This Month in M&A

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This Month's Features

- IRS makes significant changes in applying section 367(d) to outbound asset reorganizations (Notice 2012-39)
- Monetizing spin-off in connection with reverse Morris Trust transaction (PLR 201228033)
- IRS accepts crossing consideration representation outside of a spin-off transaction (PLR 201229002)
- Section 338(h)(10) election available and section 197(f) anti-churning rules held not to apply to multi-step transaction (PLR 201228011)
- Penny warrants treated as stock in spin-off (PLR 201223008)
- Cooperative's patronage dividend deduction deferred under section 267(f) (CCA 201228035)

Did you know…?

On July 13, the IRS issued Notice 2012-39, significantly changing how section 367(d) applies with respect to transfers of intangible property in certain outbound asset reorganizations. The new rules reflect IRS concerns that such transactions could facilitate tax-free repatriation of foreign earnings.

The IRS plans to issue regulations incorporating the guidance in the Notice. Because those regulations will apply retroactively to transfers occurring on or after July 13, 2012, taxpayers should consider the impact of the Notice on current transactions. Notice 2012-39 also states that "no inference is intended as to the treatment of transactions described in the notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines."

Background

Generally, pursuant to section 361, a corporation that transfers property (the transferor) to an acquiring corporation (the acquiror) in an asset reorganization in exchange for stock or other property (boot) does not recognize gain or loss. However, section 367 may cause such a transfer to be taxable if the transferor is domestic and the acquiror is foreign. For example, section 367(a) may result in immediate gain recognition with respect to certain asset transfers, subject to various exceptions.

Section 367(d) applies if a U.S. transferor transfers "intangible property," within the meaning of section 936(h)(3)(B), to a foreign acquiror in a section 351 or 361 transaction. In that case, the U.S. transferor is treated as having sold the intangible property in exchange for payments that are contingent on the productivity, use, or disposition of the property under section 367(d)(2)(A). The U.S. transferor generally must recognize royalty income annually over the useful life of the property in an amount "commensurate with the income attributable to the intangible." The acquiror can either currently pay the amount of the deemed royalty to the U.S. person recognizing such income or may maintain accounts payable to account for the deemed royalty income under Reg. sec. 1.367(d)-1T(g)(1)(i) without additional U.S. tax.

Notice 2012-39 makes substantial changes to the existing treatment of outbound asset reorganizations under section 367(d).

Boot in an outbound reorganization

The Notice includes an example illustrating the IRS's repatriation concerns. USP, a domestic corporation, owns all the stock of UST, also a domestic corporation, with a fair market value and stock basis of $100x. UST's sole asset is a patent with a tax basis of zero. In an outbound reorganization under section 368(a)(1)(D), UST transfers the patent to TFC, a controlled foreign corporation wholly owned by USP, in exchange for $100x. Thereafter, UST transfers the $100x to USP in liquidation.

In the example, USP takes the position that under section 356 it does not recognize income with respect to its receipt of $100x because there was no gain in the UST shares at the time of the reorganization. In addition, as USP includes deemed royalty income under section 367(d) over the useful life of the patent, it establishes receivables from TFC in the amount of the income inclusions and claims that the establishment and repayment of such receivables do not result in income pursuant to Reg. sec. 1.367(d)-1T(g)(1)(i). The IRS views this transaction as a repatriation abuse that is facilitated by the rules of section 367(d). However, many observers view section 356's boot-within-gain limitation as the provision that actually facilitates repatriation in this type of transaction.

To curtail the perceived repatriation abuse in such transactions, the Notice provides that section 367(d) applies to boot received in an outbound reorganization to the extent that the U.S. transferor transfers intangible property in the reorganization. Specifically, the allocable portion of such boot is treated as a prepayment of the section 367(d) royalties and is currently taxable to the U.S. transferor (the deemed prepayment), "regardless of the productivity of the transferred section 367(d) property in the year of the transfer or in subsequent years." Using the facts of the above example, the $100x received by USP from TFC would be treated as royalty income to UST, and thus be taxable currently in the U.S. tax return.

The deemed royalty prepayment also includes "non-qualifying liabilities" of the U.S. transferor, which are liabilities that are assumed by the foreign acquiror in the reorganization or are satisfied by the U.S. transferor with money. Non-qualifying liabilities do not include liabilities:

- that were incurred in the ordinary course of business;
- that did not arise in connection with the reorganization; and
- that are owed to persons to whom the U.S. transferor was not related within the meaning of section 267(b) or section 707(b) immediately before the reorganization.

The amount of non-qualifying liabilities also is increased (but not in excess of the U.S. transferor's total liabilities) by the amount of distributions with respect to its or a predecessor's stock (including redemptions) during the two-year period preceding the reorganization.

Qualified successors

Separate from the royalty prepayment characterization, the Notice also can require gain recognition in outbound reorganizations where there is solely stock consideration.

Notice 2012-39 provides that a qualified successor to the U.S. transferor must take into account income attributable to its proportionate share of the contingent annual payments that the U.S. transferor would have been treated as receiving under section 367(d) had the U.S. transferor remained in existence and had the U.S. transferor not recognized any income under the

Notice. However, a qualified successor may exclude from gross income its proportionate share of the amount of any deemed prepayment included in income by the U.S. transferor (the credit amount) until the cumulative amount of the section 367(d) royalties exceeds the credit amount. A qualified successor may establish accounts receivable for any deemed royalties included in income in excess of the credit amount.

A qualified successor is defined as a domestic corporation (other than a regulated investment company, real estate investment trust, or S corporation) that either receives stock of the foreign acquiror in connection with the reorganization or owns previously issued stock of the foreign acquiror.

To the extent that the U.S. transferor's shareholders are not qualified successors, the U.S. transferor must include in income an amount equal to the sum of the ownership percentages of all non-qualified successors multiplied by the amount of gain realized by the U.S. transferor with respect to the transferred intangible property.

New triggering event

Under the current section 367(d) regulations, certain direct or indirect transfers of intangible property can result in deemed sale treatment. For example, if a U.S. transferor disposes of the stock of the foreign transferee corporation, the U.S. transferor is treated as having sold the intangible property to such unrelated person, recognizing gain (but not loss) under Reg. sec. 1.367(d)-1T(d)(1). The U.S. transferor may offset any gain recognized with respect to the stock of the foreign acquiring corporation by the amount of gain recognized in the deemed sale. Notice 2012-39 proposes to expand this rule dramatically to transfers of the foreign acquiror's stock to related foreign parties.

Observations

This significant change could result in unexpected consequences in several transactions that do not fall within the IRS stated policy objective. For example, if a qualified successor transfers the stock of the foreign acquiror to a wholly-owned foreign subsidiary during the useful life of the transferred intangible property in a transaction otherwise qualifying as a non-taxable section 351 exchange, that transfer would trigger the deemed sale provisions of Reg. sec. 1.367(d)-1T(d)(1). Reg. sec. 1.367(d)-1T(c)(3) provides that the useful life of intangible property may be as long as 20 years. Thus, the Notice would discourage transfers of the stock of the foreign acquiror during this time.

Where the deemed sale rule applies, the qualified successor is not permitted to establish accounts receivable under Reg. sec. 1.367(d)-1T(g)(1)(i) in respect of the gain recognized in the deemed sale transaction even though the qualified successor does not receive any consideration with respect to the deemed sale. At the same time, the Notice would permit a U.S. transferor or qualified successor to further offset any gain recognized under the deemed sale rule by any unused credit amount arising from a deemed prepayment.

IRS request for comments

The IRS requests comments on the regulations to be issued under Notice 2012-39, including whether certain domestic corporations that are related to the U.S. transferor but not subject to the qualifying successors rules in the Notice nevertheless should be subject to those rules. For example, the IRS is considering whether those rules should apply to transactions in which a domestic corporation is not a qualified successor because it indirectly owns the U.S. transferor through a controlled foreign corporation. In addition, comments are requested as to the proper recovery of basis in the section 367(d) property transferred.

Unanswered Questions

The Notice raises several questions. By requiring immediate income recognition with respect to a deemed prepayment, the Notice arguably extends the application of section 367(d)(2)(A)(ii)(I) beyond the statute's commensurate-with-income standard. That provision states that the section 367(d) royalty should be taken into account "annually in the form of such payments over the useful life of such property."

The Notice does not address a number of other issues, including:

(1) Should the U.S. transferor or a qualified successor be entitled to a loss or deduction if the deemed royalties over the life of the 367(d) intangible property are less than the deemed prepayment amount;

(2) What effect should the deemed prepayment have on the basis of a U.S. transferor's stock under the consolidated return rules -- e.g., under the investment adjustment rules of Reg. sec. 1.1502-32;

(3) When should the foreign acquiror reduce its earnings and profits with respect to the deemed royalty amount -- at the time of the deemed prepayment, which is consistent with section 367(d)(2)(B), or over the useful life of the intangible property;

(4) What adjustments, if any, should be made to account for the U.S. transferor's basis in the intangible property; and

(5) Does the deemed prepayment retain its character as boot in the reorganization subject to section 356, potentially resulting in the over inclusion of income, or, rather, is the deemed prepayment removed from reorganization treatment altogether?

It is unclear when the IRS will issue regulations implementing the Notice's guidance. Until then, taxpayers continue to face considerable uncertainty regarding these and other issues. *For more information, please contact Timothy Lohnes, Marty Collins, Wade Sutton, or Kasey Kimball.*

Private Letter Rulings

PLR 201228033 - The IRS ruled that in a Reverse Morris Trust transaction no gain or loss was recognized by a distributing corporation (Distributing) that contributed property to a newly formed controlled corporation (Controlled) in exchange for cash, Controlled securities, and Controlled stock, and then distributed or exchanged such property as part of the transaction. Following the distribution, Controlled was acquired by an unrelated third party (Merger Partner) in a tax-free reorganization, completing the Reverse Morris Trust transaction. Because the taxpayer represented that the distribution was not part of a plan or series of related transactions that would violate section 355(e), it appears that the former shareholders of Controlled received Merger Partner stock representing at least 50 percent of the vote and value of Merger Partner.

Immediately before engaging in the D/355 spin-off of Controlled, each of Distributing and Controlled borrowed funds from a financial institution (the Financial Institution). Thereafter, Distributing contributed property to Controlled in exchange for Controlled common stock, Controlled debt securities, and the cash Controlled had borrowed from the Financial Institution (the Contribution).

The amount of cash received by Distributing from Controlled was less than or equal to Distributing's net basis in the property transferred to Controlled and was used by Distributing to pay creditors or to pay dividends to shareholders within one year following the spin-off. Within a specified time after issuance of the Distributing debt to the Financial Institution, Distributing repaid the debt with the Controlled securities (the Debt Exchange).

The IRS held that Distributing did not recognize gain or loss as a result of the Contribution under section 361(b)(3) or as a result of the Debt Exchange under section 361(c)(3).

Observations: In the context of a D/355 spin-off, to the extent that a controlled corporation distributes cash or other property to the distributing corporation in excess of the distributing corporation's net basis in the property transferred to the controlled corporation, the distributing corporation recognizes gain under section 361(b)(3). However, a distributing corporation generally does not recognize gain under section 361(c)(3) when it transfers a controlled corporation's securities to its creditors in retirement of its debt, even if the value of those securities exceeds the distributing corporation's net basis in the property transferred to the controlled corporation.

Legislation has been proposed that would treat distributions of a controlled corporation's debt securities in a D/355 transaction in the same manner as distributions of cash or other property. *See,* e.g., H.R. 6152, The Bring Jobs Home Act. (A similar proposal was included in earlier versions of H.R. 4348, the surface transportation bill, but not in the final version as recently enacted.) *For additional information, please contact Derek Cain, Jerry Towne, or Meryl Yelen.*

PLR 201229002 - In connection with a D/355 spin-off, the taxpayer made a so-called "crossing consideration" representation with respect to a transaction between the shareholders of the distributing corporation. Unique to this ruling was that the "crossing consideration" was not within the spin-off transaction itself, but rather in an ancillary step of the transaction. The IRS did not explicitly address the crossing consideration issue in the PLR.

In the PLR, a U.S. parent corporation and members of its consolidated group-including U.S. Sub 4-owned all of the stock of U.S. Sub 1, which had multiple classes of stock outstanding. For U.S. federal income tax purposes, U.S. Sub 1 and U.S. Sub 4 wholly owned a foreign distributing corporation (Distributing). Distributing wholly owned a foreign controlled corporation (Controlled).

The taxpayer undertook the following steps: (i) U.S. Sub 1 distributed cash to U.S. Sub 4 (the U.S. Sub 1 Cash Distribution); (ii) U.S. Sub 4 contributed to U.S. Sub 1 its shares of Distributing stock in exchange for U.S. Sub 1 tracking stock of equal value (the U.S. Sub 1 Contribution); (iii) Distributing contributed property to Controlled (the Controlled Contribution); and (iv) Distributing made a pro rata distribution of the stock of Controlled (the Spin-Off).

The taxpayer represented that there was no regulatory, legal, contractual, or economic compulsion or requirement that U.S. Sub 4 make all or part of the U.S. Sub 1 Contribution as a condition to the U.S. Sub 1 Cash Distribution.

Observations: The IRS has accepted this "crossing consideration" in the context of determining whether a spin-off is tax free (*see*, e.g., PLRs 201119002, 201106004, and 201034005). However, this PLR is the first instance of the IRS accepting this representation in more general "crossing consideration" matters. *For additional information, contact Derek Cain, Bruce Decker, or Meryl Yelen.*

PLR 201228011 - The IRS ruled that a taxpayer could make a section 338(h)(10) election as part of a multistep divestiture and that the anti-churning rules of section 197(f) would not apply to such transactions.

Seller, which is part of the taxpayer's consolidated group, proposed to create a new company (Newco), transfer to Newco all of Target's common stock, and pursuant to a binding commitment dispose of greater than 20 percent of its Newco stock in an IPO. As a result of this binding commitment, Seller's transfer of Target to NewCo did not qualify as a section 351 exchange and, consequently, was a taxable exchange of the Target stock for NewCo stock.

The taxpayer represented that there was a plan to reduce its ownership in Newco to under 50 percent and eventually to under 20 percent within a set number of months through a series of transactions including following-on public offerings, privately negotiated sales, and alternative additional transactions.

In connection with the transaction, Seller and Newco will make a section 338(h)(10) election, and Parent will make a Reg. sec. 1.1502-13(f)(5)(ii)(E) election to recognize loss on the deemed liquidation of Target in connection with the section 338(h)(10) election.

Observations: While the proposed transaction contains a binding commitment to dispose of more than 20 percent of the Newco stock for purposes of breaking section 368(c) control (relevant to avoid section 351 treatment on the transfer from Seller to NewCo), there was no binding commitment to dispose of sufficient interests to reduce Seller's ownership in Newco to under 50 percent and eventually to 20 percent or lower.

Section 338 permits taxpayers to elect to treat a qualified stock purchase (a QSP) as a deemed sale of assets. To qualify as a QSP, the buyer and the seller of the target stock may not be related persons (as relevant here, 50-percent common ownership under the attribution rules of section 318). Reg. sec. 1.338-3(b)(3)(ii)(C) permits a broad application of the step-transaction doctrine by testing relationships at the end of transactions occurring pursuant to an integrated plan. Thus, the PLR permits the taxpayer to test relatedness for purposes of section 338 after Seller's planned dispositions of its interest in Newco to below 50 percent.

The anti-churning rules of section 197(f)(9) prevent taxpayers from selling non-amortizable section 197 intangibles to related parties (generally, more than 20-percent common ownership) and claiming amortization deductions with respect to the stepped-up basis in such intangibles. The 197(f) regulations provide a similar broad application of the step-transaction doctrine to that of section 338 for purposes of testing relationships. For a detailed discussion of the application of that doctrine in a similar transaction, *see* This Month in M&A - June 2012. *For additional information, contact Tim Lohnes, Julie Allen, or John Quint.*

PLR 201230008 - In this supplemental ruling, the IRS applied Rev. Rul. 82-150 and Rev. Rul. 85-87 to treat certain Distributing penny warrants as stock for U.S. federal income tax purposes. Those revenue rulings treated deep-in-the-money options as equity interests in the issuer, rather than respecting the form of the instruments as options on the issuer's stock. In a prior PLR, the IRS had determined that Distributing's distribution of Controlled stock to its shareholders qualified as a tax-free D/355 spin-off. Accordingly, the distribution of Controlled stock to the warrant holders in the spin-off was treated as a distribution with respect to stock for purposes of section 355.

Observations: If the IRS had determined the warrants were securities (and not stock), the distribution of Controlled stock to the warrant holders likely would have been a taxable distribution because the warrant holders did not surrender any warrants in the transaction. In this regard, section 355(a)(1)(A) requires Controlled stock to be exchanged for Distributing securities, whereas Controlled stock may be distributed with respect to Distributing stock.

In a limited number of other letter rulings, the IRS has treated in-the-money options (or other derivatives) as stock. For example, in a section 382 context, without citing to Rev. Rul. 82-150 or Rev. Rul. 85-87, warrants were treated as stock for purposes of determining the section 382 limitation of a consolidated group. In addition, the IRS has issued a consistent ruling in the context of a prior section 355 transaction (*see* PLR 9747021). *For additional information, contact Henry Miyares, Jerry Towne, or John Quint.*

Other Guidance

Notice 2012-39 – See Did You Know

CCA 201228035 – The IRS applied section 267 to defer a cooperative's patronage dividends-paid deductions until the cooperative's patrons included the dividends in income.

A cooperative that pays annual dividends to its patrons within eight and one-half months of its year-end may deduct the amount paid in the tax year prior to payment in accordance with section 1382(a). The patrons, on the other hand, do not report the income until the dividend is received in accordance with section 1385(a). Thus, the cooperative rules permit a mismatch between the timing of dividends-paid deductions and the corresponding inclusion of dividend income.

In this CCA, the cooperative's patrons were members of a consolidated group and related controlled foreign corporations, which owned 55 and 45 percent of the cooperative, respectively. Although the cooperative and its related patrons each used an overall accrual method of accounting, the CCA stated that the treatments of the patronage dividends as provided by sections 1382(a) and 1385(a) were methods of accounting within the meaning of Reg. sec. 1.446-1(e)(2)(ii)(a).

Based on its conclusion that cooperative rules constituted methods of accounting, the IRS took the position that the cooperative's dividends-paid deductions would be deferred to the date the dividends are included in the gross income of the related patrons under section 267(a)(2), which applies where two related parties apply different methods of accounting that would otherwise result in the deduction of an item before the inclusion of the related income.

The IRS also analyzed the patronage dividends under the deferral regime of section 267(f) and determined that the patronage dividends were "intercompany sales" for purposes of Reg. sec. 1.267(f)-1(b)(1), resulting in the deferral of the cooperative's deduction under the matching principles of Reg. sec. 1.1503-13 until the patrons took the dividend income into account.

In addition, the IRS discussed the potential applicability of section 267(a)(3) to defer deductions on the amounts owed to the related foreign persons but stated that the facts were insufficient to determine if any of the exceptions to section 267(a)(3) applied.

Observations: In CCA 201044003, the IRS challenged a similar transaction under the consolidated return anti-abuse rule of Reg. sec. 1.1502-13(h) to treat a cooperative otherwise excluded from a consolidated group as a member of the consolidated group. That CCA did not analyze section 267. In the new CCA, it appears that the consolidated anti-abuse rule could not have applied because more than 20 percent of the cooperative was owned by non-includible foreign corporations. *See* This Month in M&A - December 2010/January 2011 for a discussion of CCA 201044033 and the application of Reg. sec. 1.1502-13(h) anti-abuse rules to a cooperative.

Also, even though the cooperative accounting rules specifically allow deferral, the IRS believes that the timing difference between the cooperative's deduction and the patrons' income is inappropriate where related parties are involved. *For additional information, contact Tim Lohnes, Rob Black, or John Quint.*

PwC M&A Publications

WNTS author Monte A. Jackel provides a survey of the many authorities that have addressed the aggregate-entity partnership question in the July 30, 2012 issue of Tax Notes, "Aggregate and Entity in the Partnership World."

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