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Internal Revenue Service
Memorandum

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to: Team Manager
(LMSB HMT Team)

from: Associate Area Counsel (Detroit)
(Large & Mid-Size Business)

subject: Tax Treatment of Post-Spinoff Payments

X is a global manufacturing company that, until Year2, had internal divisions that produced many of the components needed for its manufacturing operations. In Year2, however, X spun off many of these parts operations into a separate company, Z. The spinoff was a tax-free transaction under section 355 of the Internal Revenue Code, and X now claims that certain payments it received from Z after the date of the spinoff should be excluded from its income. This memorandum responds to your request for assistance in determining the tax treatment of the amounts X received from Z after the spinoff.

This advice may not be used or cited as precedent.

LEGEND

X =
Z =
Year1 =
Year2 =
Year3 =
Year4 =
Year5 =
Year6 =
Year7 =
Date1 =
Date2 =

ISSUE

Whether amounts X received from Z as payment for employee expenses of workers X assigned to Z are includible in X's income.

CONCLUSION

All amounts X received from Z as payment for employee expenses of workers X assigned to Z are includible in X's income.

FACTS

In formal and informal claims for refund filed on Date1, X argues that it improperly included in income the payments it received from Z for the post-retirement benefits for workers X had assigned to Z. X also claims that it failed to deduct allowable expenses for the same post-retirement benefits. In supplemental claims filed on Date2, X increased the amount of its refund claims by excluding from income additional amounts related to the payments it received from Z for a portion of the direct wage costs for X workers assigned to Z. Your question about the proper tax treatment of the amounts X received from Z arose in response to these claims.

X formed Z and, in order to

(i) alleviate competitive barriers to expanding the Business beyond sales to [X], [its] subsidiaries and [its] affiliates, (ii) allow [X] to overcome competitive barriers to making purchases from third-party automotive suppliers, and (iii) enhance the Business' ability to attract employees and permit the Business to offer employee incentives more directly tied to the performance of the Business,

X transferred to Z certain X entities, assets, and liabilities in Year2. The agreements between X and Z indicate X decided to spinoff its components divisions for a business purpose, not that the spinoff was required by any other agreements or compelled by law. X completed the spinoff in Year2 by transferring to its shareholders its stock in Z in a transaction that the Internal Revenue Service determined was tax-free under sections 351, 368(a), and 355.

Because X was subject to a Year1 collective bargaining agreement ("CBA") covering all of its hourly employees at the time of the spinoff, X and Z agreed that Z would lease from X the hourly employees who had been working in the spun-off facilities as of the transfer date. In a letter of understanding appended to the Year1 CBA, X agreed that it would not close, sell, spinoff, or otherwise dispose of any of its facilities covered by the CBA. The Year1 CBA letter of understanding contained an exception to the facility closing moratorium, however, specifically for the Z spinoff. Under the terms of the letter of understanding, X could complete the Z spinoff only if all employees at the new Z locations would remain X employees, and the X employees would continue to be covered by the CBA.¹

X therefore assigned its hourly employees to Z but retained responsibility for: (1) the payment of the assigned employees' base hourly wages, (2) the provision of all

¹ Z also was required to adopt a CBA for hourly employees that mirrored the X Year1 CBA, as well as for certain future periods.

other employee benefits generally provided to other X employees, (3) the payment of all taxes required with respect to X's payment of wages and benefits, and (4) the liability for statutory benefits, such as workers' compensation. Z, as X's agent, had authority to exercise day-to-day supervision of the assigned employees, but X continued to provide payroll services. The assigned employees were covered under the same benefit plans as other X employees and could not participate in any Z employee benefit plans. This employee assignment agreement terminates at the earlier of (a) the termination of employment of all covered X employees, or (b) when the parties otherwise agree to terminate the agreement.² In consideration for the assignment of employees, Z agreed to reimburse X for all direct wage and benefit costs.³ X was to invoice Z monthly for these amounts, and Z was to pay within 10 business days, unless the parties agreed otherwise.

X and Z also executed a tax sharing agreement, under which X agreed that the reimbursements it received from Z for the assigned employees would constitute income to X, X would treat its payments to the assigned employees as a compensation expense, and Z would treat the payments consistent with X's tax treatment. You have informed us that you believe Z deducted the payments it made to X.⁴ X, however,

² The assignment agreement did not dictate what Z could pay other non-assigned workers, including, for example, new hires after the assignment date. In fact, a supplemental agreement with the union allowed Z to pay new hires significantly lower hourly wages than the assigned employees.

³ The specific costs Z was required to reimburse are defined in the assignment agreement, but they generally include all costs that X would incur in employing the assigned workers. For certain retirement benefit plans, Z had the option of reimbursing the plans directly for the amounts attributable to the assigned employees.

⁴ Although you do not have access to Z's returns, you noted that you believe Z's failure to deduct the amounts it paid to X for the assigned employees would be a material item subject to various financial

noted in its claim for refund that it failed to treat all of the reimbursements consistently. For example, X indicated that, because of “posting errors,” it did not deduct the post-retirement expenses, and it did not include in income the post-retirement reimbursements from Z until Year6. Here is how X treated the post-retirement benefit reimbursements on its original return and in its claim for refund:

X: Post-Retirement Benefit Reimbursements Per Return

	Year3	Year4	Year5	Year6	Year7
Income	excluded	excluded	excluded	included	included
Deduction	none	none	none	none	none

X: Post-Retirement Benefits Reimbursements Per Claim (*=change from return)

	Year3	Year4	Year5	Year6	Year7
Income	exclude	exclude	exclude	*exclude	*exclude
Deduction	*deduct	*deduct	*deduct	*deduct	*deduct

Year6 and Year7 represent a whipsaw position in X’s claim because X wants to exclude the post-retirement reimbursements from income and take a deduction for the amounts of post-retirement benefits it paid to the assigned employees.

X treated the wage reimbursements on its original return and in its claim for refund as follows:

X: Excess Wage Reimbursements Per Return

	Year3	Year4	Year5	Year6	Year7
Income	included	included	included	included	none
Deduction	deducted	deducted	deducted	deducted	

X: Excess Wage Reimbursements Per Claim (*=change from return)

	Year3	Year4	Year5	Year6	Year7
Income	*exclude	*exclude	*exclude	*exclude	none
Deduction	no change	no change	no change	no change	no change

reporting standards, that you examined Z’s various publicly-available financial reports for the relevant periods, and that you found no indication that Z did not deduct these amounts.

For the sake of simplicity, X defines the “excess wage” as difference between the wage scale that X uses and the wage scale that Z would have used, but for the employee assignment agreement. X is not seeking to exclude the entire wage reimbursement it received from Z, just the “excess wage” amount.

In Year6, X and Z amended the employee assignment agreement to change the amount Z was required to reimburse X. At that time, Z still was paying the assigned employees a higher average hourly wage than its competitors were paying their employees. To assist Z in reducing its wage costs, X agreed to return to Z a portion of the reimbursement based on the cost differential between wages paid to the assigned employees and workers at other similar companies, but only for new business sourced by X to Z after January 1, Year6.

In Year7, X and Z agreed that X would re-acquire title and control of all of Z’s facilities that used X’s assigned employees, effectively terminating the employee assignment agreement.

LAW AND ANALYSIS

Gross income is income from whatever source derived, including all items that are “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” IRC § 61; Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Here, X is not arguing that the reimbursements⁵ it received from Z do not constitute “income” as defined by the Code. Instead, X argues that the reimbursements arose because of the tax-free spinoff transaction, and, therefore, are

⁵ We use the term “reimbursements” to include both the amounts attributable to the post-employment and wage-related expenses of the assigned employees.

excludable from income. In order to prevail, X must show that this type of income is excluded from taxable income by some provision of the Internal Revenue Code. See, e.g., Commissioner v. Schleier, 515 U.S. 323, 328 (1995) (noting that “exclusions from income must be narrowly construed”) (internal citations omitted).

Z’s spinoff—X’s incorporation of Z, subsequent transfer of its assets to Z, and distribution of the Z stock to the X shareholders—qualified as a tax-free reorganization under sections 368(a)(1)(D), 355(a)(1), and 351(a) of the Code. But the mere fact that the Z spinoff was tax-free does not, in and of itself, mean that the reimbursement payments are excludable from X’s income. X must show that the reimbursements should be considered part of the spinoff transaction.

X points to a published, but partially redacted, 2007 IRS Office of Chief Counsel legal advice memorandum⁶ as support for its position. The 2007 advice is a type of “written determination,” as defined in section 6110(b)(1)(A), and although not binding precedent, its reasoning may prove instructive. IRC § 6110(k)(3). Regardless, the Service and taxpayers alike should exercise caution in relying on the conclusions of non-precedential releases, because they are tailored to a specific set of facts and often considered in a context different from the taxpayer’s. See, e.g., United States v. Wisconsin Power & Light Co., 38 F.3d 329, 335 (7th Cir. 1994) (noting that, although written determinations are not precedent, they may contain “evidence of administrative practice,” but cautioning that they should not be used “as authoritative interpretations of the Code”).

⁶ The legal advice memorandum is available on www.irs.gov and is labeled as release number 20073301F.

X argues that its claim for refund is supported by the Supreme Court's holding in Arrowsmith v. Commissioner, 344 U.S. 6 (1952). In Arrowsmith, the taxpayers claimed that their payment of a judgment against their liquidated corporation was an ordinary loss because, although the corporate liquidation distributions were capital gains, the judgment occurred in a later year. Id. at 7. The Commissioner argued that the payment was a capital loss because he viewed the judgment as part of the original liquidation transaction, which was capital in nature. Id. at 7-8. The Court held for the Commissioner: "Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings." Id. at 8. In arriving at its conclusion, the Court noted that, had the payment been made in the year of liquidation, it simply would have reduced the amount of capital gains the taxpayers received. Id. The Court also rejected the taxpayers' argument that capital gain treatment of the payment would violate the "principal that each taxable year is a separate unit for tax accounting purposes." Id.

We disagree that Arrowsmith applies here. In general, Arrowsmith governs cases where a subsequent, unknown or unexpected event occurs, and the proper tax treatment of that event can be determined only after reference to an earlier transaction. In contrast, in this case there is no subsequent event whose tax treatment is related to the integrated steps of the spin-off transaction. Although X and Z entered into the employee assignment agreement in connection with the spin-off, the terms of that executory agreement fully determine the proper tax treatment of payments under the

agreement. However, to the extent Arrowsmith governs X's refund claim, we disagree that X is entitled to the outcome it seeks.

The Court's analysis in Arrowsmith is not a simple "but . . . for" test; X must show an integral relationship between the tax-free spinoff and the employee assignment reimbursements. Arrowsmith does not only stand for the proposition that a prior year (or event) may be relevant in determining the character of a gain or loss in a subsequent year; it also supports the rationale that, "if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income." United States v. Skelly Oil Co., 394 U.S. 678, 684-85 (1969). In Mitchell v. Commissioner, for example, the court held that the character of a taxpayer's repayment was governed by an earlier transaction because of the "integral relationship" between the two. 428 F.2d 259, 263 (6th Cir. 1970).

Courts have not provided a bright line test in these types of cases; rather, the "integral relationship" is determined on a case-by-case basis. In Arrowsmith, the loss attributable to the judgment was closely related to the capital corporate liquidation—the judgment, although it occurred after liquidation, was considered pre-liquidation because it was against the corporation, not its individual shareholders. 344 U.S. at 8. In Skelly Oil, the amount of the deduction in the later year was determined with reference to the earlier depletion allowance because the taxpayer otherwise would have made a profit equivalent to the taxes on the allowance. 394 U.S. at 686. Finally, in Mitchell, as well as a line of similar cases, the character of the taxpayer's repayment of short-swing profit on a stock sale was capital because the repayment grew out of the original stock sale.

428 F.2d at 264. These cases illustrate that a careful, in-depth knowledge of the facts and circumstances of both the original and subsequent transactions is required to determine if they are integrally related. The Arrowsmith doctrine ultimately is premised on the idea that, if the transactions are sufficiently related, the tax consequences should be the same as if the prior and the subsequent transactions had occurred at the same time. Seagate Technology, Inc. v. Commissioner, T.C. Memo 2000-361, 80 T.C.M. (CCH) 759, 763 (2000).

The question of what is related to a tax-free spinoff is not addressed by the Code, apart from the specific rules in sections 351, 355, and 368, which state, in essence, that the actual distribution of stock to shareholders in this type of spinoff is tax-free. § 368(a)(1)(D). The Service routinely addresses ancillary issues in private letter rulings, none of which can be cited as precedent, because the facts differ from taxpayer to taxpayer. We are not aware of any cases, rulings, or other published advice in which a court or the Service has ruled that these types of post-spinoff payments relate back to the tax-free transaction.

The reimbursements X received from Z are not sufficiently related to the tax-free spinoff so as to be excluded from X's income. The mere contemporaneous execution of the spinoff transaction and employee assignment agreement is not enough to make the two integrally related for tax purposes. The purpose of the employee assignment agreement appears to be more closely tied to obtaining the union's approval for the spinoff, rather than integrally related to the spinoff transaction itself. In Arrowsmith, the liability was not fixed and ascertainable until after the corporate liquidation, but the liability for the judgment had arisen, or was directly related to, an event that occurred

before the liquidation. Arrowsmith, 344 U.S. at 7-8. In cases in which the courts have refused to apply the Arrowsmith doctrine, the two transactions were, in all economic reality, two separate, independent events. See, e.g., Seagate Technology, T.C. Memo 2000-361, at *23. Here, X and Z were not required, by sections 351, 355, or 368, to enter into the employee assignment agreement in order to effectuate the spinoff, and, in any event, none of those provisions (or related provisions) would grant non-recognition treatment to payments received by X under the agreement. X and Z entered into the employee assignment agreement in large part because the CBA required it. The employee assignment agreement was merely an executory agreement about the parties' future dealings regarding employees. Therefore, because X has failed to show that the reimbursements are part and parcel of the tax-free spinoff of Z, X must include the reimbursements in income when received.

The Tax Sharing Agreement and the Danielson Rule

In their tax sharing agreement, X and Z expressly agreed that X would recognize the reimbursements as income and simultaneously deduct as compensation expenses the amounts it was paying its employees assigned to Z; Z was to treat the reimbursements consistent with X's treatment. X now seeks to effectively repudiate this portion of the tax sharing agreement, without any apparent regard to the effects such a retroactive act would have on Z. Z has not had any opportunity to present its views regarding the correctness of the applicable section of the tax sharing agreement.

When a party seeks to undo the tax consequences of an agreement, courts frequently limit the challenge because the taxpayer freely entered into the contract and, therefore, should be held to its bargain. The Danielson rule, adopted in all courts

relevant to X's claim, holds that "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." Commissioner v. Danielson, 378 F.2d 771, 775 (3d Cir. 1967) (en banc); see also N. Am. Rayon Corp. v. Commissioner, 12 F.3d 583 (6th Cir. 1993), Lane Bryant, Inc. v. United States, 35 F.3d 1570 (Fed. Cir. 1994). Here, the Service is not "construing" the tax sharing agreement to mean that X must include the reimbursements in income; the tax sharing agreement itself says, in clear, unequivocal language, that X will include the reimbursements in income.

One of the principal concerns of the Danielson rule, though not necessarily a prerequisite to its application, is the courts' preference for consistency in the tax consequences to both parties of a transaction and the potential problem with "whipsaw" arguments raised against the Service. Danielson, 378 F.2d at 775. Should X prevail in its argument that the reimbursements are tax-free, what are the tax consequences to Z? We do not seek to answer that question here, but it clearly illustrates the problems raised when one party to a transaction wants to, in effect, change the deal.

The Service is not bound by the "mere form" of a transaction in determining its tax consequences, and the parties cannot circumvent the tax law simply by creating artificial, non-economic agreements. Id. at 774 (citing Gregory v. Helvering, 293 U.S. 465 (1935)). Thus, if a tax sharing agreement misstates or improperly applies the law in allocating the parties' tax burdens and benefits, the Service is not bound by the agreement's terms. In this case, however, having determined that the reimbursements

are not excluded from X's income, the Service simply is attempting to hold X to its agreement. We can think of no situation in which X would be allowed to repudiate the agreement, and, regardless, the law clearly requires that the reimbursements be included in X's income.

X's Argument Fails for Lack of Consistency

Finally, assuming for the sake of argument that the employee assignment reimbursements are sufficiently related to the tax-free spinoff so that the reimbursements also are tax free, the taxpayer's claim for refund still fails. If the reimbursements are considered part and parcel of the tax-free spinoff, X may exclude them from its gross income. However, if the reimbursements are integral to the spinoff transaction, all of X's expenses related to the assigned employees also should be considered integrally related to the spinoff, and, therefore, not deductible. X fails to address this issue in its claim, but we see it as a logical extension of X's income exclusion arguments. If X is able to exclude the reimbursements from income while also deducting the related expenses, it would receive a tax benefit windfall similar to the windfall rejected by the Supreme Court in Skelly Oil. We believe, therefore, that if X ultimately is successful in arguing that the reimbursements are not taxable income, the Service should disallow any deductions for related expenses.

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Please call _____ if you have any further questions.

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