

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms.
(Also §§ 351; 1.351-1, 301.7701-3.)

Rev. Rul. 2015-10

ISSUE

Is a transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to its subsidiary (first subsidiary) in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to its subsidiary (second subsidiary) in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to its subsidiary (third subsidiary) in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, properly treated for federal income tax purposes as two transfers of stock in exchanges

governed by § 351 of the Internal Revenue Code (Code) followed by a reorganization under § 368(a)(1)(D) of the Code?

FACTS

P, a domestic corporation, owns all of the interests in *LLC*, a domestic limited liability company that elected pursuant to § 301.7701-3(c) of the Procedure and Administration Regulations to be an association taxable as a corporation for federal income tax purposes effective on its date of formation. *P* also owns all of the stock of *S1*. *S1* owns all of the stock of *S2*, which owns all of the stock of *S3*. *S3* owns all of the stock of *S4*. *S1*, *S2*, and *S3* are each holding companies that are domestic corporations. For valid business purposes, and as part of a plan:

- (a) *P* will transfer all of the interests in *LLC* to *S1* in exchange for additional shares of voting common stock of *S1* (*P*'s transfer).
- (b) *S1* will transfer all of the interests in *LLC* to *S2* in exchange for additional shares of voting common stock of *S2* (*S1*'s transfer).
- (c) *S2* will transfer all of the interests in *LLC* to *S3* in exchange for additional shares of voting common stock of *S3* (*S2*'s transfer).

(d) *LLC* will elect pursuant to § 301.7701-3(c) to be disregarded as an entity separate from its owner for federal income tax purposes, effective no sooner than one day after *S2*'s transfer (*LLC*'s election).

Following the transaction, *S3* will, through *LLC*, continue to conduct the business conducted by *LLC* prior to the transaction.

LAW

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 368(c) defines "control" to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (eligible entity) can elect its classification for federal income tax purposes. An eligible entity with at least two members can elect pursuant to § 301.7701-3(c) to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(g)(1)(iii) provides that if an eligible entity classified as an association elects pursuant to § 301.7701-3(c) to be disregarded as an entity separate from its owner, the following is deemed to occur: the association distributes all of its assets and liabilities to its single owner in liquidation of the association.

Section 301.7701-3(g)(2)(i) provides that the tax treatment of a change in the classification of an entity for federal income tax purposes by an election pursuant to § 301.7701-3(c) is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 368(a)(1)(D) provides that the term “reorganization” includes a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under § 354, 355, or 356.

Section 354(a) provides, in general, that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 368(b)(2) provides that “a party to a reorganization” includes both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or property of the other.

Section 354(b)(1) provides, in general, that § 354(a) will not apply to an exchange in pursuance of a plan of reorganization under § 368(a)(1)(D) unless (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

Section 368(a)(2)(H) provides that for purposes of determining whether a nondivisive transaction qualifies under § 368(a)(1)(D), the term “control” has the meaning given such term by § 304(c).

Section 304(c)(1) provides that “control” means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation, which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) will be treated as in control of such other corporation.

Section 304(c)(3) provides, in part, that § 318(a) relating to constructive ownership of stock will apply for purposes of determining control under § 304 and that paragraph (2)(C) of § 318(a) will be applied by substituting “5 percent” for “50 percent.”

As modified by § 304(c)(3), § 318(a)(2)(C) provides that if 5 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person will be considered as owning the stock owned, directly or indirectly, by or for

such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation.

In Rev. Rul. 67-274, 1967-2 C.B. 141, pursuant to a plan of reorganization, corporation Y acquired all of the stock of corporation X in exchange for voting stock of Y. Thereafter, X completely liquidated into Y. The ruling concludes that the two steps will not constitute a reorganization under § 368(a)(1)(B) followed by a liquidation under § 332, but instead will be considered a single acquisition of X's assets in a reorganization under § 368(a)(1)(C).

ANALYSIS

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. See Rev. Rul. 77-449, 1977-2 C.B. 110, *amplified by* Rev. Rul. 83-34, 1983-1 C.B. 79, and Rev. Rul. 83-156, 1983-2 C.B. 66; *see also* Rev. Rul. 2003-51, 2003-1 C.B. 938. 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. See Rev. Rul. 54-96, 1954-1 C.B. 111; Rev. Rul. 70-140, 1970-1 C.B. 73.

Under the facts of this revenue ruling, even though P's transfer is part of a series of transactions undertaken as part of a prearranged, integrated plan involving successive transfers of the LLC interests, P's transfer satisfies the formal requirements of § 351, including the requirement that P control S1 within the meaning of § 368(c) immediately after the exchange, and 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*. Similarly, § 351 applies to *S1*'s transfer, and no gain or loss is recognized by *S1*.

With regard to *S2*'s transfer and *LLC*'s election, if an acquiring corporation acquires all of the stock of a target corporation in an exchange otherwise qualifying as a § 351 exchange, and as part of a prearranged, integrated plan, the target corporation thereafter transfers its assets to the acquiring corporation in liquidation, the transaction is more properly characterized as a reorganization under § 368(a)(1)(D), to the extent it so qualifies. See Rev. Rul. 67-274; see also Rev. Rul. 2004-83, 2004-2 C.B. 157. Accordingly, under the circumstances described above, *S2*'s transfer and *LLC*'s election are more properly characterized as a reorganization under § 368(a)(1)(D) than as a § 351 exchange followed by a § 332 liquidation.

HOLDING

A transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to the first subsidiary in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to the second subsidiary in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to the third subsidiary in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, is properly treated for federal

income tax purposes as two transfers of stock in exchanges governed by § 351 followed by a reorganization under § 368(a)(1)(D).

DRAFTING INFORMATION

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