This Month in M&A

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This Month's Features

- IRS applies "Discretionary Rule" to exclude intercompany gain resulting from downstream merger (PLR 201210018)
- Open market stock repurchases by a distributing corporation may not count for purposes of Section 355(e) (PLR 201211008)
- Section 355 treatment granted despite liquidation of distributed corporation (PLR 201213018)
- Consistency rules of Section 338(e) do not apply to partnership's purchase of assets from a target corporation (PLR 201213013)
- Stock sale disregarded under rescission doctrine (PLR 201211009)
- Taxpayer's contribution of chain of wholly owned subsidiaries to another corporation followed by deemed liquidations did not result in gain or loss recognition; IRS did not characterize transactions (PLR 201212001)
- IRS grants relief to life insurance company to join in the filing of a life-nonlife consolidated return (PLR 201210015)
- IRS waives five-year restriction on reconsolidation following deconsolidation (PLR 201213012)

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Did you know...?

In a recent private letter ruling (PLR 201210018), the IRS ruled that intercompany gain with respect to member stock that otherwise would have been triggered as a result of a proposed merger, instead would be excluded from gross income under Reg. Sec. 1.1502-13(c)(6)(ii)(D) (the "Discretionary Rule"). This PLR is the first instance in which the IRS has exercised its authority under the final Discretionary Rule, as set forth in final regulations released in March 2011 (T.D. 9515).

In the PLR, Parent indirectly owns Seller 2. Parent and Seller 2 own all the stock of Buyer, and Buyer and Seller 2 own the stock of Seller 1. Seller 1 and Seller 2 each have deferred intercompany gain resulting from a sale of property to Buyer. The property to which both intercompany gains related was a block of Seller 1 stock (the "Block 2 Shares") held by Buyer. The facts of the PLR do not explain how the deferred intercompany gain ended up attached to the Block 2 Shares. Parent proposed to merge Buyer into a disregarded entity of Seller 1 in a section 368(a)(1)(A) reorganization.

Exercising its authority under the Discretionary Rule, the IRS ruled that Seller 1's intercompany gain with respect to the Block 2 Shares would be redetermined to be excluded from gross income, while Seller 2's intercompany gain would be taken into account.

Attribute redetermination

Under the consolidated return rules, attributes (such as character) of items arising from transactions between consolidated group members ("intercompany transactions") generally are determined on a single-entity basis. Thus, the matching rule of Reg. Sec. 1.1502-13(c)(6) generally redetermines the separate-company attributes of the selling member ("S") or the buying member ("B") arising from intercompany transactions in order to produce the same tax result to the consolidated group as if S and B were divisions of a single corporation.

Pursuant to that matching rule, S's item of income or gain will be redetermined to be nondeductible or excluded from gross income if B's corresponding item is a loss or deduction that is permanently disallowed. The regulations provide, however, that complete liquidation of a subsidiary under section 332 is not a permanent disallowance for this purpose. Thus, for example, if S sells appreciated stock of T to B, followed by T's liquidation into B in a section 332 transaction, S's intercompany gain will not be redetermined to be excluded from gross income because section 332 is not considered to be a disallowance provision under the Code.

This result is intended to preserve the policies of *General Utilities* repeal by preventing taxpayers from using intercompany transactions to dispose of unwanted assets without recognizing taxable gain.

Temporary Regulations — The IRS issued Reg. Sec. 1.1502-13T(c)(6)(ii)(C) in March 2008 (T.D. 9383) in response to PLR requests seeking relief under the Discretionary Rule with respect to intercompany gain on member stock. The Discretionary Rule under former Reg. Sec. 1.1502-13(c)(6) provided that intercompany gain would be excluded to the extent "the Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code and regulations."

The 2008 temporary regulations added a new rule designed to provide clarity and to grant automatic relief in the circumstance in which the intercompany stock gain is not reflected in basis after the transaction. In order for the automatic relief rule to apply, the parent of the consolidated group had to be the member (or successor) representing both S and B and own the member stock to which the intercompany gain related at the time of the triggering transaction, among other requirements.

The 2008 temporary regulations retained the Discretionary Rule, although the IRS explained in the preamble to the regulations that absent compelling comments, the Service anticipated eliminating the Discretionary Rule in final regulations because the new automatic relief rule appeared to address the only circumstance in which it would be appropriate to exclude intercompany gain.

Final Regulations — The 2011 final regulations expand the scope of the automatic relief rule to permit exclusion of gain where any member holds the stock to which the intercompany gain relates and that member is either (1) B or S and a successor to the other party or (2) a third member that is the successor to both B and S. In the preamble to these rules, the IRS explained that it is appropriate to provide relief where a member other than the common parent holds the subject stock. In general, Reg. Sec. 1.1502-13(c)(6)(ii)(C) applies if, among other requirements:

> (1) S or B becomes a successor to the other (e.g., where S merges into B);
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> (2) immediately before the intercompany gain is taken into account, the successor member holds the stock with respect to which the intercompany gain relates; and

(3) the successor member's basis in the stock reflecting the intercompany gain is eliminated without recognition of gain or loss.

The final regulations retained the Discretionary Rule with certain amendments. Specifically, under Reg. Sec. 1.1502-13(c)(6)(ii)(D), the requested relief can be obtained for intercompany gain only if: (1) B's corresponding item is permanently disallowed or (2) the effects of the intercompany transaction have not been reflected on the group's return and no federal income tax benefit has been derived from the intercompany transaction that gave rise to the intercompany stock gain. The Discretionary Rule provides that a determination by the IRS may be obtained only through a PLR request. Moreover, the Discretionary Rule may be available to exclude intercompany items with respect to any property, not just member stock.

Observations: This PLR illustrates the importance of the Discretionary Rule. Taxpayer's intercompany stock gain could not have been eliminated under the automatic relief rule because Buyer, the target corporation in the proposed merger, owned the Block 2 Shares in Seller 1, which was the acquiring corporation. Because Seller 1 would not become a successor to Buyer until Buyer merged into Seller 1—the same transaction that would trigger the intercompany gain—the requirement in the automatic relief rule that Seller 1 hold the relevant stock immediately before the transaction could not be satisfied. Thus, the Discretionary Rule was crucial to eliminating the gain with respect to the Block 2 Shares. For more information, contact *Pat Pellervo, Marcie Barese, or Lisa Brown*.

Private Letter Rulings

PLR 201211008 – This PLR addresses whether, if a parent corporation repurchases its shares on the open market around the same time as a Section 355 spin-off, any ownership increases resulting from such repurchases would count against the remaining shareholders for purposes of Section 355(e).

Prior to a tax-free spin-off, Distributing had repurchased its own shares in the open market as part of an ongoing program ("Completed Repurchases"). Distributing expected to enter into additional transactions pursuant to its share repurchase program ("Additional Repurchases"). The Completed Repurchases caused the relative interests of Shareholder and Person (two shareholders of Distributing) to increase because they did not participate in the Completed Repurchases and are not expected to participate in the Additional Repurchases. Person had a proxy over Shareholder's shares in

Distributing (the "Proxy"); this arrangement was replicated with respect to the Controlled stock received in the Distribution.

Section 355(e) causes an otherwise tax-free distribution under Section 355 to be taxable to the distributing corporation if the distribution and any other transactions that are part of the same plan result in an acquisition of 50 percent or more of either the distributing corporation or the controlled corporation. This provision is intended to limit a taxpayer's ability to remove assets from corporate solution in a tax-free manner where the form of such transaction resembles a sale.

The facts of the PLR state that the Distribution would be treated as a distribution to which Section 355(e) would apply if the Additional Repurchases exceeded *y* shares of Distributing common stock and the replication of the Proxy with respect to the Controlled stock would result or be deemed to result in an acquisition of stock for Section 355(e) purposes. Moreover, the PLR states that Section 355(e) would apply if each of the Completed Purchases, the replication of the Proxy and the receipt of cash in lieu of fractional shares resulted in an acquisition of stock for Section 355(e) purposes. Nonetheless, the PLR rules that Distributing did not recognize gain in the Distribution.

Observations: This PLR may suggest that in certain circumstances any increases in stock ownership in connection with open market share repurchases prior to a Section 355 spin-off should not count against shareholders for Section 355(e) purposes. The facts specify that section 355(e) would apply to the Distribution if the Completed Repurchases, the Proxy replication, and the receipt of fractional shares resulted in or were deemed to result in an acquisition of stock for Section 355(e) purposes. The PLR states that this consideration was specifically considered in ruling that the Distribution is tax-free to Distributing. Although not entirely clear, this statement seems to suggest that any relative ownership increases resulting from the Completed Repurchases are not counted for Section 355(e) purposes. *For additional information, please contact Tim Lohnes, Gerald Towne or Ruben Conitzer.*

PLR 201213018 - The IRS ruled that a spin-off of a pre-existing controlled corporation qualified under Section 355 even though the controlled corporation subsequently was liquidated for U.S. federal tax purposes.

In this PLR, Parent wholly owned Distributing, which, wholly owned Controlled. Parent, Distributing, and Controlled joined in filing a consolidated federal income tax return with Parent as the common parent of the group. For valid business reasons, Distributing distributed the stock of Controlled to Parent (the "Distribution"). At

least one day later, Controlled converted into a limited liability company that was treated as a disregarded entity for U.S. federal tax purposes (the "Conversion"). The IRS ruled that the Distribution qualified as a tax-free spin-off under Section 355 and that the Conversion qualified as a tax-free liquidation under Section 332.

Observations: A post-distribution liquidation of a controlled corporation into the distributee corporation raises the question as to whether the distribution and subsequent liquidation should be recharacterized under step-transaction principles as a taxable asset distribution. For example, if the controlled corporation is newly formed and subsequently liquidated after the distribution, it is unclear whether such entity's existence should be respected or disregarded as transitory.

In Rev. Rul. 98-27, the IRS concluded that it would not apply the step-transaction doctrine to certain transactions occurring after a Section 355 transaction. This conclusion was premised on legislative history accompanying enactment of Section 355(e), stating that no additional restrictions should be imposed on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation, (H.R. Rep. No. 105-220, at 529-30 (1997)).

Consistent with those authorities, the IRS has permitted lateral mergers of a newly formed controlled corporation following a Section 355 distribution. In recent years, the IRS has permitted upstream mergers and now state law conversions of existing controlled corporations following a spin-off without disqualifying or otherwise recasting the spin-off transaction. The transactions at issue in this PLR are consistent with these authorities. *For additional information, please contact Tim Lohnes, Bruce Decker or Ruben Conitzer.*

PLR 201213013 - The IRS ruled that a partnership's acquisition of certain assets from a target corporation that is a member of a consolidated group, followed by the acquisition of target stock did not constitute a qualified stock purchase ("QSP") within the meaning of Section 338(d)(3). That provision defines a QSP, in relevant part, as a transaction in which stock of a corporation is purchased by another corporation. Consequently, the IRS ruled that the consistency rules of Section 338(e) and Treas. Reg. § 1.338-8 did not apply.

The consistency rules of Section 338(e) and Treas. Reg. § 1.338-8 generally are intended to prevent corporate purchasers and their affiliates from directly acquiring appreciated assets of a target corporation that is a member of a consolidated group, and subsequently purchasing the stock of target during the consistency period (the 12-month acquisition period). The gain recognized on the

initial asset sale will be reflected in the stock basis of the selling corporation, thereby reducing or eliminating gain from the sale of the stock. Generally, when the consistency rules apply, the buyer takes a carryover basis in the purchased assets, thereby preserving gain in the assets. While the consistency rules have been relaxed as a result of *General Utilities* repeal, the IRS remains concerned that certain tax benefits may be achieved through the combined use of the consolidated return regulations and the selective acquisition of assets.

Observations: Because the statutory consistency rules apply only to a QSP, which requires a stock purchase by a corporation, the use of a structure in which a partnership acquires desired assets from a target corporation within a consolidated group, followed by acquisition of target stock by the partnership, may be a useful technique to which those rules do not apply. Furthermore, because the seller in the PLR was part of a consolidated group, the investment adjustment rules may permit the selling corporation to increase its basis in the shares it will sell, thereby reducing or eliminating any additional tax cost. *For additional information, please contact Henry Miyares or Ruben Conitzer.*

PLR 201211009 – The IRS ruled that a stock sale (the "Original Transaction") would be disregarded under the rescission doctrine. In the Original Transaction, two individual Sellers sold 100 percent of Corporation 1, an S corporation, to two individual Buyers. The sellers intended to elect under Section 338(h)(10) to treat the sale of the Corporation 1 stock as a sale of Corporation 1's assets. Following closing, however, the parties discovered that the Section 338(h)(10) election could not be made for the Original Transaction since the purchaser was not a corporation.

The parties unwound the Original Transaction within the same taxable year by transferring Corporation 1 back to the Sellers in exchange for the original consideration and entered into a new transaction whereby a holding company formed by the Buyers purchased Corporation 1 and joined Sellers in making a Section 338(h)(10) election (the "New Purchase Transaction"). Citing Rev. Rul. 80-58, the IRS ruled that the Original Transaction would be disregarded under the rescission doctrine.

Observations: Subsequent to issuance of this PLR but prior to its publication, the IRS announced in Rev. Proc. 2012-3 that it would not issue rulings regarding the rescission doctrine before addressing the doctrine in future published guidance. (For prior coverage, see This Month in M&A — February 2012.) Until such guidance is published, taxpayers should exercise caution in relying on the rescission doctrine to disregard a completed transaction in any situation where application

of Rev. Rul. 80-58 to the facts may be unclear, especially if the rescission is made for tax reasons. *For additional information, please contact Tim Lohnes, Gerald Towne or Kasey Kimball.*

PLR 201212001 – The IRS ruled that no gain or loss would be recognized as a result of a series of transactions in connection with an internal restructuring in which a corporation ("Parent") contributed the stock of a subsidiary, Sub 2, to another wholly owned subsidiary, Sub 1, followed by deemed liquidations of Sub 2 and various lower-tier subsidiaries of Sub 2.

In the PLR, Parent contributed its Business B assets to Sub 2. In turn, Sub 2 contributed these assets to its wholly owned subsidiary, Sub 10. Sub 10 then contributed the Business B assets to Entity 2, its wholly owned subsidiary. Entity 2 wholly owned Sub 14.

After the series of Business B contributions, Parent contributed the stock of Sub 2 to Sub 1, its wholly owned subsidiary. Following that contribution, Sub 14, Entity 2, and Sub 10 consecutively converted to LLCs to be treated as disregarded entities for U.S. federal income tax purposes (the "Lower-Tier Transactions"). Thereafter, Sub 2 merged into Sub 1.

The IRS ruled that the tiered contributions of the Business B assets qualified as tax-free contributions under Section 351 and that the contribution of Sub 2 shares to Sub 1 followed by the merger into Sub 2 would qualify as a reorganization described under section 368(a)(1)(D). The IRS also ruled that no income, gain, deduction, or loss would be recognized in connection with the Lower-Tier Transactions. The IRS did not specify whether these transactions qualified as liquidations under section 332 or, as tiered reorganizations under sections 368(a)(1)(C) or (D), however. In this regard, authorities such as *Resorts International, Inc. v. Commissioner*, 60 T.C. 778 (1973), *George,* 26 T.C. 396 (1956), and Rev. Rul. 68-526 have treated liquidations of a subsidiary following a reorganization of its parent corporation as a lower-tier reorganization.

Observations: The IRS has issued a number of PLRs addressing tiered-entity reorganizations. In PLR 8352016, the IRS had ruled that liquidation of a subsidiary combined with a reorganization of its parent corporation qualified as a reorganization of the lower-tier entity described under section 368(a)(1)(C). In PLR 200706007, the IRS appeared to change course and ruled that the lower-tier entity liquidation qualified as reorganization under Section 368(a)(1)(D).

In PLR 201212001, the IRS did not characterize the Lower-Tier Transactions. These transactions may have qualified as tax-free reorganizations under Sections 368(a)(1)(C) or 368(a)(1)(D) or as liquidations under Section 332.

The IRS also ruled that no gain or loss would be recognized in connection with the contributions of Business B assets to such entities under Section 351. Treating such contributions as Section 351 exchanges is consistent with treating the Lower-Tier Transactions as reorganizations rather than liquidations. Compare Rev. Rul. 78-330 (ruling that a contribution of property to a corporation immediately before its merger into another corporation would be respected) with Rev. Rul. 68-602 (ruling that a contribution of property by a parent corporation to its wholly owned subsidiary immediately prior to its liquidation would be disregarded). Given that these section 351 rulings indicate that the Lower-Tier Transactions should be treated as reorganizations, it is unclear why the PLR does not characterize the transactions as such. *For additional information, please contact Tim Lohnes, Wade Sutton or Kasey Kimball.*

PLR 201210015 - The IRS ruled that a nonlife insurance company that becomes a life insurance company will be includible as a life insurance member of a group including both life insurance companies and other corporations (a "life-nonlife consolidated group") under Section 1504(c)(2).

In the PLR, Parent owned Lifeco, a life insurance company, which owned all the stock of Sub, a "nonlife" company. Sub was formed in Year 3, held investment assets, and was licensed to write insurance but did not conduct an insurance business. In Year 5, Lifeco will contribute additional capital to Sub in a Section 351 transaction (the "Capital Contribution"), and Sub will begin writing insurance contracts that will give rise to life insurance reserves under Section 816(b). Although Sub initially had been a nonlife company, the IRS ruled that Sub will be an eligible and includible member of the life subgroup of the life-nonlife consolidated group.

Observations: The representations made by taxpayer indicate that the eligibility ruling in the PLR was based on the so-called "tacking rule." In general, Section 1504(c)(2) requires a life company to be a member of an affiliated group (determined without regard to the exclusion of life insurance companies under section 1504(b)(2)) for five taxable years before it is treated as an includible corporation in the life subgroup. However, the five-year waiting period effectively is waived if a transfer of assets to a new corporation meets the requirements of Reg. Sec. 1.1502-47(d)(12)(v) (the tacking rule). If the tacking rule applies, the period during which the "old" corporation (Lifeco) was a member of the group is included in (or "tacks onto") the period for the "new" corporation (Sub).

Note that, for purposes of the tacking rule, the IRS treated Sub as a "new" corporation—and not a nonlife corporation—even though Sub

had been in existence and had held investment assets (compare PLR 201213012, discussed below, in which the IRS stated that a corporation that held only investment assets would be treated as a nonlife company). Presumably, the IRS did not view the mere holding of investment assets as inconsistent with the policies of Section 1504(c)(2) and the tacking rule. If the IRS had rigidly applied the language of the regulations, the tacking rule might not have applied, and Sub could not have joined the life-nonlife group for an additional five taxable years.

This PLR illustrates an IRS willingness in appropriate circumstances to provide relief from the harsh results that otherwise would be produced by the life-nonlife regulations. Consolidated groups filing life-nonlife consolidated returns should consider the PLR process as a potential means of obtaining relief when the operation of Reg. Sec. 1.1502-47 produces unfavorable results that would be inconsistent with the purposes of Sections 1503(c)(2) and 1504(c)(2). *For additional information, please contact Pat Pellervo, Marcie Barese or Lisa Brown.*

PLR 201213012 - The IRS granted a waiver under Section 1504(a)(3)(B) permitting a parent successor to the parent of a life-life consolidated group to become the common parent of an affiliated group filing a consolidated return. In the PLR, Taxpayer was a member of a consolidated group (the "Old Group") and was a wholly owned subsidiary of Old U.S. Parent. Taxpayer owned all the stock of Sub 1.

In Month 1, Year 1, Taxpayer acquired all the stock of Sub 2, which owned Sub 3. For Year 1, Sub 2 and 3 filed a separate consolidated return including only life insurance companies (a "life-life consolidated return"). Shortly thereafter (also in Year 1), Taxpayer formed Sub 4, a life insurance company, and contributed the stock of Sub 2 to Sub 4.

Because the contribution met the requirements of a reverse acquisition under Reg. Sec. 1.1502-75(d)(3), Sub 4 became the common parent of the life-life consolidated group that included Sub 2 and Sub 3 beginning in Year 2. Subsequently, Sub 4 distributed the stock of Sub 2 to Taxpayer (and Sub 2 and Sub 3 filed a life-life return for a short period), and Sub 4 liquidated into Taxpayer. Old US Parent then sold Taxpayer to Old Foreign Parent; as a result, Taxpayer became the common parent of an affiliated group that included Sub 1.

The IRS stated that because Taxpayer was a successor to Sub 4 as a result of the liquidation, under Section 1504(a)(3)(A) Taxpayer could not be included in any consolidated return with a common parent that is a successor to Sub 4 for five years after Sub 4's deconsolidation. Based on the representation made by Taxpayer, the IRS granted the

waiver, permitting Taxpayer to become the common parent of the consolidated group.

Observations: This PLR highlights the importance of the five-year restriction on reconsolidation following a deconsolidation, and in particular, the potential impact of Section 1504(a)(3) when members are combined in Section 381 transactions. *For additional information, please contact Pat Pellervo, Marcie Barese or Lisa Brown.*

PwC M&A Publications

WNTS authors Wade Sutton and Matt Michaelangelo discuss the surprising interaction of the consolidated intercompany transaction rules to nonqualified preferred stock issued in reorganizations and redemptions in an article published in Corporate Taxation: "Nonqualified Preferred Stock in Intercompany Redemptions and Reorganizations: An Accident of History Waiting to Happen" (March/April 2012).

This Month's WNTS Editors

Tim Lohnes, Partner	*(202) 414-1686*
Wade Sutton, Director	*(202) 346-5188*
Marcie Barese, Manager	*(202) 414-4330*
Lisa Brown, Manager	*(202) 312-7681*
Ruben Conitzer, Senior Associate	*(202) 312-7687*
Kasey Kimball, Senior Associate	*(202) 312-7605*

This Month's WNTS Contributors

Henry Miyares, Partner	*(202) 312-7595*
Pat Pellervo, Principal	*(415) 498-6190*
Bruce Decker, Director	*(202) 312-1306*
Jerry Towne, Director	*(202) 346-5153*