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Circular Flow and F Reorganization

LTR 201050020 is one of a fairly large number of letter rulings issued recently on novel reincorporation patterns. It involves a foreign-to-foreign Type F reorganization of a CFC. The taxpayer engineered the reorganization by using a transitory loan from an outside lender and a circular flow of the borrowed cash around its corporations. You might think that the transitory loan and circular flow of cash would cause the IRS to view the transaction uncharitably; instead, the IRS charitably allowed an odd assortment of events to be cobbled together into what it called a section 368(a)(1)(F) reorganization.

Therefore, you would think that the taxpayer must have had a compelling business reason to reincorporate. If so, it was well-disguised. Lacking the business reason served, the best lesson to be drawn from the ruling is that the Chief Counsel will allow a wide assortment of real world transactions to amount to a Type F reincorporation.

The Facts

Recap. The simplified facts are that Parent owned foreign DRE, which owned foreign Holdco (HCO). HCO underwent a preliminary recap to eliminate preferred stock with a dividend arrearage. That event may have significance in itself, because CFCs frequently issue dividends without intending to pay the dividends, and their owners should at least worry about whether the dividend should be accrued into income; evidently the Parent here did not accrue the dividend. Assuming the recap had no relation to the reincorporation, we move on to that step.

Reincorporation. Before the reincorporation, foreign DRE owned common stock and a note of HCO; the note was treated as equity for U.S. tax purposes. Likely, HCO treated the note as debt for foreign tax purposes. After the reincorporation, Parent holds essentially identical common and a note of Newco (which took over HCO's assets and liabilities, in effect), and foreign DRE and HCO have both domesticated in the United States and HCO has checked the box to be disregarded. So after the reincorporation, Parent owns DRE and HCO down one chain as disregarded domestic entities and owns Newco, its foreign sub, that looks like old HCO.

It is obvious that if foreign DRE had simply domesticated, retaining the ownership of the common and note of foreign HCO, then the same result would have been achieved as in the reincorporation: Parent would indirectly (through what is now a domestic DRE) own the common and note of HCO. If the purpose was to eliminate an intervening foreign entity between Parent and HCO, why would the domestication of DRE not have done the trick?

Ancillary Events. Two other sets of events went on that do not explain the basic transaction. One involved the transitory borrowing. HCO borrowed $X from the bank. After HCO domesticated and became disregarded under Parent and DRE, it "lent" $X to Parent. Parent "lent" $X to Newco for note, which was the note that replicated the note foreign HCO had owed to DRE before it checked the box (and still owes for state law purposes). Newco paid off the bank loan with the $X, because Newco had assumed the bank loan when HCO transferred its assets (not including the $X) to Newco solely in exchange for the assumption of the bank loan and for Newco preferred stock; Newco did not assume the old note to DRE.

Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.239.3300
Fax: 202.239.3333

www.alston.com

For some reason, taxpayer did not want Newco to just assume the note of HCO that DRE held, but wanted Newco to issue a note in the same amount for cash to Parent. Perhaps foreign country law required that to capitalize Newco; however, why did HCO have to be reincorporated and issue a new note at all?

The second thing that went on was a pair of odd redemptions. Parent obtained the common stock of Newco for the preferred stock of DRE, but DRE immediately redeemed that stock from Newco for Note 2. Parent could have just given Note 2 to Newco, without going through the redemption business; perhaps the foreign country did not allow stock to be issued for a note? The IRS evidently collapsed the steps and treated them as if Newco issued the common stock for Note 2.

The IRS must have ignored the transfer of the DRE's preferred stock to Newco, because otherwise DRE would have ceased to be disregarded when it acquired a second owner. And the ruling must also have ignored even the Parent's deemed exchange of DRE's Note 2 for Newco common stock, because it accepted a representation from taxpayer that Parent wound up owning all the equity of Newco solely by reason of owning the equity of HCO (not for Note 2). This is the terminology used in Prop. Reg. 1.368-2(m) (2004).

Then Newco redeemed the preferred stock it had issued to HCO in exchange for the assets of HCO for Note 3. The ruling said that Notes 2 and 3 "offset." Thus, Parent and Newco owed each other offsetting amounts. At minimum, this means they were of the same amount, but it is not clear whether they were cancelled or remained in existence with Newco paying debt service to Parent and receiving mirror debt service from Parent, and Parent doing the same (through its now domestic disregarded entities). At maximum, perhaps the ruling just intended to ignore Notes 2 and 3. Presumably Parent would not have a net U.S. tax impact; perhaps Newco somehow benefits in its country from paying and receiving offsetting interest?

The ruling also seems to have entirely ignored the circular flow of cash because it accepted a representation that all the liabilities of HCO that Newco assumed were incurred in the ordinary course of business or are associated with the assets to be transferred. The transitory bank loan was not in the ordinary course of business and HCO kept the loan proceeds while it transferred the liability for the loan to Newco.

The ruling treated all of these steps as if HCO transferred its assets and liabilities to Newco and HCO liquidated and Parent exchanged its common stock and note in HCO for the common stock and note of Newco. The only thing the ruling caveated was the equity status of the notes.

When HCO domesticated and became disregarded, it held the $X cash borrowed from the bank. Under normal circumstances that would look like boot dividend in a reorganization. As a domestic DRE, it lent the $X to Parent. That presumably created an interest inclusion in domestic HCO and an interest deduction in Parent. In addition, the old note stayed in place between domestic disregarded HCO and domestic DRE. But the ruling states they are in the same state as Parent, so it is hard to see the state tax benefit.

Conclusion

Perhaps the conclusion is that if you don't create any federal income tax advantage that anyone can figure out, you can reincorporate a CFC using any assortment of value flows and transactions you can put together, so long as the old pea winds up under a new shell owned by the same shareholder.

For additional information, call Jack Cummings at 919.862.2302.

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.239.3319

Robert T. Cole
202.239.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.239.3309

Jasper L. Cummings, Jr.
919.862.2302

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.239.3394

Clay A. Littlefield
704.444.1440

Ashley B. Menser
919.862.2209

Tola Ozim
212.210.9533

Vivek Patel
404.881.7686

Timothy J. Peaden
404.881.7475

Matthew A. Stevens
202.239.3553