This Month in M&A

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This Month's Features

- Section 355 monetization transaction (PLR 201123030)
- Third Circuit affirms Schering-Plough swap transaction decision (*Merck & Co., Inc. v. U.S.*)
- Final section 956 regulations address basis of United States property acquired by a CFC in certain nonrecognition transactions
- Final regulations on automatic extensions of time to file returns for partnerships, trusts, and estates and for pension excise taxes
- Series of transactions treated as a single Section 368(a)(1)(F) reorganization that does not give rise to an indirect stock transfer under section 367(a) (PLR 201122002)
- Spinoff transaction not integrated with contemporaneous contribution of property to distributing corporation (PLR 201123022)
- Spinoff transaction not disqualified or recharacterized as a result of subsequent distribution of controlled corporation (PLR 201123025)
- Section 338(h)(10) election where target was retained by shareholders and common parent was sold to a third party (PLR 201126003)
- Merger qualifies as reorganization despite not meeting requirements of section 368(a)(2)(E) (PLR 201126006)
- Dividend treated as separate and apart from spinoff transaction (PLR 201126010)

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Did you know...?

Taxpayers undertaking a spin-off transaction may wish to monetize their investment in the stock of the corporation being distributed (the controlled corporation). One such strategy relies on section 361(c)(3) to distribute controlled corporation shares or debt securities tax-free in an exchange for commercial paper that is newly issued by the distributing corporation. A recent PLR highlights an extension of such prior monetization strategies.

PLR 201123030

A privately held distributing corporation ("Distributing") owned stock not representing section 368(c) control in a publicly traded corporation ("Controlled Sub"). Controlled Sub owned all the issued and outstanding stock of another corporation ("Controlled"). In general, a distributing corporation must distribute at least 80 percent of the total combined voting power and at least 80 percent of each class of nonvoting stock to qualify a distribution as a tax free spin-off (so called "section 368(c) control").

In order to allow Distributing to obtain section 368(c) control of Controlled prior to a contemplated split-off transaction, Controlled formed a new merger subsidiary that merged with and into Controlled Sub, with Controlled Sub surviving the merger as a wholly owned subsidiary of Controlled (the "Merger Exchanges"). Pursuant to the Merger Exchanges, all outstanding Controlled Sub's shares were converted into shares of Controlled, which were structured in classes of either high-vote shares or low-vote shares.

Thereafter, Distributing distributed high-vote shares of Controlled stock, representing section 368(c) control, to certain Distributing shareholders (the "Exchanging Distributing Shareholders") in exchange for their shares in Distributing (the "Split-Off"). Distributing retained a certain percentage of low-vote Controlled shares (the "Retained Shares").

At the same time as the Split-Off, Distributing expected to transfer the Retained Shares to one or more investment banks (the "Investment Banks") in one or more exchanges (the "Debt Exchanges") in retirement of commercial paper or other short-term debt (the "Distributing Indebtedness"). In anticipation of the Debt Exchanges, the Investment Banks were expected to purchase the Distributing Indebtedness from Distributing at least 14 days prior to any Debt Exchange.

Each Debt Exchange was to be followed by a secondary public offering of the Controlled Shares by the Investment Banks (the "Public Offering"). However, because there may be a limited market for the Controlled shares in any Public Offering, the Investment Banks are permitted to engage in multiple purchases of Distributing Indebtedness, followed by Debt Exchanges and Public Offerings over a course of a redacted number of months following the Split-Off. Any Retained Shares not distributed in the Debt Exchanges are to be disposed of by Distributing no later than five years after the Split-Off.

The IRS held that the Merger Exchanges, followed by the Split-Off, qualified as a nontaxable divisive D reorganization. The public shareholders did not recognize gain or loss on the Merger Exchanges under section 351(a), and the Exchanging Shareholders did not recognize income, gain, or loss upon the receipt of the Controlled shares in the Split-Off under section 355(a). Distributing did not recognize income, gain, or loss upon the Split-Off and the Debt Exchanges under section 361(c).

Observations: Distributing could have obtained section 368(c) control of Controlled Sub (and Controlled, in effect) via a separate recapitalization and then distributed shares of the Controlled Sub in a direct section 355 distribution. Instead, structuring the transaction as a divisive D reorganization, Distributing was able to monetize Controlled shares by exchanging them for non-security indebtedness under section 361(c)(3). If the transaction had been structured as a direct section 355 distribution, section 361(c)(3) would have been unavailable, and Distributing's ability to monetize on a tax-free basis would have been limited.

The IRS previously has approved transactions where investment banks acquired outstanding debt of a distributing corporation from existing creditors and exchanged that debt for the controlled corporation's shares or debt securities, as long as the investment banks held the debt for at least 14 days. See, for example, PLR 200944026. In PLR 201123030, the Investment Banks did not acquire the Distributing Indebtedness from Distributing's existing creditors. Rather, the Investment Banks acquired the Distributing Indebtedness directly from Distributing in anticipation of and pursuant to a plan to exchange that debt for Controlled shares. In this instance, the possibility existed that the IRS would disregard the existence of the Distributing Indebtedness as transitory and treat the Investment Banks as acquiring the Controlled shares for cash in a taxable transaction. Presumably, in this instance, the IRS concluded that the Distributing Indebtedness should be respected because it will remain outstanding for at least 14 days and will be subject to the risks attendant to holding unsecured debt during that period.

This transaction also illustrates that it may be possible to employ recapitalization strategies to maximize the value of the retained shares in the controlled corporation that are available to distribute to creditors in a divisive D reorganization or to security holders in a direct section 355 distribution. By distributing high-vote, low-value shares in a section 355 distribution, a distributing corporation can retain the low-vote, high-value shares with the flexibility to efficiently monetize such retained shares over a period of time following the section 355 distribution. Any taxpayer wishing to engage in a similar transaction should seek a private letter ruling. *For additional information, please contact Tim Lohnes Jerry Towne, or Meryl Yelen.*

Court Watch

Merck & Co., Inc. v. U.S., 2011 WL 2437762 (3rd Cir. 2011) – The U.S. Court of Appeals for the Third Circuit upheld a district court decision denying the taxpayer a refund for taxes paid with respect to a swap transaction designed to repatriate cash from a controlled foreign corporation ("CFC") without imposition of U.S. tax under section 956.

The taxpayer, Schering Plough Inc., a U.S. corporation, entered into an interest-rate swap with ABN, an unrelated bank. ABN then entered into a "mirror swap" with Merrill Lynch, thereby hedging its risk with respect to the transaction.

As part of a structured transaction, the taxpayer assigned the "receive leg" of the swap to one of its CFCs in exchange for a lump-sum payment. The CFC had an option to "put" the receive leg back to the taxpayer in exchange for the fair market value of the receive leg at the time the put was exercised. The taxpayer treated this assignment as a sale of a notional principal contract and amortized the resulting income over the life of the swap pursuant to Notice 89-21. Notice 89-21 provides guidance relevant to the treatment of lump-sum payments received in connection with interest rate swaps, currency swaps, interest rate caps, and similar financial products.

Notice 89-21 specifically provides that it does not apply to swap transactions that are properly treated as loans for U.S. federal income tax purposes. Upholding the district court's characterization of the transaction, the Third Circuit held that the swap transaction was in substance a loan. In addition, the Third Circuit concluded that ABN was merely a conduit.

Observations: The case illustrates that the IRS and the courts may scrutinize related-party transactions and that the mere imposition of an unrelated third party into a transaction may not be sufficient to shield taxpayers from substance-over-form arguments if the third party serves no independent purpose and assumes no significant economic risks. The Third Circuit declined to address whether the economic substance doctrine applied to the swap transaction. For prior coverage of the district court decision, please see *This Month in M&A* for September 2009. *For additional information, please contact David Shapiro or Colin Zelmer.*

Treasury Regulations

Basis of United States property acquired by CFCs in certain nonrecognition transactions – On June 24, the IRS published final regulations (T.D. 9530) under section 956, adopting, with minor changes, temporary and proposed regulations that had been issued in June 2008. The regulations affect U.S. shareholders of a controlled foreign corporation (“CFC”) that acquires “United States property” in certain nonrecognition transactions in which the basis of the property is determined under section 362(a).

Prior to issuance of regulations, U.S. corporate taxpayers could attempt to repatriate funds from their CFCs in a tax-free manner by transferring their own stock or securities (both United States property) to the CFC in exchange for CFC stock and cash in a purported nonrecognition transaction (e.g., a section 351 exchange). The CFC would claim zero basis in the United States property acquired in the nonrecognition exchange under section 362(a), thereby avoiding income inclusions to the U.S. shareholder under section 956. The regulations are intended to curb these transactions by deeming the basis of the United States property acquired in the exchange to be equal to the value of the boot received in the transaction by the U.S. shareholder under Reg. sec. 1.956-1(e)(6).

Under Reg. sec. 1.956-1(e)(6), solely for purposes of applying section 956, if a CFC acquires "United States property" in an exchange to which these regulations apply, the basis of the United States property "shall be no less than the fair market value of any property transferred by the CFC in exchange for such specified United States property." "Property" for this purpose is defined by reference to section 317(a), which generally means any property other than stock of the CFC.

In adopting the prior regulations, the following modifications were made:

- Language was added to Reg. sec. 1.956-1(e)(6)(iii) to clarify that liability assumptions qualify as property for such purposes.

- Reg. sec. 1.956-1(e)(6)(v) was modified to apply to instances where a CFC exchanges United States property subject to these rules for *other* United States property. For purposes of section 956, the CFC's basis in the *other* United States property shall be no less than its adjusted basis in the United States property exchanged by the CFC as determined under Reg. sec. 1.956-1(e)(6)(iii).

- A cross-reference to the anti-abuse rule of Reg. sec. 1.956-1T(b)(4) was added.

- The final regulations apply with respect to exchanges occurring on or after June 24, 2011. For earlier transactions, see the temporary regulations.

Observations: Tax practitioners have debated whether so-called "hook stock" (i.e., parent stock held by a subsidiary) has value. The regulations, by acknowledging that the transfer of parent stock to a subsidiary can qualify as a section 351 exchange, answer that question in the affirmative. If hook stock were not viewed as having value, a purported section 351 exchange of U.S. parent stock for CFC stock and boot should be characterized as a section 301 distribution with respect to the boot.

The regulations do not resolve another issue related to the transfer of parent stock to a subsidiary. In 2006, the IRS revoked Rev. Rul. 74-503, which had ruled that parent stock received by a subsidiary in a section 351 exchange should receive a zero basis under section 362 (see Rev. Rul. 2006-2). Although these regulations address the same fact patterns that may have motivated the revocation of Rev. Rul. 74-503, they do not answer the basic question regarding a subsidiary's basis in its parent stock for purposes other than section 956. Although the regulations can be read as suggesting that the subsidiary should receive a zero basis in such stock, the answer remains unclear under current law. *For additional information, please contact Tim Lohnes, Carl Dubert, or Wade Sutton.*

Automatic extensions of time to file returns for partnerships, trusts, and estates, and for pension excise taxes – On June 24, the IRS published final regulations (T.D. 9531) on automatic extensions for filing certain partnership, estate, trust and pension excise tax returns. The final regulations, which adopt with limited changes the proposed regulations and remove the corresponding temporary regulations (T.D. 9407) issued July 1, 2008, apply with respect to extension applications filed on or after June 24, 2011.

The regulations adopt the change from a six-month automatic extension period to a five-month automatic extension period for partnerships filing Form 1065 and trusts and estates filing Form 1041. The final regulations clarify that an individual bankruptcy estate (under Chapters 7 or 11 of the Bankruptcy Code) has an automatic six-month extension. The six-month automatic extension periods for electing large partnerships filing Form 1065-B and for pension excise taxpayers filing Form 8928 were adopted without modification.

Observations: The statutory deadline for partnerships filing Form 1065 continues to be the 15th day of the fourth month following the end of the tax year. Accordingly, the due date for a Form 1065 of a calendar-year partnership that files for an automatic extension is September 15. *For additional information, please contact Susy Noles, Jennifer Bennett, or Kristel Glorvigen.*

Private Letter Rulings

PLR 201122002 – This PLR analyzed transactions that could be viewed as two F reorganizations but instead treated them as a single F reorganization, eliminating concerns about the indirect stock transfer rules under Reg. sec. 1.367(a)-3(d)(1)(v).

A U.S. parent corporation ("Parent"), through its ownership in certain U.S. disregarded entities, wholly owned FSub1, a Country A entity that was treated as a controlled foreign corporation ("CFC") under section 957(a). FSub 1 wholly owned FSub2, a Country B entity that was treated as a disregarded entity for U.S. federal tax purposes. FSub2 wholly owned FSub3, a Country B entity that was treated as a disregarded entity for U.S. federal tax purposes.

Parent caused the following transactions to occur:

i. FSub1 migrated its country of incorporation from Country A to Country B, resulting in a new entity, New FSub 1;

ii. FSub 2 elected to be treated as an association taxable as a corporation for federal tax purposes; and

iii. New FSub1 merged into FSub 2, with FSub 2 surviving, under applicable Country B law (together with steps (i) and (ii), the "Reorganization").

The IRS ruled that the Reorganization constituted a single F reorganization and was not a direct or indirect transfer of stock or securities to a foreign corporation as described in Reg. sec. 1.367(a)-3.

Observations: Although generally it may seem unimportant whether a transaction constitutes a single F reorganization or two F reorganizations, the answer can make a significant difference in terms of the section 367(a) consequences.

Under Reg. sec. 1.367(a)-3(d)(1)(v), an "indirect stock transfer" occurs if (i) a U.S. person exchanges stock of a corporation (the acquired corporation) for stock of a foreign acquiring corporation in an asset reorganization – other than a same-country F reorganization (the "Same Country Exception") or other types of reorganizations not relevant here – and (ii) the asset reorganization is followed by a "controlled asset transfer." A "controlled asset transfer" occurs if the corporation acquiring assets in an asset reorganization transfers all or a portion of such assets to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction.

If the IRS had ruled that the Reorganization consisted of two F reorganizations, then this might have implicated the indirect stock transfer rules. In the first potential F reorganization (step (i)), there was a migration of FSub1 from Country A to Country B. Therefore, the first F reorganization would not qualify for the Same Country Exception if it was followed by a controlled asset transfer. In the second potential F reorganization (comprised of steps (ii) and (iii)), under Reg. sec. 1.367(b)-2(f)(2), New FSub 1 would be deemed to transfer its assets to FSub 2 in exchange for stock of FSub 2 under section 361 (the "Controlled Asset Transfer"), followed by a distribution of the FSub 2 stock to Parent in exchange for Parent's stock in New FSub 1 under section 354. Thus, the potential first F reorganization followed by the Controlled Asset Transfer would have qualified as an indirect stock transfer and would have required the filing of a gain recognition agreement (a "GRA"). However, by ruling that the Reorganization was a single F reorganization, any issues relating to an indirect stock transfer and the need to file a GRA were removed. *For additional information, please contact Tim Lohnes, Wade Sutton, or Meryl Yelen.*

PLR 201123022 – In a spin-off transaction, the IRS ruled that (i) a contribution of property to the Distributing corporation would not be integrated with the contemporaneous distribution of the Controlled subsidiary's stock, and (ii) the liquidation of three tiered subsidiaries via state law conversions – followed by the reincorporation of the liquidated subsidiaries' assets into the Controlled corporation preceding the spin-off transaction – qualified as tax-free liquidations under section 332 rather than reorganizations.

Observations: Applying step-transaction principles, a contribution of assets to a Distributing corporation by one of its shareholders and a contemporaneous distribution of Controlled stock to the shareholder could be treated as an exchange of the contributed assets for all or part of the Controlled stock. In this ruling and other recent similar rulings, the IRS has treated this "crossing consideration" as separate from the section 355 distribution so long as the taxpayer represents that there is no compulsion or requirement to make the contribution on account of the distribution. *See,* e.g., PLRs 201119002, 201106004, 201034005, and 201033007.

While a liquidation generally fails to qualify under section 332 if the liquidated corporation's assets are subsequently reincorporated, in earlier rulings the IRS has allowed the partial reincorporation of a liquidated corporation's assets into Controlled in connection with a section 355 distribution. *See,* e.g., PLRs 201017031, 200737017, 200732002, and 200645012. It appears that liquidation-reincorporation concerns may be mitigated where Controlled is distributed in a section 355 transaction, presumably because a layer of corporate ownership has been eliminated with respect to the liquidated assets. Neither this ruling nor the cited rulings provide any indication of what percentage of the liquidated corporation's assets were reincorporated in the section 355 transaction. *For additional information, please contact Jerry Towne or Colin Zelmer.*

PLR 201123025 – The IRS ruled that an internal spin-off transaction qualified for tax-free treatment under section 355 despite a subsequent distribution of the Controlled subsidiary stock to the public. The IRS did not rule on the qualification of the subsequent spin to the public as tax free under section 355.

In the ruling, Foreign Parent wholly owned Distributing. Distributing formed Controlled and transferred its subsidiary that conducted an active trade or business to Controlled in exchange for stock. Distributing then distributed the stock of Controlled to Foreign Parent. After the spin-off, Foreign Parent transferred Controlled, along with additional assets associated with its business line, to a newly formed foreign entity, and distributed shares of the new foreign entity to the foreign parent shareholders.

Observations: The IRS did not rule on the second distribution, nor did the taxpayer make a representation as to its characterization. However, by ruling that the internal spin-off transaction qualified for tax-free treatment under section 355, the IRS apparently concluded that the subsequent distribution (taxable or tax-free) should not impact the qualification of the first spin-off under section 355. *For additional information, please contact Jerry Towne or Wade Sutton.*

PLR 201126003 - This PLR addresses a section 338(h)(10) election when the "target" was retained by the existing shareholders of the common parent and the common parent was sold to a third party.

Generally, section 338(h)(10) elections may be made when a member of a consolidated group sells the stock of its subsidiary in a qualified stock purchase ("QSP") to an unrelated acquiror. By virtue of making the election, a "new" target owned by buyer is treated as purchasing the "old" target corporation's assets, resulting in a potential step-up in the target corporation's asset basis. While the tax basis benefit associated with a section 338(h)(10) election generally inures to the third-party acquiror, the transaction addressed in PLR 201126003 illustrates that buyers and sellers may arrange a sale in a manner that allows the original shareholders of target to retain target with its increased asset basis.

Prior to the Proposed Transaction, Parent owned all of the stock of Target. Target conducted two businesses, A and B. The series of steps that comprise the Proposed Transaction occur as part of an integrated plan pursuant to a stock purchase agreement ("SPA") entered into on Date 1 to sell Parent to an unrelated third party.

In the first relevant step, Target distributed the business A assets to Parent. Parent then sold Target to Newco 3, a subsidiary owned indirectly by Parent through a chain of corporations comprised of NewCo 1 and NewCo 2. Parent received common and preferred stock of NewCo 1 in exchange for Target stock (the "Sale").

Following the Sale, all the NewCo 1 common stock was distributed to Parent's shareholders and, pursuant to a binding commitment, the NewCo 1 preferred stock was sold to an unrelated third party. The stock of Parent then was acquired by an unrelated real estate investment trust ("REIT"). At the conclusion of the transaction, a timely election under section 338(h)(10) was made with respect to the Sale.

Observations: A section 338(h)(10) election only is available if a sale qualifies as a QSP. A QSP may occur only if the buyer and seller are unrelated. In the PLR, Parent and NewCo 3 were related at the time of the Sale, but Reg. sec. 1.338-3(b)(3)(ii)(C) states that relatedness is determined "immediately after the last transaction" in an integrated plan. Following the Acquisition, Target and Parent are unrelated and eligible to make a section 338(h)(10) election. Thus, the parties were able to structure the transaction in a manner that enabled Parent's original shareholders to retain Target and obtain asset basis step-up by integrating the Sale with the remaining steps.

A QSP also requires that the stock of a target be acquired by purchase and not in a nonrecognition transaction. In the PLR, Target was acquired in exchange for NewCo 1 stock in a transaction that could not qualify as a B reorganization. Furthermore, the NewCo 1 preferred stock was sold pursuant to a binding commitment to ensure that the Sale would not be viewed as consecutive section 351 exchanges.

Lastly, depending upon the makeup of the shareholders of Parent, it is possible that this structure would result in the nonapplication of the section 197 anti-churning rules. See Reg. sec. 1.197-2(k) Ex. 23. *For additional information, please contact James Prettyman or Arthur Sewall.*

PLR 201126006 - The IRS ruled that the merger of Foreign Parent's wholly owned U.S. Subsidiary ("Target") into another, unrelated U.S. corporation ("Acquiring"), where Foreign Parent received Acquiring stock and the shareholders of Acquiring ("Acquiring Shareholders") received cash and newly issued nonvoting stock in Foreign Parent, is a reorganization under section 368(a)(1)(A) (the "Merger").

To facilitate the Merger, Foreign Parent contributed newly issued nonvoting stock to Target to use as consideration in the Merger, and Target borrowed cash from various funding sources. Then, pursuant to the Merger, Target transferred all its assets and liabilities, including the Foreign Parent nonvoting stock and cash, to Acquiring. Acquiring Shareholders exchanged their Acquiring stock for cash and the Foreign Parent stock in a transaction that qualified as a redemption under section 302(a).

Observations: The transaction in PLR 201126006 has the form of a reverse subsidiary merger that fails to satisfy the requirements of section 368(a)(2)(E) because the former shareholders of Acquiring received Foreign Parent nonvoting stock. However, the IRS ruled that the Merger qualified as a reorganization under section 368(a)(1)(A) because the Merger satisfied all the necessary requirements for reorganization treatment under section 368(a)(1)(A). *For additional information, please contact Bart Stratton, Rob Black, or Jared Douds.*

PLR 201126010 - Pursuant to a single plan of reorganization, Distributing approved a D/355 spin-off of Controlled and declared a dividend distribution to its sole shareholder. The taxpayer represented that although Distributing's board of directors approved the dividend and the spin-off as part of a single plan of reorganization, the dividend (i) was distributed when the spin-off remained subject to contingencies, (ii) was not conditioned on the spin-off, and (iii) served purposes not otherwise accomplished by the spin-off and that would have been beneficial without it. The IRS accepted the taxpayer's representation and ruled that the dividend would be treated as a section 301 distribution.

Observation: This PLR illustrates that, under the right circumstances, the step-transaction doctrine may not apply to step together two related transactions—even when those transactions were approved as part of a single plan of reorganization—if the transactions are functionally unrelated. *For additional information, please contact Julie Allen or Matt Lamorena*.

PwC M&A Publications

WNTS authors Henry H. Miyares, Pat Grube, and Benjamin Willis discuss the cash D regulations (Reg. sec. 1.368-2(*l*)) as they relate to the mechanics of tiered reorganizations in an article published by Tax Notes, June 13, 2011: *Bottoms Up: Tiered D Reorganizations*.

Tax Valuation Service members Alberto Dent, Peter Corcoran, and Philip Antoon address potential income tax withholding issues relevant to an ownership interest in a U.S. real property holding corporation and potential issues arising from the treatment of intangible assets relevant to Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), in an internal article published by the Transaction Services practice: *FIRPTA and intangible assets: What you should know*.

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