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Mergers & Acquisitions Tax

This Month in M&A

May 2007

Did You Know…?

The IRS has announced that it hopes to finalize by the end of 2007 proposed regulations relating to certain transfers of partnership equity in connection with the performance of services. The 2005 proposed regulations provide that section 83 governs the transfer of a partnership interest to a service provider, and that a partnership does not recognize gain or loss when it grants a partnership interest to a service provider or when that interest vests. Although the proposed regulations would address various questions that have arisen under the current equity-for-services rules, if they are finalized without further elaboration significant issues will remain unresolved.

One issue that the proposed regulations do not address is the treatment of private equity funds that issue fund capital interests to employees of the portfolio companies that the fund acquires. Because the fund lacks direct privity with the company employees, it is unclear how the grant of interests should be treated. One view could be that the interests must pass through the company in a deemed transaction. However, there is no guidance describing the form such a deemed transaction should take. Two alternate approaches could apply: the "zero basis model" and the "cash purchase model."

Under zero basis model, the partnership would be deemed to contribute its interests to the subsidiary corporation (e.g., the portfolio company) in exchange for stock in a tax-free transaction. The subsidiary corporation receives a zero basis in the partnership interests transferred pursuant to section 362, under the assumption that the partnership has no basis in its own interests. Under this approach, the corporation recognizes gain when it subsequently transfers the partnership interests to its employees as taxable compensation, neutralizing the compensation deduction (see Rev. Rul. 99-57).

The cash purchase model would look to regulations under section 1032 to reach a different result. This model deems the partnership to contribute cash to the subsidiary corporation, which uses the contributed cash to purchase partnership interests from the partnership for fair market value. Under this deemed transaction, the subsidiary has full basis in the partnership interests and does not recognize gain or loss on the immediate deemed transfer of the partnership interests to its employees as taxable compensation. The corporation's compensation deduction thus would be preserved under this analysis.

The cash purchase model clearly is preferable since it would preserve the company's compensation deduction. However, because no guidance directly adopts the cash purchase model, funds should consider using a transactional form that, if respected, would dictate the

proper tax treatment. For example, the fund could contribute cash to the subsidiary company, which pays the contributed cash as compensation to its employees who in turn contribute the cash to the fund in exchange for partnership interests. Alternatively, the company could issue its own stock to the employees, who could then contribute that stock to the fund in exchange for partnership interests. In either case, it appears that the company should not recognize gain or loss on its payment of compensation. Although the IRS might argue that either of these transactions is circular, the fund would seek to rely on the cash purchase model if the transaction were recast.

Observations: Currently, most taxpayers apply the cash purchase model. This approach appears consistent with the IRS's overall stance on compensation payments paid by corporations and partnerships, while Reg. § 1.1032-3 and the proposed regulations on partnership equity would provide analogous support for this position. *For additional information, please contact Jeff Rosenberg, Susana Noles, or Walter Ballard.*

Court Case

Klamath Strategic Investment Fund, LLC v U.S. – "Son-of-Boss" Case Update – On July 20, 2006, the U.S. District Court issued a partial summary judgment for the taxpayer, concluding that contingent liabilities are not section 752 liabilities and that the retroactivity of Reg. § 1.752 does not apply to this taxpayer. The case proceeded to trial on the disputed facts related to the IRS's economic substance argument. On January 31, 2007, the court ruled for the IRS regarding the validity of the loans used.

Based on that ruling, the IRS requested the court to vacate the partial summary judgment and reconsider that portion of the decision. The IRS contended that the partial summary decision effectively had been rendered moot because it was premised on a factual assumption that no longer was valid (i.e. the validity of the loan transactions). The court rejected the IRS's argument that expenses incurred in connection with a non-economic substance transaction are not deductible. The court denied the government's motion on the ground that even though the loans lacked economic substance, the operating expenses were real economic losses separate from the loan transactions; therefore, the partial summary judgment was not premised on invalid factual assumptions.

***Observations*:** In 2006, the court originally rejected the IRS technical arguments and ruled for the taxpayer, but subsequently in 2007 the court ruled for the IRS on the basis of a broad judicial doctrine, economic substance. The subsequent ruling for the IRS left open the question whether the summary judgment was still valid. The denial of the latest IRS motion leaves in place the court's original decision for the taxpayer on section 752 issues. Refer to the July/August 2006 and March 2007 issues of the M&A Newsletter for additional background on the Klamath case. *For additional information, please contact Susana Noles or Walter Ballard.*

Treasury Regulations

Anti-Loss Reimportation – The IRS has published final and temporary regulations modifying the current anti-loss reimportation rule under Reg. § 1.1502-35(g). Under the current "loss duplication" regime, consolidated groups may not claim more than one tax benefit from a single economic loss. If the consolidated group recognizes a loss on the sale of a member's stock, the consolidated group cannot "reimport" the loss through a subsequent acquisition of the former member and recognize the loss on the inside assets. This restriction on reimporting the loss lasts for 10 years from the date the member leaves the group.

Some consolidated groups have taken the position that the anti-loss reimportation rule does not apply if the member first is deconsolidated and the shareholder subsequently recognizes a loss on the sale of the former member's stock. This approach is based on a literal reading of the current regulation, which states that the anti-loss reimportation rule applies if a member recognizes a loss on the disposition of a share of stock of a subsidiary. The new temporary regulations expand

this rule to include dispositions of stock of a subsidiary or former subsidiary. This revision generally applies to reimported items if the related stock loss is recognized on or after April 10, 2007.

The temporary regulations also add a standard "anti-abuse" rule granting the IRS authority to make appropriate adjustments if a taxpayer acts with a view to avoid the purposes of the loss duplication rules. This anti-abuse rule is effective on or after April 10, 2007.

Observations: Proposed loss disallowance rules issued in January 2007 would fundamentally alter the loss duplication rules. Rather than attempting to prevent one group from claiming more than one tax loss, the proposed regulations would reduce the departing member's tax attributes, including its asset basis, by the amount of the seller's loss, thereby preventing the former member or the acquiring group from claiming a second tax benefit. These proposed regulations are expected to be effective prospectively, with the result that the existing anti-loss reimportation restrictions would remain in effect up to 10 years after the proposed regulations are finalized. *For additional information, please contact David Friedel or Michelle Estrada.*

Private Letter Rulings

PLR 200713015 – Entity A purchased a number of shares of stock ("Excess Shares") of a loss corporation ("Company") in the open market after the Company filed for bankruptcy and before a Trading Order issued by the Bankruptcy Court became effective. Entity A's purchase of the Excess Shares caused Entity A to become a five-percent shareholder and triggered an ownership change of the Company under section 382. The Trading Order gave the Company the right to object to certain stock purchases in advance. If the Trading Order had been in effect when Entity A acquired the Excess Shares, the transaction would have violated the Trading Order.

At the request of Entity A and the Company, the Bankruptcy Court ordered that the purchase of the Excess Shares be void *ab initio* ("Stipulation and Order") provided Entity A sold the Excess Shares with any excess proceeds going to charity, which it did. The IRS ruled that Entity A would not be treated as purchasing the Excess Shares for purposes of section 382 so long as the Bankruptcy Court's Trading Order and Stipulation and Order remain in effect and are not set aside by a final order of a court of competent jurisdiction.

Observations: In this ruling, the IRS deferred to the authority of the Bankruptcy Court to void the purchase of the Excess Shares for purposes of determining whether there was a section 382 ownership change. The IRS did not issue a rescission ruling, which presumably would have required the original owners of the Excess Shares to reacquire such shares from Entity A. The result of the ruling was a retroactive unwind of the ownership change. The facts of this PLR can be contrasted with PLR 200605003, in which a Trading Order was in effect when stock acquisitions triggered an ownership change and the IRS disregarded such stock acquisitions for section 382 purposes. *For additional information, please contact Julie Allen or Derek Cain.*

PLR 200713020 – The IRS ruled that no share of Acquiring stock issued in a downstream A reorganization was section 306 stock in the hands of the Target shareholders. Prior to the reorganization, Target had common and preferred stock outstanding. There was no indication as to whether the preferred stock was section 306 stock.

The terms of the merger agreement specified what consideration was received in exchange for a particular share or class of Target stock. The facts stated that the terms were economically reasonable and would not result in a shareholder realizing a loss on the exchange. The IRS ruled that the shareholders may specifically identify basis and holding period under Reg. § 1.358-2.

Observations: In general, common stock issued in a reorganization is excluded from the definition of section 306 stock. The PLR cites Rev. Rul. 76-387, in which the IRS set forth two factors for determining whether "common stock" issued in exchange for section 306 stock in a reorganization is actually common stock. In that revenue ruling, the IRS determined that stock was not common stock if it could be disposed of (1) without a

loss of voting control; and (2) without a loss of interest in unrestricted equitable growth of the corporation.

This ruling is an example of the specific identification of basis and holding period permitted under the new section 358 regulations (T.D. 9244). In this case, it appears relevant that no shareholder would realize a loss on the exchange. *For additional information, please contact Michelle Estrada or Horacio Sobol.*

PLRs 200716014 and 200716016 – The IRS ruled that the exchange of existing Trading Rights and Trading Permits in the hands of members of a nonstock, not-for-profit Target corporation for similar Trading Rights and Trading Permits of an Acquiring corporation in connection with the forward triangular merger of Target into Acquiring is treated as a separate section 1001 exchange. The ruling explains that Target did not have authorized capital stock. Rather, participation in Target was obtained through a Membership Interest, which consisted of a Trading Right, a right to access certain Target business facilities, and an Equity Interest, which allowed a member to vote and receive a liquidating distribution. Members and other individuals also could hold a Trading Permit, a limited right to engage in certain trading activities associated with Target's business. In the merger, holders of Target Equity Interests received (i) a combination of Acquiring's Parent stock and cash, or (ii) solely cash. The taxpayer represented that at least 40 percent of the proprietary interest in Target will be exchanged for Parent stock.

Observations: The IRS treated the Target Trading Right as separate from the Equity Interest even though the Trading Right and Equity Interest were attached together as a Membership Interest. The characterization of the receipt of Acquiring Trading Rights and Trading Permits as part of a separate taxable transaction rather than as additional merger consideration is relevant in this case because the holders of Equity Interests could have been viewed as having boot allocated to the transfer of Equity Interests. This treatment appears consistent with the IRS's position in Rev. Rul. 98-10, holding that the exchange of target securities, some of which were held by target shareholders, for acquiring securities in connection with a B reorganization occurred as part of the overall transaction but was not part of the stock-for-stock exchange which qualified as a reorganization. *For additional information, please contact Michelle Estrada or Horacio Sobol.*

PLR 200716017 – The IRS ruled that the spin-off of Controlled immediately followed by Controlled's election to be treated as an S corporation is a tax-free section 355 transaction. The taxpayer represented that the business purpose for the transaction was to retain the services of a key employee who wanted to become a direct shareholder of Controlled.

Observations: Pursuant to Rev. Proc. 2003-48, the IRS does not rule on business purpose in section 355 transactions. A valid business purpose must be a non-federal tax purpose. Historically, the IRS has been reluctant to issue section 355 rulings if the distributing or controlled corporation makes an S election immediately after the distribution because such transactions result in elimination of federal tax at the corporate level, which the IRS believes can indicate lack of valid business purpose. This ruling is an example of the IRS's willingness to issue section 355 rulings when there is a valid non-federal tax business purpose in addition to any federal tax benefits that may result from the transaction. *For additional information, please contact Michelle Estrada or Tim Lohnes.*

PLR 200716024 – The IRS ruled that a distributing corporation's ("D1's") attempt to reverse a taxable redemption in which a distributee corporation ("D2") acquired control of D1 in violation of the active trade or business requirement in section 355(b)(2)(D) would be respected as a rescission. Within the five-year period prior to the distribution, D1 redeemed several series of publicly traded, nonvoting preferred stock, such that D2 acquired section 368(c) control of D1 in a transaction in which gain or loss was recognized (see *McLaulin v. Commissioner*, 276 F.3d 1269).

In the rescission, D1 reissued to one redeemed shareholder the shares it had redeemed from such shareholder in exchange for the original redemption proceeds in the same tax year in which the redemption occurred. In addition, D1 paid to the shareholder the

exact amount of the dividend payment that would have accrued if the shares had remained outstanding continuously from the time they were redeemed to the time they were reissued. In the rescission ruling, the IRS ruled that the redemption and reissuance transactions were disregarded, and D2 did not obtain control of D1 in the redemption.

Observations: This ruling provides an alternative avenue to the IRS's longstanding position set forth in GCM 39264 (July 23, 1984) that a taxable acquisition of control is not reversible for purposes of meeting the active trade or business requirement in section 355(b)(2)(D), which provides that control of a corporation that conducts an active trade or business cannot be acquired in a taxable transaction within the five-year period ending on the date of the distribution. This PLR indicates that a taxable acquisition of control can be reversed through a rescission if (i) the redeeming corporation reissues the redeemed shares to one of the previously redeemed shareholders in exchange for the redemption proceeds; (ii) the redeeming corporation pays the dividends to which such shareholder would have been entitled had it owned the redeemed shares continuously; and (iii) such rescission occurs in the same tax year as the original redemption transaction. The PLR does not mention payment of interest by the shareholder for its use of the redemption proceeds from the time of the redemption through the time of the reissuance. *For additional information, please contact Julie Allen or Derek Cain.*

PLR 200717014 – In a "D"/355 transaction, Distributing contributed all its interest in a disregarded entity ("DE") to Controlled (the "Contribution") prior to the spin-off. Pursuant to the Contribution and certain Intercompany Agreements, Distributing granted DE nonexclusive, royalty-free, perpetual licenses to certain intellectual property owned by the Distributing group, and DE granted Distributing nonexclusive, royalty-free, perpetual licenses to certain intellectual property owned by the Controlled Group. The IRS ruled that no part of the Controlled stock deemed issued in exchange for the licenses granted to Controlled pursuant to the Intercompany Agreements constituted Controlled stock that was purchased within five years of the spin-off and therefore treated as boot in the spin-off (see section 355(a)(3)).

Observations: The IRS did not rule on whether the license transfers represented transfers of property. It therefore appears that the IRS may have treated the exchange of licenses as a separate exchange outside of the "D" reorganization. *For additional information, please contact Michelle Estrada or Tim Lohnes.*

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