

Client Update

IRS Issues Guidance on 'North-South' Transactions

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The IRS recently issued Revenue Ruling 2017-09 (the "Ruling") covering the treatment of so-called "North-South" transactions. The Ruling sheds some light on when the IRS will respect the independence of transaction steps in a spin-off or reorganization but does not give clear guideposts. The IRS's message is that it will respect separate steps unless it believes that the transaction structure undermines the requirements of the tax laws. Perhaps most significantly, the IRS will once again provide rulings to taxpayers on North-South issues.

WHAT IS A NORTH-SOUTH TRANSACTION?

North-South transactions involve separate transfers of property from a parent to a subsidiary (the "South") and from the subsidiary to the parent (the "North"). These transfers are common within corporate groups undertaking a spin-off or other reorganization in order to move assets to the right entities. If the transactions are treated separately for tax purposes, the South is often a tax-free contribution and the North may qualify for favorable tax treatment. However, if the North and South are treated as a single integrated transaction, the result can be a taxable sale of the North property for the South property, and such treatment might even threaten the tax-free status of a spin-off.

Historically, the IRS issued to taxpayers private letter rulings confirming that, in certain situations, the IRS would not integrate North-South transactions. However, in January 2013, the IRS announced that it would no longer issue rulings on North-South issues. Taxpayers wishing to restructure corporate groups have faced great uncertainty as a result. The Ruling removes the "no-rule" policy and signals that taxpayers may again obtain rulings on North-South issues.

RULING SITUATION 1 - GOOD NEWS FOR CONTRIBUTIONS (SOUTH)

The Ruling covers two scenarios.

In Situation 1, parent corporation P owns all of the stock of corporation D, which owns all of the stock of corporation C. D wishes to spin C off to P, but the

tax rules require D to retain an active trade or business (“ATB”) following the distribution of C. To satisfy this requirement, P contributes property constituting an ATB to D, in exchange for D stock. D then distributes all of the C stock to P. The Ruling holds that these two transfers will be respected as a tax-free contribution and a separate tax-free spin-off distribution (instead of treating P as having sold the ATB assets to D in exchange for the stock of C in a taxable transaction).

While this holding is helpful, it is not entirely clear why the IRS limited the fact pattern to the contribution of an ATB. We do not think there is a principled difference between the contribution of an ATB and of other assets that would be beneficial to contribute in the overall spin-off transaction.

RULING SITUATION 2 - CAUTION FOR DISTRIBUTIONS (NORTH)

In Situation 2, C distributes property and cash to D on Date 1. On Date 2, D contributes appreciated property to C and then distributes all of its C stock to P (as part of the same plan as the Date 1 distribution). Unlike Situation 1, the IRS combined the transactions. The Ruling holds that the property distributed on Date 1 was taxable “boot” issued to D in exchange for the property contributed by D to C in the reorganization and spin-off. This causes D to recognize gain on its contribution to C (capped at the value of the boot).

The IRS position seems to be that respecting the Day 1 distribution as separate from the Day 2 transactions would impermissibly circumvent the boot rules. Boot treatment is manageable for distributions of cash in a spin-off (which becomes tax-free to D if further transferred to D’s shareholders or creditors), but Situation 2 provides a harsh result if C distributes appreciated assets.

While the Ruling provides some insight into the IRS position on North-South, its facts will not directly apply to most transactions. Taxpayers will have to evaluate the strength of their position under the reasoning of the Ruling and decide whether to seek a private letter ruling on a potential transaction.

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Please do not hesitate to contact us with any questions.