This Month in M&A / Issue 4 / April 2013

M&A Tax Recent Guidance

This month features:

- Regulations under sections 367(a)(5) and 1248(f) address cross-border transfers
- House Ways and Means Committee "discussion draft" would revamp subchapters K and S
- "Commissioner's Discretionary Rule" invoked to eliminate taxpayer's deferred intercompany gains (PLR 201312027)
- IRS reiterates its position that a sale of a partnership interest by a foreign partner constitutes effectively connected income (FAA 20123903F)

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Did you know…?

Any multinational engaged in cross-border structuring and M&A activity should consider the impact of final and temporary regulations issued March 18 that address sections 367(a)(5) and 1248(f) and also change several of the rules applicable to indirect stock transfers (T.D. 9614 and T.D. 9615). Specifically, the regulations -

- finalize, with some modifications, proposed regulations issued in August 2008 (REG-209006-89) under sections 367(a)(5) and 1248(f) (2008 proposed regulations);
- finalize an important change to Example 4 in Reg. sec. 1.367(b)-4(b)(1); and
- eliminate a key exception (the "section 367(a)(5) exception to the coordination rule") to taxation under sections 367(a) and 367(d) that generally applied to the extent a foreign acquiring corporation transferred a domestic target corporation's assets to a controlled domestic subsidiary.

Temporary regulations under section 367 were also issued in proposed form (REG 132702-10).

The regulations under sections 367(a)(5), 367(b), and 1248(f) are effective for transfers occurring on or after April 18, 2013. Temp. Reg. sec. 1.367(a)-3T, eliminating the section 367(a)(5) exception to the coordination rule, applies to transactions occurring on or after March 18, 2013.

Final regulations under section 367(a)(5)

Section 367(a)(5) provides that a domestic corporation (the "US target") that transfers appreciated property to a foreign corporation in an exchange described in section 361(a) or (b) generally may not use the active trade or business exception and the gain recognition agreement (GRA) exception to avoid recognizing gain under section 367(a)(1). However, the statute provides an exception to the gain recognition rule if the domestic corporate shareholders of the US target make basis adjustments and agree to additional requirements under regulations.

Under the newly finalized section 367(a)(5) regulations, US targets may avoid (assuming the transfer otherwise qualifies for the active trade or business exception or the GRA exception) gain recognition on the transfer of section 367(a) property provided the net built-in gain (inside gain) attributable to a control group member (defined below) can be preserved in the stock of the foreign acquiring corporation issued in the reorganization.

Five requirements must be met to avoid gain recognition under the newly finalized section 367(a)(5) regulations -

- The US target must be controlled (within the meaning of section 368(c)) by five or fewer domestic corporations (collectively, the control group members).
- The US target must recognize gain on the portion of its inside gain attributable (based on value) to non-control group shareholders (e.g., individuals, partnerships, and foreign corporations) and to any control group member that cannot make a sufficient basis adjustment to reflect the inside gain (which may occur if a control group member receives boot in the reorganization).
- Each control group member must make basis adjustments in the stock of the foreign acquiring corporation received in the reorganization necessary to preserve the US target's inside gain attributable to such member (as noted, to the extent that a control group member cannot preserve its share of the inside gain, the US target must recognize that gain).
- Except with respect to the transfer of stock or securities subject to separate rules requiring filing a GRA, the US target must agree to amend its return and recognize gain if the foreign acquiring corporation disposes of a significant portion of the section 367(a) property received from the US target.
- The US target and each control group member must complete and timely file an election statement to make the election.

As noted, under the final section 367(a)(5) regulations the US target must agree to amend its return and recognize gain if the foreign acquiring corporation disposes of a

significant portion of the section 367(a) property received from the US target. While the final regulations retain certain subsequent disposition rules in Reg. sec. 1.367(a)-2T(c)(1) that apply to the active trade or business exception, the final regulations also incorporate the principles of the GRA triggering event exceptions set forth in Reg. sec. 1.367(a)-8(k).

Consistent with the proposed regulations, the final regulations reiterate that basis adjustments under the elective regime can convert built-in loss stock into built-in gain stock. As opposed to losing outside stock basis, taxpayers may choose to recognize the inside gain and preserve the outside stock loss. The final regulations clarify that section 367(a)(5) adjustments are not required if the US target has a net built-in loss on its assets, even if the US shareholder's outside loss on the US target stock exceeds that net built-in asset loss.

Final regulations under section 367(b)

Consistent with the 2008 proposed regulations, the final regulations change the result in Example 4 of Reg. sec. 1.367(b)-4(b)(1)(iii). Before changed by the final regulations, Example 4 required a US target to include in income the section 1248 amount attributable to the stock of controlled foreign corporations (CFCs) transferred in an outbound reorganization because, as a result of the liquidation of the US target, its section 1248 shareholder status was not maintained "immediately after the exchange."

In the 2008 proposed regulations and in the final regulations, the IRS changed the analysis in Example 4. That example now provides that the "immediately after the exchange" requirement is tested after the section 361(a) or section 361(b) exchange and without regard to the distribution of the acquiring foreign corporation's stock pursuant to section 361(c)(1).

Observation: Note that since the change to Example 4 became effective on April 18, 2013, the section 361(c)(1) distribution of the foreign acquiring corporation stock is subject to the new final regulations under section 1248(f), which may require, for example, income inclusions and/or elective basis adjustments.

Final regulations under section 1248(f)

Similar to the final regulations under section 367(a)(5), Reg. sec. 1.1248(f)-2 provides an elective exception to the general rule of section 1248(f).

Under section 1248(f), deemed dividends attributable to section 1248 amounts are triggered upon certain distributions of foreign stock pursuant to distributions that usually are not taxable under US federal income tax principles. Covered transactions include liquidating distributions of CFC stock to an 80-percent corporate distributee (section 337); distributions of stock of a CFC to shareholders (section 355(c)(1)); and distributions of foreign corporation stock acquired by a US target pursuant to an asset reorganization (section 361(c)(1)).

Section 1248(f)(2) provides a statutory exception to this treatment if the distributee is (i) a US corporation that is treated as holding the foreign corporation stock during the period it was held by the distributing US corporation and (ii) a section 1248 shareholder of the foreign corporation immediately after the distribution.

The additional exceptions provided by the final regulations will apply to section 337 distributions if, immediately after the distribution, the 80-percent distributee is a section 1248 shareholder with respect to the distributed foreign corporation, has a holding period in the stock received that is the same as the US distributing corporation's holding period, and has a basis in the stock received that is not greater than the US distributing corporation's basis.

The final regulations also include an expansion of the elective regime that was not contained in the 2008 proposed regulations by allowing taxpayers to make elective basis and holding period adjustments to avoid a section 1248(f) inclusion if the three requirements are not satisfied after a section 337 distribution.

The elective exceptions for section 355 distributions and section 361(c)(1) distributions are available if adjustments are made to each section 1248 shareholder's section 358 basis and to the amount of E&P attributable to the stock received to preserve the section 1248 amount attributable to such stock. In a change from the

2008 proposed regulations, if the combined section 367(a)(5) and section 1248(f) income recognized and basis adjustments exceed the built-in gain in the property transferred by the US target, the amount subject to section 1248(f) is reduced to account for the amounts subject to section 367(a)(5). In another change from the proposed regulations, the final regulations contain rules applicable when multiple classes of a CFC's stock are distributed in a section 361(c)(1) distribution.

Temporary regulations - Elimination of coordination rule exception

The section 367(a) regulations contain rules that govern a direct asset transfer to a foreign corporation and different rules for direct and indirect stock transfers. Certain transactions can implicate both sets of rules, including certain outbound triangular asset reorganizations, outbound asset reorganizations followed by controlled asset transfers, and successive section 351 asset transfers.

With respect to these transactions, Reg. sec. 1.367(a)-3(d)(2)(vi)(A) (the coordination rule) coordinates the application of section 367(a) to the asset transfer by the US person with the application of the indirect stock transfer rules, providing such transactions are first subject to the rules governing direct asset transfers and then to the indirect stock transfer rules. This coordination rule could result in the current taxation of inside and outside gain.

Prior to issuance of the new temporary regulations, there had been three exceptions to the coordination rule. If met, each provided that section 367(a) or (d) would not apply to a US person's direct asset transfer to a foreign corporation, resulting in the transaction being subject only to the indirect stock transfer rules.

The new temporary regulations eliminate the section 367(a)(5) exception to the coordination rule. Prior to this change, a taxpayer could reorganize a US target offshore and move its domestic assets into a new foreign-owned domestic corporation without imposition of sections 367(a) and 367(d) on the retransferred domestic assets, but subject to making section 367(a)(5) basis adjustments in the stock of the foreign acquiring corporation received to preserve the gain on the retransferred assets (in the hands of the US target shareholder). This exception no longer is available.

Observations

The final and temporary regulations are significant to multinationals engaged in cross-border structuring and M&A activity. Taxpayers engaged in outbound reorganizations should consider not only the final regulations, but also Notice 2012-39 (see August 2012 edition of "This Month in M&A"), which governs the taxation of section 367(d) property in such reorganizations.

For more information, please contact Carl Dubert, Marty Collins, or Sean Mullaney.

Legislative Proposals

Pass-through tax reform "discussion draft"

In March 2013, House Ways and Means Committee Chairman Dave Camp (R-MI) released a "small business" tax reform discussion draft. The draft presents two options that would impact significantly both subchapters K and S: the first option proposes revisions to the current code provisions, while the second option proposes a new regime under which partnerships and S corporations would be subject to the same rules. The key proposals of each option include the following:

Option One (revise current law) would -

- Repeal rules relating to section 707(c) guaranteed payments
- Require mandatory section 734(b) and 743(b) basis adjustments
- Repeal the seven-year waiting period for mixing bowl transactions
- Eliminate the "substantially appreciated" requirement of section 751(b) by treating all partnership distributions of inventory as hot assets

- Reduce from 10 years to five years the period that S corporations must pay the highest corporate tax rate on built-in gains resulting from the conversion of a C corporation to an S corporation
- Increase, from 25 percent to 60 percent, the amount of passive income that an S corporation can have without paying an entity level tax
- Permit non-resident aliens to be S corporation shareholders through US electing small business trusts

Option Two (new unified pass-through regime) would -

- Treat S corporations as pass-through entities under the same new rules as partnerships
- Require each pass-through entity to withhold on entity-level income and credit the partners for such withholding
- Limit tax-free distributions of property by recognizing gain at the entity level on appreciated property distributed to owners
- Limit tax-free distributions of property by requiring the distributee owner to recognize gain on distributions of property where the fair market value of the property exceeds the distributee's tax basis in its pass-through entity interest
- Restrict pass-through entities' ability to make special allocations
- Require mandatory section 734(b) and 743(b) adjustments

This draft includes additional proposals that could have a significant impact under either option. These include (1) new due dates for pass-through entity tax returns to give individuals more time to receive Schedule K-1s, and (2) allowing pass-through entities to use the cash method of accounting only if they have less than $10 million of gross receipts.

Observations:

Ways and Means Chairman Camp has invited taxpayers and others to review and comment on the small business discussion draft and to share feedback with Committee staff, as the Committee prepares to act on a comprehensive tax reform bill for expected consideration by the full House this year. It remains uncertain whether Congress and President Obama can agree on tax reform legislation, but there has been substantial bipartisan interest in enacting tax reform. As a result, the prospects of significant tax reform legislation being enacted should be carefully considered as businesses and individuals review the Ways and Means "small business" discussion draft -- as well as earlier discussion drafts on international tax rules and financial products -- and provide input to tax policymakers.

For additional information, please contact Todd McArthur, Gretchen Van Brackle, Arielle Krause, or Matthew Arndt.

Private Letter Rulings

PLR 201312027

The IRS exercised its authority under the Commissioner's Discretionary Rule (CDR) set forth in Reg. sec. 1.1502-13(c)(6)(ii)(D) and allowed a taxpayer to exclude intercompany gain with respect to multiple member stocks that otherwise would have been taken into account as a result of multiple upstream reorganizations or liquidations. Generally, the CDR provides that an intercompany item of income or gain may be redetermined to be excluded from gross income if the Commissioner determines that treating the intercompany item as excluded from gross income is consistent with the purposes of Reg. sec. 1.1502-13 and other applicable provisions of the Code and regulations.

Taxpayer is the common parent of a consolidated group (Parent). Through a series of prior restructuring transactions, Parent indirectly owns subsidiaries that are either the subject of a prior intercompany transaction (e.g, a distributed entity), or a

successor to a selling member's intercompany gain under Reg. sec. 1.1502-13(j)(2)(i)(B).

Parent proposed to eliminate several of the affected subsidiaries, either by conversion to limited liability companies (LLCs) under state law or by upstream mergers. The proposed transactions would be triggering events that would require the intercompany gains to be taken into account under the consolidated return rules.

Parent and its subsidiaries apparently would have failed to qualify for the automatic relief rule under Reg. sec. 1.1502-13(c)(6)(ii)(C) and therefore sought a private letter ruling under the CDR. Exercising its authority under the CDR, the IRS ruled that the group may exclude from gross income the intercompany gains that will be triggered by the transactions because the taxpayer was able to represent that (1) neither the consolidated group nor any other taxpayer derived any federal income tax benefit from the intercompany transactions or from the redetermination of the gains as excluded from income; (2) the bases of the transferred stock would be permanently eliminated as a result of the proposed transactions; and (3) the consolidated group did not previously reflect the intercompany transactions on its return.

Observations

Deferred intercompany gain with respect to subsidiary stock has long been a trap for the unwary during intragroup restructurings. This PLR is the second private letter ruling issued since finalization of the CDR in 2011; thus, it appears that the CDR presents taxpayers with a potential opportunity to eliminate intercompany gains that otherwise would not be available. The regulations provide that relief under the CDR may be obtained only through a PLR issued by the IRS National Office.

For more information, please contact Pat Pellervo, Charmaine Lee, or Olivia Ley.

Other guidance

FAA 20123903F

This Field Attorney Advice addresses whether gain from the sale by a foreign partner of a partnership interest to another partner constitutes effectively connected income (ECI). Following Rev. Rul. 91-32, the FAA concludes that gain or loss of a foreign partner from the sale of its interest in a partnership that is engaged in a US trade or business will be ECI gain or loss to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributed to ECI property of the partnership.

Observations

The facts in the FAA do not differ from those in Rev. Rul. 91-32. The important takeaway is that the IRS continues to follow that ruling notwithstanding an argument that it is inconsistent with the statute.

The argument is based on the fact that section 741 requires that an entity approach to the sale of a partnership interest be applied unless the Code provides otherwise. However, the Code does not include an explicit statement that would support aggregate treatment for the sale of a partnership interest in determining whether there is ECI.

President Obama's Fiscal Year 2014 Budget proposes to codify Rev. Rul. 91-32, effective for sales or exchanges after 2013. Under the proposal, gain or loss from the sale or exchange of a partnership interest is ECI gain or loss to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The IRS would be granted regulatory authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the Code's nonrecognition provisions. The Administration expresses concern that under present law, nonresident alien individuals and foreign corporations may take a position contrary to Rev. Rul. 91-32 because no Code provision explicitly provides that gain from the sale or exchange of a partnership interest by such persons is treated as ECI.

Also under the Administration's budget proposal, the transferee of a partnership interest must withhold 10 percent of the amount realized on disposition of a partnership interest (or a lesser amount to the extent the transferor provides a certificate from the IRS showing that its US federal income tax liability with respect to the transfer would be less than 10 percent of the amount realized) unless the transferor certifies that the transferor was not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership would have to satisfy the withholding obligation by withholding on future distributions to the transferee partner. The Administration estimates that this proposal would raise $2.66 billion over 10 years.

For additional information, please contact Todd McArthur, Arielle Krause, or Matthew Arndt.

PwC M&A publications

WNTS author Wade Sutton wrote an article published in the March/April 2013 issue of the Journal of Corporate Taxation titled "*Should Hook Stock Prevent Affiliation?*." This article explores whether hook stock can prevent corporations from forming part of an affiliated group and discusses a recent PLR that sheds some light on this historically vexing question.

WNTS authors Ciara Foley, Benjamin Willis, and Mark Boyer wrote an article published in Tax Notes on March 18, 2013 titled "*Granite Trust Planning: Properly Adopting a Plan of Liquidation*." This article explores the 'foot faults' that may prevent taxpayer electivity when choosing between tax-free and taxable liquidations under sections 331 and 332.

WNTS authors Laura Nadeau and Audrey Ellis wrote an article published in the BNA TM Real Estate Journal (March 6, 2013) and in the Bloomberg BNA Tax Management Memorandum (April 8, 2013) titled "*The Net Investment Income Tax: Elections to Start Thinking About Now*." The article explores the 3.8-percent tax on net investment income imposed by section 1411 and elections that can be made to plan for the impacts of the tax.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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