# Taking Comfort in Two

By Richard C. Morris • Wood & Porter • San Francisco

In the October 2006 issue of the M&A TAX REPORT, I wrote about LTR 200630002 [Apr. 24, 2006]. [*See* Morris, *Successful Debt Restructuring*, M&A TAX REPORT, Oct. 2006, at 5.] That letter ruling found that the conversion of a parent corporation into a limited liability company did not result in a deemed exchange of the company's debt. Recently, the IRS issued LTR 200645015 [Aug. 1, 2006], supplementing LTR 200630002.

This new ruling includes a more detailed discussion of the surrounding facts and rules on the underlying F reorganization. At nearly the same time, the IRS issued another F reorganization ruling, LTR 200648011 [Sept. 6, 2006]. F reorganizations may be pretty pedestrian; still, two F reorganization rulings issued within the same month should pique readers' interest.

## Comfort Rulings

These two recent rulings showcase an often overlooked aspect of mergers. The IRS will generally not issue a ruling blessing an F reorganization. These are commonly referred to as comfort rulings. [*See* Rev. Proc. 2007-3, 2007-1 IRB 108.] Even though the IRS may have the authority to issue a ruling on any question asked, IRS policy is clear that it will not rule in certain areas.

This is often (but not always) based on the factual nature of the transaction, and Rev. Proc. 2007-3 provides a list of no-rule areas that reads like a grocery list for a smorgasbord. Starting from Code Sec. 61, the list dances through virtually every chapter and subchapter of the income tax, tip-toes a bit through the estate tax and employment tax, and grinds to a halt in the omnipresent (and omnipotent) definitions of Code Sec. 7701.

In the context of reorganizations, the IRS will not issue an advanced ruling on whether a transaction qualifies under Code Sec. 332, 351 or 1036 for nonrecognition treatment. Plus, the IRS will not rule on whether a transaction constitutes an A, B, C, E or F reorganization, nor will it rule on the various consequences associated with a proposed reorganization, such as the basis of property transferred or acquired. That's a mouthful.

Yet, there are a few special rules to keep in mind. Although the IRS generally will not rule on a Code Sec. 351 contribution, it will rule on the application of Code Sec. 351 when the transaction is undertaken prior to the distribution of a controlled corporation in a Code Sec. 355 transaction. Moreover, a request for a ruling on whether a transaction constitutes an acquisitive corporate reorganization (say a D or G reorganization) or whether a transaction constitutes a corporate distribution under Code Sec. 355 are not subject to the "significant issue" limitation, as discussed below.

## Significant Issue

Notwithstanding all of this, the IRS will rule if it determines that there is a significant issue that is not clearly and adequately addressed by published authority. If there is a significant issue, to the extent the transaction is not described in another no-rule section of Rev. Proc. 2007-3, the IRS will rule on the entire transaction, not just the significant issue. In for a penny, in for a pound, it seems.

Thus, under Rev. Proc. 2007-3, a taxpayer can only obtain a ruling about the consequences of a transaction that may be an F reorganization if there is a significant issue involved. A significant issue is an issue of law that meets all of the following requirements:

- The issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice or other authority published in the Internal Revenue Bulletin.
- The resolution of the issue is not essentially free from doubt.
- The issue is legally significant and germane to determining the major tax consequences of the transaction.

An issue of law will be considered not clearly and adequately addressed by the authorities (and its resolution will not be essentially free from doubt) when, because of concern over a *legal* issue (as opposed to a *factual* issue), taxpayer's counsel is unable to render an unqualified opinion on the tax consequences of the transaction. Even though this standard may appear to be met frequently—since practitioners typically do not issue unqualified opinions—the IRS rarely issues comfort rulings.

Perhaps this conundrum exists because there is no definition of what constitutes an unqualified opinion. For example, would

any level of opinion less than a "will" level be qualified? Even if an unqualified opinion can be considered less than a "will" level, this standard suggests a rather high level of opinion. That level may be difficult to meet.

## Ruling Amendment

In LTR 200630002, which I wrote about a few months ago [*see* Morris, *supra*], the taxpayer requested guidance whether a proposed corporate restructuring would result in a deemed exchange of Parent's debt pursuant to Code Sec. 1001. The ruling concluded that the restructuring would not result in a significant modification of the debt for purposes of Reg. §1.1001-3(e), and thus would not result in a deemed exchange of Parent's debt. Later, the taxpayer requested a supplementary ruling concerning the qualification of the restructuring as an F reorganization.

Parent is a publicly traded corporation engaging in several lines of business, both directly and through its subsidiaries. Prior to the restructuring, Parent had two series of common stock outstanding: the "A Stock" and the "B Stock." The two series were identical, except that shares of each were allotted a different number of votes.

Parent completed the restructuring to create separate series of common stock intended to track the economic performance of two operational groups: Group 1 and Group 2. To effectuate the restructuring, Parent formed a subsidiary, New Parent, which in turn formed a subsidiary, MergerSub.

Immediately following their creation, Parent merged with and into MergerSub, with Parent surviving. In the merger, each outstanding share of Parent's A Stock was converted into and exchanged for shares of New Parent Series A Group 1 Stock and New Parent Series A Group 2 Stock. Likewise, each share of Parent's B Stock was converted into and exchanged for shares of New Parent Series B Group 1 Stock and New Parent Series B Group 2 Stock.

In this manner, New Parent became the head of the group. Plus, tracking stock was introduced to follow the economic performance of a division. After the restructuring, the shareholders owned the same assets as prior to the restructuring.

In the last step of the transaction, Parent converted into a single-member LLC. Thus, Parent became a division of New Parent, since New Parent held all of the membership interests in Parent. Given the complexity of the transaction, the taxpayer asked the IRS to rule whether the transaction, taken as a whole, would qualify as an F reorganization. After all, nothing had really changed, except that the head of the group, Parent, had morphed into New Parent.

Based on these facts, the IRS concluded that the restructuring qualified as an F reorganization. Yet, perhaps the most interesting aspect of the ruling concerned the tracking stock. From the taxpayer's perspective, the tracking stock was probably an essential part of the overall transaction.

Historically, the IRS has rarely ruled on the validity of tracking stock, and LTR 200645015 is no exception. Indeed, the IRS made the taxpayer represent that its tracking stock was valid in order to obtain the ruling. This measure could perhaps allow the IRS to later challenge the validity of the tracking stock without having to challenge the validity of the ruling itself.

## Nonprofit Ruling

If one comfort ruling weren't enough this holiday season, keep reading. In LTR 200648011, the IRS ruled on whether a nonprofit membership corporation ("Oldco") could merge into a new corporation ("Newco") in another state. The merger was to have dual goals: to facilitate the company making distributions to its members and to enable the company to become an S corporation. The ruling provided that the transfer was tax-free, characterized as both an E and an F reorganization.

Oldco was organized as a State A Not-for-Profit Corporation. For federal tax purposes, Oldco was treated as a C corporation, and not as a tax-exempt entity, since Oldco did not qualify under Code Sec. 501(c)(3). Oldco had one class of equity membership outstanding, and all of Oldco's members were individuals or grantor trusts. Oldco's members were entitled to vote on corporate affairs and corporate transactions. However, under State A law, the members were not entitled to receive distributions of net profits.

The members of Oldco proposed to form Newco, a State B nonprofit corporation. Like Oldco, Newco would have outstanding one class of equity membership. Under State B law, Newco's members would have similar rights as Oldco's members. Notably, however, Newco would be able to make distributions out of net profits to its members.

Oldco's management expects that making distributions to its members and operating as an S corporation will facilitate certain changes in operations, business lines, increases in capital, and/or revenue sources that Oldco may wish to undertake in the future. To achieve these objectives, Oldco proposed to undertake a two-step transaction.

Oldco would first merge into Newco, with each Oldco member receiving a membership interest in Newco in exchange for his or its membership interest in Oldco. In addition, Newco would change its name. Next, Newco would elect to be treated as an S corporation. Yet, because of concern over the legal issues, Oldco's counsel was unable to render "an unqualified opinion" with regard to the federal income tax consequences of the merger.

## Happy Trails

Generally speaking, the IRS will not rule on the qualification of a transaction as an E or F reorganization. However, the IRS will rule when a significant issue is at stake. Taking into account the circumstances here, including counsel's statement that he was unable to render an unqualified opinion, the IRS concluded that it was appropriate to issue a ruling.

According to the ruling, the first step will be viewed as Newco's acquisition of Oldco's assets in exchange for Oldco's receipt of member interests in Newco plus Newco's assumption of liabilities, followed by Oldco's distribution to its members of the Newco member interests. That means the first step qualifies as both an E and an F reorganization. Moreover, if Newco otherwise meets the requirements of a small business corporation, Newco can make its S election.

## Conclusion

Taxpayers and practitioners can take solace from these two comfort rulings. A ruling is still a ruling, even though many may assume that a routine F reorganization should be copasetic. Perhaps the real value here is the discussion concerning tracking stock. Although the taxpayer had to represent that the tracking stock was "stock," given the dearth of authority on this topic, LTR 200645015 may end up acquiring a status beyond that of the comfort ruling.

**ARTICLE SUBMISSION POLICY**

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodporter.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

CCH

a Wolters Kluwer business

4025 W. Peterson Ave.
Chicago, IL 60646

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH