

## **Entity Identity: The Taxation of Quasi-Separate Enterprises**

I started to write this paper with the intention of discussing only series funds, at a time when the IRS had yet to issue any meaningful guidance on whether a series fund was to be treated for tax purposes as a single entity or a group of entities, one for each series. My plans changed, however, after Jim Peaslee and Jorge Tenreiro came out with a superb article on this issue,<sup>1</sup> leaving me with little to add on this focused topic.

That article, did however, inspire me to pursue a path that led to this paper. They briefly discussed analogies between series funds and other arrangements such as tracking stock and stapled stock. It occurred to me that no commentary had been written that looked more broadly at the questions of when parts of a single legal entity should be treated as separate for tax purposes, or when multiple legal entities should be treated as one. In starting to look at these questions, I realized that other arrangements would also be relevant, including securitization vehicles, consolidated groups, and dual listed companies.

The resulting paper is a collection of mini-essays on the various arrangements that give rise to “quasi-separate” enterprises. But it seeks to be more than that, by examining ways in which the treatment of each of these arrangements sheds light on the others and extracting, to the extent possible, some general principles about when and how these quasi-separate enterprises should be treated as distinct entities for tax purposes.

<sup>1</sup> James M. Peaslee and Jorge G. Tenreiro, *Tax Classification of Segregated Portfolio Companies*, 117 TAX NOTES 43 (Oct. 1, 2007).

## Contents

I.	Introduction.....	588
II.	Single Entity, Separate Interests .....	590
	A. Series Funds .....	590
	1. Corporations .....	591
	2. Trusts .....	595
	3. Limited Partnerships and LLCs .....	603
	4. Proposed Regulations on Series Organizations.....	608
	B. Tracking Stock.....	612
	C. Targeted Debt.....	629
	1. Nonrecourse Debt .....	629
	2. Structured Notes .....	633
	3. Securitization Vehicles.....	638
III.	Multiple Entities, Shared Interests .....	642
	A. Subsidiaries .....	642
	B. Stapled Stock.....	647
	1. Early Bank Cases.....	647
	2. Rulings .....	650
	3. Section 269B .....	655

C.	Dual Headed Companies.....	667
1.	Stapling Risk.....	669
2.	Deemed Partnership Risk.....	672
3.	Analogous Arrangements.....	678
IV.	Criteria for Joint or Separate Taxation.....	682
A.	Policy Principles.....	682
1.	Constraints of Case Law.....	682
2.	Clarity.....	684
3.	Reflection of Substance.....	685
4.	Prevention of Abuse.....	688
B.	Lessons Learned.....	694

## I. INTRODUCTION<sup>2</sup>

Many of the fundamental questions of the tax law can be posed by applying the great interrogatory pronouns to income: how much is there, who should be taxed on it, when should it be recognized, where should it be sourced, what should be its character? This article asks a different sort of question, of entities: How many?

Usually, it's an easy question. Each corporation, partnership, LLC, or trust that is a distinct entity under its governing law is treated as a single separate entity for federal income tax purposes. But exceptions come quickly to mind: a transparent entity<sup>3</sup> or grantor trust<sup>4</sup> with a single owner is treated as a branch of that owner, even though it is legally separate; a contractual profit-sharing arrangement can be viewed as a separate entity that is a partnership for tax purposes, and can even elect corporate status under the “check the box” regulations;<sup>5</sup> and a portion of an entity may be treated as a separate corporation if it constitutes a taxable mortgage pool.<sup>6</sup>

More interesting questions arise when a set of enterprises share some, but not all, characteristics of a single entity. A variety of domestic and foreign statutes allow business trusts and limited liability companies to establish separate cells or series, each of which can issue equity and debt instruments backed only by its own pool of assets. Corporations lacking separate series commonly issue nonrecourse debt backed only by specified assets, and less commonly issue tracking stock or structured notes that are entitled to a return calculated by reference to specified assets. Conversely, legally separate

<sup>2</sup> The author gratefully acknowledges the research assistance of Andrew Bloom, Jessica Millett, and Jonathan Van Loo.

<sup>3</sup> Treas. Reg. § 301.7701-2(a).

<sup>4</sup> I.R.C. § 671.

<sup>5</sup> See *infra* notes 248–250 and accompanying text.

<sup>6</sup> I.R.C. § 7701(i)(2)(B).

entities might align themselves by stapling their equity interests to ensure parallel ownership, or by establishing equalization arrangements designed to ensure that their equity interests maintain fixed relative values.

In each of these cases, determining whether there is one entity or many for tax purposes is absolutely fundamental, since so much else depends on it. Yet guidance is more sparse than one would expect, given the frequency with which these questions arise. The arrangements described here are commonly, though not always, set up for commercial reasons having nothing to do with tax avoidance. The parties deserve to know how they will be viewed by the tax authorities.

This article discusses some of the tax issues associated with a variety of these arrangements for creating “quasi-separate” enterprises. It does not attempt to do so comprehensively; rather, the goal is to explore those aspects of these arrangements that are most relevant to the question whether they should be treated as separate entities, with a view to seeing whether the lessons learned in one area can be usefully applied to another.

The article concludes with a discussion of general principles that should guide the development of rules for determining when two enterprises should be treated as parts of a single entity and when they should be treated as separate entities. In the interest of clarity, significant weight should be given to the formal trappings of the arrangements, even though this means that economically similar arrangements may be treated dissimilarly. To the extent that opportunities for abuse exist, they are best addressed in the context of the particular tax rules that are being applied.

## II. SINGLE ENTITY, SEPARATE INTERESTS

An entity can issue instruments that represent interests in less than all of its assets. Special classes of stock can be created that provide for distributions based solely on the performance of a specified pool of assets. These classes of stock can be used by investment funds to give investors a choice among different types of investments, or by operating companies to give investors an opportunity to take on investment exposure that is principally related to a single line of business.

Debt instruments can also relate to a subset of the issuer's assets. Conventional nonrecourse debt is an example of this, and in other cases the debt may be more tightly bound to the fate of particular assets. This most commonly arises in structured note issuances where the interest on the debt, and sometimes the principal, is governed by a formula that may relate to the value or proceeds of specified assets; or in special purpose vehicles that issue separate classes of notes, each with its own pool of collateral. In many cases there will be questions whether the instrument should be treated as debt or equity for tax purposes, but the focus here is instead on whether there are grounds for treating the underlying assets as belonging to a separate entity.

### A. *Series Funds*

Series funds go by a variety of names, including “protected cell companies” and “segregated portfolio companies,” but the idea is the same: to provide for separate classes of stock that are backed by distinct pools of assets. They are not tax-motivated, since separate legal entities could have been used; instead, the goal is to get the benefits of multiple entities with the administrative overhead of a single entity only.

There is limited authority on the question whether a series fund should be treated as one entity or many. One might expect the question to turn on how complete the segregation of each series is. The existing authorities, however, rely more on the legal characteristics of the entity itself. Consequently, whether a series fund is one entity or many will depend on whether it is organized as a corporation, a business trust, or other form of business entity.

The IRS has issued proposed regulations that, when finalized, will provide separate-entity treatment for series funds generally.<sup>7</sup> But these regulations are not yet in effect, apply only to domestic entities and foreign insurance companies, reserve on the question of employment taxes, and contain transition relief to allow some entities to continue to apply existing law. Hence some discussion of the historical background is in order.

### 1. *Corporations*

The status of a series fund organized as a corporation was settled over 60 years ago in *Union Trusteed Funds, Inc. v. Commissioner*.<sup>8</sup> The taxpayer was a Delaware corporation operating as a regulated investment company under the predecessor to Section 851 of the Internal Revenue Code. It was a series fund entity with six classes of stock, representing interests in three bond funds, a preferred stock fund, and two common stock funds. Most of the capital gains for the year in issue were realized by one of the bond funds, but the taxpayer treated a uniform percentage of the dividends paid on all series as a capital gain dividend, equal to the percentage of the funds' overall distributions that were attributable to net capital gains. The result was that shareholders in funds that realized little or no gain nonetheless received a capital gains dividend, while shareholders in the bond fund

<sup>7</sup> Prop. Treas. Reg. § 301.7701-1(a)(5), discussed *infra* in Part II.A.4 (p. 608).

<sup>8</sup> 8 T.C. 1133 (1947).

with sizable gains received a capital gains dividend that was much smaller than the net capital gain actually realized by that fund.

The taxpayer in this case was organized as a regular Delaware corporation, rather than under any of the special segregated portfolio company regimes that have since been developed in a number of jurisdictions, including Delaware.<sup>9</sup> Consequently, the separation of the classes of shares was accomplished entirely by the designation of share rights in the certificate of incorporation, as follows:

- (i) The proceeds of issuance of each class of shares were invested separately for the benefit of that class, subject only to the rights of creditors.
- (ii) Dividends were payable on each class only out of the earnings or surplus for that class.
- (iii) On dissolution, each class received only assets of its own class, plus its share of any general assets.
- (iv) The assets of each class were subject only to liabilities of that class and its share of any general liabilities.

Notwithstanding the potential rights and obligations of each class with respect to “general” assets and liabilities, it does not appear that there were any material assets or liabilities of that sort. The absence of liabilities in this case is unsurprising, since regulated investment companies are subject to restrictions on the issuance of “senior securities” under the Investment Company Act of 1940 (the “1940 Act”).<sup>10</sup>

The Tax Court rejected the Service’s position that the net long-term capital gain of each fund be determined by treating it as a separate corporation. The taxpayer was legally a single corporation, and statutory references to “the corporation” necessarily referred to the

<sup>9</sup> See *infra* note 41.

<sup>10</sup> The 1940 Act § 18(a) permits a closed-end company to issue debt securities if it has an asset coverage ratio of 300 percent at the time of issuance. § 18(f) has a similar restriction for open-end companies, with the further requirement that the debt be limited to bank loans.

taxpayer as a whole. Yet the Court's ultimate conclusion was hardly a victory for the taxpayer, either. The Court declared that the relevant statutory rules governing capital gain dividends limited the amount of capital gain dividend that could be declared on any one series fund to the capital gains actually realized by that fund. Consequently, the taxpayer was denied a deduction for distributions designated as capital gain dividends on the funds that had no capital gains, and the deduction was limited to the amount of actual gain for the fund whose own gain was smaller than the capital gain dividend declared on its shares based on the uniform percentage applied by the taxpayer. Conversely, the fund whose gains exceeded the amount of its declared capital gain dividend could deduct no more than the amount of that declared capital gain dividend, since that was all that its shareholders were treating as capital gains. The overall result was that the fund in effect wasted some of its potential to distribute capital gain dividends, and it might have been better able to utilize that potential if it had correctly anticipated the Tax Court's holding.

Although the Tax Court gave effect to the separate existence of each series in determining the amount of the permitted capital gain dividend, the case is better known for its underlying premise that a series fund organized as a domestic corporation is a single entity for federal income tax purposes, notwithstanding the complete segregation of its assets among various fund portfolios. Although the decision leaves scope for series funds to direct their capital gains dividends to the series that have capital gains, it appears that net losses in one series would reduce the amount of net gains of other series that could support capital gains dividends in those series.

This is a nonsensical result given the economic separation of the series, and other troubling conclusions could be, and were, derived from this single entity treatment. For example, in Revenue Ruling 56-

246,<sup>11</sup> the Service concluded that sales of securities by one series to another were nontaxable carryover basis transactions, since they were merely transfers among different pockets of the same taxpayer. In testimony in support of a legislative fix, Treasury officials noted that single entity treatment could be used to circumvent the statutory requirements for regulated investment companies.<sup>12</sup> For example, a particular series could be allowed to fail the diversification test<sup>13</sup> if the fund group as a whole satisfied the test. Other anomalies include the application of the wash sale rules<sup>14</sup> to sales by one series if within 30 days another series bought substantially identical securities.<sup>15</sup>

These problems were addressed by legislatively overruling *Union Trusteed Funds* in the regulated investment company context. As part

<sup>11</sup> 1956-1 C.B. 316. The ruling was declared obsolete by Rev. Rul. 88-14, 1988-1 C.B. 405, because of the 1986 legislative change described in the text immediately below.

<sup>12</sup> See, e.g., *Tax Reform Act of 1986: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 99th Cong. (1986) (statement of Dennis E. Ross, Tax Legislative Counsel, Department of Treasury), reprinted in SUSAN A. JOHNSTON & JAMES R. BROWN, *TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS* ¶ A.21[1][a][iii] (RIA) (2009).

<sup>13</sup> I.R.C. § 851(b)(3) requires that (i) at least 50 percent of a regulated investment company's assets be represented by cash, government securities, securities of other regulated investment companies, and other securities in an amount that does not exceed 5 percent of the company's assets or 10 percent of the outstanding voting securities of the issuer, and (ii) no more than 25 percent of its assets be invested in the securities of any one issuer other than government securities or securities of other regulated investment companies.

<sup>14</sup> I.R.C. § 1091(a) disallows a loss deduction on a sale of securities if substantially identical securities are bought within 30 days before or after the sale.

<sup>15</sup> Another possible concern would be the potential for tax-free exchanges of shares of one series for shares of another, either under Section 354 as part of a recapitalization, or under Section 1036 as an exchange of common for common, or preferred for preferred. The IRS, however, rejected both grounds for tax-free treatment, viewing these exchanges as not being pursuant to a plan of reorganization, and regarding the shares of each series as being neither common nor preferred stock. Rev. Rul. 54-65, 1954-1 C.B. 101; see also I.R.S. Priv. Ltr. Ruls. 84-13-032 (Dec. 23, 1983); 83-22-050 (Feb. 28, 1983).

of the Tax Reform Act of 1986,<sup>16</sup> Section 851(g) was added to the Code to treat series funds as separate corporations.<sup>17</sup> The threshold for being treated as a separate fund is quite low: for this purpose, “the term ‘fund’ means a segregated portfolio of assets, the beneficial interests in which are owned by the holders of a class or series of stock of the regulated investment company that is preferred over all other classes or series in respect of such portfolio of assets.”<sup>18</sup>

There are no regulations or other interpretive guidance regarding this definition. Presumably “segregated” simply means that the assets are maintained in a separate account for each series so that it is possible to track value and income separately. Curiously, there is no express requirement that any debt of a series be secured or otherwise supported only by the assets of that series, although as a commercial matter any series that has debt would likely arrange for the debt to be recourse to the assets of that series only.

## 2. *Trusts*

Series funds can be set up as business trusts rather than in corporate form. While the difference in legal form may be of little significance to investors, the separate entity analysis for business trusts has been completely unlike the analysis for corporations. In *Union Trusteed Funds*, the idea of treating each series as a separate corporation was viewed as “a novel theory and one for which we find no support in either the statute, the regulations, or the decisions.”<sup>19</sup> Yet when the same question arose shortly thereafter in *National Securities Series-Industrial Stocks Series v. Commissioner*,<sup>20</sup> a case involving three series funds organized as business trusts, the separateness of the series

<sup>16</sup> Pub. L. No. 99-514 § 654(a).

<sup>17</sup> Pub. L. No. 99-514, § 654(a), 100 Stat. 2085.

<sup>18</sup> I.R.C. § 851(g)(2).

<sup>19</sup> 8 T.C. 1133, 1137 (1947).

<sup>20</sup> 13 T.C. 884 (1949), *acq.* 1950 1 C.B. 4.

was accepted without discussion. Indeed, the proceeding itself was treated as a consolidated disposition of three separate cases involving each of the series trusts, and the issues addressed by the court had to do with the availability of the dividends paid deduction for earnings paid out on a redemption of trust shares, and the deductibility of federal stamp taxes. The separateness of the series was presumed even though the trusts were created under a single trust instrument, and shared the same trustee.

The Service expressly considered the treatment of series trusts in a 1984 General Counsel Memorandum (the “1984 GCM”),<sup>21</sup> which became the basis for a flurry of rulings over the subsequent two years treating series corporations as separate trusts that qualified as regulated investment companies.<sup>22</sup> The series trust arrangements in the 1984 GCM and the rulings are similar, and have the following indicia of separateness:

- (i) assets for each series are held in separate portfolios;
- (ii) shareholders of a series participate only in the assets and income of that series;
- (iii) liabilities of each series are backed only by the assets of that series;
- (iv) expenses of a series are charged solely to that series;
- (v) any liability incurred by shareholders of a series can be recovered only out of the assets of that series;

<sup>21</sup> I.R.S. Gen. Couns. Mem. 39,211 (Apr. 13, 1984).

<sup>22</sup> I.R.S. Priv. Ltr. Ruls. 85-12-056 (Dec. 27, 1984); 85-10-013 (Dec. 5, 1984); 85-09-072 (Dec. 4, 1984); 85-07-013 (Nov. 16, 1984); 85-06-073 (Nov. 14, 1984); 85-06-065 (Nov. 13, 1984); 85-02-022 (Oct. 12, 1984); 85-02-019 (Oct. 12, 1984); 85-02-021 (Oct. 12, 1984); 85-01-040 (Oct. 5, 1984); 84-30-058 (Oct. 1, 1984); 84-51-029 (Nov. 14, 1984); 84-46-029 (Aug. 15, 1984); 84-44-064 (July 31, 1984); 84-22-028 (Feb. 23, 1984); 84-19-017 (Feb. 2, 1984). In the late 1990s, there was a second flurry of rulings involving series trusts that were treated as separate partnerships, with regulated investment companies as partners. I.R.S. Priv. Ltr. Ruls. 98-37-005 (June 9, 1998); 98-19-022 (Jan. 27, 1998); 98-19-002 (Jan. 27, 1998); 97-21-016 (Feb. 19, 1997); 97-03-012 (Oct. 11, 1996); 97-02-027 (Oct. 11, 1996); 96-19-003 (Dec. 21, 1995).

- (vi) each series has different types of assets;
- (vii) management fee arrangements differ among the series;
- and
- (viii) each series has different shareholders.

Against this array of separate features, it appears that the series have few features in common. They are organized under a single trust instrument and appear to share a common trustee. According to the 1984 GCM, “the funds will be able to achieve substantial cost savings by sharing a single prospectus, one proxy statement, one annual report, and one set of filings among themselves.”

The voting arrangements are somewhat separate, but not wholly so. Among the matters subject to shareholder vote include the election of trustees, approval of management advisors, termination of the trust, amendment of the trust instrument, and initiation of a derivative suit. Shares are voted by series, except that they are voted in the aggregate when required by the 1940 Act, and matters affecting only one series are voted on only by shareholders of that series. It is not specified, however, whether the shareholders of a particular series can elect separate trustees for that series, or whether all the series must continue to share the same trustee or trustees.<sup>23</sup>

The degree of separateness among the series is strikingly similar to that in *Union Trusteed Funds*, yet the outcome is different. The 1984 GCM acknowledges the similarity, and does not try to distinguish *Union Trusteed Funds* on substantive grounds relating to the degree of separateness. Instead, the 1984 GCM simply states, “incorporated entities are characterized for tax purposes as corporations without regard to the rules for classifying unincorporated entities.”

<sup>23</sup> Delaware business trust law provides broad flexibility regarding the appointment of trustees and the management arrangements for differing series of a business trust. *See* DEL. CODE ANN. tit. 12, § 3806.

The 1984 GCM refers to a prior GCM,<sup>24</sup> which concluded that an entity incorporated under Nigerian law was a *per se* corporation that could not be treated as a partnership for United States federal income tax purposes. The prior GCM cites a number of cases to that effect for domestic incorporated entities,<sup>25</sup> and the principle is enshrined today in the check the box regulations. Those regulations treat as a *per se* corporation any “business entity organized under a Federal or State statute, ... if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.”<sup>26</sup> Thus, the criterion for being a *per se* corporation is purely linguistic: if the governing law describes or refers to the entity using these special words, then the entity is a corporation, regardless of its actual characteristics.

While such a linguistic rule seems, and is, arbitrary, it is probably too well established in the law to be changed by any means short of legislation. Yet there is a curious elision in the 1984 GCM’s reliance

<sup>24</sup> I.R.S. Gen. Couns. Mem. 34,376 (Nov. 13, 1970), *revoked by* I.R.S. Gen. Couns. Mem. 36,693 (Jan. 20, 1988).

<sup>25</sup> *United States v. O’Neill*, 410 F.2d 888 (6th Cir. 1966); *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969); *Smith v. United States*, 301 F. Supp. 1016 (S.D. Fla. 1969); *Williams v. United States*, 300 F. Supp. 928 (D. Minn. 1969); *Wallace v. United States*, 294 F. Supp. 1225 (E.D. Ark. 1968). In each of these cases, the IRS sought to treat a professional service corporation as a partnership for federal income tax purposes, based on regulations in effect at that time that applied the same four-factor test to professional service corporations as were then applied to other unincorporated entities. Treas. Reg. § 301.7701-1(c), -2(h) (prior to amendment by T.D. 7515 (Oct. 17, 1977)). The IRS was seeking to restrict the use of professional service corporations to allow their shareholder-employees to participate in qualified retirement plan arrangements that would not have been available to them as partners in a partnership. The regulations were held invalid, and in 1982 the qualified plan rules for partners were substantially conformed to those for shareholder-employees, making the issue moot. Tax Equity & Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 237–41, 96 Stat. 324, 511–20. *See also* STAFF OF JOINT COMM. ON TAX’N, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 308 (Comm. Print 1982).

<sup>26</sup> Treas. Reg. § 301.7701-2(b)(1).

on this *per se* rule to justify separate treatment of series trusts but not series corporations. The *per se* rule says that certain entities must be treated as opaque rather than transparent. This does not necessarily imply that a *per se* entity organized as a series fund must always be treated as a single entity. That is, of course, the premise of *Union Trusteed Funds*, but one could argue that *Union Trusteed Funds* was wrongly decided in that respect without otherwise rejecting the *per se* rule.

Even if one accepts that a *per se* corporation must always be not only opaque but also a single entity (except when varied by statute, as under Section 851(g)), one could distinguish series trusts from series corporations by means other than simple fiat. To see why, it is worth taking a closer look at how a business trust is constituted.

Business trusts were originally formed as common law trusts that were organized to carry on a business in circumstances where the corporate form was not available. They first arose in Massachusetts because corporations in that state were at one time not permitted to be organized for the purpose of developing real estate.<sup>27</sup> Even today, business trusts, including those organized in other states, are sometimes referred to as “Massachusetts trusts.”

Although business trusts have evolved considerably from the classic trust formed to hold and conserve property, they still bear the stamp of their phylogeny. Even in states with statutes governing business trusts, the statutory rules modify the common law of trusts but do not supplant it.<sup>28</sup> Accordingly, a business trust, like any other trust, is defined in terms of rights, obligations and powers attaching to specific property. One commentator states,

Modern cases support the view that a business trust is an unincorporated organization created by an instrument by which property is

<sup>27</sup> See GEORGE GLEASON BOGERT, GEORGE TAYLOR BOGERT & AMY MORRIS HESS, *THE LAW OF TRUSTS AND TRUSTEES* § 247[C] (2007).

<sup>28</sup> For example, Delaware law provides: “Except to the extent otherwise provided in the governing instrument of a statutory trust or in this subchapter, the laws of this State pertaining to trusts are hereby made applicable to statutory trusts...” DEL. CODE ANN. tit. 12, § 3809 (2009).

to be held and managed by trustees for the benefit and profit of such persons as may be or become the holders of transferable certificates evidencing the beneficial interests in the trust estate.<sup>29</sup>

The trust property is not an incidental feature of a business trust; it is an essential feature of the trust itself, since a trust is, at its root, a means for holding title to particular property for the benefit of another.<sup>30</sup> There can be no trust without trust property.<sup>31</sup>

Being a legal “entity”, on the other hand, does not appear to be an essential attribute of a business trust. In some contexts and places it is; in others, it is not.<sup>32</sup> In this regard, the governing law of business trusts is not so different from the federal income tax treatment of trusts generally, which in different contexts treats trusts as entities (in some cases a partnership or association taxable as a corporation) or as a pool of assets without entity status (such as a grantor trust or a disregarded entity under the check the box rules). One reason that

<sup>29</sup> Herbert B. Chermiside, Jr., *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R.3d 704, § 2 (1978).

<sup>30</sup> AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* § 2.6, at 48 (4th ed. 1987). Although a trust is often thought of as a means of separating legal and beneficial ownership, a trustee need not have legal title to the trust property, since an equitable interest can be held in trust. *Id.* at § 83, at 468. Moreover, there are non-trust arrangements, such as a bailment or nomineehip, that separate legal and beneficial ownership without creating a trust.

<sup>31</sup> See SCOTT & FRATCHER, *supra* note 30, §74, at 428. Like other common law rules, this can be varied by statute. For example, Delaware law provides that the existence of a business trust “as a separate legal entity shall continue until cancellation of the statutory trust’s certificate of trust.” DEL. CODE ANN. tit. 12, § 3810(a)(2) (2009). This rule has limited practical significance, however, since Delaware law also provides, “A certificate of trust shall be cancelled upon the dissolution and the completion of winding up of a statutory trust.” *Id.* § 3810(d). A trust that no longer has property would likely be considered to have been wound up for this purpose, although if its governing instrument does not provide for a dissolution in that circumstance it could potentially remain in existence as a vacuous “shelf trust,” which could not occur under common law.

<sup>32</sup> The question often arises in the context of whether the trust can be a party to a contract or a lawsuit in its own name. See generally Chermiside, *supra* note 29, at §§ 4[a]–[b].

legal entity status is in some sense optional for a business trust is that an alternative characterization is available: actions of the trust are simply those of the trustee acting in its capacity as such. When a trustee acts for the trust, it does so not as agent but as principal,<sup>33</sup> although it owes a fiduciary duty to the trust beneficiaries.

The statutory overlay for business trusts can affect whether a trust constituted with series is a single legal entity. Delaware law offers wide flexibility for the governing instrument to establish multiple series, which can have separate assets, separate liabilities, separate beneficiaries and even separate trustees. In these cases, the overall trust, not the individual series, is considered to be the legal entity.<sup>34</sup> For example, the trust itself, not a series, would be the named party to any lawsuit involving the series.<sup>35</sup> It is hard to attach great significance, however, to this designation of legal entity status to the trust as a whole, since the statute also makes clear that a claim arising from the activities of a series can be enforced against that series only.<sup>36</sup>

The establishment of multiple trusts with a single trust instrument and a common trustee is by no means an innovation of series funds. It happens all the time with classic testamentary and *inter vivos* trusts. In these cases, the trustee has a duty not to mingle the property of the separate trusts.<sup>37</sup> Whether such a trust instrument creates multiple trusts or a single trust with a sharing of income is a question of interpretation that turns on the settlor's intent.<sup>38</sup>

<sup>33</sup> Because the trustee acts as principal and not as agent, an individual trustee is not viewed as an employee of the trust for employment tax purposes. *Loring v. United States*, 80 F. Supp. 781 (D. Mass. 1948). The trustee is viewed as acting as principal even though the trust itself is treated as a corporation for federal income tax purposes. *United States v. Griswold*, 124 F.2d 599 (1st Cir. 1941).

<sup>34</sup> DEL. CODE ANN. tit. 12, §§ 3801(g), 3810(a)(2) (2009).

<sup>35</sup> *See id.* § 3804(a).

<sup>36</sup> *Id.*

<sup>37</sup> *See* SCOTT & FRATCHER, *supra* note 30, at § 179.2.

<sup>38</sup> *See Murray v. Hale*, 203 F. Supp. 583 (E.D. Ark. 1962) (quoting RESTATEMENT OF TRUSTS § 179).

In the case of the series funds described in the 1984 GCM, the intent to create separate trusts can be inferred from the distinct provisions that apply to each series with regard to investment objectives and advisory fees, and the segregation of assets and liabilities. There is therefore no need to posit a single overarching entity as a legal matter, although the 1984 GCM itself presents the question as “[w]hether three investment funds formed as a single Massachusetts business trust consist of one or three separate unincorporated associations taxable as corporations.”<sup>39</sup> Perhaps there was language in the particular Declaration of Trust that affected the 1984 GCM’s choice of words, but it could have easily framed the question as whether three trusts set up under a single instrument should be treated as one or three entities for tax purposes. That is how the court appears to have framed the question in *National Securities*, and framing the question in this fashion may explain the court’s facile assumption that the trusts should be viewed as separate.<sup>40</sup>

These features of trust law provide an alternative explanation of the different tax treatment of series funds that are organized as trusts compared with those that are organized as corporations. In the corporate case, there is a single entity created under state law that is independent of the assets it owns. In the trust case, however, each trust is defined under state law by its pool of assets, and the separateness of those pools can justify a determination that there are multiple trusts governed by a single trust instrument. Neither the 1984 GCM nor the subsequent private rulings, however, expressly distinguish corporations from trusts on this ground, relying instead on the idea that a *per se* corporation is a single entity by fiat.

<sup>39</sup> I.R.S. Gen. Couns. Mem. 39,211, *supra* note 21.

<sup>40</sup> See Nat’l Sec. Series—Indus. Stocks Series, 13 T.C. 884, 885 (1949), *acq.* 1950-1 C.B. 4.

### 3. *Limited Partnerships and LLCs*

Many states and foreign countries have statutes that allow series funds to be organized as limited partnerships or limited liability companies.<sup>41</sup> Until recently, however, the IRS has given no indication whether these funds should be treated as separate entities for federal income tax purposes. Since these are not *per se* corporations, one could argue that they should be analyzed like trusts, and treated as separate entities if, as one would expect to be the case, each fund has its own assets, liabilities, investment objectives, and fee arrangements.

On the other hand, limited partnerships and LLCs are unlike trusts in that they have an identity under their governing laws that is independent of the pools of assets that they own. If the proper rationale for treating series trusts as separate entities is that they are properly viewed as separate trusts as a legal matter, then this rationale would not justify treating series funds organized as partnerships or LLCs as separate entities. That distinction, however, may be difficult to draw in practice, given the nuances of the governing statutes for series entities in various countries. For example, Bermuda law governing “segregated account companies” allows these companies to establish segregated accounts with assets and liabilities that are distinct from the company’s general account. A Bermuda law firm states, “The substance of the relationship between [a segregated accounts company (SAC)] and its assets which the SAC Act imposes is in the nature of a trust, in that the SAC Act describes a segregated account as being a separate fund from within the company’s own assets.”<sup>42</sup> Yet unlike the Delaware business trust statute, the Bermuda statute provides that its rules governing the rights and obligations with respect to segregated accounts “operate to the exclusion of any

<sup>41</sup> See, e.g., DEL. CODE ANN. tit. 6, §§ 17-218(b) (limited partnerships), 18-215(b) (limited liability companies) (2009).

<sup>42</sup> Appleby, *Guide to Segregated Accounts Companies in Bermuda 2000*, [http://www.applebyglobal.com/uploaded/Publication/390\\_File\\_5.pdf](http://www.applebyglobal.com/uploaded/Publication/390_File_5.pdf).

rule of law relating to trusts treating with the same subject matter, and no rule of law relating to trusts may be pleaded by any person to augment or modify the operation of this Act.”<sup>43</sup>

Since the trust rulings distinguished business trusts from corporations on the ground that they are not *per se* corporations, rather than on the separate legal status of series trusts, one might expect that the IRS would view each series of a series fund organized as a limited partnership or LLC as a separate entity as well, and indeed recent IRS guidance has followed this course.

A private ruling issued in January 2008 presents the case that is perhaps most sympathetic to separate–entity treatment.<sup>44</sup> Here, a series trust reorganized itself as a series LLC. As before, each series was an investment fund with a segregated pool of assets, with separate investment objectives, expenses, and creditors. Some of the series elected to be corporations, and qualified as regulated investment companies. Other series did not make this election, and defaulted to either partnership or disregarded entity status, depending on whether the series had more than one owner. The ruling reaches the sensible conclusion that the conversion from trust to LLC status did not affect the separate status of the series for tax purposes, since the relevant indicia of economic separateness were unchanged by the conversion.

At about the same time, the IRS issued Revenue Ruling 2008-8,<sup>45</sup> which treats the series of a “protected cell company” as separate entities for tax purposes without any discussion of the type of legal entity that was set up to be the protected cell company. Unlike the series funds in the prior cases and rulings, the cells in Revenue Ruling 2008-8 were not investment funds but were engaged in an insurance busi-

<sup>43</sup> Bermuda Segregated Accounts Companies Act 2000 § 18(16).

<sup>44</sup> I.R.S. Priv. Ltr. Rul. 2008-03-004 (Jan. 18, 2008).

<sup>45</sup> 2008-1 C.B. 340.

ness, insuring risks of the cell owners and their affiliates.<sup>46</sup> Given this insurance context, it is likely that the protected cell companies actually considered by the IRS in this context were established in Bermuda under its Segregated Accounts Companies Act 2000. As noted in the ruling, each cell is not a separate legal entity, but has its own assets and liabilities, and the assets of a cell are protected by statute from the claims of creditors of other cells, or of the cell company generally. Concurrent with the ruling, the IRS issued Notice 2008-19,<sup>47</sup> requesting comments on further guidance to be issued regarding the insurance aspects of these arrangements.

On the face of it, separate entity status for series funds and protected cell insurance companies is compelling.<sup>48</sup> The series or cells not only have separate assets and liabilities, but separate owners, with only incidental overlap in ownership. There is no sense of a common business enterprise beyond that of a suite of investment funds with varying investment objectives, or a suite of captive insurance companies operated for the clients of the sponsoring cell company. Conversely, single entity treatment would create anomalies, as well as potential for abuse, even outside the regulated investment company context. The anomalies would include, in the case of entities treated as corporations, the potential for earnings and profits of one series or cell to be offset by deficits in another. For series funds that are passive foreign investment companies (PFICs), single entity treatment could distort the effects of a qualified electing fund election,<sup>49</sup> if gains of one series could be offset by losses of another.

<sup>46</sup> The fact that the cells were captive insurance companies brings them within the scope of the battles long waged by the IRS over whether insurance arrangements among affiliates can qualify as such for tax purposes, which are discussed *infra* in Part IV.A.4, p. 688.

<sup>47</sup> 2008-1 C.B. 366.

<sup>48</sup> See N.Y. ST. BA. ASS'N TAX SEC., *Report on Notice 2008-19 and Protected Cell Companies Outside of the Insurance Arena* 1, 3 (2008) (recommending a safe harbor for separate treatment of protected cell companies).

<sup>49</sup> See I.R.C. §§ 1293–95.

If a protected cell company were treated as a single entity, PFIC status would presumably be determined for the entity as a whole, even if some cells had predominantly active assets, while others were passive; and one might imagine operating companies establishing passive cells that escaped PFIC classification based on the characteristics of the entity as a whole. This possibility was foreseen by the drafters of the PFIC rules, and Section 1298(b)(4) of the Code provides, “Under regulations prescribed by the Secretary, where necessary to carry out the purposes of this part, separate classes of stock (or other interests) in a corporation shall be treated as interests in separate corporations.” No such regulations have yet been issued, and it is not clear whether the statute is self-enforcing in the meantime.<sup>50</sup> It appears from the legislative history that any such regulations would apply for PFIC purposes only, and would not treat the assets backing the separate class of stock as a separate entity for all tax purposes.<sup>51</sup>

<sup>50</sup> The adjacent statutory clause in Section 1298(b)(5) provides that “under regulations” indirect dispositions of PFIC interests can also be caught by the PFIC rules. Only proposed regulations have been issued under this clause, and those proposed regulations reserve on the treatment of estates, trusts and beneficiaries. The IRS has nonetheless asserted that the PFIC rules apply to indirect dispositions by trust beneficiaries even in the absence of regulations, since “[t]he language of Section 1298(b)(5) is clear on its face.” I.R.S. Tech. Adv. Mem. 2007-33-024 (Oct. 26, 2006). *See also* N.Y. ST. BA. ASS’N, TAX SEC., *Report on Legislative Grants of Regulatory Authority* (2006).

<sup>51</sup> The General Explanation states,

A foreign corporation engaged in an active trade or business generally will not be a PFIC. If such a corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or to invest directly in passive assets, the corporation will still probably not be a PFIC under the general definition. However, in these instances, it may be necessary for regulations to treat the separate class of stock as a separate corporation *for this purpose*. In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors.

STAFF OF J. COMM. ON TAX’N, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1032 (Comm. Print 1987) (emphasis added).

More broadly, single entity treatment could open the door for holders to vary their investments without triggering gains, simply by swapping shares of one series for shares of another, or by causing the vehicle to move assets from one series to another. Some have conjured the spectacle of the “ultimate mixing bowl,” a cell company with bespoke cells for a huge number of investors, who can then trade among each other on a tax-free basis by causing their respective cells to exchange assets.<sup>52</sup>

Yet there are contexts in which separate entity treatment for cells is much less compelling. Cell companies can be used to compartmentalize assets and liabilities of a unitary business, such as a real estate development company or an aircraft leasing company. If there is common ownership among the cells, the result is similar to the old-fashioned way of compartmentalizing a business, which is to have a parent company form subsidiaries. Those subsidiaries, if not *per se* corporations, could check the box to be disregarded entities, achieving single entity treatment for a group of asset pools with separate liabilities. A cell company could achieve the same compartmentalization without the administrative overhead of multiple legal entities, and it would be unfortunate to require separate entity treatment as a tax matter in order to obtain those administrative cost savings.<sup>53</sup> The proposed regulations for series funds, discussed in the next section, appear to allow scope for single-entity treatment in this context even though they generally treat series as separate entities.

<sup>52</sup> See Terence Floyd Cuff, *Series LLCs and the Abolition of the Tax System*, 2 BUS. ENTITIES 26, 27 (2000) (arguing that with single entity treatment, “The Series LLC has the potential of a tax planning H bomb.”). *But see* Rev. Rul. 1954-65, 1954-1 C.B. 101 (treating exchanges of shares of a series fund as taxable).

<sup>53</sup> See Howard J. Levine, *Attorney Seeks Guidance on Treatment of Delaware Series LLCs*, 2004 TAX NOTES TODAY 181–23 (Sept. 17, 2004).

#### 4. *Proposed Regulations on Series Organizations*

In 2010 the IRS expanded on the approach taken in its 2008 ruling,<sup>54</sup> by issuing proposed regulations which, when finalized, will generally treat each series of a series organization as a separate entity. The regulations broadly apply to any series established by a juridical entity pursuant to a “series statute,” which is a statute that permits a series organization to establish segregated pools of assets, with separate (but possibly overlapping) owners, and ringfenced liabilities.<sup>55</sup> Existing series statutes apply to limited liability companies and their foreign counterparts, which are generally not *per se* corporations under the check-the-box rules. But the definition of series statute is not so limited, and it is perhaps only a matter of time before series are provided by a state corporate statute or a foreign statute governing a type of *per se* corporation. The application of the regulations to those entities would represent a departure from the corporate single-entity treatment in *Union Trusteed Funds*,<sup>56</sup> although the segregation of series in that case was caused by designation of share rights rather than by statute. On the other hand, the regulations apply only to trusts that are juridical entities, which would typically include the business trusts discussed in Part II.A.2 above, but not common law trusts.

The regulations apply to a series established under foreign law only if the series, viewed separately, would be an insurance company for United States federal income tax purposes.<sup>57</sup> The reluctance of the IRS to apply these rules more broadly to foreign series organizations is no doubt attributable to their being gun-shy as a result of the tax

<sup>54</sup> See *supra* n. 45.

<sup>55</sup> Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(B), 75 Fed. Reg. 55,699, 55,708 (Sept. 14, 2010). The states have had to wrestle with this question as well; for a survey of state income tax rules in this area, see AM. BA. ASS'N, SEC. OF TAX'N, *Survey of the States Regarding Their Intent to Conform to the Classification of Series LLCs for Federal Income Tax Purposes* (Apr. 30, 2013).

<sup>56</sup> See *supra* n. 8.

<sup>57</sup> Prop. Treas. Reg. § 301.7701-1(a)(5)(i) and (ii), 75 Fed. Reg. 55,699, 55,707 (Sept. 14, 2010).

planning opportunities that arose when the check-the-box regulations were applied generally in the foreign context.<sup>58</sup> Moreover, a Treasury official has voiced concern that providing separate treatment for foreign series could give rise to foreign tax credit “splitters” if United States tax law treats each series as earning its own income as a separate entity, but foreign law imposes tax on that income on the series organization itself.<sup>59</sup> That concern can presumably be addressed through the recent legislation restricting splitter arrangements,<sup>60</sup> but it illustrates the further potential for mischief that can arise when these rules are extended to foreign entities.

Yet providing separate treatment only for foreign entities that are insurance companies creates the potential for an anomalous result when a foreign series organization has multiple series, only some of which would be insurance companies if viewed separately. Presumably, the intention is that each insurance company series would be treated as a separate entity, and the other series would be viewed separately or jointly as dictated by pre-existing principles of United States tax law. If, however, the series organization were itself a *per se* corporation, it might be treated as a single entity under *Union Trusteed Funds*. But single-entity treatment would cause any insurance company series to be simultaneously a separate entity and part of a larger single entity, which cannot be the case. The only coherent outcome would be a rule prescribing single- or separate- entity treatment for

<sup>58</sup> The Preamble diplomatically states, “Foreign series raise novel Federal income tax issues that continue to be considered and addressed by the IRS and the Treasury Department.” Pmb. to Prop. Treas. Reg. § 301.7701-1(a)(5), Explanation of Provisions, Part 1, 75 Fed. Reg. 55,699, 55,703 (Sept. 14, 2010).

<sup>59</sup> See Stephanie Hench, *Official Welcomes Comments on Annuity Contracts, Proposed Series LLC Regs*, 2010 TNT 188-6 (Sept. 29, 2010).

<sup>60</sup> See I.R.C. § 909, added by Pub. L. No. 111-226 § 211(a), 124 Stat. 2389 (2010) (deferring foreign tax credits until related income is taken into account). See also Treas. Reg. § 1.901-2(f) (allocating foreign tax liability of a group of entities to each such entity in proportion to its share of the income on which the foreign taxes were imposed); H. Karl Zeswitz, Jr. and William R. Pauls, *Almost a “Fall Classic”*: Proposed Treasury Regulations Leave a “Series” of Issues Unresolved, 40 TAX MGMT. INT’L J. 131, 140 (2011).

the non-insurance company series only. It might seem odd for the separateness of a foreign series to depend on whether it conducts an insurance business, but that potential already exists under the check-the-box rules, since a wholly-owned insurance subsidiary is a *per se* corporation and cannot elect to be treated as a disregarded entity.<sup>61</sup> In the end, limiting the application of the new regulations in the foreign context to insurance companies is conceptually unstable, and an broader extension to foreign series organizations seems likely.

Mechanically, the regulations achieve separate-entity treatment by treating each series as “an entity formed under local law,” which, notwithstanding the reference to local law, is a federal tax concept. The result is that each series is treated as an entity formed under local law, even though, in most cases, the series is not actually viewed as an entity for local law purposes.<sup>62</sup> On the other hand, the series organization itself is in fact an entity for local law purposes, but the regulations specifically do not address whether the series organization is treated as “an entity formed under local law” if it has no assets or activities that are not part of a series.<sup>63</sup>

Although a typical hallmark of a series is ringfencing of liabilities, the regulations do not require that this ringfencing actually be achieved.<sup>64</sup> Thus, a series will be treated as separate even if ringfencing of liabilities is not achieved because of a failure to comply with applicable notice requirements under state law, or if ringfencing is

<sup>61</sup> Treas. Reg. § 301.7701-2(b)(4).

<sup>62</sup> The preamble to the proposed regulations points out that domestic series statutes generally do not treat individual series as entities for state law purposes, but two states (Illinois and Iowa) treat a series as an entity to the extent provided in its articles of organization. Pmbl. to Prop. Treas. Reg. § 301.7701-1(a)(5), Background, Part 3(A), 75 Fed. Reg. 55,699, 55,701 (Sept. 14, 2010).

<sup>63</sup> Pmbl. to Prop. Treas. Reg. § 301.7701-1(a)(5), Explanation of Provisions, Part 1, 75 Fed. Reg. 55, 699, 55703 (Sept. 14, 2010). *See also* AM. BA. ASS'N, SEC. OF TAX'N, *Comments on Reg-119921-09 Proposed Regulations on Series of a Domestic Series Organization* 5–7 (Apr. 29, 2011) (requesting clarity on this issue).

<sup>64</sup> Prop. Treas. Reg. § 301.7701-1(a)(5)(viii)(C), 75 Fed. Reg. 55,699, 55,708 (Sept. 14, 2010).

waived, such as by a guarantee by one series of the liabilities of another. While the absence of ringfencing blurs the separateness of the series as a substantive matter, the approach of the regulations eases administration by avoiding the need to assess the efficacy of ringfencing in order to determine separate entity status. The presence of ringfencing remains relevant for purposes of tax collection, since the IRS, in its capacity as a creditor of a series for its tax liability, can go after the assets of the series organization or of any other series to the extent permitted under federal or local law.<sup>65</sup>

The regulations do not purport to specify who will be treated as the owner of the assets of a series, or of interests in a series, leaving these determinations to general tax principles.<sup>66</sup> The fact that under some series arrangements the series organization is the holder of legal title to the assets of each series will not itself cause the series organization to be treated as the owner of those assets for federal income tax purposes.<sup>67</sup> While it is understandable that the regulations seek to avoid vexing questions of tax ownership, their diffidence on this point leaves open the question of what it means to hold series assets through a series rather than through the series organization.<sup>68</sup> In the normal case, a series organization that holds assets in series and issues series interests will treat the holders of series interests as owners of that series, which in turn owns the series assets. But the series organization might designate itself as the owner of series interests, in addition to its possible role as holder of legal title of series assets for the benefit of the series.<sup>69</sup> In that case, the series organization would

<sup>65</sup> Prop. Treas. Reg. § 301.7701-1(a)(5)(vii), 75 Fed. Reg. 55,699, 55,707-08 (Sept. 14, 2010).

<sup>66</sup> Prop. Treas. Reg. § 301.7701-1(a)(5)(vi), 75 Fed. Reg. 55,699, 55,707 (Sept. 14, 2010).

<sup>67</sup> *Id.*

<sup>68</sup> For a discussion of some of the conceptual difficulties that remain, see Jasper L. Cummings, Jr., *Ownership, Series, and Cells*, 129 TAX NOTES 1129 (Dec. 6, 2010).

<sup>69</sup> See Carter D. Bishop, *The Series LLC: Tax Classification Appears in Rear View*, 130 TAX NOTES 315, 320 (Jan. 17, 2011); Paul D. Carman, Steven G. Frost, and

hold, as a non-series asset, an interest in a series. Legally, such an interest might be a sort of treasury stock, but it should not be viewed as such for tax purposes once the series is viewed for tax purposes as a separate entity formed under local law. If the series organization owns all of the interests in a series, then the series could be treated as a disregarded entity under the check-the-box rules, and the series organization would be treated as the owner for tax purposes of the assets of the series. In such a case, the separateness of series is effectively elective, and the regulations should make it possible for an organization to set up a parent-subsidary structure, with statutory ringfencing of liabilities, while creating only a single legal entity and only a single entity for tax purposes.<sup>70</sup> This should not be problematic where the owners of interests in the series organization have, by reason of this arrangement, identical interests in each series. If, however, the series organization were to issue interests that tracked particular series, while taking the position that the series organization, and not the holders of those interests, was the owner for tax purposes, the arrangement would raise the concerns generally associated with tracking stock and similar arrangements, which are discussed in the next section.

### **B. *Tracking Stock***

“Tracking stock” is a class of stock with dividend and liquidation rights that pertain to a particular line of business of the issuer, whether in divisional or, much more likely, subsidiary form. It is typically

Kelley M. Bender, *First Steps—Proposed Regulations on Series LLCs Provide Clarity*, 113 J. TAX’N 325, 331 (2010).

<sup>70</sup> It has been suggested that single-entity treatment be made expressly elective, presumably without requiring that the series organization be the owner of each series for tax purposes. See ST. BA. OF TEX., SEC. OF TAX’N, *Comments Concerning Guidance Regarding Series LLCs and Cell Companies* (Mar. 28, 2011). These comments, however, do not address what should happen if the series are not all under common ownership.

issued by a *per se* corporation, and consequently, the question whether the issuer should be treated as two separate corporations does not arise, given the view implicit in *Union Trusteed Funds* that a *per se* corporation is a single entity no matter what. Instead, where the tracking stock relates to the assets and income of a subsidiary, the concern is ensuring that the stock is properly regarded as stock of the parent rather than of the subsidiary.<sup>71</sup>

The principal nontax reasons for issuing tracking stock are either to dispose of an interest in a business or to acquire one.<sup>72</sup> Tracking stock is a somewhat ungainly way to dispose of a business, but it enables a corporation to give the capital markets direct access to a particular line of business without having to surrender control of it. This may be particularly useful if management believes that the capital markets cannot perceive the value of a particular line of business so long as it remains under the overall corporate umbrella. One might debate whether this capital markets inefficiency is at work in any particular case, but the tax benefits are beyond debate: the proceeds of a properly structured tracking stock issuance, unlike the proceeds of a sale, are exempt from tax under Section 1032, and the tracked subsidiary can continue to benefit from membership in the parent's consolidated group.

Tracking stock can also be used as consideration in a corporate acquisition, providing an earn-out to the sellers. This is a perfectly valid nontax business purpose, since it permits the sellers to retain

<sup>71</sup> See James L. Dahlberg & Jay D. Perry, *Tracking Stock: Virtual Equity, Virtual Entities, and Virtual Mergers and Acquisitions*, 78 TAXES 18, 24 (2000); Charles A. Borek, *Corporate Taxation's Square Peg: An Analysis of Possible Solutions to the Problem of Characterizing "Tracking Stock" for Tax Purposes*, 43 CATH. U.L. REV. 1107 (1994); Jeffrey T. Sheffield & Barbara M. St. Clair, *An Abecedarium on Alphabet Stock*, 66 TAXES 954 (1988); N.Y. ST. BA. ASS'N TAX SEC., *Report Regarding "Tracking Stock" Arrangements*, 43 TAX. L. REV. 51, 58 (1987) [hereinafter "Tracking Stock Report"].

<sup>72</sup> See Dahlberg & Perry, *supra* note 71, at 23–24. Other potential purposes include use as a takeover defense measure or as currency for employee compensation. *Id.*

some exposure to the performance of the business, which can help resolve differences over the purchase price and, if the sellers have a continuing management role, gives them a more direct stake in the business than ordinary stock of the parent would provide. In principle, much the same result could be achieved with a contractual earn-out. But a tracking stock issue, if treated as equity of the parent, will help satisfy the continuity of interest test in qualifying the acquisition as a reorganization,<sup>73</sup> as well as the specific statutory requirements for reverse triangular mergers<sup>74</sup> and “B” or “C” reorganizations.<sup>75</sup>

In both the acquisition and the disposition cases, the tax and non-tax purposes are so blended that it may be difficult to tell in any specific case which is predominant. But the disposition case is particularly problematic from a tax policy standpoint, since it allows a virtual corporate separation without satisfying the specific requirements for a tax-free spin-off,<sup>76</sup> and may also be seen as a means of avoiding the consequences of the repeal of *General Utilities*.<sup>77</sup>

<sup>73</sup> Treas. Reg. § 1.368-1(e).

<sup>74</sup> I.R.C. § 368(a)(2)(E) requires that 80-percent “control” be acquired solely for voting stock of the acquirer.

<sup>75</sup> I.R.C. § 368(a)(1)(B) requires that no consideration be used other than voting stock of the acquirer or, in a “triangular B,” the acquirer’s parent. I.R.C. § 368(a)(1)(C) has a similar requirement, although a “boot relaxation” rule permits boot of up to 20 percent if assumed liabilities are counted as boot. I.R.C. § 368(a)(2)(B). While some of the objectives of tracking stock as an earn-out device could be achieved by varying the number of non-tracking shares issued, the ability to treat contingent shares as qualifying stock consideration is subject to restrictions. *See* Rev. Proc. 1977-37 § 3.03, 1977-2 C.B. 568–69, *amplified by* REV. PROC. 1984-42, 1984-1 C.B. 521–22. For an example of tracking stock being used for this purpose, *see* I.R.S. Priv. Ltr. Rul. 88-17-007 (Aug. 12, 1987). *See also* Robert A. Rizzi, *Developments in Tracking Stock*, 29 J. CORP. TAX’N 34 (2002).

<sup>76</sup> *See* Tracking Stock Report, *supra* note 71, at 62.

<sup>77</sup> I.R.C. § 337(d) authorizes regulations to prevent such avoidance, and presumably provides authority for regulations that could treat tracking stock issuances as a disposition of the tracked subsidiary in appropriate cases. These rules are associated with the statutory override of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). Tax Reform Act of 1986, Pub. L. No. 99-514 § 631(a), 100 Stat. 2271–72.

The stakes are usually quite high, since a failure to qualify tracking stock as stock of the parent can have profound consequences, including taxability of the proceeds, deconsolidation of the tracked subsidiary, or disqualification of an acquisition as a reorganization. For this reason, tracking stock is typically structured conservatively, so that one can reach a fairly robust conclusion that under current law the tracking stock is properly regarded as stock of the parent. While tracking stock resembles an interest in a series fund in that both relate to less than all of the assets of the issuer, both the need to preserve parent stock characterization for tax purposes and, to varying degrees, the commercial objectives of the arrangements, cause tracking stock to differ in many important respects from a pure equity interest in the underlying business.

Individual issuances of tracking stock differ, but some of the common aspects that bolster characterization as parent stock include the following:<sup>78</sup>

- (i) Tracking stock is junior to all creditors of the issuer, including those of the non-tracked businesses. There is no counterpart to the statutory ringfencing of liabilities that is found in a segregated portfolio company, nor would there typically be any attempt to isolate liabilities contractually, although creditors of one subsidiary would not have access to assets of parent or sister affiliates absent a guarantee by those entities.
- (ii) Dividends must be declared by the parent's board of directors, and are subject to state law limitations based on the parent's capital. The parent's board of directors will have authority to pay different amounts of dividends on

<sup>78</sup> A comprehensive tally of tracking stock issuances, and their specific features, is reported in Stuart M. Finkelstein, Benjamin Handler & Joseph K. Todd, *Tracking Tracking Stock*, reprinted in PRACTICING LAW INSTITUTE, STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 2013, at 241-1.

the tracking stock and the regular stock, and will typically announce a policy regarding its intention to declare future dividends. For example, the parent might declare an intention to pay tracking stock dividends based on a fixed payout ratio applied to the reported income of the tracked subsidiary.

- (iii) The parent maintains full voting control of the tracked subsidiary, by reason of the parent's ownership of all of the subsidiary's outstanding stock.
- (iv) The holders of tracking stock have voting rights, if any, that are similar to those of the holders of the parent's regular stock, including the right to vote for directors, although holders of the tracking stock may vote as a class on matters that pertain to its rights. The percentage of total voting power represented by the tracking shares may be fixed at the time of creation based on relative fair market values, or may be adjusted from time to time based on trading prices.
- (v) Liquidation rights are not strictly related to the tracked subsidiary's shares or assets. Instead, holders of the tracking stock are entitled to a percentage of the parent's total assets on liquidation. The percentage may be based on the relative aggregate market values of the tracking stock and the regular stock at the time the tracking stock is created. In such a case, the tracking stock has exposure to the value of the parent's other assets, and the regular stock has exposure to the tracked subsidiary. The percentage may be adjusted to reflect changes in the trading prices of the tracking and regular stock, although there can be a self-fulfilling quality to any market expectations regarding this percentage.
- (vi) The parent will normally reserve a power, exercisable after some period of time, to clean up its capital structure by

forcing a conversion of the tracking stock into regular stock. The tracking stock may convert into a percentage of the total regular stock based on the relative aggregate market values at the time of conversion, based on trading prices, although in that case, as with the division of liquidation proceeds, there is a self-fulfilling quality to any market expectations regarding the conversion ratio. Alternatively, the parent may have the right to redeem the tracking stock for shares of the tracked subsidiary.

This list is not exhaustive, nor does it reflect the full variety of actual tracking stock issuances. But the general message is clear: the financial results of tracking stock are only imperfectly related to the performance of the tracked subsidiary, and there are significant differences between tracking stock and stock actually issued by the tracked subsidiary.

Tracking stock is therefore not only a poor candidate for viewing the parent as representing two entities, as can plausibly be determined for segregated portfolio companies, but is also a poor candidate for treatment as *de facto* subsidiary stock. The New York State Bar Association, in its Tracking Stock Report, proposed instead that the tracking stock be viewed as an interest in a deemed joint venture between the parent and the tracking stock holders.<sup>79</sup> This approach has the virtue of being able to reflect the various ways in which both the parent and the tracking stock holders have an interest in the performance of the subsidiary. But it has drawbacks as well, since the deemed joint venture model does not reflect rights that the tracking stock holders may have with regard to the parent generally, including overall voting rights and potential exposure to the parent's other as-

<sup>79</sup> Tracking Stock Report, *supra* note 71, at 74–75. In one court case, a tracking stock arrangement was actually recharacterized as a partnership between the issuer and the shareholder, but there were facts present in that case that tended to undermine the form of the transaction, including the parties' own characterization of their arrangement as a "joint venture." *S. & M. Plumbing Co. v. Comm'r*, 55 T.C. 702, 708–09 (1971).

sets and liabilities. Even the Tracking Stock Report does not propose this model wholeheartedly, regarding the deemed joint venture as merely a useful fiction rather than an arrangement that ought to be recognized as a separate entity for tax purposes.

Still, recognition has to be given to the fact that tracking stock is quite unlike regular stock of the parent,<sup>80</sup> and the differences may well justify differing tax treatment. One possible case for distinct treatment is the determination of whether tracking stock that is distributed tax-free should be treated as Section 306 stock. Under current law, avoidance of Section 306 stock status is premised on the idea that tracking stock is not preferred stock for tax purposes, since it participates in corporate growth to a meaningful extent.<sup>81</sup> Yet the relevant definition of preferred stock was developed long before tracking stock arrangements appeared, and that definition could plausibly be updated to treat stock as preferred stock unless it participated *generally* in the growth of the issuer. Under this updated view, stock could be Section 306 stock if its participation in corporate growth were determined by reference to less than substantially all of the assets of the issuer. (Given the current preferential rates on stock dividends, Section 306 is of limited significance in preventing the opportunities for bailout, but those preferential rates are scheduled to expire and might not be renewed.<sup>82</sup>)

<sup>80</sup> Outside the tax area, a vexing aspect of tracking stock is its effect on the fiduciary duties of the corporation's board of directors, who must deal with differing classes of owners with distinct and potentially conflicting interests. See Jeffrey J. Hass, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 MICH. L. REV. 2089 (1996).

<sup>81</sup> Treas. Reg. § 1.305-5(a) provides that the "distinguishing feature of preferred stock is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent." Accordingly, issuers of tracking stock take the view that their stock is not Section 306 stock. See, e.g., Liberty Media Corp., Registration Statement (Form S-4), at 83 (Feb. 6, 2006); Sprint Corp., Registration Statement (Form S-3), at 171 (Sep. 25, 1998).

<sup>82</sup> I.R.C. § 1(h)(11), which is scheduled to expire for taxable years beginning after December 31, 2012. Tax Relief, Unemployment Insurance reauthorization, and

One could go further and question whether it is appropriate to allow tracking stock to be distributed tax-free at all. The Tracking Stock Report proposes that the Section 305 regulations be amended to provide that distributions of tracking stock are taxable.<sup>83</sup> But even if tracking stock were viewed as a form of preferred stock, its status as such would not cause its distribution to common shareholders to be a taxable stock dividend. Since straight preferred stock can be distributed to common shareholders tax-free (although it will normally be Section 306 stock), it is difficult to see why tracking stock, which is more dependent on the fortunes of the issuer, should not receive at least as favorable treatment.

A related question is whether to permit a tax-free exchange of tracking shares for regular shares, and vice versa. Section 1036 broadly permits tax-free exchanges of common for common, and preferred for preferred,<sup>84</sup> provided that the preferred stock is not redeemable or is otherwise treated as nonqualified preferred stock under Section 351.<sup>85</sup> Treating tracking stock as a form of preferred stock would block the application of Section 1036 to exchanges of tracking and regular shares, but Section 1036 might still be available for exchanges of one class of tracking stock for another. The Service has denied tax-free treatment under Section 1036 for exchanges of shares of different series of a regulated investment company (prior to the statutory change that treats these series as separate corporations) on the grounds that series fund shares are neither common nor preferred stock.<sup>86</sup> It is not clear, however, whether it is correct to say that

Job Creation Act of 2010, Pub. L. No. 111-312, § 102(a), 124 Stat. 3296; Jobs & Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 303, 117 Stat. 764.

<sup>83</sup> Tracking Stock Report, *supra* note 71, at 79, 81.

<sup>84</sup> I.R.C. § 1036(a).

<sup>85</sup> I.R.C. § 1036(b). Preferred stock is generally treated as nonqualified preferred stock if within 20 years of issue it is redeemable, puttable, or likely to be called, or if it has a floating dividend rate. I.R.C. § 351(g)(2).

<sup>86</sup> See *supra* note 15.

a class of shares can be neither common nor preferred, since “common stock” could be taken to mean any stock that is not preferred stock. The Service viewed series fund shares as not constituting common stock because the holders of those shares had no interest in the other assets of the issuer, but most tracking stock arrangements do confer some interest in other assets, since their rights on liquidation can depend in part on the value of those other assets. In any case, Section 354 will nonetheless offer tax-free treatment if the exchange is made pursuant to a recapitalization of the issuer, in which case the only consequence of treating the tracking stock as preferred stock would be to treat tracking stock received in such an exchange as Section 306 stock.<sup>87</sup>

There is something troubling about permitting these tax-free exchanges, since they permit shareholders to swap what is principally an interest in the tracked subsidiary to what is principally an interest in other assets of the issuer, even if in both cases the alignment is not perfect. This strays from the purpose of the reorganization rules, which are intended to provide tax-free treatment for arrangements that “effect only a readjustment of continuing interest in property under modified corporate forms.”<sup>88</sup> Consequently, a strong case can be made for taxing exchanges of tracking stock for other classes of stock of the issuer, even if the tracking stock is conservatively structured so as to be properly treated as stock of the parent rather than of the subsidiary.

Treatment of the issuer upon the creation of tracking stock is a more complicated matter. Four general contexts can be distinguished, since the tracking stock can be:

- (i) issued in an acquisition context, in exchange for shares of the tracked subsidiary itself;

<sup>87</sup> I.R.C. § 306(c)(1)(B).

<sup>88</sup> Treas. Reg. § 1.368-1(b).

- (ii) issued for proceeds that are used in the tracked subsidiary's business;
- (iii) issued for proceeds that are retained by the parent; or
- (iv) distributed to the parent's shareholders without consideration.

In the first context, the issuance of the tracking stock reduces the issuer's exposure to the tracked business that it assumes in the acquisition. In the latter three contexts, the issuer divests itself of some of its existing exposure to the tracked business.

In 1999, the Clinton Administration proposed to treat the creation of tracking stock as a taxable event without regard to context.<sup>89</sup> In each case, the parent would be taxed on the excess of the value of the tracking stock over the parent's basis in the assets of the subsidiary. The proposal ran into significant criticism,<sup>90</sup> and never progressed as legislation. A principal problem with the proposal was that it failed to distinguish among the contexts in which tracking stock might be issued. The rationale for the proposal was that the issuance of tracking stock circumvented the repeal of *General Utilities* by disposing of an interest in the tracked subsidiary without recognizing gain.<sup>91</sup> But this makes no sense when tracking stock is issued in exchange for shares of the tracked subsidiary, because in that context the parent is acquiring an interest in the tracked subsidiary, not disposing of it.

Even when tracking stock relating to an existing subsidiary is issued for cash, there are good grounds to distinguish between cases where the cash is used by the tracked subsidiary and cases where the

<sup>89</sup> DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 129 (1999).

<sup>90</sup> See Dahlberg & Perry, *supra* note 71, at 18–20; AM. BA. ASS'N, SEC. OF TAX'N, Letter of Section members to Charles O. Rossotti (June 23, 1999), N.Y. ST. BA. ASS'N, TAX SEC., Letter to Bill Archer (June 2, 1999), Letter of H. Ways & Means Comm. members to Bill Archer and Charles Rangel (May 6, 1999); Testimony of Edward D. Kleinbard on behalf of the Securities Industry Association before the S. Comm. on Finance (Apr. 27, 1999).

<sup>91</sup> See *supra* note 89.

cash is retained by the parent.<sup>92</sup> In the former case, an issuance of actual stock by the tracked subsidiary would be tax-free under Section 1032, and it is difficult to see why an issuance of tracking stock should be treated more harshly. Of course, issue proceeds initially transferred to the subsidiary might be distributed back to the parent at some point. But that can happen with an actual stock issuance by the subsidiary, and absent the application of traditional step-transaction principles, the subsidiary is not denied the benefits of Section 1032 even though the stock issuance coupled with the distribution has the net effect of a sale of subsidiary stock by the parent.

The more sympathetic cases for taxing the issuance of tracking stock are where the issue proceeds are retained by the parent, or where the stock is distributed without consideration. The former resembles a sale, and the latter a distribution, of the tracked interest. But the resemblance is incomplete, since the parent retains control over the tracked subsidiary, and the dividend and liquidation rights of the tracking stock only imperfectly capture the subsidiary's economic value. A more promising approach to consider here is that of Section 1259, which taxes constructive sales of appreciated financial positions. Corporate stock is considered to be a "financial position" for this purpose,<sup>93</sup> and under Section 1259, a constructive sale of stock can occur if the taxpayer enters into a short sale, a forward or futures contract, or a total return swap that covers substantially all of the income and changes in value of the stock.<sup>94</sup> The statute also authorizes regulations extending this treatment to other transactions that have a similar effect,<sup>95</sup> although no such regulations have yet been issued.

There are as yet no precise standards as to when a forward contract or swap is considered to transfer substantially all of the income and changes in value of an asset so as to trigger application of the

<sup>92</sup> See Tracking Stock Report, *supra* note 71, at 80–81.

<sup>93</sup> I.R.C. § 1259(b)(1).

<sup>94</sup> I.R.C. § 1259(c)(1), (d)(2).

<sup>95</sup> I.R.C. § 1259(c)(1)(E).

constructive sale rule. The relevant legislative history and commentary focus on whether the taxpayer has retained the risk of loss or opportunity for gain in a collar around the current value of the asset, although the threshold width of such a collar should presumably depend on the volatility of the asset's value.<sup>96</sup>

These standards would need to be adapted in order to apply them intelligibly to tracking stock. For example, if a public company has made a public statement regarding its dividend policy on tracking stock, that policy should be assumed to be followed, even if the policy is subject to the discretion of the board of directors and is therefore not legally binding.<sup>97</sup> Even with that assumption, many existing tracking stock issues would be unlikely to meet a standard for a constructive sale, at least in cases where the liquidation rights of the tracking stock do not closely track the value of the tracked subsidiary.

A final question considered here is whether tracking stock should block consolidation of a tracked subsidiary with its parent. In general, a subsidiary can join a consolidated group only if other group members own at least 80 percent of the voting power and value of its stock.<sup>98</sup> In form, of course, the parent has complete ownership of the tracked subsidiary, but the tracking arrangements can separate, to a

<sup>96</sup> See S. REP. NO. 105-33, at 127 (1997); H.R. REP. NO. 105-148, at 443 (1997); James H. Combs, *Will a Variation Lead to Consistency? Implications of Forward Contract Ruling for Hedging Appreciated Stock*, 102 TAX NOTES 1245, 1262–67 (Mar. 9, 2004). But see AM. BA. ASS'N, SEC. OF TAX'N, *Comments Concerning Forthcoming Regulations Regarding Constructive Sales* 13 (2001) (arguing that only the term of the arrangement, and not the volatility of the underlying asset, should affect the threshold width of a collar).

<sup>97</sup> Even a nonbinding policy can have powerful enforcement mechanisms, such as a prohibition on paying dividends on the common shares unless tracking stock dividends are paid, or a transfer of substantial voting rights to the tracking stockholders if dividends are sufficiently in arrears. “The obvious incentives for [the parent] to maintain the stated dividend policy on this subsidiary tracking stock clearly increases the likelihood that performance of that stock will be closely linked to [the subsidiary's] performance.” Tracking Stock Report, *supra* note 71, at 57 n.9.

<sup>98</sup> I.R.C. § 1504(a) (2).

meaningful degree, ownership of interests in the subsidiary from ownership of interests in the parent's remaining assets. While this implicit separation of ownership might not be so complete as to trigger constructive sale treatment, it may be sufficient to call into question the application of the "single entity" theory that underlies the consolidated return rules. For this reason, a much lower threshold of economic separation could plausibly apply to block consolidation than to cause a constructive sale.<sup>99</sup>

Tracking stock is not the only equity-like instrument that the parent can issue to convey an indirect interest in its subsidiary. The grant of an option on subsidiary stock gives the holder an interest in the appreciation in the subsidiary's value, even though the parent retains legal and tax ownership. When such an option is held by a person outside the consolidated group, a similar question arises whether the presence of the option should be taken into account in determining whether the subsidiary is a member of the group. The Code authorizes regulations that treat warrants, convertible securities, and similar instruments as stock, to treat stock as a non-stock instrument, or to treat options to acquire or sell stock as exercised, in applying the 80-percent affiliation tests.<sup>100</sup> This authority was exercised with the issuance of regulations in 1992,<sup>101</sup> which generally disregard options and conversion rights in determining consolidated group membership, unless the option or conversion right is substantially certain to be exercised, and the failure to take the option or right into account would result in the elimination of a substantial amount of federal income tax

<sup>99</sup> In principle, the same question could arise if the tracked business was held in a division or through a disregarded entity. The question would be whether losses of the tracked division should be allowed to offset other profits, and *vice versa*. Under current law, these offsets would likely be permitted. *See Maxwell Hardware Co. v. Comm'r*, 343 F.2d 713, 722–23 (9th Cir. 1965).

<sup>100</sup> I.R.C. § 1504(a)(5)(A)–(B).

<sup>101</sup> T.D. 8462, 1993-9 I.R.B. 22. These regulations declined requests to address tracking stock: "[T]he final regulations do not address the treatment of tracking stock. The Service and Treasury continue to study the questions raised by tracking stock and may issue guidance in the future." *Id.*

liability.<sup>102</sup> Since this is a conjunctive test, an option that is not substantially certain to be exercised is disregarded even though disregarding it may result in substantial tax savings.

Tracking stock lacks an optionality feature, and it will ordinarily be reasonably certain that the holders of the tracking stock will benefit from dividends declared pursuant to the stated policy of paying dividends based on the performance of the tracked subsidiary. If the indirect rights of the tracking stock holders in the tracked subsidiary are of sufficient magnitude in relation to those of the common stockholders, then the presence of the tracking stock should block consolidation. The consolidated return rules allow a subsidiary to issue up to 20 percent of its stock to non-group members, and this standard is the best guide for determining when an issuance of tracking stock should prevent the tracked subsidiary from joining in the consolidated group.

One approach would be to value the tracking stock, and compare it to the value of the subsidiary as a whole. If the tracking stock is worth more than 20 percent of the total, then consolidation would be disallowed. Such a rule might be difficult to apply in practice, since even if the tracking stock is publicly traded, there may be no comparable benchmark for valuing the tracked subsidiary as a whole. In principle, however, this valuation problem is no more difficult than that faced by a subsidiary that issues a class of publicly traded shares to non-group members, while its parent owns shares of a separate non-traded class. The rule may be a bit overbroad, since tracking stock does not typically correlate perfectly with the performance of the tracked subsidiary, and therefore an issuance of tracking stock that is worth 20 percent of the value of the tracked subsidiary could plausibly be said to represent exposure to less than 20 percent of the subsidiary's economic value, with the balance of the tracking stock's exposure being attributable to the parent's other assets. This over-

<sup>102</sup> Treas. Reg. § 1.1504-4(b)(2)(i).

breadth, however, may be unavoidable in attempting to establish a clear rule that is not dependent on nuances of correlation in performance between the tracking stock and the tracked subsidiary.

An alternative approach that avoids valuation would look to whether the stated dividend policy can be reasonably expected to direct more than 20 percent of the subsidiary's income or cash flow to holders of the tracking stock. Again, this approach may be a bit overbroad, since it disregards the possible participation of the tracking stock in the parent's other assets, but it should be simple to apply, at least in cases where the dividend payout policy is based on a relatively straightforward formula.

This discussion of tracking stock has focused on the kinds of tracking stock that are typically issued by public companies in the United States. But tracking stock can also be used to create series funds outside the context of protected cell company legislation. Here, the series fund vehicle issues classes of shares that each track the performance of an underlying sub-fund that is held through a subsidiary. The correlation is intended to be perfect, in that 100 percent of the cash flows, including periodic income and disposition proceeds, of the underlying sub-fund is directed to the holders of the corresponding series of tracking stock. Indeed, the only difference between such an arrangement and the protected cell companies discussed in Part II.A.3 above is that there is no statutory isolation of creditors. Consequently, the claims of any creditor of the series fund vehicle can be enforced against any of its assets. Yet this distinction will be of little practical importance if the series fund has no creditors, or its borrowings are contractually arranged to be recourse only to the shares or assets of a particular sub-fund, and the likelihood of material non-consensual general creditors is remote. Moreover, if such a fund were treated as a single entity, then the potential would arise for tax-free exchanges of shares of one series for shares of another, as discussed above in connection with protected cell companies.<sup>103</sup>

<sup>103</sup> See *supra* note 52 and accompanying text.

There is a spectrum of potential applications for tracking stock of this type, from fund-of-fund vehicles, to private equity funds that acquire significant stakes in underlying investments, to multinational conglomerates that have relatively thin management at the holding company level. In some cases (quite typically for the conglomerates, and occasionally for the private equity funds) the parent vehicle is a *per se* corporation, which presumably mandates single entity treatment under *Union Trusteed Funds*,<sup>104</sup> at least if the vehicle is domestic.<sup>105</sup> Whether single entity treatment would be likewise mandated for foreign *per se* corporations is less clear. Although separate entity treatment could be provided for foreign corporations that are PFICs,<sup>106</sup> PFIC status can often be avoided for funds or holding companies that acquire at least 25-percent stake in their underlying investments.<sup>107</sup>

Outside the context of a *per se* corporation, one might look to the authorities defining partnerships to determine whether the holders of the various classes of stock have joined together in a single venture. As the leading family partnership cases indicate,<sup>108</sup> even the presence of an actual state-law partnership is itself no guarantee that the arrangement will be treated as a partnership for tax purposes. Consequently, the use of a single noncellular fund vehicle does not necessarily imply a single partnership for tax purposes. The existence of a partnership is a question of fact to be decided based on all relevant factors:

Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise...

<sup>104</sup> See *supra* note 8.

<sup>105</sup> See *supra* Part II.A.1 (p. 591).

<sup>106</sup> See *supra* note 50 and accompanying text.

<sup>107</sup> I.R.C. § 1297(c) (providing a look-through to underlying assets and income for shareholdings of at least 25 percent of the issuer's outstanding stock by value).

<sup>108</sup> See *Comm'r v. Culbertson*, 337 U.S. 733 (1949); *Comm'r v. Tower*, 327 U.S. 280 (1946).

The following factors, none of which is conclusive, bear on the issue...: The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.<sup>109</sup>

Applying these standards to the holders of separate classes of shares of a noncellular fund would suggest that no partnership exists among those holders. Most fundamentally, there is no sharing of profits and losses among the classes, except to the extent that they might share the burden of paying general creditors.<sup>110</sup>

The leading cases that define partnership ventures predate the check the box regulations. If a noncellular fund elects (or defaults to) corporate status, should the applicable standards be any different? One might think that the boundaries of the legal entity, or of its cells, ought to be given more weight in the corporate context than in the partnership context, but the check the box rules undermine any attempt to ground such a distinction based on the legal characteristics of the entities involved. Moreover, if differing standards were to apply to entities treated as corporations, difficult questions arise as to who should make the election. For example, suppose a noncellular fund defaults to corporate status and would be treated as a single en-

<sup>109</sup> *Luna v. Comm'r*, 42 T.C. 1067, 1077–78 (1964) (citations omitted).

<sup>110</sup> See Thomas M. Stephens & Marc L. Schultz, *Segregating Assets Within a Single Partnership: Delaware Series Partnerships and LLCs*, 78 TAXES 231, 233 (2000).

tity under standards applicable to corporations, but as a collection of separate partnerships under standards applicable to partnerships. In such a case, the (single) corporate entity might file an election to be treated as a group of partnerships, an implausible outcome that is not currently contemplated by the check the box rules.

A more sensible approach would have the determination of whether there is, for tax purposes, a single entity or many made prior to the determination of whether any such entity is a partnership or a corporation. Once the scope of each such entity is determined, the application of the check the box rules is straightforward. But this approach would require that the same standards apply to entities treated as corporations as apply to entities treated as partnerships. Since the authorities dealing with partnerships treat the boundaries of any legal entities involved as only one factor among many, these boundaries should arguably be given no more respect when dealing with entities that elect or default to corporate status.

### ***C. Targeted Debt***

There is no term for “tracking debt” comparable to tracking stock, and debt ordinarily carries a fixed or floating yield that is independent of the performance of the issuer’s assets. But in fact debt can be, and routinely is, linked to the performance of particular assets of the issuer, and in those cases one can legitimately ask what entity should be regarded as the true issuer.

#### ***1. Nonrecourse Debt***

The blandest case of debt that is linked to particular assets of the issuer is nonrecourse debt. Of course no debt is “nonrecourse” in the sense that the creditor has no recourse to any assets of the issuer; rather, the term is used for what might more precisely be called “limited recourse” debt, in that only specified assets of the issuer are

subject to the creditor's claims. In another sense all debt is limited recourse, since there is only a finite universe of assets that stands behind it, and for that reason no obligation to pay is ever completely absolute. Although the term "nonrecourse debt" is sometimes used to describe debt that is backed by all of the assets of an entity, such as a partnership, but not by its owners, it will be more useful here to confine the term to debt that is backed by less than all of the assets of its issuer.

Finance theory points out that all debt contains an embedded put option on the assets that back it.<sup>111</sup> The lender's entitlement to repayment is effectively the lesser of the face amount of the debt and the value of those assets, the latter being the determinant of the lender's recovery in bankruptcy. But the embedded put is even more evident in the case of nonrecourse debt that is secured by a single asset or pool of assets. The borrower on a loan secured only by Blackacre can default on the loan with no consequence beyond the loss of Blackacre in foreclosure. In such a case, the tax law treats the borrower as having sold Blackacre for the face amount of the loan.<sup>112</sup> But another way to view this situation is as a borrowing by a subentity that owns nothing but Blackacre. Under that view, a default becomes a sort of mini-bankruptcy proceeding in which the assets of the subentity are liquidated to pay its creditors, even though the larger entity of which it is a part may be solvent. This view might suggest treating the foreclosure of Blackacre as a sale at fair market value, with discharge of indebtedness income for any excess of the amount of the debt over that fair market value. (That was the treatment suggested by the concurring opinion<sup>113</sup> in *Commissioner v. Tufts* but was not the holding of the case.)

<sup>111</sup> See Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637, 649–50 (1973); Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141, 146, 169 (1973).

<sup>112</sup> *Comm'r v. Tufts*, 461 U.S. 300, 317 (1983).

<sup>113</sup> *Id.* at 319 (O'Connor, J., concurring).

Another way to view nonrecourse debt is by treating the lender as the owner of the property, with the actual owner owning an in-the-money call option. The premium paid for the deemed option is the owner's equity investment, and the strike price is the amount of the loan. Thus, the owner can acquire unburdened title by paying the strike price (*i.e.*, paying off the loan), or can allow the option to go unexercised (*i.e.*, not paying off the loan and allowing the lender to keep the property). This precise economic equivalence between nonrecourse borrowing and the purchase of a call option is the basis for the fund-linked accreting strike price options that banks use to enable investors to acquire interests in hedge funds. In those cases, the bank provides the financing by actually acquiring the fund interest, in part with its own money (the debt component) and in part with the option premium paid by the investor (the equity component). The strike price is equal to the original amount of debt financing, and increases at LIBOR or some other rate that reflects the cost of debt capital. The investor may be given the option to reduce the strike price by paying additional premium; this is tantamount to paying off a portion of the loan.

These arrangements may be structured for nontax reasons, since there may be restrictions on the option holder's ability to actually own the fund interest. But they raise the question who should be the owner of the fund interest for tax purposes.<sup>114</sup> The option holder has all of the upside by reason of holding the option, and much of the downside as well by reason of the substantial option premium. Indeed, the option holder's exposure to the fund interest is exactly what it would be if the option holder had actually purchased that interest with nonrecourse financing for part of the purchase price. Notwithstanding this exposure, the option arrangements can be viewed as a

<sup>114</sup> In informal guidance, the IRS has treated the holder of an option over a basket of securities as the owner of those securities, where the terms of the option resembled a total return derivative, and the option holder had practical control over the composition of the basket. ILM 2015-47-004 (Aug. 11, 2015); AM 2010-005 (Oct. 15, 2010).

pure derivative if the option holder has no particular rights in respect of the actual fund interest, but only an abstract right to payments from the counterparty based on the fund's value or distributions. Indeed, the counterparty will often be under no obligation to actually own the fund interest, although it will almost always hedge its position, and an actual purchase may be the easiest, and in some cases the only, way to do it. The standard documentation for fund-linked options carefully refers only to amounts received by a "hypothetical investor" in the fund, which supports derivative treatment.<sup>115</sup> But the terms of particular options may vary the standard terms in ways that are inconsistent with pure derivative treatment, and may support treating the option holder as the owner of the underlying fund interest.<sup>116</sup>

While traditionally the tax law treats nonrecourse debt as debt provided it is adequately secured, this treatment creates an anomaly in that the issuer's equity ranks senior to nonrecourse debt in respect of the issuer's other assets. If the debt is not adequately secured, because there is an insufficient equity cushion in light of the riskiness of the underlying asset, then the debt might be recharacterized as equity, but in that case it would in effect be a form of tracking stock, since its return is linked to the particular assets that secure it. As with tracking stock, one might posit a deemed joint venture between such a creditor and the issuer, but again the reasons for doing so are not compelling. If the debt is secured by stock of a subsidiary, then one

<sup>115</sup> See INT'L SWAPS & DERIVATIVES ASS'N, INC., FUND DERIVATIVES DEFINITIONS (2006).

<sup>116</sup> Even if the option holder is not the owner under general tax principles, care must be taken to avoid the constructive ownership rules of Section 1260. In general, a call option is not a constructive ownership transaction unless married to a put, so that the holder has both risk of loss and opportunity for gain. I.R.C. § 1260(d)(1)(C). But there is regulatory authority to extend the coverage of the constructive sale rules to arrangements that have substantially the same effect as the long positions that are expressly covered, and an option that is deep in the money might be caught by any such regulations when and if they are issued. I.R.C. § 1260(d)(1)(D).

might question whether the debt should be treated as an interest in the subsidiary. But in general it is probably best to acknowledge that the instrument really does represent an interest in the issuer, and to apply the same rules to it as would be appropriate for any other tracking stock.

## **2. *Structured Notes***

The universe of debt instruments includes a variety of so-called structured notes, with terms limited only by the imaginations of the designers, the demands of the capital markets, and the constraints of regulatory and tax law. The return on these instruments can represent exposure to any kind of financial asset or index, singly or in combination, and a fixed right to repayment of principal is just another optional term that may or may not be present. The issuers are either financial institutions or special-purpose vehicles, in either case of a sort that is expected to be creditworthy, since the credit risk of the issuer, while always present, is not the primary risk that is intended to be associated with these instruments.

One reason for the popularity of structured notes is that they provide a means for investors who are not established participants in derivatives markets to take positions in various types of derivatives. The investor's entire exposure is paid up front, so the issuer, which is effectively the counterparty in the embedded derivative, does not have to worry about the credit of the investor. The issuer is then typically in a position to pass on the derivative exposure to other participants in the derivatives markets.

In cases where there is a fixed right to repayment of principal, these instruments may be viewed as contingent payment debt instruments; but where there is no such fixed right, their characterization for tax purposes is often uncertain. In some cases, the cash flows on the instrument will sufficiently resemble those of a cash-settled option or forward, or a notional principal contract with one leg prepaid,

that one can with some confidence characterize the note as in fact being what it resembles. But the categories into which the tax law classifies financial instruments are not always well-defined, and have gaps as well as zones of overlap.<sup>117</sup>

What is relevant for purposes of the discussion here is not the proper “cubbyhole”<sup>118</sup> in which to place any particular type of structured note, but rather the relationship between such a note and particular assets of the issuer. Where the issuer is a financial institution, the note is typically an unsecured recourse obligation of the issuer, and is therefore not tied to any particular assets of the issuer in the way that nonrecourse debt is. On the other hand, the terms of the note itself will provide for amounts to be paid on the note that in fact track, with greater or lesser precision, the assets that the issuer may acquire to hedge its position. For this reason, structured notes share some of the characteristics of tracking stock, in that they create a separate class of investors whose interests in particular assets of the issuer vary from those of the issuer’s common stockholders.

Notwithstanding this resemblance, the grounds for treating structured notes as anything other than an interest in the stated issuer is even shakier than for tracking stock. Tracking stock typically tracks a unique asset of the issuer (*e.g.*, shares of the tracked subsidiary). By contrast, structured notes typically track a more abstract financial risk, such as a stock market index, a foreign exchange rate, or the credit status of an unrelated entity. In these cases, there is no requirement beyond the dictates of prudence for the issuer to hedge itself by owning the underlying asset, and indeed, there may not be a unique asset whose ownership would constitute such a hedge. For example, a structured note with a return linked to a stock index could be hedged by owning the stocks in the index, by purchasing a futures

<sup>117</sup> See Michael S. Farber, *Equity, Debt, NOT—The Tax Treatment of Non-Debt Open Transactions*, 60 TAX LAW. 635 (2007).

<sup>118</sup> See Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991).

contract on the stock index, or by acquiring a call and writing a put on the index. Moreover, a financial institution with a high volume of derivative trades is likely to hedge its overall exposure to various risks, rather than the exposure that results from a single issuance of structured notes, and the institution may choose to allow itself some unhedged exposure on an opportunistic basis if it judges market conditions to be right. These possibilities make it hopeless as a general rule to suppose that there will always be specific assets of the issuer that can be said to be tracked by an issue of structured notes.

One can, however, imagine cases where it is easier to identify the tracked asset. The structured notes may relate to the performance of an illiquid or unique asset that the issuer is for practical purposes compelled to own, even if it is not legally required to do so. Some structured notes, for example, simply pass through the cash flows that the issuer receives from a private loan or hedge fund investment. Unlike tracking stock, these are not designed to be equity interests, so they are issued in the form of notes rather than stock, and payments are mandatory rather than subject to the discretion of the board of directors. But they may track the underlying asset much more closely than tracking stock does, and for that reason can be said to resemble the special classes of shares issued by a series fund.

In examining these arrangements, the usual inquiry is into whether the issuer or the investor should be treated as owning the tracked asset. Such an inquiry will focus on the extent to which the benefits and burdens of ownership have been passed to the investor, and the extent to which the issuer has retained a power of disposition or other rights to control the tracked asset. An alternative inquiry into whether the issuer should be treated as multiple deemed entities, with one of these deemed entities holding the tracked asset, is normally foreclosed by the fact that the issuer is a single entity as a legal matter, and in the case of a financial institution almost always a *per se* corporation that is considered a single unit under *Union Trusteed Funds*.

Yet in a related context, the law does posit such a deemed entity. Under the ERISA “plan assets” regulations,<sup>119</sup> the assets of a qualified plan include not only its equity investment in another entity, but may also include an undivided interest in the assets of that entity.<sup>120</sup> Plan asset status is critical under ERISA, because persons with control over plan assets are *de facto* fiduciaries subject to strict standards of conduct under ERISA,<sup>121</sup> and transactions involving plan assets with counterparties that are parties in interest<sup>122</sup> with respect to the investing plan are “prohibited transactions” that, absent an exemption, not only violate ERISA fiduciary standards<sup>123</sup> but trigger penalty excise taxes of up to 100 percent of the amount involved in the transaction.<sup>124</sup>

The plan assets regulations have their own definition of equity interest, which includes “any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features.”<sup>125</sup> While a structured note may be treated as indebtedness under its governing law, in many cases the contingencies associated with its cash flows could well be regarded as substantial equity features. Instruments issued by a financial institution typically do not implicate the plan assets regulations, because there is a broad exemption for issuers that are operating companies, loosely defined to include any “entity that is primarily engaged, directly or through a majority owned subsidiary or subsidi-

<sup>119</sup> 29 C.F.R. § 2510.3-101.

<sup>120</sup> 29 C.F.R. § 2510.3-101(a) (2) (2008).

<sup>121</sup> Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 404(a), 88 Stat. 829.

<sup>122</sup> “Parties in interest” include plan fiduciaries, service providers to the plan, the plan’s sponsoring employer, and affiliates of any of the foregoing. ERISA § 3(14). The Internal Revenue Code uses instead the term “disqualified person,” but the meaning is essentially the same. I.R.C. § 4975(e)(2).

<sup>123</sup> ERISA § 406.

<sup>124</sup> I.R.C. § 4975(b).

<sup>125</sup> 29 C.F.R. § 2510.3-101(b)(1).

aries, in the production or sale of a product or service other than the investment of capital.”<sup>126</sup> The activities of most financial institutions can be considered to extend considerably beyond the mere investment of capital, so they can normally expect to be exempt from these regulations as operating companies.

There is, however, a clause in the plan assets regulations that can undermine the operating company exemption for issuers of structured notes, by positing a deemed entity that owns nothing but the tracked asset. That clause provides, “Where a plan jointly owns property with others, or where the value of a plan’s equity interest in an entity relates solely to identified property of the entity, such property shall be treated as the sole property of a separate entity.”<sup>127</sup> If a structured note provides simply a pass-through of the return on a tracked asset, such as a loan or hedge fund investment, then presumably the value of that note will “relate solely” to that tracked asset. A deemed entity that owns the tracked asset, and nothing else, will not be an operating company, so the operating company exemption will not apply. Consequently, the tracked asset will be treated as “plan assets” to the extent that qualified plans own the structured notes, unless another exemption applies. The alternative exemption that is most likely to be available in this circumstance applies only if qualified plans subject to ERISA own less than 25 percent of the note issue.<sup>128</sup> Compliance with this exemption, however, requires continuous monitoring while the notes are outstanding, which can be difficult if the notes are freely tradable.

This deemed entity rule is quite broad in that it can apply even though the structured note is a general unsecured recourse obligation of the issuer, and there is no legal ringfencing of the tracked asset from the issuer’s other assets. Yet its breadth is undercut by the requirement that the value of the interest “relate solely” to the tracked

<sup>126</sup> 29 C.F.R. § 2510.3-101(c)(1) (2008).

<sup>127</sup> *Id.* § 2510.3-101(g).

<sup>128</sup> *Id.* § 2510.3-101(f)(1).

asset. This standard is arguably so strict that nothing other than a pure pass-through instrument is covered. Yet many structured notes incorporate features that vary the return from the return on the tracked asset. For example, the note may contain an embedded cross currency interest rate swap that changes the effective interest rate and currency denomination of an underlying loan, or the note might provide for returns based on the extent to which an underlying hedge fund exceeds that of a benchmark equity index. Perhaps the rule could be applied to these cases by identifying the related foreign currency or equity hedges and bringing them into the pool of assets held by the deemed entity. But since these additional elements of the return reflect more abstract types of financial risk, it may not be easy to identify specific assets as constituting the hedges, and in some cases the hedge may be done globally, imperfectly, or not at all.

### ***3. Securitization Vehicles***

When structured notes are issued by a special purpose entity that is established as a repackaging or securitization vehicle rather than by a financial institution, it is never hard to find the hedged assets, since those are typically all that stand behind the notes. These entities rarely have substantial equity capital: it would not be unusual for an entity with \$500 million in notes to have only \$10,000 of stated equity, which is held in trust for the benefit of a charity. Consequently, the most junior class of notes issued by such an entity is generally regarded as equity for tax purposes. The entity, if foreign, will almost certainly be a PFIC, so those notes will be attractive to a U.S. taxable investor only if the vehicle elects to be transparent for U.S. tax purposes, or allows the holder of those notes to make a qualified electing fund election under the PFIC rules.

For example, a “synthetic CDO” issuer of collateralized debt obligations might issue several classes of credit-linked notes in ranked order of seniority. The proceeds are used to purchase high-grade col-

lateral, and the issuer sells credit protection on a portfolio of reference entities by entering into a credit default swap with a financial institution on that portfolio. Each class of notes bears the cost of protection payments on the swap to the extent that those payments exceed, in the aggregate, the size of the more junior classes. If the most junior class is large enough, the risk of loss on the other classes may be so low that they can safely be regarded as debt for tax purposes. The matter may be less clear, however, when the amount due on each class of notes is reduced by the amount of any protection payments that are actually made and borne by that class, since the principal is not by its terms unconditionally due. Yet even if the principal were unconditional, the economic risk on the notes would be no different: the issuer would simply lack funds to repay the notes to the extent that protection payments were made under the swap.

There can be two sources of subordination in a synthetic CDO arrangement. First, each class of notes bears the economic risk of loss on a distinct layer of potential overall loss on the reference portfolio: if there are \$30 million of the most junior class of notes, those notes bear the first \$30 million of loss; if there are \$70 million of the next most junior class, those notes bear the next \$70 million, and so forth. Yet the “attachment” and “detachment” points that measure the minimum and maximum aggregate losses on the reference portfolio that are borne by each class of notes can be arbitrarily defined for each class of notes. For example, if the sponsoring institution wishes to retain the first \$50 million of loss exposure to the reference portfolio, the credit default swap could provide that protection payments would be made only to the extent that losses exceed that amount. In that case, a \$30 million junior class of notes would have an attachment point of \$50 million and a detachment point of \$80 million. In a sense, the sponsoring institution has retained the “equity tranche” with regard to the reference portfolio; but looking at the CDO issuer itself, the most junior class of notes would still be normally viewed as

equity, since the sponsor's loss exposure is not attributable to an interest in the CDO issuer itself.

A second source of subordination arises from the use of a common pool of collateral to secure all of the classes of notes. Although the collateral is usually of high credit quality, the recent turmoil in the credit markets is a reminder that no debt is immune from default risk. Even if there are no losses on the reference portfolio, the various classes of notes will bear the risk of loss on the collateral, taking into account the subordination of each class relative to the others. This further element of subordination is a complicating factor in designing a CDO arrangement, since it means that the overall credit risk borne by a class is a function not only of its attachment and detachment points on the reference portfolio, and the quality of the collateral as a whole, but also on the size and relative subordination of the claims of other note classes on that collateral.

This second source of subordination can be eliminated by creating a separate pool of collateral for each class of notes. This separation is accomplished by a pledge of each such pool to its corresponding class of notes, and by causing the claims of each class to be recourse only to its own pool of collateral. At this point, each class of notes stands on its own, being backed by its own pool of collateral and a right to a portion of the periodic payments on the credit default swap, and subject to the particular protection payments under the swap that are assigned to that class by the designation of attachment and detachment points. Under such an arrangement, every class of notes could be said to be equity, since each class represents the only external claim (apart from the swap) on the pool of assets that back it, although notes of extremely high credit quality might nonetheless be regarded as debt in accordance with their form.

In such an arrangement, if each class of notes is regarded as equity, the question arises whether they should be regarded as interests in the same entity. As a legal matter, the CDO issuer is typically a single entity that does not have protected cells. Instead, the separation of

liabilities is accomplished contractually through the pledging and limited recourse arrangements. As a practical matter, it makes little difference whether the separation of liabilities is accomplished contractually or by statute, since the potential for any liabilities other than the notes themselves is remote. Consequently, the holders of each class of notes are in a position of near total indifference as to what happens to the others. In such a case, one might well wonder if there is any reason, beyond the existence of a common legal form, for regarding the different classes of notes as interests in the same entity for tax purposes.

The same question arises in more general form in the case of repackaging vehicles that are set up to issue various unrelated series of notes, each backed by its own collateral and swap arrangements. Although such a vehicle could be established as a protected cell company, there is no compelling nontax reason to do so, since a contractual separation of the assets and liabilities is regarded as sufficiently complete by the investors in these vehicles. If protected cell companies are to be treated as multiple entities for tax purposes based on the statutory separation of assets and liabilities, then it is hard to find a substantive basis for differing treatment of such an issuer that has achieved substantially the same result contractually.

### III. MULTIPLE ENTITIES, SHARED INTERESTS

Just as it is possible for a single entity to have distinct pools of assets with separate owners, it is possible for multiple entities to have common owners or common pools of assets backing the interests of separate owners. These arrangements lead to the question of when these multiple entities should be treated as one for tax purposes.

Some of these arrangements involving multiple entities, such as stapled stock and dual headed companies, are somewhat unusual in the United States, perhaps in part because of the tax uncertainties associated with them. But before turning to those arrangements, it will be useful to consider briefly a far more mundane example of multiple entities with shared interests: a parent holding company and its subsidiaries.

#### A. *Subsidiaries*

A parent-subsidary relationship is an old-fashioned form of stapling: a transfer of stock in the parent automatically causes a transfer of an indirect interest in stock of the subsidiary. When the subsidiary is wholly owned, the equity interests in the parent and the subsidiary are almost completely aligned, but not quite. The parent's creditors also have an interest in the stock of the subsidiary, since that is one of the assets backing the debt. Even with the potential presence of parent creditors, or minority shareholders in the subsidiary, the tax law has struggled almost since its inception<sup>129</sup> with the question of when to treat a parent and its subsidiaries as a single entity.

The consolidated return rules, as they have evolved to the present day, represent a compromise between single and separate entity concepts. The authority granted to the Treasury Department to establish

<sup>129</sup> For historical background, *see* ANDREW J. DUBROFF, JERRED G. BLANCHARD, JR., JOHN BROADBENT & KEVIN A. DUVALL, FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS § 1.02 (2d ed. 2007).

the terms of this compromise was most recently confirmed in 2004,<sup>130</sup> when Congress overturned some of the reasoning, if not the result, in *Rite Aid Corp. v. United States*.<sup>131</sup> As stated in the legislative history,

The provision confirms that, in exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

Thus, under the statutory authority of section 1502, the Treasury Department is authorized to issue consolidated return regulations utilizing either a single taxpayer or separate taxpayer approach or a combination of the two approaches....<sup>132</sup>

The blending of single and separate entity approaches can be illustrated by the intercompany transaction regulations. When proposing substantial revisions to those regulations in the mid-1990s, the Service noted,

The current consolidated return regulations use a deferred sale approach that treats the members of a group as separate entities for some purposes and as a single entity for other purposes. For example, the amount, location, character, and source of items from an intercompany transaction are generally determined as if separate returns were filed (separate entity treatment), but the timing of items is

<sup>130</sup> American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 844(a), 118 Stat. 1418, 1600.

<sup>131</sup> 255 F.3d 1357 (Fed. Cir. 2001). This case invalidated Treasury regulations restricting the deductibility of losses on the disposition of subsidiary stock in circumstances where built-in loss in the subsidiary's assets could result in loss duplication. The Federal Circuit held that Treasury had no authority to address this problem under the consolidated return regulations, since the same problem could arise even when separate returns were filed. *Id.* at 1359–60. Although Congress rejected this restriction on Treasury's authority, "The provision nevertheless allows the result of the *Rite Aid* case to stand with respect to the type of factual situation presented in the case." H.R. REP. NO. 108-548, pt. 1, at 311 (2004); American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 844(b), 118 Stat. 1418, 1600.

<sup>132</sup> H.R. REP. NO. 108-548, pt. 1, at 311 (2004).

determined more like the timing that would apply if the participants were divisions of a single corporation (single entity treatment).<sup>133</sup>

While the conceptual purity of single entity treatment is appealing,<sup>134</sup> the practical considerations that arise in fashioning a workable set of rules for intercompany transactions led Treasury to continue to balance the two approaches even when these rules were substantially revised.<sup>135</sup>

Curiously, the delicate balance between single and separate entity treatment in the consolidated return regulations co-exists with alternative regimes that provide, on the one hand, for complete separate entity treatment, and on the other, for complete single entity treatment. The consolidated return rules are themselves elective:<sup>136</sup> a group that does not elect to file consolidated returns is treated as a collection of completely separate entities, although in substance the alignment of interests that would justify consolidated reporting is equally present. Moreover, as a practical matter, the electivity even extends to individual group members. Although a consolidated return election initially requires the consent of all group members,<sup>137</sup> and subsequent members are required to join in the return,<sup>138</sup> it is simple enough to deconsolidate a member by holding it through an ineligible entity such as a partnership.<sup>139</sup>

At the other extreme, a parent can elect complete single entity treatment for subsidiaries that are wholly owned and are not *per se*

<sup>133</sup> Notice 1994-49, 1994-1 C.B. 358, 359.

<sup>134</sup> "It is generally acknowledged that greater single entity treatment reduces anomalies and planning opportunities, and better reflects the economic unity of a consolidated group." *Id.*

<sup>135</sup> See T.D. 8597, 1995-2 C.B. 147.

<sup>136</sup> I.R.C. § 1501; Treas. Reg. § 1.1502-75(a)(1).

<sup>137</sup> Treas. Reg. § 1.1502-75(a)(1).

<sup>138</sup> Treas. Reg. § 1.1502-75(e).

<sup>139</sup> See Treas. Reg. §1.1502-20(b)(6), Ex. (2) (contribution to a partnership causes basis reduction on deconsolidation); *cf.* I.R.S. Priv. Ltr. Ruls. 1996-40-010 (Oct. 4, 1996), 1996-26-031 (June 28, 1996) (corporation held through a partnership not treated as affiliated in the Subchapter S context).

corporations, by causing the subsidiaries to elect to be treated as disregarded entities. When available, this approach fulfills the dream of single entity treatment that is sought by, but eludes, the consolidated return regulations.<sup>140</sup>

Given the focus on isolation of liabilities in determining whether series of a segregated portfolio company should be treated as separate entities, it is striking that isolation of liabilities plays no role in determining whether partial or complete single entity treatment should be available for affiliated groups. Consider the simple case of a domestic LLC that is a holding company with no liabilities, and no assets except two wholly owned domestic LLC operating subsidiaries. If only the holding company elects corporate status, then all three LLCs will be treated as a single entity, even though all of the liabilities are at the subsidiary level and completely separate. If all three LLCs elect corporate status, they will be treated purely as three separate entities, unless they further elect mixed single and separate entity treatment under the consolidated return rules. Finally, if only the subsidiaries elect corporate status, then they will be treated purely as separate entities, with no entitlement to file consolidated returns, assuming that the holding company is not itself owned by a domestic corporation. All of this is familiar enough, but it underscores the importance of tax elections, and the limited role of “substance,” in determining not only whether an entity is tax transparent, but how many entities there are.

While separateness of liabilities is irrelevant in electing to file consolidated returns or to treat a subsidiary as a disregarded entity, having the same, or largely the same, ultimate equity owners is essential. For consolidated return filing, the overlap in equity ownership need not be complete, since those rules allow a 20-percent minority interest. Yet even where there is complete overlap in equity ownership, consolidation will not always be available. The definition of

<sup>140</sup> See *supra* note 134; see also David S. Miller, *The Strange Materialization of the Tax Nothing*, 87 TAX NOTES 685, 685–86 (May 1, 2000).

affiliated group for this purpose requires that a common parent own directly 80 percent of the vote and value of the stock of another member, and that 80 percent of the vote and value of each member's stock (other than the common parent) be directly owned by group members.<sup>141</sup> Moreover, each member must be an eligible corporation, a category that most notably excludes foreign corporations.<sup>142</sup> For example, this definition rules out consolidation, and therefore mandates separate entity treatment, in the following circumstances:

- (i) Two domestic corporations are wholly owned by a US citizen.
- (ii) Two domestic corporations are wholly owned by a foreign corporation.
- (iii) A domestic corporation is wholly owned by another domestic corporation, but indirectly through partnerships among other wholly owned subsidiaries.
- (iv) The shares of two widely held domestic corporations are stapled together.

Each of these arrangements has no less an alignment of equity interests, and no greater a separation of assets and liabilities, than those of an affiliated group that is allowed to consolidate.

The particular texture of the requirements for membership in an affiliated group in part reflect the mechanics by which the consolidated return rules work, since those rules contemplate the existence of a common parent that is ultimately entitled to all, or substantially all, of the earnings and profits of other group members. But these rules did not need to be designed that way, and features of consolidation, such as the ability to use losses to offset the profits of other group members or the deferral of gain on intercompany transactions, could be

<sup>141</sup> I.R.C. § 1504(a).

<sup>142</sup> I.R.C. § 1504(b).

accomplished under regimes that took a broader view of affiliated group membership.<sup>143</sup>

## B. *Stapled Stock*

A share of stock is said to be stapled to another if they cannot be transferred separately. This stapling can be built into the terms of the shares themselves, or can be accomplished by holding one of the shares subject to the stapling arrangement in a trust for the benefit of the holder of the other share, whoever that may be. And, as noted earlier, a practical form of stapling occurs whenever the shares are held by the same entity, at least as far as the entity's owners are concerned, since they are not at liberty to separately transfer their indirect interests in each of those shares, although the entity itself may be at liberty to do so.

### 1. *Early Bank Cases*

The tax law has struggled for decades with the treatment of stapled stock. The issue first arose in the 1920s, when banks were

<sup>143</sup> The United Kingdom, for example, allows losses to be “surrendered” to profitable group members, regardless of whether there is a U.K. common parent. Income and Corporations Act, c. 4, § 402 (Eng). For this purpose, corporations are considered to be members of the same group if one is a 75-percent subsidiary of the other, or if both are 75-percent subsidiaries of a third company. *Id.* at § 413(3). In determining whether a corporation is a 75-percent subsidiary of another, indirect ownership through other entities is taken into account on a proportionate basis. *Id.* at § 838. This test is broader than the U.S. affiliated group test in that indirect ownership can be taken into account (including through non-U.K. resident entities), but is less broad in that multiple tiers of minority ownership can break affiliation. For example, in the United States an 80-percent subsidiary of an 80-percent subsidiary could be members of the same U.S. affiliated group, but in the United Kingdom the lower-tier subsidiary would be only a 64-percent subsidiary of its grandparent and therefore could not surrender losses to it.

forced to divest nonbanking businesses for regulatory reasons.<sup>144</sup> Seeking to retain managerial control of those businesses, they spun them off into companies owned by trusts that were set up for the benefit of their shareholders and controlled by bank management. This was the context of *De Coppet v. Helvering*, in which the court disallowed a loss deduction for the shares of a spun-off investment company that subsequently went under.<sup>145</sup> In an opinion by Learned Hand, the Second Circuit held that what happened on the original distribution was, essentially, nothing:

For all purposes except conformity with banking requirements the result was...substantially the same as though the Bank itself held the shares. If the Bank had been the sole shareholder, its directors could have managed the investment company's property as they thought best, and the bank shareholders could have controlled them only through their power to elect or remove them. Since the trustees, who were the holders of the investment shares, must be directors or officers of the Bank, they were equally subject to the control of the bank shareholders, but no more so. Again, the beneficial interest of the bank shareholders was the same as though the Bank were the sole holder of the investment shares.... We do not say that no differences can be conjured up between the legal form chosen and the usual share holding of a subsidiary; but they are immaterial to the subject at hand.<sup>146</sup>

Other cases that considered this issue reached the same conclusion.<sup>147</sup>

<sup>144</sup> See Christopher J. Lord, *Stapled Stock and I.R.C. Section 269B: Ill-Conceived Change in the Rules of International Tax Jurisdiction*, 71 CORNELL L. REV. 1066, 1077 (1986).

<sup>145</sup> 108 F.2d 787, 787, 789 (2d Cir. 1940).

<sup>146</sup> *Id.* at 788.

<sup>147</sup> See, e.g., *Moore v. Hoey*, 31 F. Supp. 478, 480–81 (S.D.N.Y. 1940). But see *Comm'r v. Hagerman*, 102 F.2d 281, 281–82 (3d Cir. 1939), which did allow such a loss. In that case, the stapled affiliate was dissolved and the taxpayer received a separately transferable certificate in a liquidating trust. The appeals court in *De Coppet* concluded that this case was arguably distinguishable, or should just be ignored. *De Coppet*, 108 F.2d at 789.

In *De Coppet* and similar cases, the taxpayer argued for separate entity treatment, while the Service asserted that the stapled interests should be treated as a unitary investment in a single entity. In *Wilkinson v. Commissioner*, the issue was whether the original spin-off was a taxable dividend to the bank's shareholders.<sup>148</sup> (The possibility of tax-free spin-off treatment was not discussed, and presumably was not available.<sup>149</sup>) Here, the shoe was on the other foot, and it was the Service that was arguing for separate entity treatment. Nonetheless, the outcome was the same: citing *De Coppet*, the Tax Court held that the transfer of the subsidiary to a trustee for the bank's shareholders was not a taxable distribution:

The formal legal differences that exist between the usual shareholding of a subsidiary and the trustee shareholding here involved are unimportant when the inquiry is whether the transfer shall be deemed a taxable transaction for the shareholder. Where the transfer to the trustee is made under an agreement which limits the rights and privileges of the shareholders of the bank to substantially the same rights to the stock of the bank's subsidiary as existed before the transfer, no taxable dividend to them occurs by reason of the transfer.<sup>150</sup>

Yet the Service did win a few. In cases where the bank, instead of distributing shares of an existing subsidiary, transferred cash to the trustee to fund a new corporate venture, the courts held that the transfer was treated as if cash had been paid to the shareholders as a taxable dividend, and then contributed by the shareholders to the trustee.<sup>151</sup>

<sup>148</sup> 29 T.C. 421 (1957), *nonacq.* 1960-2 C.B. 3.

<sup>149</sup> Under Sections 112(b)(3) and (11) of the Internal Revenue Code of 1939 (the predecessors to Section 355) such a distribution, in order to be tax-free, would have had to have been made pursuant to a plan of reorganization. *See* I.R.S. Gen. Couns. Mem. 35,177 (Dec. 20, 1972).

<sup>150</sup> *Wilkinson*, *supra* note 148, at 427.

<sup>151</sup> *Lonsdale v. Comm'r*, 32 F.2d 537 (8th Cir. 1929); *Twohy v. Comm'r*, 34 B.T.A. 444 (1936); *Hopkins v. Comm'r*, 27 B.T.A. 1331 (1933); *Andrews v. Comm'r*, 26 B.T.A. 642 (1932). The Service later confirmed that these results could not

It is hard to reconcile the results in these cases based on whether the stapled entities should be seen as separate. The new ventures that were set up in the cases finding a taxable distribution were as much under the thumb of the bank as the pre-existing subsidiary in *Wilkinson*. Moreover, the Service never reconciled itself to *Wilkinson*: it filed a nonacquiescence,<sup>152</sup> and has consistently ruled ever since that these distributions are taxable, regardless of whether the stapled enterprise was a pre-existing subsidiary.

## 2. *Rulings*

While it was fighting the *Wilkinson* case, the Service set out its litigating position in Revenue Ruling 54-140.<sup>153</sup> Concluding that the transfer of a bank subsidiary to a trust for the benefit of its shareholders was a taxable dividend to them, the Service noted that the powers of the trustees in regard to the subsidiary's stock could not be exercised without the consent of the shareholders. This consideration, however, was dismissed by the Tax Court in *Wilkinson*, based on the dubious logic that the shareholders had similar rights with regard to the subsidiary's stock while it was still owned by the bank:

The authority of the Bank shareholders as beneficiaries was no greater than the authority which they possessed with reference to the Securities stock when it was held as an asset of the Bank. The Bank shareholders by collective action of a majority could have controlled the Securities stock when it was an asset of the Bank, though the ex-

be avoided by arguing that the distribution was a stock dividend, since cash, not stock, was in fact distributed, and the stock that was purchased with that cash was stock of the new venture, not stock of the bank. Rev. Rul. 69-155, 1969-1 C.B. 93.

<sup>152</sup> 1960-2 C.B. 3.

<sup>153</sup> 1954-1 C.B. 116. Rev. Rul 1980-213, 1980-2 C.B. 101, acknowledges the difficulties in determining the fair market value of the distribution in the absence of separate trading prices, and provides some general guidance on the valuation issue.

ercise of that power might be limited to the election of a new Board.<sup>154</sup>

Yet the fact that the shareholders' control no longer had to be exercised indirectly through the Board would seem to be highly germane to the question whether the subsidiary stock should still be treated as owned by the Bank.

Shortly after *Wilkinson* was decided, the Service was asked to consider whether a subsequent dissolution of the trust would be a taxable dividend. Such a result would appear to be consistent with the decision in *Wilkinson*, but the Service declined to rule pending the appeal of the case (although in the end, no such appeal was ever decided). However, an earlier GCM, prepared in connection with the issuance of Revenue Ruling 54-140, expressed a concern that, since the dissolution of such a trust is not normally a taxable event, "it would be difficult or impossible to tax this later event (termination of the trust) to the stockholders."<sup>155</sup>

The Service continued to deal with the adverse case law authority by ignoring it. The result, however, could be benign for taxpayers in situations where the distribution of the subsidiary shares could qualify as a tax-free spin-off under Section 355. While the stapling of the distributing and controlled corporations might seem inconsistent with the business purpose of a spin-off where that purpose relied on a separation of management and ownership, for many spin-offs, including those motivated by bank regulatory constraints, the stapling could be seen as perfectly compatible with the separation,<sup>156</sup> as was evidently the case in a 1957 private letter ruling.<sup>157</sup> The Service at one point considered issuing a revenue ruling on the spin-off of a stapled

<sup>154</sup> *Wilkinson*, 29 T.C. at 427.

<sup>155</sup> I.R.S. Gen. Couns. Mem. 35,177 (Dec. 20, 1972), quoting I.R.S. Gen. Couns. Mem. 27,767 (Apr. 29, 1953).

<sup>156</sup> See Daniel M. Dunn & Robert A. Rizzi, *Spin-Off and Stapling Transactions*, 28 J. CORP. TAX'N 25 (2001).

<sup>157</sup> I.R.S. Priv. Ltr. Rul. 5708306360A (Aug. 30, 1957).

subsidiary,<sup>158</sup> but in the end no ruling was issued, because of concerns about whether the spin-off had truly effected a corporate separation.<sup>159</sup> Although the Service stated that it would conduct a study of the issue, no such study was ever released, nor was any further guidance produced regarding spin-offs of stapled stock.

In the 1970s the Service addressed a number of issues regarding the stapling of real estate investment trust (REIT) shares to those of an ordinary domestic corporation. As with the bank cases, the REIT shares were owned by a trust for the benefit of the shareholders of the corporation. First, the Service considered whether rent and interest received by the REIT from the corporation to which it was stapled constituted qualifying REIT income. Qualifying income does not include rent received by a REIT from a corporation in which the REIT has a 10 percent or greater interest,<sup>160</sup> and for this purpose the attribution rules of Section 318 apply.<sup>161</sup> In a 1975 General Counsel Memorandum,<sup>162</sup> the Service concluded that Section 318 would cause the lessee to be treated as owned by the REIT for this purpose, thereby disqualifying the rental income. The Service reached the opposite result in the case of interest received by a stapled REIT,<sup>163</sup> since interest is not subject to a similar rule that incorporates attribution of stock ownership under Section 318.

Interestingly, the Service reached an adverse result for rent received by a REIT from a stapled entity even though the relevant attribution rules between shareholders and corporations under Section 318 require a threshold of 10-percent ownership, and there is no indication that any shareholder owned 10 percent of both entities. Instead, the Service concluded that the trust that owned the lessee

<sup>158</sup> I.R.S. Gen. Couns. Mem. 35,177 (Dec. 20, 1972).

<sup>159</sup> See I.R.S. Gen. Couns. Mem. 35,633 (Jan. 23, 1974).

<sup>160</sup> I.R.C. § 856(d)(2).

<sup>161</sup> I.R.C. § 856(d)(5).

<sup>162</sup> I.R.S. Gen. Couns. Mem. 36,185 (Mar. 10, 1975).

<sup>163</sup> I.R.S. Gen. Couns. Mem. 36,004 (Sep. 25, 1974).

would be treated as owning the shares of the REIT owned by the trust beneficiaries,<sup>164</sup> making the trust the constructive owner of 100 percent of the REIT, which in turn caused the REIT to be the constructive owner of the lessee.<sup>165</sup> This reasoning leaves open the possibility that a REIT could receive qualifying rental income from a stapled entity if the stapling were accomplished by means other than a trust, such as restrictions on transfer in the share certificates.<sup>166</sup> It is hard, however, to find a principled reason for the result to depend on the method of stapling.

In another GCM,<sup>167</sup> the Service applied the grantor trust rules to treat a REIT as the owner of one-third of the shares of a non-REIT that were held by a trust for the benefit of the REIT's shareholders, causing it to violate the restriction that generally limits REIT ownership to 10 percent of the outstanding voting securities of any one issuer.<sup>168</sup> Under the trust arrangements in that case, the REIT could dilute the interests of shareholders in the trust holding the non-REIT shares by issuing additional shares itself, since it had no obligation to contribute any of the issue proceeds to the trust. The grantor trust rules treat a grantor as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or income is subject

<sup>164</sup> Although there is a 10-percent ownership threshold for attribution from shareholders to corporations, there is no such threshold for attribution from beneficiaries to trusts, except that there is no attribution from a beneficiary with a contingent interest that actuarially represents less than 5 percent of the value of the trust. I.R.C. § 318(a)(3)(B). While a beneficiary of a stapled REIT trust might have less than a 5-percent interest, that interest would not be contingent.

<sup>165</sup> I.R.C. § 318(a)(5)(A) generally treats constructive ownership as actual ownership for purposes of applying the stock ownership rules successively.

<sup>166</sup> In I.R.S. Priv. Ltr. Rul. 5708306360A, *supra* note 157, the stapling was accomplished by restrictions in the corporate charter, and enforced by the simple expedient of printing the certificates for both shares on the same piece of paper. *See also* Speckels-Rosekrans Inv. Co. v. Comm'r, 146 F.2d 982, 982-83 (9th Cir. 1945); John A. Corry, *Stapled Stock—Time for a New Look*, 36 TAX L. REV. 167, 167 n.1 (1981)

<sup>167</sup> I.R.S. Gen. Couns. Mem. 36,373 (Aug. 12, 1975).

<sup>168</sup> I.R.C. § 856(c)(5)(B).

to a power of disposition, exercisable by the grantor or a non-adverse party, without the approval of an adverse party.<sup>169</sup> The power to add new beneficiaries is such a power, since it dilutes the interest of existing beneficiaries. In this particular case, the REIT could accomplish the dilution only with the consent of two-thirds of its shareholders. Since such a group of shareholders would constitute an adverse party, the REIT was not treated as the owner of two-thirds of the trust;<sup>170</sup> but it was treated as the owner of the other one-third.<sup>171</sup>

Since the grantor trust rules generally apply for all income tax purposes, one might wonder whether treating the REIT as the owner of all or part of a trust holding shares of another entity might be inconsistent with the Service's view that the transfer of assets to that trust constitutes a taxable dividend to the REIT shareholders. The Service acknowledged the tension here, but did not address it since the request for a ruling on the issue was withdrawn. Mysteriously, the Service did state that its position on the grantor trust issue did not require modification of its position in *Wilkinson* and Revenue Ruling 54-140, but also noted that if the Service were to acquiesce in *Wilkinson*, the acquiescence would provide a further rationale for treating the REIT as the owner of the trust.

Shortly thereafter, the Service issued another GCM<sup>172</sup> that did not treat the REIT as the owner of the trust established for the benefit of its shareholders, since in that case the REIT was required to contribute a portion of any new issuance proceeds to the trust, and therefore it did not have the power to dilute the interests of the trust beneficiaries. This GCM provided the recipe for a series of rulings that

<sup>169</sup> I.R.C. § 674(a).

<sup>170</sup> See Treas. Reg. § 1.672(a)-1(b).

<sup>171</sup> The logic of the GCM is shaky in treating the REIT as the owner of that other one-third, because the REIT would need the consent of two-thirds of the shareholders to accomplish *any* dilution. Since those shareholders are adverse parties, it does not appear that the REIT had any power to affect beneficial ownership of the trust without the consent of an adverse party.

<sup>172</sup> I.R.S. Gen. Couns. Mem. 36,893 (Oct. 22, 1976).

enabled REITs to hold, via stapled entities, interests that they could not hold directly. Thus, REITs became able to use stapled entities to avoid tax restrictions on ownership of controlled entities in exactly the way that banks had avoided regulatory restrictions fifty years earlier.

Although this REIT technique was curtailed by the enactment of Section 269B as described in the next section, a plot line left dangling by these developments was the potential use of the grantor trust rules to avoid a dividend distribution. In the bank cases described above, the banks were dealing with a regulatory restriction, not a tax constraint. It might well have been possible for them to have retained a grantor trust power that would cause them to continue to be treated as the owner of the trust holding the stapled subsidiary: for example, the bank could have retained the right to substitute the trust property with other property of equivalent value.<sup>173</sup> It remains an open question whether a spin-off of a stapled subsidiary that was not tax-free under Section 355 could nonetheless avoid being treated as a dividend if grantor trust powers were retained.

### 3. *Section 269B*

The Service's persistence in treating stapled entities as separate went far in dimming the memory of Learned Hand's view that no significance should be attached to whether a corporation is held through another as a subsidiary, or alongside another as a stapled entity. Yet stapled stock proved to be another example of Marty Ginsburg's adage that every stick handed to the Commissioner to beat the taxpayer with turns into a snake that bites the Commissioner.<sup>174</sup>

<sup>173</sup> See I.R.C. § 675(4)(C).

<sup>174</sup> In the inimitable original, "[E]very stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the commissioner on the hind part." Martin D. Ginsburg, *Making the Tax Law Through the Judicial Process*, 70 A.B.A. J. 74, 76 (1984).

The Service itself pointed the way with favorable REIT rulings that allowed REITs to be stapled to entities that they would not be allowed to own.<sup>175</sup> This stapling arguably undermined those REIT restrictions, which were intended to ensure that REITs were focused in a defined way on passive real estate investments.<sup>176</sup>

Stapling posed a potentially even greater threat to the Subpart F regime. In a development that foreshadowed more recent controversies on expatriation,<sup>177</sup> companies saw the potential to de-control their foreign subsidiaries by causing them to be stapled to their domestic parents.<sup>178</sup> The scale of potential tax avoidance, coupled with the desire for revenue raisers in the wake of massive deficits in the early 1980s, led to the enactment of Section 269B,<sup>179</sup> which curtails the use of stapling to avoid both REIT restrictions and the Subpart F regime.

Section 269B accomplishes this result through the following provisions:<sup>180</sup>

<sup>175</sup> See I.R.S. Gen. Couns. Mem. 36, 893, *supra* note 172, and accompanying text.

<sup>176</sup> In 1999, when Congress amended the REIT rules to permit taxable REIT subsidiaries, the Senate Committee on Finance stated it was “concerned that under [prior] law, disqualified income of a REIT may be avoided through transactions with entities that are engaged in activities that produce disqualified income but that are effectively owned by the REIT.” S. REP. NO. 106-201, at 57 (1999).

<sup>177</sup> See *infra* notes 192–197 and accompanying text.

<sup>178</sup> See Walter C. Cliff, *Pairing: A Technique for Avoiding Controlled Foreign Corporation Status and Other Burdens of U.S. Taxation*, 57 TAXES 530, 530–31 (1979); Corry, *supra* note 166, at 181–88; Donald J. Fitzgerald, *Does Service’s Position on ‘Stapled Stock’ Open a Loophole for Foreign Operations?*, 50 J. TAX’N 354, 356 (1979); Allen Schuldenfrei, *Stock-Pairing to Decontrol a CFC*, 6 INT’L TAX J. 424, 428 (1980); *A Plan to Shelter Overseas Profits*, BUS. WK., May 8, 1978, at 112. The de-control of foreign subsidiaries through stapling was also part of the fact pattern in some rulings that were issued in the late 1970s. I.R.S. Priv. Ltr. Rul. 78-42-104 (July 24, 1978), *supplemented by* I.R.S. Priv. Ltr. Rul. 78-52-101 (Sep. 29, 1978); I.R.S. Priv. Ltr. Rul. 78-39-012 (June 27, 1978), *supplemented by* I.R.S. Priv. Ltr. Rul. 79-35-084 (May 31, 1979).

<sup>179</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 136(a), 98 Stat. 494, 669.

<sup>180</sup> A third provision ensures that stapled entities will get the benefit of only one set of graduated tax rates. I.R.C. § 269B(a)(2).

- (i) If a domestic corporation and a foreign corporation are stapled entities, the foreign corporation is treated as domestic.<sup>181</sup>
- (ii) In determining whether a stapled entity is a regulated investment company or a REIT, all entities which are stapled entities with respect to each other shall be treated as one entity.<sup>182</sup>

The application of these rules depends crucially on the definition of “stapled entity.” Unfortunately, the statutory drafting defies plain-language interpretation:

The term “stapled entities” means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

The vital piece that is missing from this formulation is any requirement that the interests in these entities be stapled *to each other*. So if the stock of corporation *A* is stapled to the stock of corporation *B*, and the stock of corporation *C* is stapled to the stock of corporation *D*, then under the literal terms of this definition, *A* and *C* are stapled entities, which is clearly not the correct result.

In this circumstance, two competing interpretations, both plausible, could be advanced. The first such interpretation requires only a slight change in the statutory drafting:

*Option 1:* The term “stapled entities” means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of ~~stapled~~ interests that are stapled to interests in the other entity.

Although the question went unresolved for more than twenty years, regulations issued in 2005 came down decisively in favor of this in-

<sup>181</sup> I.R.C. § 269B(a)(1).

<sup>182</sup> I.R.C. § 269B(a)(3). In view of the Service’s prior ruling policy allowing stapled REITs, any REITs that were stapled as of June 30, 1983 are exempt from this rule. Deficit Reduction Act of 1984, *supra* note 179, § 136(c)(3).

terpretation.<sup>183</sup> The regulations provide an example in which a class of shares representing 75 percent of corporation *A* is stapled to a class of shares representing 25 percent of corporation *B*, and a class of shares representing 75 percent of corporation *B* is stapled to a class of shares representing 25 percent of corporation *A*. The regulations confirm that these corporations are indeed stapled.<sup>184</sup>

Although the regulations brought clarity to this issue, there is a sense in which this interpretation is overbroad, as can be seen by substituting “99” and “1” for “75” and “25” in the example. With this change, there is no longer any meaningful alignment of economic interest between the shareholders of the two companies, yet the regulations would treat them as stapled. On the other hand, if one instead substituted the percentages “51” and “49” in this example, the alignment would be nearly perfect, and any proper definition of stapled entities should capture that case. The example actually given in the regulations is an intermediate case, where there is a meaningful, but far from complete, alignment of interests between the two corporations.

A more nuanced interpretation would take into account the degree of alignment created by the stapling:

*Option 2:* The term “stapled entities” means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of ~~stapled~~ interests that are stapled to interests in the other entity, taking into account any such stapled interests only to the extent that they represent interests in both entities.

This Option contains an added clause, shown here in italics, that limits the extent to which an interest in one entity is treated as stapled, if it is disproportionately large in relation to the interest in the other entity to which it is stapled.<sup>185</sup> Any such disproportion represents a

<sup>183</sup> T.D. 9216, 2005-2 C.B. 461.

<sup>184</sup> Treas. Reg. § 1.269B-1(b)(3).

<sup>185</sup> A similar approach is used in I.R.C. § 1563(a)(2), which treats two or more corporations as members of a brother-sister controlled group if five or fewer persons collectively own more than 50 percent of the vote or value of each

divergence of interests, and is therefore properly disregarded in measuring the degree of economic alignment created by the stapling.

The operation of Option 2 can be best explained by applying it to the example in the regulations. The class of shares representing 75 percent of corporation *A* that is stapled to a class of interests representing 25 percent of corporation *B* would be regarded as a stapling of 25 percent of the interests in both corporations, since only to that extent do these stapled interests represent interests in both corporations. Likewise, the other class of shares would be regarded as a stapling of 25 percent of the interests in both corporations. Together, they would be regarded as a stapling of 50 percent, which is just shy of the statutory threshold of “more than” 50 percent. While this would reverse the result in the regulations, it is in keeping with the intuition that although all of the interests in both entities are in fact stapled, there is only a partial alignment of interest.

Option 2 also produces more appropriate results in the variations on the example considered above. In the 99-1 example, the first stapled pair of classes would be treated as a stapled interest only to the extent of the 1-percent interest in both corporations represented by that pair, and the other stapled pair would also be treated as a further 1-percent stapling. The combined stapled interests of 2 percent would be far below the threshold needed to treat the two corporations as stapled entities. By contrast, in the 51-49 percent case, each pair would represent 49-percent stapling, and the combined stapled interests would total 98 percent, demonstrating a nearly complete alignment of ownership, which justifies stapled entity treatment.

Although the regulations by their terms deal only with stapled foreign corporations, it is hard to imagine that a different regulatory definition for “stapled entities” would be proposed for regulated investment companies (RICs) and REITs, since a common statutory

corporation’s stock, “taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.”

definition (however inadequate) applies in both contexts. Whenever the Service gets around to drafting regulations for entities stapled to RICs and REITs, it will encounter another logical conundrum that results from the statutory drafting. The statute requires that in determining RIC or REIT status, “all entities which are stapled entities with respect to each other shall be treated as 1 entity.” Such a rule could only have been written in this fashion if the drafter thought that stapling of entities was an “equivalence relation.” In set theory, a relationship between two objects is an equivalence relation if it has the following properties:

- (i) *Identity*: Each object is related to itself.
- (ii) *Reflexivity*: If one object is related to a second, the second is also related to the first.
- (iii) *Transitivity*: If one object is related to a second, and the second is related to the third, then the first is also related to third.

The beauty of equivalence relations is that they can be used to establish “equivalence classes,” which are groups of objects that are related to each other but to no object outside the group.<sup>186</sup>

Stapling of *shares* is an equivalence relation, since each share is stapled to itself (identity), and if one share is stapled to a second, the second is stapled to the first (reflexivity). Finally, if one share is stapled to a second, and the second is stapled to the third, then the first share is stapled to the third, since a transfer of the first share will cause a transfer of the third share (transitivity). A group of shares that can only be transferred as a unit forms an equivalence class based on this relation.

Stapling of *entities*, however, is another matter. Entity stapling trivially satisfies the identity criterion, and virtually any plausible definition of stapled entities, including both Options 1 and 2 above, is reflexive. But entity stapling is transitive only in the limiting case of

<sup>186</sup> See I.N. HERSTEIN, TOPICS IN ALGEBRA 6–7 (1964).

100-percent stapled interests. If stapled entities are to include entities that are less than 100-percent stapled, then stapling will not be an equivalence relation, and it will not be possible to build equivalence classes around it.

The statutory problem here is that the phrase “all entities which are stapled entities with respect to each other” purports to define an equivalence class. Yet the intransitivity of the stapling relationship makes it easy to come up with examples of an entity that is stapled to two other entities that are not stapled to each other. Here is one such example:

Each of three corporations has three classes of stock, each representing one-third of the total value of the issuer's stock. Class A and Class B stock of  $C_1$  are stapled to Class A and Class B stock of  $C_2$ , respectively; so  $C_1$  and  $C_2$  are stapled entities.

Also, Class B and Class C stock of  $C_2$  are stapled to Class B and Class C stock of  $C_3$ , respectively; so  $C_2$  and  $C_3$  are stapled entities.

Yet  $C_1$  and  $C_3$  are *not* stapled entities. A transfer of Class A stock of  $C_1$  would cause a transfer of Class A stock of  $C_2$ , but that stock is not stapled to any  $C_3$  stock. A transfer of Class B stock of  $C_1$  would cause a transfer of Class B stock of  $C_2$ , which in turn would cause a transfer of Class B stock of  $C_3$ , so these shares are stapled; but they only represent one-third of each entity, and there is no other stapling between them.

Note that the entities that are stapled in this example would be stapled even under the stronger definition in Option 2, as well as the weaker definition in Option 1 that was adopted by the regulations. This shows that both definitions of stapled entities are intransitive, and neither can be used as the basis for an equivalence class.

At a more practical level, if a REIT is stapled to another entity, which in turn is stapled to a third entity, but the REIT is not stapled to that third entity, should the third entity be taken into account in determining whether the REIT qualifies as such? As with the definition of stapled entities, the statute may need to be “interpreted” by

rewriting it. One plausible approach would be to determine REIT status of a particular entity by including only those entities that are stapled to it (regardless of whether those other entities are stapled to each other).

For a stapling of domestic and foreign corporations, Section 269B operates with stunning breadth. The foreign corporation is treated as domestic for U.S. tax purposes, and is subject to U.S. tax on its worldwide income without the protection of any tax treaty, regardless of whether the treaty was entered into before or after the enactment of Section 269B.<sup>187</sup> It makes no difference whether the foreign corporation is bigger than the domestic corporation, or which, if either, was the parent before the stapling. For example, a large foreign corporation that spins off a small U.S. subsidiary to a trust for the benefit of its shareholders could be brought fully into the U.S. tax net. The only exception applies if it can be established “to the satisfaction of the Secretary” that at least 50 percent of the vote and value of the stock of both the domestic corporation and the foreign corporation are foreign-owned, taking into account a set of stock attribution rules.<sup>188</sup>

This exception for foreign-owned corporations at least has the virtue of greatly reducing the circumstances in which a pair of stapled corporations might become dual resident if the foreign corporation’s country of residence had tax rules that mirror Section 269B. But tracking the nationality (with attribution!) of a public company’s stock ownership is no easy feat. Worse yet, changes in ownership, including through public trading, can cause the corporations to drift in and out of this exception, causing the foreign half of the pair to switch back

<sup>187</sup> I.R.C. § 269B(d). Companies that were stapled as of June 30, 1983, however, were allowed to retain treaty benefits to which they were then entitled. Deficit Reduction Act of 1984, *supra* note 179, § 136(c)(5).

<sup>188</sup> I.R.C. § 269B(e).

and forth from domestic status, with all the attendant consequences under the Section 367 regulations.<sup>189</sup>

More fundamentally, one might question whether foreign ownership is the right test for escaping Section 269B. The legislative history indicates that the principal concern addressed by Section 269B in this context was the use of stapling to avoid the Subpart F and foreign personal holding company rules.<sup>190</sup> The foreign personal holding company rules were effectively made obsolete by the PFIC rules and were repealed in 2004,<sup>191</sup> leaving Subpart F avoidance as the principal target of the foreign-domestic stapling rules. Yet no Subpart F avoidance occurs if a foreign parent spins off a stapled domestic subsidiary, and the vagaries of shareholder nationality are irrelevant to Subpart F. Foreign-domestic stapling is only a threat to Subpart F when it is used as an expatriation device by a U.S. multinational. Twenty years after the enactment of Section 269B, Congress enacted a set of rules to deal with the expatriations of U.S. companies.<sup>192</sup> For all their faults,<sup>193</sup> those rules are at least targeted at situations that start out with a U.S. parent. Like Section 269B, the expatriation rules can have the effect of treating a foreign corporation as domestic, without the benefit of tax treaty protection. But the expatriation rules have this effect only if there has been an “inversion” transaction in which the foreign corporation has acquired, directly or indirectly, substantially all of the properties of a domestic entity, and after the acquisition at least 80 percent of the vote or value of the foreign cor-

<sup>189</sup> See Treas. Reg. § 1.269B-1(a)(2), (c).

<sup>190</sup> H.R. REP. NO. 98-432, pt. 2, at 1543 (1984).

<sup>191</sup> I.R.C. §§ 551–59, *repealed by* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 413(a)(1), 118 Stat. 1418, 1506.

<sup>192</sup> I.R.C. § 7874, added by American Jobs Creation Act of 2004, Pub. L. No. 108-357, §801(a), 118 Stat. 1418, 1562.

<sup>193</sup> See N.Y. ST. BA. ASS'N TAX SEC., *Report on Temporary Treasury Regulations* § 1.7874-1T 1, 3 (2006).

poration's stock is, as a result of the transaction, owned by the former owners of the domestic entity.<sup>194</sup>

The expatriation rules, unlike Section 269B, operate without regard to whether the entities involved are owned by U.S. or foreign persons. They do, however, provide an exception for expatriations to a country where the group has substantial business operations,<sup>195</sup> since these rules principally address expatriations to tax havens such as Bermuda where the group otherwise has no substantial connection.<sup>196</sup> If Section 269B, insofar as it addresses stapling of foreign and domestic corporations, is concerned with Subpart F avoidance, it might best be replaced with an expansion of the inversion rules to cover appropriate situations where a domestic corporation is stapled to a foreign corporation. Those "appropriate situations" would be those in which an acquisition by the foreign corporation would trigger the inversion rules: where the stapling causes the foreign corporation to become at least 80-percent owned by the shareholders of the domestic corporation, and the group has no substantial business in the country of residence of the foreign corporation.

Properly drafted, these expanded expatriation rules would not apply if a foreign parent spun off a domestic stapled subsidiary, but could apply if a domestic parent spun off a foreign stapled subsidiary. Thus, it matters how you get to the stapling.<sup>197</sup> This dependence on

<sup>194</sup> I.R.C. § 7874(b). Other, less drastic, consequences arise under the inversion rules if a lower 60-percent threshold is met. I.R.C. § 7874(a)(1)–(2).

<sup>195</sup> I.R.C. § 7874(a)(2)(B)(iii).

<sup>196</sup> "The Congress believed that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed." STAFF OF J. COMM. ON TAX'N, 108TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 343 (COMM. PRINT 2005).

<sup>197</sup> Stapling can also be a feature of a business enterprise from its inception, as was the case with the stapled shares of EuroTunnel SA and EuroTunnel P.L.C., which together carried out the development of the English Channel tunnel. That arrangement was subsequently terminated in a 2007 reorganization, in favor of a group with a single French parent, Groupe Eurotunnel SA. *See* Offer

prior history mirrors the premise of the existing inversion rules, which restrict the overseas migration of U.S. corporations, but do not prevent the same arrangements from being established offshore in the first place.

As mentioned earlier in connection with subsidiaries, two entities can be effectively stapled by simply placing them under a holding company.<sup>198</sup> If the holding company is a domestic corporation, the Subpart F avoidance targeted by Section 269B is not possible. If the holding company is a foreign corporation, there is Subpart F avoidance potential, but that is already addressed by the inversion rules.

There does not appear to be any evidence that Section 269B was drafted with this sort of stapling in mind. On the other hand, stapling by means of a trust was a feature of a bank case mentioned in the legislative history to Section 269B,<sup>199</sup> although in the bank cases only one company of the pair was held through a trust. There is nothing to prevent the use of a trust to hold shares of both companies. Such a trust, for example, was established to reassemble the pieces of AT&T after its breakup in the early 1980s, although on a scale that involved only a small percentage of the outstanding shares of those companies.<sup>200</sup> Such a trust functions essentially as a stapling device, and should be regarded as such for purposes of Section 269B.

A partnership can also be a stapling device, and can offer the potential to avoid Subpart F. If the shares of a U.S. multinational were

Document of Groupe Eurotunnel SA, EuroTunnel SA and EuroTunnel P.L.C., at viii (Apr. 3, 2007).

<sup>198</sup> See *supra* Part III.A (p. 642).

<sup>199</sup> See HR. REP. NO. 98-432, *supra* note 190, at 1543 (citing *DeCoppet v. Helvering*, 108 F.d.787 (2d Cir. 1940)).

<sup>200</sup> See *Americus Trust for AT&T Common Shares, Series A, Prospectus* (Oct. 25, 1983). That particular trust had two separate classes, one being entitled to the dividend yield and the value of the underlying shares up to a point, and the other being entitled to any further appreciation. Under current regulations, a trust with this feature would not be a trust for tax purposes, but would instead be a business entity classified as a corporation or partnership under the check the box rules. See Treas. Reg. §301.7701-4(c)(2), Ex. (3).

dropped down to a foreign partnership, the multinational could then de-control its foreign subsidiaries by transferring them to that partnership. Alternatively, it might cause the foreign partnership to establish new foreign subsidiaries and steer business opportunities to them. The Service has voiced concern about this technique, but in the context of the inversion regulations under Section 7874 rather than under Section 269B,<sup>201</sup> and those regulations now apply Section 7874 to acquisitions by publicly traded foreign partnerships.<sup>202</sup> Although Section 7874 by its terms addresses only inversion transactions using a foreign corporation rather than a foreign partnership, it provides authority to issue:

regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—

(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries...<sup>203</sup>

Either Section 7874 or Section 269B could be deployed to prevent Subpart F avoidance through partnership stapling, but their effects are different. Section 269B would treat the foreign subsidiaries as domestic, but it can be overbroad in its application, and overly harsh in its consequences, for the reasons stated earlier in connection with more conventional stapling. If Section 7874 were applied to treat the foreign partnership as a domestic partnership, this treatment would cause the foreign subsidiaries to retain their status as con-

<sup>201</sup> Pmb. to Temp. Treas. Reg. § 1.7874-1T, T.D. 9238 (Dec. 27, 2005), 2006-1 C.B. 408. In its partnership IPO earlier that year, Lazard took the position that the inversion rules did not apply to the acquisition of a U.S. corporation by a foreign partnership. *See* Lazard Ltd., Registration Statement (Amendment No. 2 to Form S-1), at 37, 191 (May 2, 2005); Robert S. Bernstein, *Use of Foreign Publicly Traded Partnerships and the Lazard IPO*, 32 Corp. Tax'n 45 (2005).

<sup>202</sup> T.D. 9265, 2006-2 C.B. 1. Although publicly traded partnerships are generally treated as corporations under Section 7704, this extension of the inversion regulations is aimed at partnerships that principally earn dividends and other qualifying income, and are therefore entitled to partnership treatment notwithstanding the public trading. *See* I.R.C. § 7704(c).

<sup>203</sup> I.R.C. § 7874(g).

trolled foreign corporations.<sup>204</sup> But it would be the owners of the foreign partnership, rather than the U.S. affiliate, that would be taxed on any resulting Subpart F income as well as on any actual distributions of other income.

Instead of treating the foreign partnership as a domestic partnership, the Section 7874 regulations preserve U.S. corporate taxation on the earnings of these foreign subsidiaries by treating the foreign partnership as a *per se* domestic corporation, even though it might otherwise have been eligible for transparent status under the check the box regulations and the publicly traded partnership rules.<sup>205</sup> On the other hand, these regulations do not address inversion transactions involving a foreign partnership that is not publicly traded, and it remains unclear whether the stapled stock rules might nonetheless apply to these partnerships or even to publicly traded partnerships as well. The possible overlap, with differing results, of Sections 269B and 7874 in the context of partnership stapling provides further reason to reconfigure the stapled stock rules in the foreign context so that they are better aligned with the inversion rules.

### C. *Dual Headed Companies*

“Dual headed” or “dual listed” companies have separate groups of shareholders, but align their interests through arrangements that ensure common management and proportionate dividend payouts. To date, these arrangements have always involved pairs of foreign corporations.<sup>206</sup> Although some domestic corporations have considered adopting these structures, they have held back for reasons that include uncertainty about the tax consequences.

<sup>204</sup> See *Report On Temporary Treasury Regulations*, *supra* note 193, at 17–19.

<sup>205</sup> Treas. Reg. § 1.7874-2T(c)(1).

<sup>206</sup> Since public companies are involved, the details of these arrangements are publicly available and will not be cataloged here. A description of the arrangements outstanding in 1999 can be found in Stephen Hancock, Bradley Phillips & Maryse Gray, *When Two Heads are Better than One*, EUR. COUNS. 25 (1999).

Common management is typically achieved through arrangements that ensure that (i) the two companies have the same boards of directors, (ii) the same resolutions are put to both groups of shareholders at the same time, and (iii) a shareholder vote for each company is determined by the votes collectively cast by the shareholders of both companies. The mechanics differ depending on the company law of the countries in which the two companies are organized, but an example would be the issuance by each company of a special voting share to a special purpose corporation or trust that would be obligated to vote the share in a manner that precisely reflects the votes cast by the shareholders of the other company.

Another way to achieve common management at the operating company level is for each of the two companies to contribute all of their operating subsidiaries to a single joint venture vehicle. In this case, there is no operational need to unify the boards of the two head companies, although the parties may nonetheless desire to do so to cement the relationship and to ensure that each head company acts in the interests of the combined shareholder groups.

Proportionate dividend payouts can flow naturally from a decision by common management, but are further reinforced by the terms of an equalization agreement between the two companies. If either company lacks sufficient cash to fund its proportionate dividend, the other would be obligated to make an equalization payment to cover the shortfall. That payment could be a contractual obligation, or it could be made by a dividend payment on a special equalization share that each company grants to the other. Even where the two companies retain separate ownership of their pre-existing subsidiaries, it will normally be expected that each can fund its proportionate dividend without requiring an equalization payment; therefore, as a practical matter, an actual equalization payment may be only a distant possibility.

Given the coordination of dividends, one might expect the market value of the shares of the two companies to move in tandem, but

they can diverge based on local conditions affecting supply and demand. Most notably, if either company is in a prominent stock index, demand for its shares will arise from index-based investors. Indeed, the need to preserve index membership is often cited as a motivation for forming a dual headed structure rather than a conventional merger. Yet the benefits of index membership can cut the other way: some dual headed companies have chosen to merge in order to increase the market capitalization represented by the surviving head company in a stock index.<sup>207</sup>

Although tax savings are not typically cited as a principal motivation for a dual headed structure, tax considerations lurk behind other motives, such as minimizing “flowback” that can occur on a conventional cross-border merger, where shareholders of the merged corporation sell the shares of the acquiring corporation that they receive in the merger, thereby depressing its stock price. Taxes can magnify flowback, since, for example, a U.S. tax-exempt investor can receive dividends from a U.S. corporation tax-free, but may suffer a withholding tax on dividends that it receives from a foreign acquirer. There can be tax benefits at the corporate level as well: a pure dual headed structure, where the operating subsidiaries are not pooled into a joint venture vehicle, potentially allows tax-efficient “streaming” of income from subsidiaries located in the same country as the head company that owns them.

### 1. *Stapling Risk*

The principal sources of tax uncertainty for a dual headed structure involving a U.S. corporation are the risks for stapled stock treatment, or, in the case of an arrangement not involving an actual

<sup>207</sup> See, e.g., Grant Samuel & Assocs. Pty Ltd., Financial Services Guide and Independent Expert’s Report in Relation to the Proposed Unification of Brambles Industries Limited and Brambles Industries plc, at 20–21 (Sept. 12, 2006) attached to Brambles Limited, Information Memorandum Unification Proposal (Sept. 13, 2006).

joint venture vehicle, a deemed partnership.<sup>208</sup> On the face of it, the stapled stock rules seem out of place here, since a dual headed structure achieves an alignment of interests in a manner very different from stapling. Stapled entities have the same owners, but each is an independent economic entity. Dual headed companies have different owners, but their economic fortunes are dependent on each other through the equalization arrangement.

The only technical basis on which stapling might be found is through the arrangements for common management. In most cases, those arrangements effectively confer on the shareholders of each company the power to vote an equivalent number of shares of the other company. Since that voting power is effectively tied to ownership of a share, there is a sort of stapling going on. But a stapling of what? Although the definition of stapling in Section 269B is technically flawed, it clearly looks to stapling of “beneficial ownership,” and the 50-percent threshold for stapled entities is expressed solely in terms of value rather than voting power. If the voting power is conferred through the ownership of a special voting share that has no economic rights, it arguably does not represent “beneficial ownership” of the issuer. In some countries, corporate law may require a small economic interest to be attached to the voting share, but it would be anomalous for the application of the stapled stock rules, with draconian consequences for the foreign head company, to hinge on an economically insignificant economic interest that might be attached to the special voting share for corporate law reasons.

Before the issuance of final stapled stock regulations in 2005, one might have hoped that the stapling issue would be avoided by defining “stapled entities” along lines similar to Option 2 as described in Part III.B.3 above. Since the special voting shares represent far less than a 50-percent interest in their respective issuers, the stapling of

<sup>208</sup> See David A. Waimon, Steven M. Surdell & J. Russell Carr, *Almost a Merger: Achieving Cross-Border Shareholder Unity Without a Shareholder Exchange*, 78 TAXES 163, 183–85 (2000).

interests in those shares to shares of the other head company would not cause the head companies to become stapled under Option 2. Although the Service and the Treasury Department indicated that they were aware of concerns about the potential application of Section 269B to dual headed companies, they adopted Option 1 as their definition of stapling, which would cause dual headed companies to be stapled if the special voting share were viewed as a beneficial interest. Moreover, they rejected requests to provide an express exclusion from the stapled stock rules for these voting arrangements, claiming that “further study of dual listed structures is warranted.”<sup>209</sup>

As a technical matter, the seriousness of the stapling issue could turn on the details of the voting arrangements. In some cases, the obligation of the holders of each of the special voting shares to vote that share in a manner that reflects the votes cast by shareholders of the other head company is an obligation owed to the two head companies, not to either of their shareholder groups. The shareholders have no power to enforce those obligations, and the head companies, not their shareholders, have the power to amend those arrangements. Under these circumstances, it would be difficult to say that the shareholders of the other company have a “beneficial interest” in the special voting share. While they might be said to hold such an interest indirectly through their direct ownership of shares of the other company, two interests can hardly be said to be stapled merely because one interest is held by a corporation that issues the other interest; otherwise, every foreign subsidiary of a U.S. company would be considered to be stapled to it.

By contrast, if the special voting share were held in trust for the benefit of the other company’s shareholders, and perhaps had a small economic interest as well, then the technical risk of stapling could be quite significant. While this risk could presumably be avoided by proper planning, it is disturbing that something as fundamental as the

<sup>209</sup> T.D. 9216, 2005-2 C.B. 461.

foreign status of the foreign head company should depend on details of this sort.

That the possible application of the stapling rules could turn on such technical details suggests that dual headed arrangements are quite unlike the “true” stapling arrangements addressed by Section 269B. Like stapling, dual headed arrangements create an alignment of interests between two companies, and companies considering a “virtual merger” might look at both alternatives. Indeed, the Fortis Group, which had established itself as a pair of dual headed companies in The Netherlands and Belgium, later switched to a stapled stock arrangement.<sup>210</sup> But the means by which economic alignment is achieved under the two approaches are so different that it would be an unpromising strategy for the Service to rely principally on the stapled stock rules to attack dual headed companies.

## **2. Deemed Partnership Risk**

The risk of a deemed partnership, in the case of dual headed arrangements that do not include an express joint venture vehicle, is more serious, since even in such a “pure” structure there is a strong joint venture flavor to the overall enterprise. The absence of an explicit joint venture vehicle is itself no bar to finding a partnership for U.S. tax purposes, since the Internal Revenue Code defines a partnership broadly to include “any syndicate, group, pool, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on.”<sup>211</sup> The entity classification regulations echo this theme: “Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the

<sup>210</sup> See Fortis (B), Tender Offer/Rights Offering Notification Form (Form CB), Exhibit 1.1 (Oct. 31, 2001).

<sup>211</sup> I.R.C. §§ 761(a), 7701(a)(2). See also *supra* notes 108–110 and accompanying text.

organization is recognized as an entity under local law.”<sup>212</sup> In particular, “a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”<sup>213</sup> Business entities covered by the check the box rules include any entity recognized for tax purposes,<sup>214</sup> so it is even possible to elect corporate status for an arrangement that does not involve the creation of a legal entity.

If there is to be a deemed partnership, the question arises where to put it: should the deemed partnership be considered to be among the two groups of shareholders of the head companies, or among the head companies themselves? The latter is far more plausible, since the equalization arrangements, which would presumably play an essential role in finding a deemed partnership, are between the two head companies, not their shareholders.<sup>215</sup> The discussion here therefore focuses on the possibility that the two head companies might be deemed to own their operating subsidiaries through a deemed partnership for U.S. tax purposes.

Dual headed arrangements may lack not only a legal entity co-owned by the head companies; they may lack co-ownership altogether. The arrangements that are deemed to be a partnership for tax

<sup>212</sup> Treas. Reg. § 301.7701-1(a)(1). This theme is further echoed by the proposed regulations for series organizations, discussed *supra* in Part II.A.4 (p. 608).

<sup>213</sup> Treas. Reg. § 301.7701-1(a)(2).

<sup>214</sup> Treas. Reg. § 301.7701-2(a).

<sup>215</sup> Curiously, no attention appears to have been given to the possibility that, instead of positing a deemed partnership, one should regard the two head companies themselves as a single entity. Just as the Tax Court in *Union Trusteed Funds* could not imagine a single corporation being treated as two, it is perhaps even harder to imagine two separately owned corporations being treated as one. Yet, in a somewhat analogous context, the Service considered, at least for a time, treating multiple S corporations as one for purposes of determining whether they had a sufficiently low number of shareholders, where those S corporations had joined in a common enterprise. See *infra* Part III.C.3 (p. 678).

purposes in the case law<sup>216</sup> and regulations<sup>217</sup> have typically had at least co-ownership of property constituting the joint venture.<sup>218</sup> But the head companies in a pure dual headed arrangement have sole ownership and control of their respective operating subsidiaries.

For these reasons, a deemed partnership might seem as ill-suited a tool to challenge a dual headed arrangement as the stapled stock rules. Yet these arrangements do have features that effectively substitute for co-ownership and joint management of the operating companies: the arrangements for equalization of dividends and the joint management of the head companies. Even if no payments are foreseen under the equalization arrangements, the mere existence of those arrangements gives each company a stake in the profits and losses of the other, and the shareholders of each company are relying on those arrangements when they assess the value of their shareholdings based on the fortunes of the group as a whole, rather than of the particular head company in which they hold shares.

While the equalization arrangements may be unlikely to trigger actual payments in the ordinary course of business, they can be expected to have an economic impact when the dual headed arrangement comes to an end. There have been several examples in the past decade of dual headed companies converting to more conventional groups with a single common parent, including a conversion of the oldest dual headed structure, that of the Royal Dutch/Shell group.<sup>219</sup> In those conversions, the dual headed struc-

<sup>216</sup> See *Madison Gas & Elec. Co. v. Comm'r*, 633 F.2d 512, 517 (7th Cir. 1980) (co-owned power plant); *Bentex Oil Corp. v. Comm'r*, 20 T.C. 565, 570 (1953) (co-owned oil & gas wells).

<sup>217</sup> See Treas. Reg. § 301.7701-1(a)(2) (co-owned apartment building).

<sup>218</sup> In some cases, however, a profit-sharing arrangement has been found to constitute a partnership even in the absence of formal co-ownership of property. See *Podell v. Comm'r*, 55 T.C. 429, 431 (1970) (real estate development); *Beck Chem. Equip. Corp. v. Comm'r*, 27 T.C. 840, 841 (1957) (flame thrower patent).

<sup>219</sup> In addition to Royal Dutch/Shell's unification in 2005, Merita Nordbanken unified in 2000, Dexia in 2000, ABB in 1999, and Zurich in 2000. In each case,

ture included an actual joint venture vehicle or explicit co-ownership of the operating subsidiaries, which diminished the importance of the equalization arrangements. But even if the head companies in a pure dual headed structure were to combine, one would expect the relative proportions of the resulting common parent owned by each of the head company shareholder groups to be determined based on the proportions to which they are entitled under the equalization arrangements, regardless of the relative stand-alone values of the two companies at the time of the conversion.<sup>220</sup> If the combination were accomplished by an exchange offer, one would also expect a premium to be offered to the shareholders of the acquired company to induce their participation, but such a premium would presumably be benchmarked off trading values that reflected the equalization arrangements.

The equalization arrangements can also be seen as playing a role analogous to capital accounts in a conventional partnership. Allocations of profits and losses that are properly reflected in capital accounts in accordance with the Section 704 regulations are considered to have substantial economic effect, even though they may have no actual effect on distributions until the partnership is liquidated.<sup>221</sup> These regulations focus on liquidating distributions even for a partnership that plans to operate as a going concern indefinitely.

The allocation of partnership income and loss is based on the terms of the partnership agreement, which for this purpose includes all arrangements among the partners concerning the affairs of the

the unification was accomplished by an exchange offer. *See* Grant Samuel, *supra* note 207, at 20.

<sup>220</sup> The shares of one head company may be subject to a mandatory exchange into shares of the other if the dual headed structure encounters tax or legal problems that cannot be solved by other available alternatives. In such a case, the exchange is based on the ratios established by the equalization arrangements. *See* P&O Princess Cruises plc, Proposed DLC Transaction with Carnival Corporation: Circular to P&O Princess Shareholders and Notice of Extraordinary General Meeting, at 192–93 (Mar. 17, 2003).

<sup>221</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b).

partnership.<sup>222</sup> In a deemed partnership construct, the equalization agreement might be seen as the means by which the amounts of income earned by each head company and the amounts made available to that head company for distribution are reconciled—precisely the function performed by capital accounts.

The partnership allocation regulations have a strong bias against the “streaming” of particular categories of income to partners who may be the most tax-efficient recipients. They contain examples of partnerships that purport to allocate tax-exempt interest to high-bracket partners while allocating comparable amounts of taxable investment income to low-bracket partners. Those allocations are not respected in circumstances where the income is relatively predictable; consequently, the differing allocations of these classes of income have little effect on the partners other than to reduce their collective tax burden.<sup>223</sup>

Consider a pure dual headed arrangement in which the domestic head company owns only domestic subsidiaries, and the foreign head company owns only foreign subsidiaries. If the form is respected, the domestic subsidiaries can consolidate with the domestic head company, the foreign subsidiaries escape U.S. taxation altogether, and there are no U.S. withholding taxes on the flow of income from the operating subsidiaries to the head companies. These are powerful tax advantages compared with the consequences of an actual or deemed joint venture. Yet the arrangements are designed to ensure that the economic outcome is substantially equivalent to that of a joint venture, so that the shareholders of each the head companies are indifferent as to where income is earned among the operating subsidiaries. These circumstances support the view that each head company has in substance a proprietary interest in the operations of the other, and the streaming of income that follows the form of the arrange-

<sup>222</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b).

<sup>223</sup> See Reg. § 1.704-1(b)(2)(iii)(b), -1(b)(5), Ex. (5), (7).

ment cannot form the basis of a tax allocation that has substantial economic effect.

Although the participants in a pure dual headed arrangement may not hold themselves out as partners, they do present themselves to the world as a single business.<sup>224</sup> The presence of an actual joint venture vehicle is a feature of the structure that may be omitted because of various legal or tax objectives, but it makes little difference to both the self-perception and the external perception of the group as a unified enterprise.

For these reasons, it is difficult to design a pure dual headed structure for which the deemed partnership risk would be low enough to satisfy the extremely low risk tolerance that large public companies have for fundamental issues of this sort. Consequently, except in the unlikely event that the Service offers an affirmative blessing to pure dual headed arrangements,<sup>225</sup> it is likely that any dual headed arrangement with a U.S. company will involve an actual joint venture vehicle, since it is much easier to plan more effectively for an actual partnership than for a deemed partnership that is imposed after the fact.

There is of course no deemed partnership risk in cases where there is an actual joint venture vehicle. What about the stapled stock risk? There might seem to be no point in applying the stapled stock rules in a case where there is an actual joint venture that properly reflects the substance of the arrangement. Moreover, if the common management arrangements are implemented solely at the joint venture level, then there would be no special voting share at the head

<sup>224</sup> For example, they publish financial statements on a consolidated basis. *See, e.g.,* Carnival plc, Annual Report (Form 10-K) at 3 (Jan. 29, 2008) for the period ending Nov. 30, 2007.

<sup>225</sup> The Service is well aware of both the deemed partnership and stapling issues, but the Service is reluctant to commit resources to these difficult issues when there are no actual cases of a dual headed structure involving a U.S. company. *See Jeremiah Coder, Cross-Border Guidance in Pipeline, Officials Say*, 119 TAX NOTES 254 (Apr. 21, 2008). It is a classic chicken and egg problem, since U.S. companies are reluctant to enter into these arrangements without IRS guidance.

company level that might be regarded as a stapled interest. In some cases, however, the parties may wish to have unified boards of directors at the head company level, and in that case all of the technical issues regarding stapling arise. The presence of an actual joint venture vehicle would have no bearing on the technical analysis of the stapling risk, but it may give the Service reason to conclude that there is no point in seeking to apply the stapled stock rules to the structure.

### 3. *Analogous Arrangements*

At the heart of a dual headed structure is a pair of companies that own an explicit or implicit joint venture and nothing else. This same structure can arise in other contexts where special purpose vehicles are formed to invest in a joint venture. In general, the form of these arrangements is accepted without question. Although the joint venture participants may have separate ownership, they do have shared economics and possibly shared management, and there are occasions when the separate status of the participants may be subject to challenge.

One such challenge was made in Revenue Ruling 77-220,<sup>226</sup> when an enterprise run by thirty individuals sought to convert to an S corporation. Since at that time there was a ten-shareholder limit on S corporations,<sup>227</sup> the parties formed three corporations with ten shareholders each, which in turn organized a partnership to own the business. The Service concluded that since the three corporations were organized solely to avoid the ten-shareholder limitation, they would be treated as a single corporation for this purpose, and consequently their S corporation elections would be invalid.

<sup>226</sup> 1977-1 C.B. 263, *revoked by* Rev. Rul. 94-43, 1994-2 C.B. 198.

<sup>227</sup> I.R.C. § 1361(b)(1)(A) (prior to amendment by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669).

Later the Service had second thoughts. In Revenue Ruling 94-43,<sup>228</sup> the Service revoked Revenue Ruling 77-220, and concluded that the separate status of each of the three corporations should be respected for purposes of determining their eligibility to make S corporation elections.<sup>229</sup> The reason given for the reversal was that the limitation on the number of shareholders was “to obtain administrative simplicity in the administration of the corporation’s tax affairs.”<sup>230</sup> This simplicity was thought to be unaffected by the fact that each corporation was in a joint venture with the others, so their elections were respected.

One might debate whether the Service ultimately reached the right result, but it was at least asking the right questions. Rather than try to recharacterize the structure generally, which would have been an uphill battle, the Service considered whether it was appropriate to allow taxpayers to dodge the limitation on the number of shareholders in this fashion. Ultimately, the Service did allow the technique, based on its view of administrative simplicity. It is unclear, however, why the Service thought it was administratively simpler to deal with three corporations with ten shareholders each plus a partnership than to deal with one corporation with thirty shareholders, which would plainly not have been allowed under the law at that time. Rather than force taxpayers into tiered structures in the name of “simplicity,” it would have been better to have Congress adjust the statutory limit on the number of shareholders. This in fact has been done, in stages, so that the current limit is 100 shareholders.<sup>231</sup> In light of these statutory

<sup>228</sup> 1994-2 C.B. 199.

<sup>229</sup> 1994-2 C.B. 198.

<sup>230</sup> *Id.*

<sup>231</sup> The limit was raised to 35 shareholders by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669; to 75 shareholders by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1301, 110 Stat. 1755, 1777; and to 100 shareholders by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1434.

changes, there is less need for the sort of relief that the Service offered in Revenue Ruling 94-43.

This same structure arises when feeder funds are organized for the sole purpose of investing in a master fund. Here the question of counting owners can arise at the master fund level. Regulations issued under the publicly traded partnership rules contain a safe harbor that allows a partnership to treat itself as not publicly traded if its interests were privately offered and it has no more than 100 owners.<sup>232</sup> In counting the number of owners of the master fund, each owner of the feeder is counted as a separate owner if substantially all of the feeder's assets consists of its investment in the master fund, and a principal purpose of the tiering was to qualify for the safe harbor.<sup>233</sup> Unlike the S corporation context, the publicly traded partnership regulations do not allow taxpayers to use tiering in order to avoid a limitation on the number of owners. Presumably the reason for the different result is that the 100-owner limitation in the publicly traded partnership rules is not merely for administrative simplicity, but to ensure that the partnership interests eligible for the safe harbor are not too widely held.

Similar questions arise whenever tax-favored treatment is conditioned on there being a limited number of owners. For example, the limitation on benefits clauses in a number of treaties with European countries provide that a resident of the treaty partner can qualify for treaty benefits if 95 percent of its shares are held, directly or indirectly, by seven or fewer residents of a country that is a member of the European Union or a party to the North American Free Trade Agreement.<sup>234</sup> If more than seven persons wish to obtain treaty bene-

<sup>232</sup> Treas. Reg. §1.7704-1(h)(1).

<sup>233</sup> Treas. Reg. §1.7704-1(h)(3).

<sup>234</sup> In each case, a base erosion test must also be satisfied. *See, e.g.*, Convention for the Avoidance of Double Taxation, and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.–U.K., art. 23, para. 3, July 24, 2001, S. TREATY DOC. NO. 107-19; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes

fits through a resident of a country with such a treaty, they might consider forming multiple feeders in that country solely to invest in a partnership that would hold the investments earning the income on which treaty benefits are sought. This technique is essentially the same as the one blessed by the Service in the Subchapter S context. But whether it would be upheld in the treaty context would depend on whether the seven-person limitation is also based on considerations of administrative simplicity, or on some more substantive basis.

on Income and on Capital, U.S.–Lux., art. 24, para. 4, Apr. 3, 1996, S. TREATY DOC. NO. 104-33; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Neth., art. 26, para. 3, Dec. 18, 1992, S. TREATY DOC. NO. 103-6.

## IV. CRITERIA FOR JOINT OR SEPARATE TAXATION

This tour of quasi-separate enterprises, from the exotic to the mundane, illustrates the difficulty of distinguishing between one entity and many. Yet distinguish we must: the tax law is founded on the concept of a taxable unit; and all, except flesh-and-blood individuals, are entities. The specific contours of any rules that guide this exercise must reflect the constraints of case law, and balance considerations of clarity, reflection of substance, and prevention of abuse.

### A. *Policy Principles*

#### 1. *Constraints of Case Law*

Short of legislation, any attempt to develop rules in the area must take into account existing case law. In the stapled stock context, the Service has been able to get away with essentially ignoring contrary authorities,<sup>235</sup> and the constraints of case law may prove to have some elasticity when tested against a coherent set of rules for determining entity boundaries. The boldest example can be found in the check the box rules, which jettisoned decades of case law for distinguishing corporations from partnerships in favor of an elective regime, and conflated entity boundaries by creating the concept of a disregarded entity for a transparent entity with a single owner. Yet even here, the Service felt that its freedom was not total, since the ability to elect transparent status was denied not only to domestic corporations but also to foreign entities that were thought to have similar characteristics.<sup>236</sup> Acceptance of the check the box rules was made easier by the fact that they are taxpayer-friendly and consequently wildly popular. A challenge to these rules by a rare taxpayer who had cause to com-

<sup>235</sup> See *supra* Part III.B.2, p. 650.

<sup>236</sup> See Notice of Proposed Rulemaking, 61 Fed. Reg. 21,989 (May 13, 1996).

plain was recently rejected in court,<sup>237</sup> and absent any sign of discontent in Congress,<sup>238</sup> it appears that these rules will remain in place for the foreseeable future.

Two lessons can be drawn from this background. First, the boundaries of *per se* corporations, domestic or foreign, are normally etched in stone. Consistent with *Union Trusteed Funds*, no court has ever treated a single corporation as more than one entity, although the proposed series fund regulations may have this effect if applied to a corporate law that provides for series. Similar, apart from the early stapled stock cases (which are of questionable validity today), two corporations have never been treated as a single entity. Of course, any rule can be varied by statute, as has been done with series funds established by regulated investment companies.<sup>239</sup> And separate entity treatment can be authorized for limited purposes, such as PFIC classification.<sup>240</sup>

Second, there is doubtless scope for an elective rule that would, for example, allow series funds to elect whether to be treated as one entity or many. An elective rule provides a handy solution to the line-drawing problem, but is potentially a threat to the fisc since taxpayers will naturally elect in a manner that minimizes their taxes. The proposed series fund regulations eschew an outright election, but provide some scope for implicit electivity, at least in cases of series with common ownership.<sup>241</sup>

<sup>237</sup> See *Littriello v. United States*, 484 F. 3d 372, 374–75, 380 (6th Cir. 2007).

<sup>238</sup> For example, an attempt by the Service to restrict the use of hybrid entities to reduce subpart F income was effectively abandoned after an outcry from Congress. See Pmb. to Prop. Treas. Reg. § 1.954-9, 64 Fed. Reg. 37,727 (July 13, 1999); Notice 98-35, 1998-2 C.B. 34.

<sup>239</sup> See *supra* notes 16–18 and accompanying text.

<sup>240</sup> See *supra* notes 50–51 and accompanying text.

<sup>241</sup> See *supra* Part II.A.4 (p. 608).

## 2. *Clarity*

A driving force behind the check the box rules was the need for clarity in entity classification.<sup>242</sup> The same can be said for determining entity number. Both rules have to do with what the taxpaying unit is, and everything else in the tax law hinges off that. If there is uncertainty on this point, a taxpayer that guesses wrong can face a cascade of consequences for improperly filed returns and missed election deadlines. These consequences can be out of proportion to the actual tax differences that might properly result from the differences in treatment.

For example, a series fund might offer one series to U.S. taxable investors, and another series to foreign and U.S. tax-exempt investors. Suppose the series fund is organized offshore, and all owners have limited liability, so the default classification is corporate. Typically, the U.S. taxable investors will prefer that their series elect to be a partnership for U.S. tax purposes, so they can avoid PFIC consequences and enjoy pass-through of losses. The other investors will prefer that their fund retain its default treatment as a corporation, since they are unaffected by the PFIC rules, and prefer to avoid any risk of personal liability for U.S. tax on the fund's income.

Such a fund would naturally wish to file a check the box election for the first series, but not for the second. This is perfectly feasible if the series are treated as separate entities, and the fund might be encouraged to act on that assumption based on the separate entity treatment applied by the Service in Revenue Ruling 2008-8.<sup>243</sup> But if the fund guessed wrong, and single entity treatment was ultimately determined to be appropriate on that fund's facts, then the election would be invalid and the U.S. taxable investors would hold equity in a

<sup>242</sup> In particular, the Service complained about having to devote resources to analyzing the characteristics of evolving forms of business entities, particularly in the foreign context. *See* Notice of Proposed Rulemaking, 61 Fed. Reg. 21,989 (May 13, 1996); I.R.S. Notice 1995-14, 1995-1 C.B. 297.

<sup>243</sup> *See supra* note 45 and accompanying text.

PFIC. Yet had the rules been clear, the fund could have taken the steps necessary to ensure separate entity treatment, including, if necessary, using two separate fund entities rather than a single series fund.

Similarly, the uncertainties surrounding the stapled stock and deemed partnership issues have no doubt played a role in the absence of U.S. corporations from the roster of dual headed companies. Since the parties have no tolerance for risk on these issues, the need for clear rules in this context is particularly compelling.

### ***3. Reflection of Substance***

Most attempts to resolve questions of separate entity status focus on the substance of the arrangements. Thus, tracking stock is designed to have key characteristics of parent stock, in order to minimize the risk of its being treated as stock of the tracked subsidiary or an interest in a deemed joint venture; while series funds typically seek a maximum degree of economic separation within a common legal framework, and would normally prefer separate entity treatment for tax purposes. A substantive analysis focuses on the extent to which each of the components:

- (i) are recognized as separate entities under relevant local law;
- (ii) have rights in separate streams of income or pools of assets;
- (iii) have separate creditors;
- (iv) have separate management; and
- (v) have separate ownership.

None of these factors is an all-or-nothing matter. Local law can recognize the separateness of entity components for some purposes but not others: for example, the separate series of a series fund may enjoy statutory isolation of creditors but share a single legal personality. Some aspects of local law may be relevant but unclear, such as the

extent to which the separateness of entity components will be respected in bankruptcy.

In most cases there is an identifiable income stream and asset pool associated with each entity component, but the degree to which they are separate can range along a spectrum. Tracking stock is deliberately ambiguous in this regard, since there is usually a commercial desire to have the tracking be as accurate as possible, but countervailing reasons, often tax-motivated, to make the tracking imperfect. Each head company in a pure dual headed structure has its own separate group of operating subsidiaries; actual claims by one head company on the income or assets of the other under the equalization arrangements may be unlikely, yet these companies regard themselves as so much of a common enterprise that they publish financial statements on a combined basis.<sup>244</sup>

The statutory isolation of creditors might appear to be a bright-line distinction, but even that line can be blurred by contractual ringfencing in contexts where non-consensual creditors, who would not be bound by the ringfencing, are unlikely to arise. And the line can be blurred the other way through cross-guarantees by entities that would otherwise be entitled to treat their creditors as separate. Moreover, some liabilities can be separate while others are joint, with selective use of guarantees and nonrecourse arrangements. The proposed regulations for series organizations avoid this line drawing issue by ignoring the actual presence of ringfencing,<sup>245</sup> even though the potential for ringfencing is a principal characteristic of a series organization.

Similar line-drawing problems arise in determining the separateness of management. Series fund statutes provide wide latitude in the extent to which each of the classes of shares have separate voting rights with regard to the management of each series, so an analysis of the particular share rights is necessary in each case. Even questions of

<sup>244</sup> See *supra* note 224 and accompanying text.

<sup>245</sup> See *supra* note 64 and accompanying text.

voting power percentage turn into broad inquiries into all relevant facts and circumstances, as *Alumax Inc. v. Commissioner*<sup>246</sup> demonstrates in the context of determining affiliated group status, or *Garlock, Inc. v. Commissioner*<sup>247</sup> in determining controlled foreign corporation status. Moreover, common management by itself may not mean much: consider a family of investment funds, each organized as a separate limited partnership with distinct investors and investment objectives, but with a common general partner.<sup>248</sup>

The degree of common ownership can of course vary from zero to 100 percent. Moreover, the common ownership can be “accidental,” in the sense that the alignment can at any time be altered by transfers of interests in the individual entity components, or it can be enforced by stapling or by ownership through pooled holding entities. What qualifies as “ownership” may be unclear, and separate entity status can turn on the distinction. For example, a transparent entity with a single owner that would otherwise be treated as a disregarded entity could be treated as a separate partnership if it has issued to a third party a debt instrument that is recharacterized as equity.

Even where the separate or common nature of each of these factors is clear, there may be uncertainty as to the overall substance when some factors are common but others are separate. Stapled entities and pure dual headed companies are both distinct under local law but have common management. Stapled entities have separate income, assets, and creditors, but common ownership; while the dual headed companies have some sharing of income, assets, and credi-

<sup>246</sup> 165 F.3d 822, 826 (11th Cir. 1999).

<sup>247</sup> 489 F.2d 197 (2d Cir. 1973).

<sup>248</sup> In some contexts, however, common decision-making could be sufficient to warrant single-entity treatment. See Treas. Reg. §§ 1.382-3(a)(1)(i), -9(d)(3)(ii)(A) (treating a group of shareholders acting in concert as a single entity). *But see* I.R.S. Priv. Ltr. Rul. 2008-18-020 (May 2, 2008) (allowing an issuer not to aggregate the clients of a single investment advisor); Robert J. Willens, *Qualifying for Section 382's 'Bankruptcy Exception' Never Easy*, DAILY TAX REP. (BNA), June 3, 2008, at J-1.

tors, but separate ownership. No single factor is determinative, and the perceived importance of each factor may change with the context. For example, the potential for statutory isolation of creditors might be seen as critical to determining whether classes of a series fund are separate, but may be irrelevant in determining whether a holding company and its subsidiaries should be treated as a single entity by reason of check the box elections.

These considerations show that entities can be true hybrids in the sense that they are in some respects separate and in other respects not. In these cases, any attempt to impose a dichotomy between pure separate entity treatment and pure single entity treatment will fail to reflect fully the nuances of their quasi-separate status. In that regard, the distinction between single and separate entities is like the debt-equity distinction or, in the pre-check-the-box era, the corporation-partnership distinction. And in both those cases, attempts at substance-based codification ultimately failed, with the Service abandoning attempts to codify the debt-equity distinction after an abortive attempt at regulations under Section 385,<sup>249</sup> and with the corporate-partnership distinction having become a matter of election under the current entity classification regulations.<sup>250</sup> All of this suggests that substance is a less helpful guide than might at first appear.

#### ***4. Prevention of Abuse***

A common theme of these various quasi-separate entity structures is the richness of the potential tax-planning opportunities that arise. Single entity treatment of series funds raises the possibility of tax-free exchanges of interests in one series for interests in another, and of tax-free movements of assets between series. Tracking stock

<sup>249</sup> T.D. 7920, 1983-2 C.B. 69 (withdrawing final regulations under Section 385; *see also* Rev. Rul. 1983-98, 1983-2 C.B. 40 (adjustable rate convertible notes treated as equity)).

<sup>250</sup> Reg. § 301.7701-3(a).

can allow a *de facto* divestiture on a tax-free basis without running the gauntlet of the spin-off rules, while retaining the benefits of tax consolidation. Before the enactment of Section 269B, stapling offered attractive possibilities for de-control of foreign subsidiaries and avoidance of some of the REIT restrictions. And dual headed companies offer at least the hope of streaming income from operating subsidiaries to their respective head companies and their shareholders in a tax-congenial manner.

In some cases, however, these planning opportunities can be seen as an abuse of rules that were formulated without quasi-separate entities in mind. In the case of stapling, a legislative response was necessary; but with tracking stock and dual headed companies, the uncertainties of tax treatment, the natural risk aversion of public companies, and the inevitable tax “frictions” associated with these arrangements<sup>251</sup> have prevented widespread use of these arrangements in ways that might best fulfill their tax planning potential. Thus, tracking stock tends to track only imperfectly; and dual headed arrangements, when they have been considered for U.S. companies, have been generally thought feasible only with an actual joint venture vehicle instead of the more tax-efficient pure dual headed structure.

In this as in other areas, clear rules can aid tax administration but also undermine it. The helpful guidance offered by the Service in its stapled stock rulings in the 1970s opened the door to the tax planning that made Section 269B necessary. Similarly, the clarity of the “one corporation, one tax entity” rule in *Union Trusteed Funds* created a potential for unwarranted tax-free exchanges of assets among different series of a regulated investment company, again triggering a need for legislation. By treating cells of protected cell companies as separate entities for tax purposes, the Service foreclosed similar results with these companies, but the issue could recur if the Service

<sup>251</sup> See David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312 (2001).

were to affirm single entity treatment for series funds with only contractual ringfencing.

Stepping back, one can see the abuse potential of quasi-separate entities behind some of the most common and high-stakes controversies that arise in tax enforcement. The most notable is transfer pricing, an issue that arises only when entities are treated as separate for tax purposes but share economic interests and management to such a degree that they cannot be counted on to act at arm's length. Here we find the most broad and open-ended definition of relatedness to be found in the Internal Revenue Code:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests...<sup>252</sup>

This definition fails to satisfy any reasonable standard of clarity, but it does not need to, since a deviation from arm's length pricing itself indicates that the parties are owned or controlled by the same interests.<sup>253</sup> The voluminous regulations under Section 482 have much to say about how to determine an arm's length price, but nothing at all to say about relatedness.

Shared ownership and control are such important elements of quasi-separate entity status that the Internal Revenue Code is littered with rules providing special treatment for related parties: non-deductibility of losses on sales between related parties,<sup>254</sup> restrictions on deductibility of interest paid to exempt related parties,<sup>255</sup> anti-churning rules that accompany the introduction of more favorable

<sup>252</sup> I.R.C. § 482.

<sup>253</sup> The evidentiary arrow can point the other way, however, since a significant non-overlap in ownership and control between the parties can be evidence that their arrangements are at arm's length.

<sup>254</sup> I.R.C. § 267(a)(1).

<sup>255</sup> I.R.C. § 163(j).

depreciation or amortization schedules,<sup>256</sup> recharacterization of stock redemptions or sales as dividends,<sup>257</sup> and limitations on multiple low corporate tax brackets by members of controlled groups,<sup>258</sup> to name a few.

Each of these rules has its own definition of relatedness, and no general principles for treating multiple entities as one, or single entities as many, can possibly hope to capture all of the relevant ways in which links of varying strength between enterprises should affect the tax treatment of their relationships with each other and the rest of the world. Having clear entity boundaries is important, and preventing abuse is important, but the former is not the means of achieving the latter. Instead, careful attention needs to be given to how particular tax rules should properly apply to quasi-separate enterprises.

This is not to say that the task will be easy. The frustrations of devising appropriate standards, and making them stick, are well illustrated by the saga of captive insurance companies. In the 1970s, the Service issued a ruling<sup>259</sup> that disallowed the deductibility of insurance premiums paid to affiliates, on the grounds that they were members of a “single economic family” and therefore arrangements among them lacked the features of risk shifting and risk distribution, which are the defining attributes of insurance for tax purposes.<sup>260</sup> Decades of litigation ensued. Although the Service achieved an early success in *Carnation Co. v. Commissioner*,<sup>261</sup> it ran into difficulties when it sought to apply this theory to captives that also insured the risks of unrelated

<sup>256</sup> E.g., I.R.C. §§ 168(f)(5), 197(f)(9).

<sup>257</sup> I.R.C. § 302(b).

<sup>258</sup> I.R.C. § 1561(a).

<sup>259</sup> Rev. Rul. 1977-316, 1977-2 C.B. 53, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348.

<sup>260</sup> See *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *Comm’r v. Treganowan*, 183 F.2d 288, 290 (2d Cir. 1950).

<sup>261</sup> 640 F.2d 1010, 1012 (9th Cir. 1981); see also *Clougherty Packing Co. v. Comm’r*, 811 F.2d 1297, 1307 (9th Cir. 1987).

parties.<sup>262</sup> In such a situation, there is arguably risk distribution, but it is hard to see the risk shifting when the parent, through its stock ownership, retains the burden of any insured risks. Nonetheless, the courts treated the insurance premiums as deductible,<sup>263</sup> and the Service ultimately conceded the issue.<sup>264</sup>

More problematically, the courts rejected the single economic family doctrine when applied to *bona fide* arrangements between a captive and its sister companies, on the grounds that those sister companies, unlike the common parent, owned no stock of the captive and therefore did not retain any risk for insured losses.<sup>265</sup> As a result of these set-backs, the Service in 2001 formally backed away from the single economic family doctrine,<sup>266</sup> and issued a ruling in 2002 accepting the deductibility of insurance premiums paid to a captive by sister companies, even where the captive insures no risks of unrelated parties.<sup>267</sup>

The spectre of *Moline Properties*<sup>268</sup> haunts these authorities. That case, which has come to stand for the proposition that a corporation must be respected as a separate entity, can be seen as the flip side of *Union Trusteed Funds*,<sup>269</sup> which holds that a corporation cannot be

<sup>262</sup> Rev. Rul. 1988-72, 1988-2 C.B. 31, *obsoleted by* Rev. Rul. 2001-31, 2001-1 C.B. 1348.

<sup>263</sup> *Ocean Drilling & Exploration Co. v. United States*, 988 F.2d 1135 (Fed. Cir. 1993); *AMERCO, Inc. v. Comm'r*, 979 F.2d 162, 162 (9th Cir. 1992).

<sup>264</sup> Rev. Rul. 2002-89, 2002-2 C.B. 984. That ruling allowed a deduction where less than half of the captive's premium income was earned by insuring risks of its parent.

<sup>265</sup> *Humana, Inc. v. Comm'r*, 881 F.2d 247 (6th Cir. 1989); *Kidde Ind. Inc. v. United States*, 40 Fed. Cl. 42 (1997). *Hosp. Corp. of Am. v. Comm'r*, T.C. Memo. (CCH) 1997-482 (1997). The Service could nonetheless still win by arguing that the captive was a sham or was inadequately capitalized. *See Malone & Hyde Inc. v. Comm'r*, 62 F.3d 835 (6th Cir. 1995); *Gulf Oil Corp. v. Comm'r*, 914 F.2d 396 (3d Cir. 1990).

<sup>266</sup> Rev. Rul. 2001-31, 2001-1 C.B. 1348.

<sup>267</sup> Rev. Rul. 2002-90, 2002-2 C.B. 985.

<sup>268</sup> *Moline Properties v. Comm'r*, 319 U.S. 436 (1943).

<sup>269</sup> *See supra* note 8 and accompanying text.

viewed as more than one separate entity. Yet the delineation of entity boundaries has ultimately been given too much weight in the determination of what constitutes insurance. The culmination of this trend can be seen in Revenue Ruling 2005-40,<sup>270</sup> where an unrelated insurance company insured the risks of twelve subsidiaries of a common parent, and no one else. In one of the situations covered by the ruling, each of the twelve subsidiaries was an LLC that was treated as a disregarded entity, and therefore all were branches of its common parent. The ruling concluded that even though there was risk-shifting (since the insurer was unrelated), there was no risk distribution (since there was only a single insured and therefore no pooling of risk among different insureds). This conclusion is understandable, but what is astonishing is the conclusion reached in a further situation covered by ruling, which is identical except that each of the LLCs has checked the box to be treated as a corporation. In that situation, the Service concludes that there was risk distribution, and therefore insurance, since there were multiple insureds. After a decade of working with the check the box rules, one gets accustomed to disregarded entity status having dramatic effects. But it is disappointing to see such a form-driven answer to the question of risk pooling, which ought to turn on more substantive considerations.

Given this history, it is perhaps fitting that the first official guidance from the Service on the treatment of protected cell companies came in the captive insurance context. In Revenue Ruling 2008-8, discussed earlier,<sup>271</sup> the Service applied the principles of Revenue Ruling 2005-40 to situations where the insurer was a cell of a protected cell company. Since each cell was regarded as a separate entity for tax purposes, the determination of whether there was adequate risk distribution was made by reference to the activities of each particular cell; what the other cells did was irrelevant.

<sup>270</sup> 2005-2 C.B. 4.

<sup>271</sup> See *supra* notes 45–47 and accompanying text.

### **B. *Lessons Learned***

Although the circumstances vary, some common themes emerge from this tour of quasi-separate enterprises. Of these, the most important is the dramatic nature of the tax consequences that can turn on separate or single entity status, even though the substantive differences between single entity and multiple entity arrangements may be slight. Consequently, we need clear rules for making this determination, but also robust anti-abuse rules to address unwarranted tax-planning techniques that arise when the single/multiple dichotomy is imposed on the spectrum of arrangements of varying degrees of separateness.

On the core question whether there is one entity or many, a conservative approach is in order. Given the need for clarity, attention to form is entirely appropriate, and the entity boundaries established by local law, where they are clear, ought to be respected. Of course, there will be cases where local law supplies an ambiguous answer, or none at all. For example, protected cell companies may purport to be a single legal entity under local law, but local law may give such a strong effect to cell boundaries that the tax law would better accord with ordinary expectations by treating the individual cells, rather than the whole company, as the relevant entity for tax purposes. In other cases, sharing arrangements may be established contractually without any form of legal entity, and the tax law is forced to undertake a substantive analysis to determine if one or more tax entities have been created, as with dual headed companies and other potential deemed partnerships. But in general, a healthy respect for legal entity boundaries is justified.

By contrast, the application of specific rules of tax law to quasi-separate entities should be undertaken with due regard to the substance of the arrangements. The degree of separateness that might warrant varying treatment will depend on the specific rule in ques-

tion. For example, as discussed earlier,<sup>272</sup> an issuance of tracking stock might not create a sufficient divergence of interests to justify treating the issuance as a constructive sale, but may nonetheless create enough divergence to deny continuing consolidation of the tracked subsidiary. And the use of stapling to de-control foreign subsidiaries would be better addressed in a manner consistent with the expatriation rules;<sup>273</sup> in that context, the debates in the bank cases on whether stapled companies are two or one are beside the point.

The history of the captive insurance cases and rulings shows that the task is not easy. That history also shows that the challenges arise not only for exotic arrangements such as tracking stock or stapling, but also for the more mundane quasi-separate enterprises that arise whenever separate legal entities are formed with close relationships of ownership and control. But that task is made more difficult, rather than easier, by giving too much regard to entity boundaries, and too little to the purposes of the specific rules under consideration.

<sup>272</sup> See *supra* notes 93–102 and accompanying text.

<sup>273</sup> See *supra* notes 187–197 and accompanying text.

