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This Month in M&A

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This Month's Features

- Unreasonable redemption premium under sections 305 and 1504 (CCA 201152016)
- Temporary regulations on interest expense allocation and apportionment (T.D. 9571)
- Tax Court finds Offshore Portfolio Investment Strategy transaction lacked economic substance (*Blum v. Comm'r*)
- Tax Court rules section 1060 and the *Danielson* rule preclude modifications to purchase price allocations (*Peco v. Comm'r*)
- Second Circuit holds two foreign banks do not qualify as partners under section 704(e)(1) (*TIFD III-E, Inc. v. U.S.*)
- Assignment of controlled stock to an affiliate corporation treated as a D/355 reorganization (PLR 201152008)
- Transaction qualifies as a QSP because spin-off severs the "attributive link" between Buyer and Seller (PLR 201203004)
- IRS updates no-rulings list (Rev. Proc. 2012-3)
- IRS issues Form 8937, *Report of Organizational Actions Affecting Basis of Securities*

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Did you know...?

In recent guidance, the IRS ruled that the payment of unpaid accumulated dividends in redemption of cumulative preferred stock does not constitute an unreasonable redemption premium for purposes of section 1504(a)(4)(C), although the accrued dividends constituted an unreasonable redemption premium under section 305(c).

Under the facts of CCA 201152016, a corporate taxpayer ("Taxpayer") owned a class of voting and nonvoting preferred stock (the "Preferred Stock") of a corporation, which was majority-owned by a bank. The terms of the Preferred Stock provided for a fixed dividend rate that compounded daily; payment of cash dividends in the first two years; and accrual of dividends thereafter, payable only at redemption (the "Accrued Dividends").

Pursuant to sections 305(b)(4) and 305(c), Taxpayer reported the Accrued Dividends as income in the year accrued and claimed an 80-percent dividends received deduction ("DRD") under section 243(c). The IRS disallowed the DRD on the ground that the Preferred Stock constituted section 1504(a)(4) preferred stock, which is not taken into account in determining ownership under section 243(c); therefore, Taxpayer did not possess the requisite ownership entitling it to the 80-percent DRD.

Classification as Section 1504(a)(4) preferred stock

Section 1504(a)(4) preferred stock is defined as stock that, among other characteristics (not at issue in the CCA), has redemption and liquidation rights which do not exceed the issue price of the stock (except for a reasonable redemption or liquidation premium). *See* section 1504(a)(4)(C). Stated differently, section 1504(a)(4) preferred stock is stock that does not have an unreasonable redemption premium.

In the CCA, Taxpayer took the position that the portion of the redemption payment attributable to the unpaid and accumulated dividends received in exchange for the Preferred Stock constituted an unreasonable redemption premium and therefore precluded the Preferred Stock from constituting section 1504(a)(4) preferred stock. Taxpayer argued that because the payment would have been an unreasonable redemption premium under section 305(c), it should be treated similarly under section 1504(a)(4)(C).

The IRS responded that there is no indication in the legislative history of section 1504(a)(4)(C) to support such a conclusion. Further, the IRS noted that the section 305(c) regulations were adopted to prevent a corporation from using redemption premiums to pay its preferred shareholders the equivalent of dividends that would be taxed at capital gains rate, while section 1504(a)(4) seeks to separate preferred stock that is limited in nature from preferred stock that shares in corporate growth. Thus, the IRS concluded, the existence of an unreasonable redemption premium for purposes of section 305(c) is not dispositive under section 1504(a)(4)(C).

In concluding that the redemption payment, specifically the portion attributable to the accumulated dividends, did not constitute an unreasonable redemption premium, the IRS referred to PLR 200329028. In that PLR, the IRS ruled that the redemption of preferred stock with proceeds equal to the stock's issue price, plus unpaid dividends, did not constitute an unreasonable redemption premium for purposes of section 1504(a)(4)(C). Applying the rationale of that PLR, the IRS stated in the CCA that after offsetting the Accrued Dividends that already had been reported in income under section 305(c) against the price paid at redemption, the Preferred Stock clearly was redeemed at its issue price. Accordingly, the IRS said, an unreasonable redemption premium did not exist, and thus the Preferred Stock constituted section 1504(a)(4) preferred stock.

Observations: While the CCA concludes that the Accrued Dividends did not increase the redemption price of the Preferred Stock for purposes of section 1504(a)(4)(C), that determination should not be dispositive as to whether, under section 305(c), the Accrued Dividends should be treated as increasing the redemption price and giving rise to a redemption premium.

Neither section 305 nor the regulations thereunder address whether accumulated and unpaid dividends should be treated as increasing the redemption price on preferred stock, thus creating a redemption premium. The legislative history to section 305 suggests that such dividends should be included in the redemption price if, at issuance of the cumulative preferred stock, there is no intention by the issuer to pay dividends currently. *See* H.R. Rep. No. 881, 101st Cong., 2d Sess. 347, 348. However, where there is an intention to pay dividends, or where the preferred stock has no redemption date (i.e., evergreen preferred), it appears that dividend accruals under section 305(c) should not be required. *For more information, please contact Tim Lohnes or DiAndria Green.*

Treasury Regulations

Section 861 Interest Expense Allocation Regulations (T.D. 9571, REG-113903-10)

The IRS recently issued temporary regulations (T.D. 9571, REG-113903-10) under section 861 (computation of U.S.-source income) on allocation and apportionment of interest expense for corporations owning a 10-percent or greater interest in a partnership, as well as on allocation and apportionment of interest expense using the fair market value ("FMV") method. The temporary regulations generally apply for taxable years beginning after January 17, 2012. The text of the temporary regulations also was issued as proposed regulations. A public hearing on the proposed regulations is scheduled for April 3.

Reg. sec. 1.861-9T(e) provides rules governing apportionment of interest expense by a partner in a partnership. The existing temporary regulations were revised to clarify that a corporate partner with a 10-percent or greater interest in a partnership must allocate its interest expense to all its assets,

including its proportionate share of partnership assets. Thus, when a corporate partner with a 10-percent or greater interest in a partnership uses either the tax book value or the FMV method to allocate interest expense, it looks to the partnership's inside basis in its assets when allocating interest expense, including any section 734(b) or 743(b) basis adjustments.

The new temporary regulations also modify Reg. sec. 1.861-9T(h)(4) to include related-party debt as an asset when using the FMV method. Under the revision, related-party debt is taken into account (1) as an asset in the hands of the creditor and (2) in the valuation of the stock of a related person. That is, the taxpayer's pro rata share of related-party debt held by the related person is included for purposes of valuing the stock in a related person. The revisions are intended to clarify that both the receivable and the payable sides of related-party debt are to be included for valuation purposes under the FMV method.

The revisions also reflect statutory changes to section 864(e), providing that certain foreign corporations are treated as affiliated corporations for allocating and apportioning interest expense.

Observations: The change in the method for determining asset value under the FMV method was formulated in response to taxpayer positions that ran counter to the IRS's interpretation of the then-existing rules. In particular, the preamble states that some taxpayers have taken the position that the requirement that related-party debt be excluded as an asset means that such debt is not treated as an asset in the hands of the taxpayer at all for purposes of determining asset value under the FMV method.

Changes to the application of the FMV method are targeted to a particular set of tax planning techniques involving controlled foreign corporations; however they may be deemed to affect a wider population of taxpayers that have related-party debt arrangements. *For additional information, contact Craig Gerson or Lisa Wamboldt.*

Court Watch

***Blum v. Comm'r*, T.C. Memo 2012-16 (Jan. 17, 2012)** – The Tax Court concluded that an Offshore Portfolio Investment Strategy ("OPIS") transaction lacked economic substance and that taxpayers were liable for accuracy-related penalties under section 6662(a) for gross valuation misstatements and negligence.

The Tax Court found that the basis-shifting nature of the OPIS transaction was designed to create significant capital losses to offset capital gains generated from a prior stock sale and that the series of steps within the transaction was a "subterfuge to orchestrate a capital loss." Thus, rather than analyze each step separately, the Tax Court focused on the economic substance doctrine in the OPIS transaction.

The Tax Court concluded that the prearranged steps were designed and intended solely to generate an artificial loss to offset the prior capital gain;

that the facts did not support the taxpayer's claim that he invested for profit; and that any profit potential was "miniscule" compared to the loss. Accordingly, the losses were disallowed because the transaction lacked economic substance. In addition, the Tax Court held that under the facts of the case, the taxpayer could not rely on an opinion from his tax advisor to avoid penalties.

Observations: In Notice 2001-45, the IRS classified the OPIS transaction as a listed transaction. This case was the first OPIS transaction analyzed by the Tax Court. *For more information, please contact James Prettyman or Matthew Michaelangelo.*

***Peco Foods v. Comm'r*, T.C. Memo 2012-18 (Jan. 17, 2012)** – The Tax Court held that, following a taxable asset acquisition, the taxpayer was bound by the terms of its written, agreed-upon section 1060 purchase price allocation.

Section 1060 prescribes special allocation rules to determine the buyer's basis in the assets acquired in a taxable asset acquisition and the seller's gain or loss arising from such acquisition. In general, under section 1060, once the parties to the acquisition agree in writing as to the allocation of consideration, that agreement is "binding" on the buyer and the seller. Thus, without bilaterally agreed amendments to the allocations, taxpayers generally are precluded from modifying the prescribed allocation schedule at a subsequent date.

Under *Comm'r v. Danielson*, 378 F.2d 771 (3d Cir. 1967), a taxpayer may challenge the tax consequences of its written agreement as construed by the IRS "only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc."

In this Tax Court case, buyer and seller had engaged in a taxable asset acquisition and signed an agreement allocating the purchase price among the different asset classes "for all purposes (including financial accounting and tax purposes)." A subsequent cost segregation study conducted by the buyer - determining potential for additional depreciation expenses through a different allocation schedule - was rejected by the Tax Court since the buyer was bound by the original allocations.

Observations: This case illustrates the importance of conducting a cost segregation study prior to agreeing to a section 1060 allocation in order to avoid possible lost tax savings. In the instant case, although the accounting method change was automatic, the buyer was bound by the original allocation schedule and could not claim accelerated depreciation deductions on the basis of the cost study. *For more information, please contact Bart Stratton or Matthew Michaelangelo.*

TIFD III-E, Inc. v. U.S., No. 10-70-cv (2d Cir. 2012) – Once again, the U.S. Court of Appeals for the Second Circuit reversed the District Court's decision in this case (known as *Castle Harbour*) and held that under section

704(e)(1), certain partnership interests "overwhelmingly in the nature of secured debt" are not capital interests in a partnership under section 704(e)(1) because there was no bona fide equity participation.

In its initial 2004 decision, the District Court had ruled that a partnership ("Castle Harbour") formed between three subsidiaries of General Electric Capital Corporation ("GECC") and a group of foreign banks should be respected as a partnership. The overall economic impact of the partnership arrangement was to allocate income away from GECC to the foreign banks, which were not subject to U.S. income tax. The IRS attacked the arrangement on three grounds: (1) it was a sham; (2) the foreign banks were lenders and not partners; and (3) the allocations lacked substantial economic effect.

The Second Circuit reversed and remanded the 2004 decision, concluding that the District Court had erred by not assessing the economic realities in determining whether the investment by the foreign banks was debt or equity. The appellate court found that both the downside and upside of the foreign banks' investment were limited, and therefore the interest was not a bona fide equity interest. The appellate court concluded that the Supreme Court's decision in *Culbertson* setting forth the "totality-of-the-circumstances" test mandated that outcome, but remanded the case back to the District Court to consider the application of section 704(e).

On remand, the District Court held that under section 704(e)(1), the foreign banks' interest was an equity interest. The District Court stated that *Culbertson* and section 704(e)(1) are alternative tests to determine the characterization of partnership interests for tax purposes. The District Court cited two other Second Circuit decisions for establishing the Second Circuit's position that debt-like instruments can be considered equity (*Comm'r v. O.P.P. Holding* and *Jewel Tea Co. v. U.S.*).

In January 2012, the Second Circuit reversed the District Court's second decision, and held that the foreign banks' interest was not a capital interest under section 704(e)(1) because it was not bona fide equity participation but was "overwhelmingly in the nature of secured debt."

Referring back to its original analysis that the foreign banks had no real risk of downside loss or upside gain in the partnership, the Second Circuit disagreed with the District Court's application of section 704(e)(1), stating that the test still was whether the foreign banks' interests were considered equity. In footnote eight of its opinion, the appellate court noted that whether the *Culbertson* test replaces section 704(e)(1) is relevant only if the taxpayers would have an equity interest in the partnership, which was not the situation in this case.

The Second Circuit also imposed a section 6662 penalty for substantial understatement of income. The appellate court disagreed with the District Court's reliance on the decisions in *O.P.P. Holding Corp.* and *Jewel Tea* to justify that interests that have debt-like features nonetheless may be treated as equity. The appellate court stated that neither case supported treating an

interest that is “overwhelmingly in the nature of a secured lender’s interest” as equity.

The Second Circuit similarly rejected the proposition that the *Dyer* and *Slifka* decisions allow partners to treat their interests as equity if their partnership has a valid business purpose. The appellate court held that the business purpose for the partnership was not relevant in this analysis. Instead, the key question was whether the interests are more properly treated as debt or equity. The Second Circuit concluded that the taxpayer failed to identify substantial authority to support treating the banks as partners under this test. *For more information, please contact Craig Gerson or Lisa Wamboldt.*

Private Letter Rulings

PLR 201152008 - Where a domestic corporation assigned the stock of its subsidiary, the IRS treated the assignment as a section 355 spin-off of the subsidiary to an affiliate, followed by a series of deemed distributions and contributions through the chain of ownership.

In this ruling, a foreign parent holding corporation ("FP") indirectly owned all the stock of a domestic corporation ("Distributing") and all the stock of a foreign corporation ("FSub"). Distributing contributed assets to a newly formed domestic corporation ("Controlled") and assigned the stock of Controlled to FSub, rather than distributing the stock of Controlled up the chain to FP and down the chain to FSub, in consideration of certain foreign laws.

For federal income tax purposes, FP and its direct and indirect subsidiaries (the "FP Group") treated the assignment as a distribution by Distributing of the Controlled stock to its foreign shareholder, followed by a series of distributions through the chain of ownership to FP and contributions from FP down the chain to FSub (the "Deemed Distributions and Contributions").

The IRS respected the FP Group's treatment of the transaction and ruled that, solely for federal income tax purposes, the assignment of the Controlled stock to FSub was treated as a distribution by Distributing of the Controlled stock to Distributing's foreign shareholder, followed by the Deemed Distributions and Contributions.

Observations: This PLR indicates that if a taxpayer undertakes a transaction in a manner solely to comply with foreign laws, the IRS may disregard the form of the transaction where necessary to treat the transaction in accordance with U.S federal income tax laws. Furthermore, rather than deeming a different fiction, the IRS accepted the taxpayer's treatment of the transaction for federal income tax purposes. Thus, in such a case, it appears that the IRS may respect a taxpayer's treatment of a transaction provided the taxpayer consistently treats and reports the transaction as such for all federal income tax purposes. *For more information, contact James Prettyman or Meryl Yelen.*

PLR 201203004 - A publicly traded parent company ("Distributing") of a consolidated group disposed of its interest in a wholly owned subsidiary ("Sub 1") through a "busted 351" transaction, resulting in a section 338 qualified stock purchase ("QSP") of Sub 1. Sub 1 held assets with a built-in loss. The taxpayer avoided the related party acquisition rules of section 338 through a spin-off of an entity that owned Sub 1.

As part of a series of complex restructurings (the "Restructuring"), Distributing contributed the stock of Sub 1 to a newly formed domestic corporation ("Corp 1") in exchange for common stock and nonvoting preferred stock (the "Corp 1 Preferred Stock") of Corp 1 (the "Contribution"). Distributing contributed the common stock of Corp 1 to a newly formed domestic corporation ("Controlled") in exchange for common stock of Controlled.

Pursuant to a binding agreement entered into prior to the Contribution, Distributing sold all the Corp 1 Preferred Stock to insiders and investors. Thereafter, Distributing distributed the Controlled stock pro rata to its public shareholders (the "Spin-off").

The IRS ruled that following completion of the Restructuring, Corp 1's acquisition of the Sub 1 stock from Distributing constituted a QSP within the meaning of section 338(d)(3). Thus, Distributing and Corp 1 were eligible to make a section 338(h)(10) election with respect to Sub 1 and treat the transfer of the Sub 1 stock as a taxable sale of Sub 1's assets. The IRS also ruled that Distributing could take into account the loss recognized as a result of the section 338(h)(10) election under section 267(f)(2)(B) and Reg. sec. 1.267(f)-1(c).

Furthermore, any goodwill, going concern value, and other "section 197 intangibles" for which depreciation or amortization would not have been allowable but for section 197 of Sub 1 were not subject to the anti-churning rules of section 197(f)(9) and constituted "amortizable section 197 intangibles," the IRS stated.

Observations: To constitute a QSP, section 338(d)(3) provides that one corporation ("Buyer") must acquire stock representing at least 80 percent (by vote and value) of another corporation ("Target") by purchase during the 12-month acquisition period. Section 338(h)(3)(A)(iii) precludes an acquisition from constituting a QSP if Buyer acquires stock from a related seller ("Seller"). Seller is related to Buyer if stock owned by Seller may be attributed to Buyer pursuant to section 318(a) (other than under section 318(a)(4), relating to options). In general, this requires 50 percent or greater ownership, including through attribution.

In this PLR, Corp 1's acquisition of Sub 1 from Distributing was not deemed an acquisition from a related Seller because, following the Spin-off, stock owned by Distributing could not be attributed to Corp 1 under section 318. Thus, this PLR reflects the use of a spin-off transaction to sever the

"attributive link" between Distributing and Corp 1 in what is commonly referred to as a "self-help" or "do-it-yourself" QSP.

Also note that the taxpayer represented that "[t]he formation of [Corp] 1 and the . . . Contribution is not an acquisition described in section 269(a)(1) or (a)(2), the principal purpose of which is evasion or avoidance of U.S. federal income tax within the meaning of section 269(a)." The IRS's acceptance of the representation serves to indicate that the representation was not viewed as per se unreasonable. *For more information, please contact James Prettyman, Timothy Lohnes, or Meryl Yelen.*

Revenue Procedures

Rev. Proc. 2012-3 – At the beginning of each year, the IRS provides a list of tax matters on which it will not issue letter rulings or determination letters. This year, Rev. Proc. 2012-3 added two new areas of interest for which no rulings or determination letters will be issued by the IRS:

- Economic substance doctrine and section 7701(o): No rulings will be issued to determine whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).
- Rescissions of completed transactions: No rulings will be issued to determine whether a completed transaction can be rescinded for Federal income tax purposes.

For additional information, contact Derek Cain or Matthew Michaelangelo.

Other Guidance

CCA 201152016 – *See* "Did You Know" above.

Form 8937 – On January 5, the IRS released Form 8937, *Report of Organizational Actions Affecting Basis of Securities*, which provides the mechanism for taxpayers to meet their section 6045B reporting obligations.

Section 6045B requires any issuer, whether domestic or foreign, which engages in an "organizational action" that affects the basis of all holders of the corporation's stock or all holders of a class of stock (including certain securities) to file an information return with the IRS setting forth a description of the transaction and the quantitative effect of the transaction on the basis of each share of stock. Under the statute, the information return (Form 8937) must be filed within 45 days of the transaction or, if earlier, by January 15 of the year following the calendar year in which such transaction took place.

If the filing requirement applies, the statute further provides that the issuer must furnish affected shareholders with similar information by January 15 of the year following the calendar year in which such transaction took place. The section 6045B filing and notice requirements apply for organizational

actions occurring after 2010 (after 2011 for regulated investment companies (RICs)).

Under the section 6045B regulations and the Form 8937 instructions, the issuer may publicly report an organizational action by posting (and maintaining for 10 years) the completed Form 8937 with the required information in a readily accessible format to an area of its primary public website. The IRS will treat the issuer as having filed Form 8937 and having furnished the required shareholder notifications on the date of such posting. Thus, the issuer need not actually file Form 8937 with the IRS or furnish the same to its shareholders if, by the due date, the issuer posts a completed Form 8937 in a readily accessible format in an area of its primary public website dedicated to this purpose.

The section 6045B requirement does not apply if the issuer reasonably determines that all the holders of the security are "exempt recipients" as defined in the regulations. These include C corporations (but not S corporations); tax-exempt organizations (as defined in section 501(a)); individual retirement plans; foreign holders; and certain governmental units (see Regs. secs. 1.6045B-1(b)(5) and 1.6045-1(c)(3)(i)(B)). Special reporting rules apply with respect to S corporations and certain RICs and real estate investment trusts.

Under sections 6721(a) and 6722, an issuer that fails to comply with the filing and furnishing requirements of section 6045B and Form 8937 may be subject to a penalty of $100 for each failure; however, the total penalty imposed on such person may not exceed $1.5 million for each failure (combined $3 million) during any taxable year. Special transitional relief may be available with respect to organizational actions that occurred in 2011 (*see* Notice 2012-11). As a practical matter, because it is highly unlikely that the maximum penalty for failing to file with the IRS could be reached in any one year, the combined maximum penalty is likely a few hundred dollars over $1.5 million.

Observations: The Form 8937 instructions describe two types of "organizational actions" that trigger a taxpayer's reporting obligation under section 6045B: nontaxable cash distributions to shareholders and nontaxable stock distributions to shareholders, including a stock split. Taxpayers should understand that in addition to the "organizational actions" mentioned in the instructions to Form 8937, other corporate transactions may cause a reporting obligation under section 6045B, including certain nontaxable acquisitions. *For more information, please contact Pat Pellervo or DiAndria Green.*

PwC M&A Publications

WNTS author Matthew Lamorena discusses recapturing consolidated overall foreign losses in an article published in Corporate Taxation: "Recapturing Consolidated Overall Foreign Losses: Is Immediate Recapture Required in Certain D/355 Transactions?" (January/February 2012).

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