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Second Bite at the Apple: Unwinding Subsidiary Liquidations Under Annual Accounting

By Stan D. Blyth • Wood & Porter • San Francisco

Unanticipated economic shifts often require a change in a company's strategy. The change in strategy might be a change of a few degrees, or might literally require doing a 180. In fact, when unexpected economic conditions require a new direction, a company may be forced to unwind an already completed transaction.

Whether a completed transaction can be unwound without triggering unwanted tax consequences is an issue of paramount concern to management. With this in mind, recently issued LTR 200701019 [Oct. 5, 2006] provides guidance regarding how a completed subsidiary liquidation might be unwound. Significantly, the IRS says this is A-OK under the annual accounting concept if, prior to the end of the tax year in which the transaction was originally completed, all of the parties involved are restored to the relative positions they would have occupied if the transaction had not occurred.

Times Are A Changin'

Under the facts of LTR 200701019, Parent corporation acquired all of the outstanding common stock of Subsidiary 1 for cash, and retired an unspecified amount of Subsidiary 2's debt in exchange for Subsidiary 2's promissory note in the same amount as the debt. At the time of Parent's stock acquisition, neither Subsidiary 1 nor Subsidiary 2 had other equity interests outstanding, and the sole asset of Subsidiary 1 was all of the outstanding common stock of Subsidiary 2.

In order to maximize operational efficiencies, after Parent acquired all of Subsidiary 1's outstanding stock, Subsidiary 1 was merged into Parent, with Parent surviving. In the merger transaction, Subsidiary

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1 transferred its sole asset, the Subsidiary 2 stock, to Parent. After completing the merger, Parent loaned Subsidiary 2 an unspecified amount of money to sustain its operations.

After liquidating Subsidiary 1, Parent experienced unexpected weakness in two of its core businesses. In an effort to offset these weaknesses, Parent realized that it might have to dispose of one or more lines of business, including that of Subsidiary 1. For this reason, Parent realized that its decision to liquidate Subsidiary 1, rather than preserve its adjusted tax basis in its Subsidiary 1 stock, had been unwise.

After coming to terms with its mistake, Parent formed a new Subsidiary 1, under the laws of the same state in which the original Subsidiary 1 had been incorporated, and contributed all of the outstanding stock of Subsidiary 2 to the capital of new Subsidiary 1 in exchange for all the common stock of new Subsidiary 1. Upon completion of these transactions, the assets and liabilities of the original Subsidiary 1 became the assets and liabilities of the new Subsidiary 1. Additionally, new Subsidiary 1's Articles of Incorporation and Bylaws were identical to those that the original Subsidiary 1 had in effect at the time of its merger into Parent.

Between the time of the liquidation of the original Subsidiary 1 and Parent's incorporation of new Subsidiary 1, other than the money loaned by Parent to Subsidiary 2, there were no other transfers of money or property between any member of Parent's affiliated group and Subsidiary 2, nor were there any material changes in the legal or financial arrangements between any member of Parent's affiliated group and Subsidiary 2. Upon completion of Parent's contribution of Subsidiary 2 stock to the capital of new Subsidiary 1, all of the legal and financial arrangements among Parent, new Subsidiary 1 and Subsidiary 2 were identical in all material respects to the legal and financial arrangements among Parent, the original Subsidiary 1, and Subsidiary 2 prior to liquidation of the original Subsidiary 1.

The liquidation of the original Subsidiary 1, Parent's incorporation of new Subsidiary 1 and Parent's contribution of Subsidiary 2's stock to the capital of new Subsidiary 1 all occurred within the same tax year of Parent, the original Subsidiary 1, new Subsidiary 1 and Subsidiary 2.

Deja Vu

This isn't the first time the IRS has looked at rescission. In making its determination regarding the subject transactions, the IRS relied on Rev. Rul. 80-58, 1980-1 CB 181, in which the IRS examined two varying sets of facts. Under the first set of facts, in February 1978, a calendar year taxpayer sold a tract of land to B and received cash for the entire purchase price. The contract of sale obligated A, at the request of B, to accept reconveyance of the land from B, if at any time within nine months of the date of sale, B was unable to have the land re-zoned for B's business purposes.

If there was a reconveyance under the contract, A and B would be placed in the same positions they were prior to the sale. In October 1978, B determined that it was

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not possible to have the land re-zoned and notified A of its intention to reconvey the land pursuant to the terms of the contract of sale. The reconveyance was consummated during October 1978, the tract of land was returned to A, and B received back from A all amounts expended in connection with the transaction.

The second set of facts in Rev. Rul. 80-58 was identical to the first, with the exception that the period within which B could reconvey the property to A was one year. In January 1979, B determined that it was not possible to have the land re-zoned and notified A of its intention to reconvey the land pursuant to the terms of the contract of sale. The reconveyance was consummated during February 1979, and the tract of land was returned to A. B received back from A all amounts expended in connection with the transaction.

In ruling on the two sets of facts, the IRS cited the annual accounting concept, citing *Security Flour Mills Co.*, SCt, 44-1 USTC ¶9219, 321 US 281, 64 SCt 596 (1944), Ct. D. 1603, 1944 CB 526, for the proposition that transactions are examined on an annual basis. The facts must be examined as they exist at the end of the year, since each tax year is a separate unit for tax accounting purposes.

The IRS also looked to *Penn v. Robertson*, CA-4, 40-2 USTC ¶9707, 115 F2d 167 (1940). In *Penn*, the taxpayer was a participant in an employees' stock benefit fund created by the directors of the company, but without the approval of the shareholders. Under the plan, the taxpayer was credited with earnings from the fund for the years 1930 and 1931. In 1931, as a result of suits filed by a shareholder, the directors of the company passed a resolution rescinding the plan as to all participants who agreed to relinquish their previous credits and rights.

The Court of Appeals held that although the plan was rescinded for 1930, the annual accounting principle required income to be determined at the close of the tax year, without regard to subsequent events. That meant the rescission in 1931 was disregarded in determining 1930 taxable income. With regard to whether the 1931 income should be taxed, the Court of Appeals found that the rescission in 1931 extinguished what otherwise would have been taxable income for that year.

Rev. Rul. 80-58 notes that the facts of *Penn* were similar to both sets of facts before it. Under the first set of facts, the rescission of the sale during 1978 placed A and B at the end of the tax year in the same positions as they were prior to the sale. Thus, the IRS disregarded the original sale because the rescission extinguished any taxable income for that year with regard to that transaction.

Under the second set of facts, there was a completed sale in 1978. However, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale. Under both sets of facts, the IRS found that annual accounting requires a determination of income at the close of the tax year without regard to subsequent events. Accordingly, no gain on the sale was recognized by A under the first set of facts. Conversely, A was required to report the sale for 1978 under the second set of facts. In 1979, when the property was reconveyed to A, A acquired a new basis in the property, which was the price paid to B for such reconveyance.

Applying Annual Accounting

Annual accounting hardly seems difficult. But, as the recent 2007 letter ruling shows, it's terribly important. Relying on the annual accounting concept in LTR 200701019, the IRS ruled that because of the parties' restoration, before the end of the tax year, of the relative positions they would have occupied if the merger had not occurred:

- The original Subsidiary 1 would be treated as not having been merged into Parent, and the original Subsidiary 1 and Parent will be treated as two separate corporations at all times during the tax year.
- Parent would be treated as having been the shareholder of the original Subsidiary 1 at all times during the tax year.
- The merger of the original Subsidiary 1 into Parent would not be treated as a liquidation of the original Subsidiary 1 for purposes of determining the taxable income of Parent or the original Subsidiary 1.

Annual accounting concepts are unforgiving, since the march of time is unrelenting. Still, a taxpayer may have an opportunity to unwind a merger, if unforeseen developments occur which make the completed transaction undesirable and if you act quickly. The key to successfully unwinding a transaction without triggering unwanted tax consequences is the ability to restore all of the parties involved to the same position they would have occupied had the transaction not occurred, prior to the end of the tax year in which the transaction was originally completed.