ID: CCA-251219-09

Number: **200950036**
Release Date: 12/11/2009

Office:

UILC: 304.00-00, 301.00-00,
1059.01-00, 1502.32-00

From:
Sent: Thursday, February 05, 2009 12:19 PM
To:
Cc:
Subject: Hi

See draft slides. << File: Strip and Sell Slides for CPE 8-8-08 draft.pdf >>
Thanks.

Attachment 1

The "Strip and Sell" Transaction

Legend

X, C, Holdco, Oldco, Buyer 1 and E&P Co:	corporations that are not members of a consolidated group.
L :	a life insurance company. Sections 801 and 1504(b)(2).
CP :	the common parent of a consolidated group.
M, M-1, M-2:	subsidiary members of the CP consolidated group.
FMV:	fair market value.
E&P :	earnings and profits.
DRD :	dividends received deduction.

Part One:
Building Blocks

Basis

Distributions of E&P

Return of Capital

The Simple Concepts

The Simple "2 Levels of Tax" Rule: Under our income tax system, a "C" corporation's ("C") earnings are generally to be taxed at only 2 levels:

C is to pay tax on its income/gain.

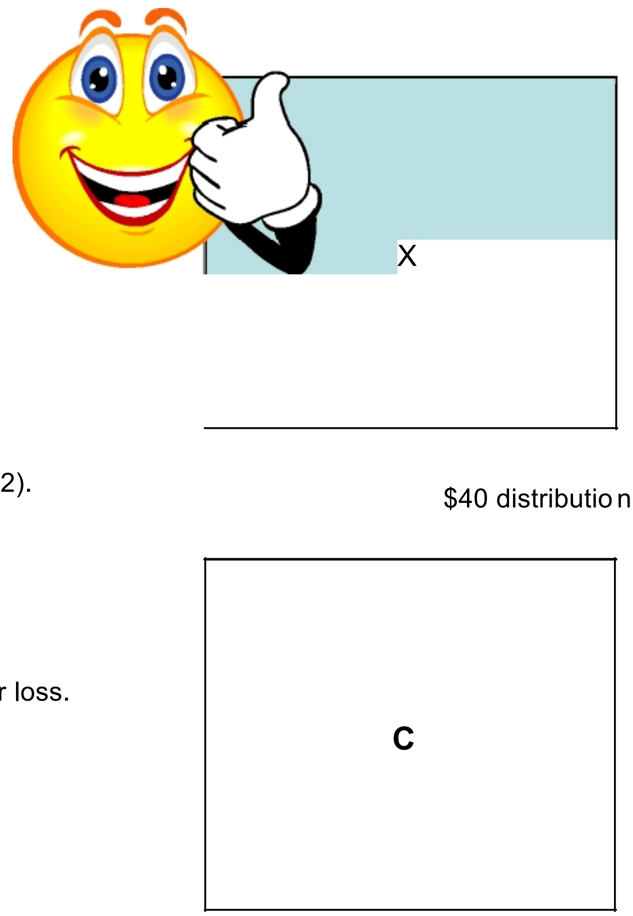
C's shareholder ("SH") is to be taxed when C distributes a dividend. The dividend is generally to be included in SH's taxable income.

The Simple Concept of "Basis": "Basis" is a tool that allows us to separate previously taxed earnings from earnings that have not yet been subject to tax.

For example, if SH invests $100 of post-tax earnings in an investment asset (e.g., "C" stock) and later sells that stock for $125, SH should only be taxed on the part of the $125 that hasn't already been subject to a SH level tax. Thus, SH gets $100 of "basis" in the C stock when SH makes the investment, and deducts this $100 of basis from the $125 in determining what part of the $125 will be subject to tax ($125 minus $100 = $25).

Generally, (where SH and C are not filing a consolidated return) SH increases its basis in its C stock when SH makes a contribution to C's capital and SH's basis in the C stock is decreased by non-dividend distributions – and any excess distribution is treated as gain from a sale or exchange.

Example 1 : Return of Capital



X owns all the stock of C.

At the end of Year 1, X's basis in its C stock is $100.
C's FMV is $100.

C has no E&P.

C makes a $40 distribution to X.
X reduces the basis of its C stock by $40. Section 301(c)(2).

<u>Post-distribution:</u>

- X's basis in its C stock = $60;
- C's FMV = $60.

If X sells all of its C stock for $60, X will not realize gain or loss.

BUT NOTHING IS SIMPLE

What if C's shareholder ("X") is itself a "C" corporation, and X and C file separate income tax returns?

Because X's stock basis in C is not adjusted when C has income/gain or losses, or changes in the "inside" basis of C's assets, and because C's dividend distributions to X do not generally reduce X's basis in its C stock, the simple rules will not always work as intended without some help.

Taxpayer Unfavorable Result:

Example 2: (See next slide.) X forms C with a $100 capital contribution. C earns $60 and pays $20 of tax. At such time, X's C stock has a $100 basis and the stock's value is $140. If X sells its C stock, X will have a $40 gain. However, X's $40 of gain in its C stock is entirely attributable to C's $40 of previously taxed income.

If X pays $14 of income tax on its $40 gain, X would only have $26 available to distribute to its (individual) shareholder as a dividend.

The simple rules don't always work so well for taxpayers.

Example 2: Too Much Tax?

[redacted]

X

C

$40 of E&P (after tax)

X, in forming C, contributes $100 to C’s capital.

X has $100 basis in its C stock. C

earns $60 and pays $20 of tax.

Due to C’s post-tax earnings, X’s C stock now has a FMV of $140.

If X sells the C stock, X will have a $40 capital gain.

Assuming a 35% tax rate, X will pay $14 of tax on its $40 gain. (Note that this gain will increase X’s E&P.*)

The Fix? More Rules. Taxpayers Use a Little "Self-Help"

The Dividends Received Deduction – seems like a good idea. Congress thought it would be excessive to have a corporation's earnings fully taxed more than once at the corporate level. Thus, if the shareholder receiving the dividend is a corporation holding a qualifying level of ownership in the distributing corporation, the shareholder gets a "dividends received deduction." See § 243.

With the help of the DRD, taxpayers can avoid the result in Example 2 by having C make a distribution to X.

Thus, if X forms C with a $100 capital contribution, and C earns $60 and pays $20 of tax, X will have a $100 basis in its C stock, and C will have a $140 value. To avoid the result in the prior example, C distributes its $40 of earnings to X as a dividend subject to the DRD. After the distribution, X will have a $100 basis in its C stock and C's value will be $100. (See Example 3)

Section 243 and a little "dividend strip" can reach the result Congress intended.

Example 3 : Distribution of E&P—DRD

In Year 1, X forms C with a $100 contribution. § 351.
X's basis in the C stock is $100. C's FMV is $100.

C nets (an aggregate of) $40 in earnings in Years 1, 2 and 3.
At the end of Year 3, C's E&P is $40.
X's basis in the C stock is $100.
C's FMV is $140.

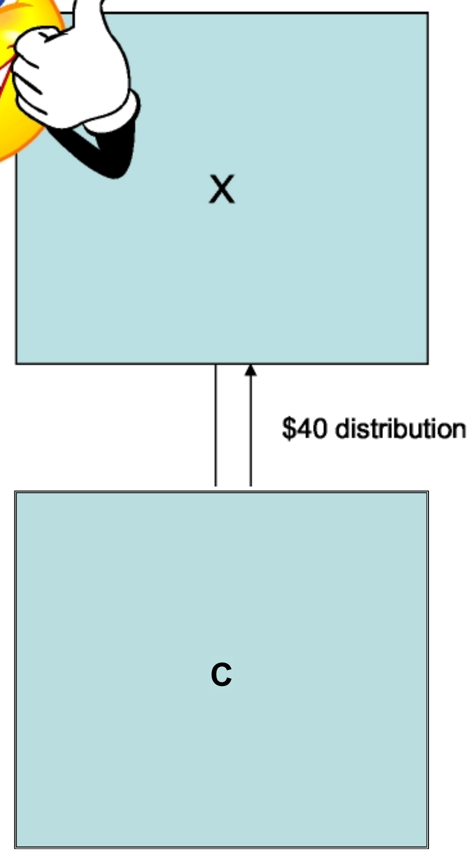
At the end of Year 3, C makes a $40 dividend distribution to X. § 301(c)(1).

X applies § 243. (DRD). (Special rules apply if C is a life company.)

Immediately after the distribution:

- X's basis in the C stock = $100
- C's FMV = $100.

If X sells the C stock for $100, X will not realize gain or loss.



Nothing is Simple

In the prior example, X's basis in its C stock reflected X's $100 capital investment in C and did not reflect C's $40 of E&P.

What would happen if X's basis did reflect C's E&P? See Example 4:

Example 4 : Basic "Strip and Sell" Transaction

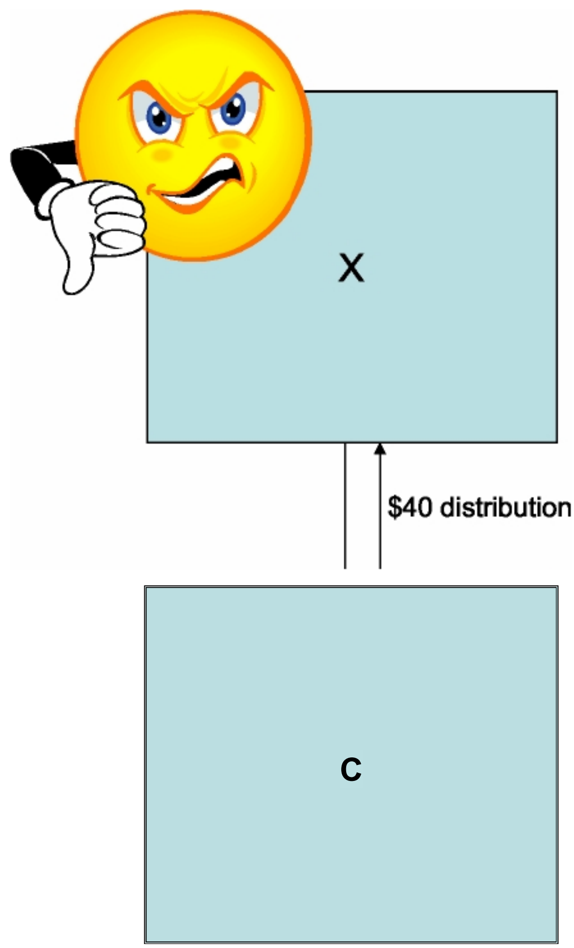
On 1/1 of Year 1, X buys C for $140.
At the time of the purchase, C has $40 of E&P.
X's basis in its C stock is $140.

More than 2 years later, C distributes a $40 dividend to X. Assume C's E&P is still $40 before the distribution. X applies the DRD.

Immediately after the distribution:

- X's basis in its C stock = $140
- C's fair market value = $100.

X sells the C stock and claims a capital loss of $40. (Note that X will reduce its E&P accordingly.*)



Nothing is Simple

Is the result in Example 4 consistent with our tax policy?

C paid $20 of tax on its $60 of earnings. X paid no tax on

receipt of the $40 dividend.

X has a $40 capital loss on the sale of the C stock. X will be able to reduce its E&P. X will use this loss to eliminate $40 of X's capital gain. Assuming a 35% tax rate, the loss will enable X to save $14 in taxes.

Does the answer depend on whether the person who sold C to X was an individual or a C corporation? (See Example 2.)

What other factors may influence our decision?

Characteristics of a "STRIP & SELL"

(1) A direct or indirect subsidiary of X has E&P that was not earned while X was the shareholder of such subsidiary...

For instance:

- X purchased a corporation that had E&P at the time of the purchase;
- Someone other than X purchased a corporation that had E&P at the time of the purchase and contributed such corporation to X in a § 351 transaction;
- X purchased a corporation that did not itself have E&P, but a subsidiary of the target corporation had E&P at the time of the purchase;
- X purchased a corporation with E&P and subsequently moved the target's E&P to another X subsidiary in a § 381 transaction;

(2) A dividend subject to a DRD

(4) **A sale** (the sale need not result in a loss – the taxpayer may just pay less gain than it otherwise would).

There are many ways to lead up to a strip and sell transaction.

Example 5 : Tracing E&P and Keeping Track of Basis

Step 1

[redacted]

Buyer 1

B= 40
V = 40

B = 100
V = 100

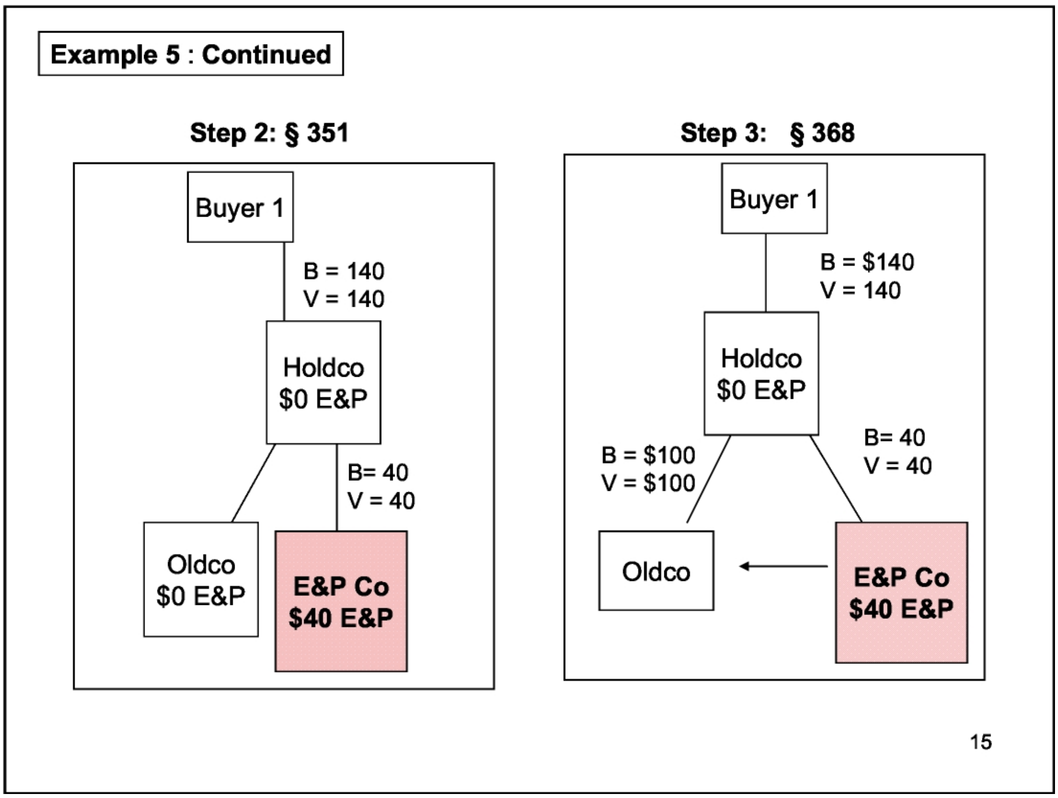
[redacted]

Holdco
$0 E&P

B = 100
V = 100

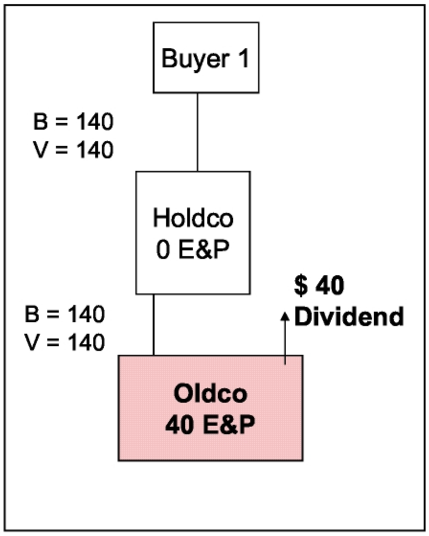
Oldco 0
E&P

Buyer also owns Holdco and Oldco.

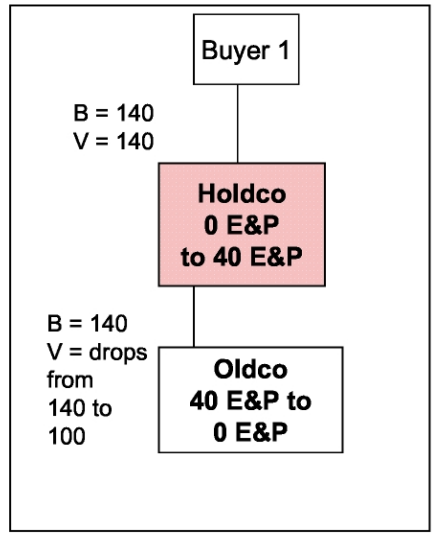

Example 5 : Continued
Step 2: § 351
Buyer 1
B = 140
V = 140
Holdco
$0 E&P
B= 40
V = 40
Oldco
$0 E&P
E&P Co
$40 E&P
Step 3: § 368
Buyer 1
B = $140
V = 140
Holdco
$0 E&P
B = $100
V = $100
B= 40
V = 40
Oldco
E&P Co
$40 E&P
15

Example 5 : Continued

Step 4: Dividend



Step 4 – Post Dividend



Example 5 : Continued

[redacted]

Holdco sells Oldco for $100 –

Holdco takes a $40 capital loss

Holdco will reduce its E&P
by the amount of the loss.*

Section 1059

Congress enacted § 1059 to prevent taxpayers from exploiting the DRD. Section 1059(a) requires a corporate shareholder to reduce the basis of the stock it holds in a subsidiary if the subsidiary makes an extraordinary dividend on stock held less than 2 years.

See § 1059(e)(2)(B) regarding E&P earned by a corporation during a period it was not a member of the affiliated group (etc.).

Section 1059 and the regulations thereunder are complex. A full discussion of the provisions is beyond the scope of this class.

If a corporate shareholder is patient, it can avoid the application of § 1059.

Example 6: Distribution of E&P with Application of § 1059

[redacted]

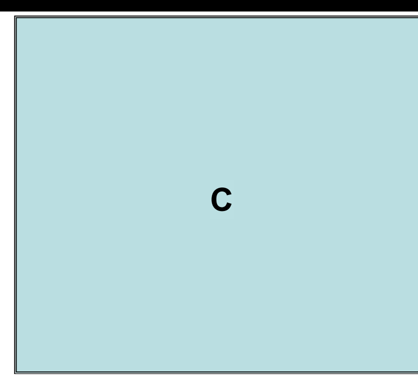
Same facts as Example 4, except that C's $40 distribution of E&[redacted] to X occurs at the end of Year 1.

Prior to the distribution, X's basis in the C stock was $140 and C[redacted] FMV was $140.

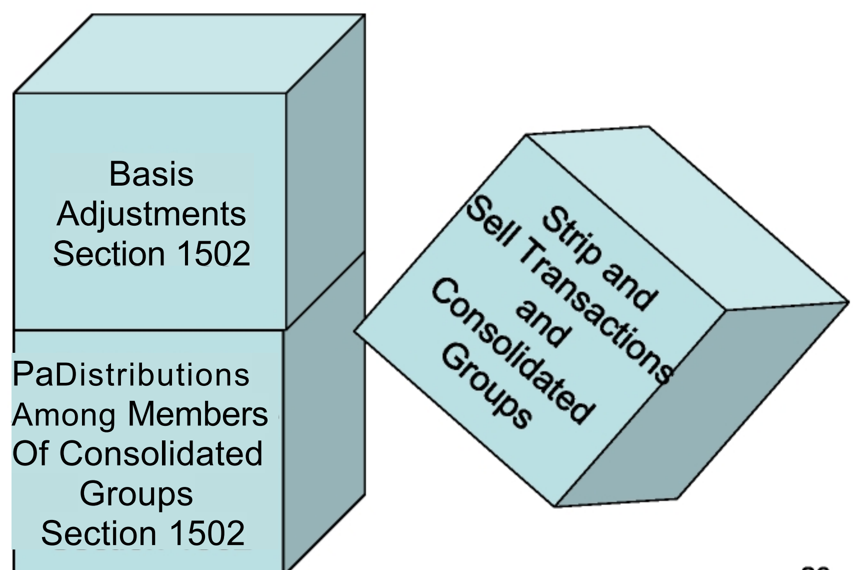
Immediately after the distribution:

- C's FMV = $100.
- Section 1059 applies: X must reduce its basis in its C stock from $140 to $100.

If X immediately sells its C stock, X will not realize gain or loss.



Part Two:



Basis Adjustments Section 1502
PaDistributions Among Members Of Consolidated Groups Section 1502
Strip and Sell Transactions and Consolidated Groups

The Consolidated Return Investment Adjustment Rules:

The consolidated return regulations provide a fairly comprehensive set of rules (the investment adjustment rules) that require a member of a consolidated group to make upward and downward basis adjustments in the stock it holds in a subsidiary member upon the occurrence of certain events. The rules are complex, and beyond the scope of this presentation.

The investment adjustment rules are intended to treat the separate corporate taxpayers that join in the filing of a consolidated income tax return as if they were a single entity. The are designed to:

- avoid duplication of operating income as investment gain; and
- preserve special treatment under the Code of certain items (e.g., tax exempt interest).

Amount of Adjustment: A full discussion of this issue is beyond the scope of this class.

A member will generally increase the basis of the stock of its subsidiary member when the subsidiary takes income and gain into account.

A member will generally decrease the basis of the stock of its subsidiary member when the subsidiary takes a loss into account. When negative adjustments under § 1.1502-32 exceed the member's basis in the stock of its subsidiary, instead of an immediate tax, the downward adjustment results in an excess loss account (ELA).

The Consolidated Return Investment Adjustment Rules continued.

Tiering Up: If there is a "chain" of corporations in the consolidated group, such that CP owns P and P owns S, any adjustment that P makes to its S stock is duplicated in CP's basis in its P stock.

Illustration 1: CP owns all of the P stock and P owns all of the S stock. CP, P and S are members of the CP consolidated group. At the beginning of Year 1, CP has $10 of basis in its P stock and P has $10 of basis in its S stock. In Year 1, S earned $5 of taxable income. P makes a $5 positive basis adjustment to its S stock, increasing it to $15. CP also increases its basis in its P stock by $5, increasing it from $10 to $15.

Illustration 2: Basis adjustment when S makes a distribution to P -- Prior to any distributions, CP has a $10 basis in its P stock, and P has a $10 basis in its S stock; CP and P are mere holding companies and S has $10 of assets.

If S makes a $2 distribution to P – be it a dividend or a return of capital, the value of S decreases by $2, so P would reduce its basis in its S stock from $10 to $8.

P has lost $2 of basis in its S stock, so CP would reduce its basis in its P stock by $2. However, P has received $2, and the investment adjustment rules require CP to increase its basis in its P stock by $2. Thus, there will be no net change to CP's basis in its P stock due to S's $2 distribution to P..

After the distribution: CP has $10 of basis in its P stock (and P's value is $10 -- $2 of cash and $8 of S stock). P has $8 of basis in its S stock (and S's value is $8).

Example 7 : Distribution Between Members of a Consolidated Group

[redacted]

CP owns all of the M stock.
CP's basis in its M stock is $100.
M's FMV is $100.

M earns (net) $40, thus M's FMV increases to $140.
CP's basis in its M stock increases by $40 to $140. § 1.15[redacted]

M makes a $40 distribution to CP.
M's FMV decreases by $40 to $100.
CP's basis in its M stock decreases by $40 to $100.

If immediately after the distribution CP sells its M stock t[redacted]
unrelated buyer for $100, CP will not realize gain or loss [redacted]
sale.

Interaction of Single Entity and Consolidated Return Rules

Generally, if one or more members of a consolidated group own 80 percent of the vote and value of the stock of a corporation, such corporation is required to join in the filing of such group's consolidated return. See §§ 1501, 1502, 1504.

However, to join in the filing of a consolidated return, a corporation must be an "includible" corporation. See § 1504(b).

Certain corporations – such as those listed below --- do not qualify as includible corporations:

- insurance companies subject to tax under § 801
- RICs and REITs
- Foreign corporations

Don't forget that if a member of a group owns less than 80 percent of the vote and value of a subsidiary, a distribution by such subsidiary to the member may qualify for the DRD, albeit less than 100 percent.

Example 8 : Distribution out of E&P from a Life Insurance Corp[redacted]
Member of a Consolidated Group

CP owns all the M stock. CP's basis in M is $100. M owns all the L stock. M's basis in its L stock is $100. L's FMV is $100. None of the entities have E&P.

L nets (an aggregate of) $40 in earnings in Years 1, 2 and 3. L's E&P is now $40. M's basis in its L stock is still $100 and L's FMV is now $140. (See Example 2)

At the end of Year 3, L dividends $40 to M. §301(c)(1).

M applies the DRD. §§ 243 and 1.243-4.

<u>Post-dividend:</u>

- Section 1059 does not apply: M's basis in its L stock = $100.
- L's FMV = $100.
- CP's basis in its M stock = $140.
- M's FMV = $140.

$40 distribution

If after the distribution M sells its L stock to an unrelated buyer, M does not realize gain or loss on the sale. (See Example 3)

Example 9 : Another Distribution of E&P From a Life Insurance Corporation to a Member of a Consolidated Group

CP forms M with $100 contribution. § 351. CP's basis in M is $100. M's FMV is $100.

On 1/1 of Year 1, M buys all the L stock for $100. L has $40 of E&P. M's basis in its L stock is $100. § 1012. L's FMV is $100.

If M immediately sells its L stock for $100, M will not realize gain or loss. If, instead, CP sells its M stock for $100, CP will not realize gain or loss.

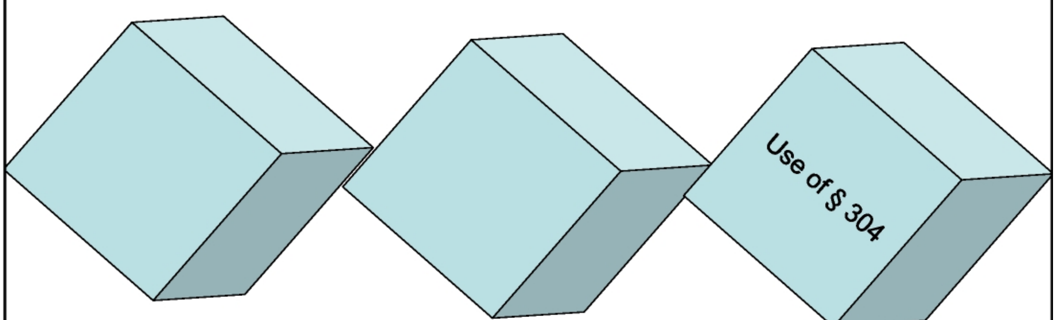
On 2/1 of Year 3, L dividends $40 to M. § 301(c)(1). M applies the DRD. §§ 243 and 1.243.

Post-dividend:

- Section 1059 does not apply: M's basis in its L stock = $100. L's FMV is $60.
- CP's basis in its M stock increases by $40 to $140. § 1.1502-32. M's FMV is $100.

If CP sells its M stock for $100, CP would take a $40 capital loss. If, instead, M sells its L stock for $60, M would take a $40 capital loss. (Note that the corporation taking the loss would also reduce its E&P.) **Are these economic losses?**

Part Three:



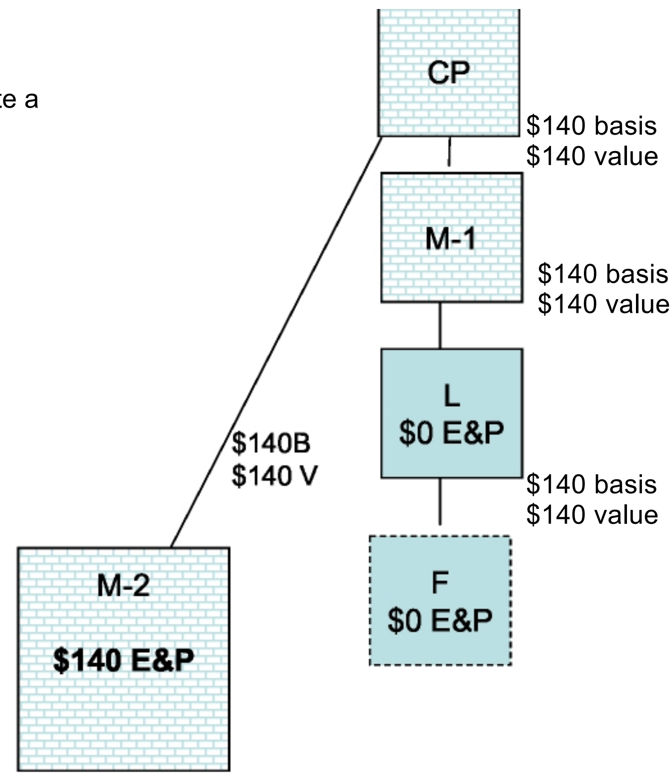
Example 10 : Strip and Sell Transaction via a Section 304 Stock Transfer

The CP consolidated group wants to generate a loss. How can it do so?

If L makes a distribution to M-1, the distribution will be a return of capital. M-1's basis in its L stock will drop, dollar for dollar, by the amount of the distribution.

If M-2 makes a distribution to CP, CP's basis in its M-2 stock will be reduced, dollar for dollar, by the amount of the distribution. § 1.1502-32.

What if M-2's E&P could easily be moved to L?



Example 10 : Continued

[redacted]

To generate a "strip and sell" loss, the group needs to shift M-2's E&P to L.

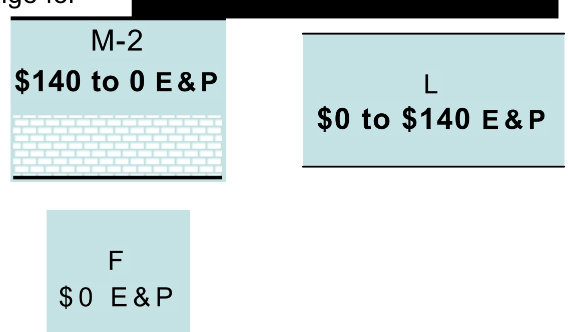
L is willing to transfer F to M-2, but L does not want to own any M-2 stock. Instead, L only wants cash.

If L only gets cash from M-2 in exchange for F, is the exchan[redacted] respected as a sale? If so, L would not get any E&P becau[redacted] L's basis in the F stock was equal to its value.

Suppose L transferred its F stock to M-2 in exchange for M-2 stock (either in a qualifying § 351 or in a sale) and then redeemed the M-2 stock for $140 cash? If the IRS respects the redemption, L would be treated as receiving a $140 dividend (due to attribution rules of § 318).

Would step transaction apply (ignore M-2's issuance of stock and redemption)?

Section 304: If L transfers its F stock to M-2 in exchange for property (e.g., cash) L is treated as receiving a dividend from M-2.



Example 10 : Continued

Section 304: If L sells F to M-2 in exchange for “[redacted] (e.g., cash) in a **qualifying § 304 transaction**,** L’s [redacted] be $140 after the exchange and L will have $140 of E&P [redacted]

If L distributes $40 to M-1, the result will be similar to that [redacted] Example 9.

The distribution qualifies for the DRD and is not subject to [redacted] § 1059.

<u>Post-dividend:</u>
M-1 will have $140 of basis in its L stock;
L’s FMV will be $100.

CP will increase its basis in its M-1 stock to $180.
M-1’s FMV will still be $140. ($40 cash and $100 of L stock)

If CP sells its M-1 stock, or if M-1 sells its L stock, the seller will claim a $40 capital loss. **Is this an economic loss?**

** § 304 does not apply to a sale from one member of a consolidated group to another member. The Ex. 10 transaction qualifies under § 304 because L is a life insurance company.

A full discussion of § 304 is beyond the scope of this course.

In order to trigger the loss, the taxpayer may sell the built-in-loss stock to an unrelated party.

However, the taxpayer may sell some of the built-in loss stock in its subsidiary (“SUB”) to a related party in a § 267(f) transaction. In such transactions, the shareholder will sell enough stock to reduce its ownership in SUB to less than 80 percent. The loss realized in the § 267(f) sale is generally deferred until a certain triggering event.

The shareholder will then liquidate SUB in a § 331 transaction and claim the loss on both the Sub stock it exchanges in the liquidation and the deferred § 267 loss.

Contact Information