subsequent acquisition of S1's assets as a Section 351 contribution by P to S2 followed by a "D" reorganization of S1. Rather, the IRS recast and collapsed these two steps — which were part of a prearranged, integrated plan — to deem S1 as transferring its assets to N in exchange for S2 stock. Furthermore, the IRS ruled that this recast transaction, while qualifying as a triangular "C" reorganization, did not qualify as a "D" reorganization,

because neither the transferor, S1, nor its shareholder, P, was in “control” of N immediately after the transaction. While the definition of “control” for purposes of a “D” reorganization has been amended since 1978, the ruling’s continued existence created uncertainty regarding whether the IRS would respect the form of a transaction structured with preliminary contributions followed by an asset reorganization, or recast and collapse the transaction as a direct transfer of assets.

The New View: Revenue Rulings 2015-9 and 2015-10

The new rulings, in contrast to the holding in Revenue Ruling 78-130, respect the form of the preliminary contributions as Section 351 exchanges and only recast the final component of the restructuring (*i.e.*, the final drop-and-check) as an asset transfer treated as a “D” reorganization. The facts of Revenue Ruling 2015-9 are the same as those of Revenue Ruling 78-130, which the new ruling explicitly revokes. In the new ruling, the IRS reasoned that P’s transfer of S1 to S2 may be respected under Section 351 even though — as part of a prearranged, integrated plan — P’s transfer was followed by S1’s transfer of its assets to N and S1’s liquidation. These facts, the IRS said, did not warrant a different treatment to reflect the overall transaction’s substance.

Accordingly, the IRS respected the form of the initial contribution rather than recast it, treating P’s transfer of S1 to S2 as a Section 351 contribution followed by a “D” reorganization.

Revenue Ruling 2015-10 involved a triple-drop-and-check. In this case, a US parent corporation (P) owned all the interests in a US limited liability company (LLC) that had elected to be taxable as a corporation. P also owned a chain of corporate subsidiaries: P owned all the stock of S1, which owned all the stock of S2, which in turn owned all the stock of S3. P transferred all the LLC interests down the ownership chain, first from P to S1, then from S1 to S2 and from S2 to S3. LLC then made a “check-the-box” election to be treated as a disregarded entity, once it became owned by S3.

Similar to its approach in the companion revenue ruling, the IRS respected the successive transfers of LLC, by P to S1 and S1 to S2, as two Section 351 exchanges, even though each was followed by subsequent transactions as part of a prearranged, integrated plan. The IRS then characterized S2’s transfer of LLC to S3, followed by LLC’s check-the-box election (which, for US federal income tax purposes, constituted a liquidation of LLC and a distribution of its assets up to S3), as a “D” reorganization, rather than as a Section 351 exchange followed by a tax-free Section 332 liquidation.

Conclusion

The results in Revenue Rulings 2015-9 and 2015-10 had been foreshadowed by private letter rulings the IRS had issued in recent years.⁴ However, private letter rulings can be relied upon only by the taxpayers to whom the letters are directed. The issuance of the new revenue rulings and the revocation of Revenue Ruling 78-130, therefore, are welcome developments that bring additional certainty to US corporate groups, including those with multinational operations, in respect of the US federal income tax consequences of certain multi-tier restructuring transactions.

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Endnotes

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- ¹ Rev. Rul. 2015-9 (May 5, 2015); Rev. Rul. 2015-10 (May 5, 2015). The rulings will be published on May 26 in Internal Revenue Bulletin 2015-21, which will be available at <http://www.irs.gov/irb/>.
 - ² All "Section" references are to the Code.
 - ³ 1978-1 C.B. 114.
 - ⁴ See, e.g., PLR 201252002 (Dec. 28, 2012) and PLR 201150021 (Dec. 16, 2011) (the IRS, in both private rulings, treated a multi-step restructuring as two Section 351 exchanges followed by a "D" reorganization).