This Month in M&A

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This Month's Features

- Final and proposed section 368 regulations address time for measuring the continuity of interest requirement
- Tax Court rules a purported stock sale lacked economic substance (*Feldman v. Comm'r*)
- A "triple drop" followed by the liquidation of target treated as section 351(a) contributions followed by a D reorganization (PLR 201150021)
- In determining whether a corporation has completely liquidated, ownership of reincorporated assets was tested at the completion of all related steps in a transaction (PLR 201149012)
- Contribution of a subsidiary's stock, followed by an election to convert to a limited liability company, treated as a C reorganization when followed by a spin-off (PLR 201150019)
- IRS modifies 165(g) "Look-Through Approach" to gross receipts test (PLR 201149015)

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Did you know…?

Final IRS regulations published December 19, 2011 make it easier for taxpayers to meet the continuity of interest (COI) requirement for tax-free reorganizations in certain situations where there is uncertainty as to the mix of consideration to be received by target shareholders. Also, proposed regulations issued on the same date, if adopted, would provide more flexibility regarding the amount and mix of consideration to be received by target shareholders.

COI is a non-statutory requirement that a substantial part of the value of the proprietary interests in the target corporation must be preserved in a tax-free reorganization. Absent the final regulations, a transaction intended to qualify as a reorganization might risk failing the COI requirement if the target shareholders agree to receive a fixed ratio of acquiring stock and other property and the value of the acquiring stock declines between the date the parties entered into a binding contract and the closing date of the transaction.

The final regulations apply to transactions occurring pursuant to binding contracts entered into after December 19, 2011. For transactions entered into after March 19, 2010, and occurring pursuant to binding contracts entered into on or before December 19, 2011, the parties may elect, as specified in the regulations, to apply the relevant provisions of the temporary regulations issued in 2007 (see Notice 2010-25).

If adopted, the proposed regulations would apply to transactions occurring on or after the date the regulations are finalized, unless completed pursuant to a binding agreement in effect before that date and at all times thereafter.

Final Regulations

The final regulations, which adopt the 2007 temporary regulations with minor changes, retain a rule under which COI is tested on the last business day before the sales contract becomes binding if the contract provides for fixed consideration (the "signing date rule"). This rule is based on the principle that when a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the last business day before the signing date (the pre-signing date).

A contract is deemed to provide for fixed consideration if it provides for the number of shares of each class of stock of the acquiring corporation, the amount of money, and any other property (identified either by value or by specific description) to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. The final regulations state that fixed consideration is present where the contract permits a target corporation shareholder to elect the mix of consideration to be received in the exchange (i.e., stock of the issuing corporation, money, other property, or a combination thereof), provided that the determination of the number of shares of the issuing corporation stock to be issued is made using the value of the issuing corporation stock on the pre-signing date.

Proposed Regulations

The IRS states in the preamble to the proposed regulations that the underlying principles of the signing date rule support additional methods for determining whether COI is satisfied. Accordingly, the proposed regulations would expand the scope of that rule to include situations in which the terms of the binding contract manage the potential fluctuation in the value of the stock of the issuing corporation between the pre-signing date and the closing date by including "ceiling" or "floor" value limits.

Where the terms of the binding contract provide that the amount of an item of consideration may vary between the pre-signing date and the closing date as the value of the issuing corporation's stock declines, but not below a prescribed floor price, and if the closing date value is less than the floor price, COI would be determined as if the consideration that would have been delivered at the floor price were issued and valued based on the floor price. Similar rules would apply when the contract includes a ceiling price and the value of the issuing corporation's stock increases between the pre-signing date and the closing date.

The proposed regulations also would allow the use of average value if: (1) the average value is based upon prices of issuing corporation stock occurring after the signing date and before the closing date, and (2) the binding contract uses the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and other property to be exchanged for all proprietary interests in the target corporation or to be exchanged for each proprietary interest in the target corporation.

In requesting comments on the proposed regulations, the IRS recognized that the target shareholders may become subject to the economic fortunes of owning an item and for purposes of COI, the IRS may find it appropriate to value an item of consideration on a date between the signing date and the closing date, and to value different items on different dates. For prior coverage of the 2007 temporary regulations, see the April 2007 edition of "This Month in M&A." For prior coverage of Notice 2010-25, see the April 2010 edition of "This Month in M&A." *For additional information, please contact Pat Grube, Jay Haksar, or Dorothy Lo.*

Court Watch

Feldman v. Comm'r, TCM 2011-2967, December 27, 2011 – The Tax Court concluded that a purported stock sale was a sham and recast the transaction as a direct liquidation to the shareholders. The shareholders who engaged in the purported stock sale were held liable as transferees for the corporation's unpaid tax liability.

The taxpayers were shareholders of Woodside Ranch Resorts, Inc. ("Woodside Ranch"). On May 17, 2002, the operating assets and business of Woodside Ranch were sold at a significant tax gain to an entity solely owned by an unrelated individual. Following the sale, Woodside Ranch retained the sales proceeds but ceased to engage in any meaningful business activity.

Prior to liquidating Woodside Ranch, MidCoast Credit Corp. and MidCoast Acquisition Corp. (collectively, "MidCoast") offered to purchase the stock of Woodside Ranch as part of a "potential tax-avoidance transaction." The proposal was designed to maximize the cash payment to the Woodside Ranch shareholders by having Midcoast offer to purchase Woodside Ranch for an amount equal to the net proceeds available for a liquidating distribution (after payment of any taxes due as a result of the asset sale) plus a "premium" equal to approximately one-third of the taxes owed by Woodside Ranch following the sale of its assets to the unrelated party. MidCoast planned to offset or eliminate Woodside Ranch's unpaid tax liability using other losses.

The IRS and Tax Court treated the stock sale to MidCoast as a sham transaction similar to tax-avoidance transactions described in Notice 2001-16. The Tax Court concluded that the price MidCoast paid for the Woodside Ranch stock was not at fair market value but rather a split of the projected tax liabilities from the asset sale. Furthermore, the parties appear to have funded the stock sale through a loan from Woodside Ranch to MidCoast, which used the loan proceeds to buy the stock of Woodside Ranch. The court viewed the purported loan to MidCoast as a sham; thus, the purported stock sale was deemed to be transitory and not a bona fide sale of Woodside Ranch stock. Instead, Woodside Ranch was treated as having liquidated, and the stock sale was ignored for lack of economic substance.

Observations: This case illustrates the IRS and courts' continued reliance on the economic substance doctrine to scrutinize tax-motivated transactions, specifically certain intermediary transactions, regardless of whether the form otherwise would meet the literal requirements of the Code. *For additional information, please contact Richard McManus or Matthew Michaelangelo.*

Private Letter Rulings

PLR 201150021 – The IRS ruled that cascading contributions of a target corporation's stock, followed by the deemed liquidation of the target corporation into a third-tier subsidiary (a "triple drop and check" transaction), should be treated as successive section 351(a) transfers of target corporation's stock followed by an acquisitive reorganization pursuant to section 368(a)(1)(D). Further, the IRS did not apply section 304 upon the contribution of stock effected, in part, by an assumption of acquisition indebtedness even though stock in other subsidiaries, not purchased with the acquisition indebtedness, were transferred as part of the same plan.

In the PLR, Parent wholly owned Foreign Sub 1, Foreign Sub 4, Foreign Sub 5 (collectively, the "Foreign Subs"), and US Holdco. Parent contributed the

Foreign Subs to US Holdco for shares of USHoldco common stock ("Contribution 1").

US Holdco contributed the Foreign Subs and Preferred Equity Certificates of Foreign Holdco 1 (a wholly owned sub of US Holdco) to its wholly owned sub, Foreign Holdco 2, in exchange for shares of Foreign Holdco 2 common stock and Preferred Equity Certificates issued by Foreign Holdco 2 ("Contribution 2"). Foreign Holdco 2 then contributed the Foreign Subs and a target corporation to Foreign Holdco 1 in exchange for its common shares and Foreign Holdco 1's assumption of the outstanding debt incurred by Foreign Holdco 2 to acquire the target corporation ("Contribution 3").

Pursuant to Regs. §§ 301.7701-2 and 301.7701-3, elections were made for each of the Foreign Subs to treat each as an entity disregarded as separate from Foreign Holdco 1 for U.S. federal income tax purposes (collectively, the "CTB Elections").

The IRS ruled that Contribution 1 and Contribution 2 were section 351(a) exchanges on which no gain or loss was recognized to the transferor or the transferee. The IRS concluded that the transfers of the Foreign Subs (in Contribution 3) coupled with the CTB Elections were reorganizations pursuant to section 368(a)(1)(D).

Observations: Practitioners have raised questions about the tax treatment of "triple drop and check" transactions. One possible characterization would view the transaction in the PLR as a section 351(a) transfer of the stock of Foreign Subs to US Holdco, followed by a triangular C reorganization of Foreign Subs into Foreign Holdco 1. In the PLR, however, the Taxpayer's representation that the Preferred Equity Certificates, issued as consideration in Contribution 2, were treated as a separate class of non-voting equity for U.S. tax purposes precluded the reorganization from satisfying the "solely for voting stock" statutory requirement applicable to C reorganizations.

Alternatively, some would argue that the transaction could be viewed as a direct D reorganization of Foreign Subs into Foreign Holdco 1 in an "all boot D reorganization." In this potential characterization, US Holdco stock would be deemed contributed through the chain to Foreign Holdco 1, who then used such US Holdco stock to acquire the Foreign Subs in D reorganizations. The US Holdco stock would be considered "grandparent" stock, and would thus be treated as boot in the D reorganization. However, the IRS did not recast the transaction, instead holding that the characterization should be two section 351(a) transfers followed by a D reorganization. For additional commentary, see PwC letter to the IRS and Treasury on cash D reorganizations (November 23, 2009), *Doc 2009-26224, 2009 TNT 228-13*.

Additionally, in this PLR, the IRS ruled that acquisition indebtedness was not allocated to the stock of entities other than the target acquired with such indebtedness ("Target"), but was instead allocated solely to the transfer of the Target shares. This ruling allowed the taxpayer to escape section 304 characterization by invoking application of the acquisition indebtedness exception to section 304 found in section 304(b)(3)(B). More specifically, in

Contribution 3, Foreign Holdco 2 transferred the stock of Target, along with other subsidiaries, to Foreign Holdco 1, in exchange for Foreign Holdco 1 shares and the assumption of Foreign Holdco 1's acquisition indebtedness incurred to buy Target. Generally, liabilities assumed in such a section 351 transaction are allocated to all transferred properties in determining whether section 304 is invoked to recharacterize any portion of the stock transfers (*See* Rev. Rul. 68-55). The ruling in the instant case is consistent with a recent ruling where the IRS has declined to allocate acquisition debt to property other than shares associated with such debt for purposes of section 304. For a discussion of a prior section 304(b)(3)(B) ruling see PLR 201047023 in the December 2010/January 2011 edition of "This Month in M&A." *For additional information, please contact Tim Lohnes, Henry Miyares or Matthew Michaelangelo.*

PLR 201149012 – In determining whether a company has completely liquidated for purposes of section 332, the IRS ruled that ownership should be tested at the completion of all related steps in a transaction. As part of a larger transaction, Sub 8 converted under state law into a limited liability company and then distributed some of its assets to its single shareholder, Distributing 5. Distributing 5 contributed its Sub 8 stock, a portion of the property it received from Sub 8, and other assets to a newly formed company, Controlled 5, in exchange for Controlled 5 stock. Parent then distributed its Controlled 5 shares pro rata to the public. The IRS ruled that the conversion of Sub 8 qualified as a liquidation under section 332, even though a portion of Sub 8's assets were reincorporated in Controlled 5.

***Observations*:** Taxpayers seeking a section 332 ruling must represent that the assets of the liquidated corporation will not be reincorporated. The standard representation looks to whether a person who owns, directly or through attribution, more than 20 percent of the liquidated corporation also owns, directly or through attribution, 20 percent of any corporation to which the liquidated corporation's assets are subsequently transferred (i.e., the recipient corporation in a reincorporation transfer).

In a "D/355" reorganization, a corporation transfers assets to a controlled subsidiary and distributes the stock of the subsidiary to its shareholders. Most liquidations that are followed by a "D/355" reorganization where the liquidated corporation's assets are reincorporated would not be able to satisfy the standard liquidation-reincorporation representation if ownership of the recipient corporation were tested prior to the distribution of the recipient corporation's stock. In this PLR, the IRS determined that the proper time for testing the ownership for liquidation-reincorporation transactions that are followed by a "D/355" reorganization is after the completion of the transactions, rather than immediately after the contribution of liquidated assets to a controlled company.

In the context of a "D/355" reorganization where the recipient corporation is distributed to public shareholders, taxpayers generally should be able to make the standard liquidation-reincorporation representation. However, that representation may prove difficult to make for internal "D/355" reorganizations because of application of the constructive ownership rules. *For additional information, please contact Wade Sutton or Kasey Kimball.*

PLR 201150019 – The IRS ruled that the transfer of a wholly owned subsidiary into another wholly owned subsidiary, followed by an election by the first subsidiary to convert to a limited liability company ("LLC"), will be treated as a C reorganization under section 368(a)(1)(C) rather than a D reorganization under section 368(a)(1)(D) when followed by a spin-off of the acquiring subsidiary under sections 355 and 368(a)(1)(D). In the instant case, Parent contributed the stock of its wholly owned subsidiary, S3, to another wholly owned subsidiary, S10 (the "S3 Contribution"). Immediately thereafter, S3 converted under state law to an LLC. After S3's conversion, S10 borrowed funds from a third-party lender and distributed the loan proceeds to Parent. Parent then distributed the stock of S10 pro rata to the public and used the borrowed funds to repay existing debt (the "Distribution"). The IRS ruled that the S3 Contribution and subsequent conversion resulted in a tax-free C reorganization under section 368(a)(1)(C).

Observations: Section 368(a)(2)(A) states that if a transaction could qualify as both a C reorganization under section 368(a)(1)(C) and a D reorganization under section 368(a)(1)(D), the transaction will be treated as a D reorganization (the "Overlap Rule"). One requirement of a D reorganization is that the transferor, or one or more of its shareholders, must be in control of the corporation to which the assets were transferred immediately after the transfer. Viewed in isolation, the S3 Contribution and subsequent conversion appear to qualify as both a C and D reorganization.

However, in this PLR the IRS apparently determined that the S3 Contribution followed by S3's conversion fails to qualify as a D reorganization because the proper time for satisfying the control requirement in a D reorganization is after completion of any related spin-off transactions. After completion of all related transactions, S3 (the transferor) does not hold any S10 shares, and Parent (S3's shareholder) has distributed its shares of S10 pro rata to the public. It would appear that the Overlap Rule had no effect on this transaction because the transaction failed the "control immediately after" test under section 368(a)(1)(D).

Additionally, the IRS declined to integrate S10's distribution of the loan proceeds to Parent with the reorganization of S3 into S10. When viewed in isolation, the S3 Contribution and S10's subsequent distribution of the loan proceeds could be viewed as a transfer of S3's shares partially for cash. If that were the case, the cash could have violated the "solely for voting stock" requirement of a C reorganization. Instead, the IRS appears to have first determined that the drop of S3 into S10, followed by the conversion of S3 to disregarded status was an asset reorganization, which then allowed for the conclusion that the distribution from S10 did not need to be allocated to the transfer of S3 shares. *For additional information, please contact Tim Lohnes, Bart Stratton or Kasey Kimball.*

PLR 201149015 – The IRS appears to have again refined the methodology used for calculating gross receipts in the context of claiming a section 165(g) worthless stock deduction on the dissolution of a wholly owned U.S. subsidiary set forth in previous letter rulings. In the PLR, Hold Co 1 wholly owned Hold Co 2, which wholly owned Sub1. In previous years Sub 1 had made various distributions to Hold Co 2. Because Hold Co 2 became insolvent, Hold Co 2 dissolved/liquidated and Hold Co 1 claimed a worthless stock deduction with respect to its Hold Co 2 shares. All entities at issue were domestic and members of a consolidated group.

***Observations*:** A domestic corporation may classify a worthless stock deduction as an ordinary loss if (1) the taxpayer directly owns at least 80 percent of the voting power and 80 percent of the value of the corporation's stock and (2) more than 90 percent of the corporation's aggregate gross receipts for all tax years has been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities. Previously, the IRS has ruled that, for purposes of computing the 90 percent gross receipts test, a holding company must include in its aggregate gross receipts all dividends received from lower-tier subsidiary members of its consolidated group, and that such dividends will be treated as "gross receipts from passive sources" to the extent they are attributable to the respective distributing member's "gross receipts from passive sources" (the "Look-Through Approach") From a computational standpoint, however, the IRS has been unclear how the portion of "passive" intercompany dividends from lower-tier subsidiaries should be calculated for purposes of the gross receipts test. *See* PLR 200710004, discussed in the April 2007 edition of "This Month in M&A."

Under section 316(a), a dividend is sourced out of current E&P and thereafter the most recently accumulated E&P (i.e., a LIFO approach). In the current PLR, the IRS ruled that in applying the Look-Through Approach with respect to gross receipts from intercompany dividends, the amounts (i.e., active and passive receipts) will be attributed pro rata to the gross receipts that gave rise to the earnings and profits ("E&P") from which the dividend was distributed. Thus, it appears that the Look-Through Approach also applies LIFO method accounting principles as the Sub 1 E&P that gave rise to the E&P Sub 1 distributed to Hold Co 2 would be determined applying LIFO principles pursuant to section 316 as the ruling looks to the gross receipts that gave rise to such E&P. See the August 2007 and July 2009 editions of "This Month in M&A" for prior coverage of section 165(g)(3) issues. *For additional information, please contact Rob Black or Kasey Kimball.*

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