Avoiding Constructive Distributions

by Robert W. Wood • San Francisco

All tax advisors are aware that the most painful type of taxable corporate distribution is one that does not really occur. When a corporation is deemed to have distributed amounts to shareholders, they will be taxable on that distribution (according to its amount and type) even though they did not physically receive anything. Many types of corporate restructurings carry at least some risk of constructive distribution treatment. The situation presented by Letter Ruling 9551001 provides a suitable example.

Closely Held Consolidated Group

In 1989, the parent of a group of companies not only held a variety of subsidiaries, but also conducted an active business directly. The parent company ("Old Parent") was closely held, and its board decided to restructure the group so that the active businesses were all held by subsidiaries of a holding company. The rationale for this change was the taxpayer's belief that a restructuring would protect and isolate the Old Parent's business assets from creditors of other members of the group, plus facilitating future acquisitions by protecting the operating assets of the Old Parent's business.

Consequently, the board adopted resolutions to incorporate a new entity ("New Parent"). Old Parent would buy $100 worth of New Parent stock, and then contribute all of the stock of Old Parent's active subsidiaries to New Parent. Old Parent was also authorized to take steps needed to complete a transaction in which New Parent would (in exchange for its own shares) become the parent of old corporation. This was accomplished by causing a transitory subsidiary to merge into Old Parent.

Following this plan, New Parent was incorporated shortly thereafter, the active subsidiaries were transferred to New Parent for the nominal consideration of $100, and Old Parent received 100 shares of New Parent stock.

When the smoke cleared, New Parent became a wholly-owned subsidiary of Old Parent, and the active subsidiaries of Old Parent became wholly-owned by New Parent. New Parent then transferred the $100 it received from Old Parent to the transitory subsidiary in exchange for 100 shares of the transitory subsidiary's common stock. Finally, the restructuring plan called for the investment subsidiary to transfer some stock interests to New Parent.

On the day that all of this restructuring activity occurred, the boards of Old Parent, New Parent and the transitory subsidiary each approved a merger agreement under which the transitory subsidiary would be merged into Old Parent. The merger agreement required approval by Old Parent's shareholders, which approval was given. When this merger was consummated, each share of Old Parent stock was converted into stock of New Parent, having the same terms and characteristics as the stock that was originally held. Plus, the shares of the stock in the transitory subsidiary that were held by New Parent were converted into shares of Old Parent stock. Finally, the merger agreement required Old Parent to surrender New Parent stock that had been issued to Old Parent on the incorporation of New Parent.

This transaction all went as contemplated. In the aftermath, the former shareholders of Old Parent now owned all of the shares of New Parent. New

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Parent owned all of the stock of Old Parent, plus all of the stock of the active subsidiaries that had previously been owned by Old Parent.

Distribution of Subsidiaries?

How did this fact pattern end up as a Technical Advice Memorandum? The examining Internal Revenue Service agent characterized this transaction as involving, in substance, a distribution of the active subsidiaries by Old Parent to its individual shareholders, followed by the contribution of Old Parent and the active subsidiaries to New Parent. The primary argument the agent voiced was that the transaction was a taxable distribution to the former Old Parent shareholders, because the cancellation of the New Parent stock issued to Old Parent (in exchange for the subsidiary stock) was a transfer of the subsidiary stock without consideration, a transfer designed to benefit only the Old Parent shareholders. The question was whether this amounted to a distribution.

Sorry, Charlie

Technical Advice Memorandum 9551001 concludes that there was no constructive distribution despite the Revenue Agent's argument. The National Office characterized the transaction, instead of a distribution, as merely a contribution of Old Parent stock to New Parent, followed by a distribution of the active subsidiary stock by Old Parent to New Parent. In other words, as stated by the Service, "The stock of the active subsidiaries did not actually leave corporate solution to be held directly by the individual shareholders, who merely exchanged their interests in one corporation, Old Parent, for interests in another, New Parent."

One would think this situation would be obvious. After all, while one might choose to make certain changes in the structure and execution of the transaction, there certainly seems to be no abuse in this mere rescrambling of corporate ownership. When a "real" distribution is made—say in a Section 355 transaction—there is generally enormous scrutiny by the taxpayer's advisors on the question whether the distribution will be tax-free or is suspect. Of course, if the Internal Revenue Service is asked for a ruling, the standards for spotlessness go up accordingly.

Conclusion

If nothing else, Technical Advice Memorandum 9551001 should demonstrate that even transactions that seem simple may invoke some Internal Revenue Service concern. Where this occurs, there will doubtless be upset (and expense) to the constituent companies. ■