This Month in M&A

A Washington National Tax Services (WNTS) Publication

June 2012

This Month's Features

- Section 338(h)(10) election available for internal stock acquisition followed by the spin-off of the selling corporation pursuant to an integrated plan (PLR 201220020)
- Proposed Regulations revise rules on agent of consolidated group (Prop. Reg. sec. 1.1502-77)
- Rev. Rul. 2012-14 addresses treatment of partnership discharged excess nonrecourse debt in determining partner insolvency
- Tax Court rules purported equity interest constituted debt (*Hewlett-Packard Co.*)
- Redemption during reorganization did not disqualify transaction as valid F reorganization (PLR 201220010)
- Special dividend declared by a RIC qualifies as a section 301 dividend distribution in light of taxpayer's representation that not less than 20 percent of the special dividend will be paid in the form of cash (PLR 201220022)
- Worthlessness not satisfied in consolidated return context if subsidiary member has tax refund claim (AM 2012-003)

Did you know...?

When selling, spinning-off, or otherwise disposing of a corporation with subsidiaries that are to be retained, a section 338(h)(10) election may be made with respect to sales of the retained subsidiaries. This planning can provide a step up in the retained assets, and may avoid application of the section 197 anti-churning rules.

PLR 201220020

In PLR 201220020, Acquirer, a publicly-traded foreign corporation, indirectly owned 100 percent of a U.S. corporation ("Target Parent"), and Target Parent owned 100 percent of another U.S. corporation ("Target"). Target Parent and Target were members of a U.S. consolidated group. To effect a spin-off of Target Parent to Acquirer's shareholders, Target Parent sold Target to Acquirer in a taxable exchange (the "Target Sale"). Following the Target Sale, Acquirer distributed a subsidiary owning the stock of Target Parent, pro-rata, to its shareholders (the "Share Distribution").

The IRS ruled that Acquirer's acquisition of the stock of Target in the Target Sale qualified as a "qualified stock purchase" ("QSP") under section 338(d)(3) and that Target Parent and Acquirer were entitled to make a section 338(h)(10) election with respect to the Target Sale. The IRS did not address whether the section 197 anti-churning rules apply to the asset basis step-up resulting from the section 338(h)(10) election.

A section 338(h)(10) election is available only if a sale qualifies as a QSP. Section 338(h)(3)(A)(iii) precludes an acquisition from qualifying as a QSP if a buyer acquires stock of a target from a related seller. A seller is "related" to the buyer if stock owned by the seller may be attributed to the buyer pursuant to section 318(a) (other than under section 318(a)(4), relating to options). In this regard, Reg. sec. 1.338-3(b)(3)(ii)(C) provides that "in the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, [the time for testing the relationship] is immediately after the last transaction in such series."

Observations: The taxpayer may have requested the PLR because it was not certain whether the language in Reg. sec. 1.338-3(b)(3)(ii)(C) required that relatedness be tested upon completion of the Target Sale (arguably, the last transaction effected to "dispose of target stock") or upon completion of the Share Distribution (the last transaction effected pursuant to the "integrated plan"). This PLR indicates that the IRS views the latter as the appropriate time for testing relatedness. Because Acquirer and Target Parent were no longer related following the spin-off of the owner of Target Parent, the buyer and seller were not considered related, and the sale of Target constituted a QSP, thereby allowing an election under section 338(h)(10). This is consistent with the position of the IRS in PLR 201126003 (For prior coverage, see the July/August 2011 edition of This Month in M&A).

In the PLR, the parties were able to structure the transaction in a manner that enabled Acquirer group to obtain an asset basis step-up in retained assets held by Target by integrating the Target Sale with the Share Distribution. In this instance, the asset basis step-up structure was utilized in the context of a public spin-off transaction. However, PLR 201126003 illustrates that an asset basis step-up in retained assets can also be achieved in the context of a disposition of a business to a third party.

In this PLR and in PLR 201126003, the IRS is silent on the application of the section 197 anti-churning rules to the asset basis step-up resulting from the section 338(h)(10) election. Generally, under section 197(c)(1), a section 197 intangible becomes amortizable when it becomes an "amortizable section 197 intangible." That generally occurs if the section 197 intangible is acquired after the date section 197 was enacted. In general, the anti-churning rules prevent taxpayers from converting non-amortizable goodwill and going concern value (as well as any other intangibles owned prior to enactment of section 197) into amortizable section 197 intangibles by acquiring the intangibles from a related party (among other methods). The anti-churning rules are contained in section 197(f)(9) and Reg. sec. 1.197-2(h).

In the context of a section 338 election, Reg. sec. 1.197-2(h)(8) provides that a corporation that is treated as purchasing assets (new target) is not considered the person that held or used the assets during any period in which the assets were held or used by the corporation treated as selling such assets (old target). However, the anti-churning rules nevertheless may apply to a deemed asset purchase resulting from a section 338 election if "new target" is related (within the meaning of Reg. sec. 1.197-2(h)(6)) to "old target." Under Reg. sec. 1.197-2(h)(6), "new target" is "related" to "old target" if "new target" bears a relationship to "old target" specified under section 267(b), section 707(b)(1), or "new target" and "old target" are engaged in trades or businesses under common control (within the meaning of section 41(f)(1)(A) and (B)).

Reg. sec. 1.197-2(h)(6)(ii)(B) provides that, "in the case of a series of related transactions (or a series of transactions that together comprise a [QSP]), [the appropriate time for testing the relationship is] immediately before the earliest such transaction or immediately after the last such transaction." In the context of a section 338 election, "new target" cannot be related to "old target" immediately before the deemed asset acquisition because "new target" does not exist immediately before the sale giving rise to the QSP. See Reg. sec. 1.197-2(k), Example 24. Thus, whether the anti-churning rules apply would appear to turn on the relationship of "old target" to "new target" "immediately after the last such transaction."

In the PLR, it is clear that Target Parent and Acquirer, and thus "old target" and "new target," were related for purposes of the anti-churning rules immediately after the Target Sale, but that they were unrelated immediately after the Share Distribution. Arguably, Reg. sec. 1.197-2(h)(6)(ii)(B) could be interpreted to require that relatedness be tested immediately after the completion of the Target Sale (the last step in the QSP). However, based on broader step-transaction principles that are consistent with the IRS position with respect to the interpretation of Reg. sec. 1.338-3(b)(3)(ii)(C), it would appear more appropriate to test relatedness for purposes of the anti-churning rules immediately after the Share Distribution (the last step in the series of transactions that included the QSP). *For more information, please contact Tim Lohnes, Jerry Towne, or Dorothy Lo.*

Treasury Regulations

Proposed Rules Regarding Agent of Consolidated Group (REG-142561-07)

Generally, the consolidated return regulations require an agent to act on behalf of a consolidated group. The IRS recently issued proposed regulations that would amend Reg. sec. 1.1502-77 concerning the identity and authority of the agent for a consolidated group. While the proposed regulations generally retain the rules, concepts, and examples from the existing regulations, such rules, concepts, and examples would be renumbered, restricted, and revised to provide greater clarity.

For example, under the current regulations, a common parent that is the agent for the group and that goes out of existence may designate its successor, another member of the group, or a group member's successor entity as a substitute agent for the group. The proposed regulations would limit the common parent's ability to designate a substitute agent to circumstances where the terminating common parent does not have a successor.

A "successor" under the proposed regulations is an individual or entity (including a disregarded entity) that is primarily liable for the tax liability of a corporation which was a member of the group but no longer is in existence. Thus, under the proposed regulations, if the terminating common parent has a successor, then that successor becomes the default agent for the group--the terminating common parent has no voice in the matter.

The amendments to the existing regulations under Reg. sec. 1.1502-77 generally are proposed to apply to consolidated return years beginning on or after the date final regulations are published.

Observations: By designating a default successor, the proposed regulations would provide greater certainty as to which entity will be the substitute agent for the group when the common parent of the group goes out of existence. *For additional information, please contact Olivia Ley or DiAndria Green.*

Revenue Rulings

Treatment of Partnership Discharged Excess Nonrecourse Debt for Purposes of Determining Partner Insolvency (Rev. Rul. 2012-14)

On May 25, the IRS issued Rev. Rul. 2012-14, extending the application of Rev. Rul. 92-53 (the "1992 Ruling") to the partnership context. This guidance was included in Treasury's 2011-2012 Priority Guidance Plan.

In Rev. Rul. 92-53 (1992-2 CB 48, June 22, 1992), the IRS held in three situations that an individual taxpayer could include excess nonrecourse debt (*i.e.,* nonrecourse debt that exceeds the fair market value of the property securing the debt), to the extent discharged, as a liability for purposes of determining insolvency under section 108(d)(3).

Under section 108(d)(3), insolvency is defined as liabilities in excess of the fair market value of the taxpayer's assets. To the extent a taxpayer is insolvent, as measured immediately prior to the discharge, section 108(a)(1)(B) provides an exclusion from gross income for cancellation of indebtedness income ("COD income"). Section 108(d)(6) provides that insolvency is measured at the partner level, not the partnership level. The IRS stated in the 1992 Ruling that the legislative intent behind the insolvency exclusion is to provide taxpayers with a "fresh start."

Keeping with the logic of the 1992 Ruling, Rev. Rul. 2012-14 holds that a partner may include her share of partnership discharged excess nonrecourse debt as a liability for purposes of determining insolvency. Applying the 1992 Ruling, Rev. Rul. 2012-14 provides that this discharged excess nonrecourse debt is allocated to the partner in accordance with how the related COD income is allocated.

In the facts of Rev. Rul. 2012-14, the partners are allocated COD income from a partnership in which the fair market value of their respective partnership interest is zero. The ruling states that the partners have no other assets or liabilities other than the partnership interest. The discharged excess nonrecourse debt is the only item included in their insolvency calculations. Thus, the partners can exclude from gross income their entire allocations of COD income.

***Observations*:** Rev. Rul. 2012-14 clarifies that discharged excess nonrecourse debt in the partnership setting is included in insolvency calculations in the same manner as previously provided in the individual context. While section 752 and the regulations thereunder generally govern the allocation of partnership liabilities, Rev. Rul. 2012-14 provides that discharged excess nonrecourse debt is aligned with the allocation of the related COD income. This may result in a different measure of insolvency for the taxpayer than if the taxpayer had used the section 752 debt allocation as a measure of insolvency because COD income is allocated under section 704(b) and the regulations thereunder (*see* generally, Rev. Ruls. 99-43 and 92-97). Further, the inclusion of discharged excess nonrecourse debt as a liability for purposes of measuring insolvency increases the possibility that a taxpayer will be considered insolvent.

It is important to note that Rev. Rul. 2012-14 applies solely to the treatment of discharged excess *nonrecourse* debt, and it does not address the calculation of insolvency for a partner in the more common situation in which the partnership holds assets other than those securing the debt. *For additional information, please contact Brian Meighan, Nadine Holovach, or Laura Nadeau.*

Court Watch

***Hewlett-Packard Co. and Consol. Subsidiaries v. Comm'r*, T.C. Memo. 2012-135 (May 14, 2012)**

The Tax Court denied a taxpayer's claim of direct and deemed-paid foreign tax credits by ruling that the taxpayer's investment in a foreign corporation should be characterized as debt, rather than as an equity interest.

According to the form of the transaction, the taxpayer held preferred shares in a Dutch corporation ("DutchCo"). DutchCo had issued loans to ABN, a Dutch Bank, in exchange for four contingent interest notes ("CINs") under which ABN would be required to pay a fixed interest amount and a contingent interest amount. For Dutch tax purposes, both the fixed interest amount and the contingent interest amount accrued to DutchCo; however, for U.S. tax purposes, only the fixed interest amount accrued to DutchCo.

Each year the taxpayer would receive a dividend of 97 percent of the total fixed interest payments minus any Dutch taxes paid. The taxpayer also would claim the deemed-paid foreign tax credit paid by DutchCo for the fixed and contingent interest amounts received or accrued under Dutch tax law with respect to the CINs and direct foreign tax credits for the withholding tax imposed on such distributions. In connection with the transaction, the taxpayer could "put" its preferred shares to ABN in January 2003 or January 2007 for the shares' fair market value.

The IRS challenged the transaction at issue, asserting that (i) the transaction was a sham, (ii) DutchCo was merely a conduit entity acting as an agent on behalf of the taxpayer, and (iii) the taxpayer's investment should be treated as debt. In concluding that the taxpayer's interest in DutchCo was debt, and thereby denying the taxpayer's claim on direct and deemed-paid foreign tax credits, the Tax Court declined to consider the IRS's other arguments. The court used a court-developed set of factors to be considered in making a determination regarding whether an investment is more appropriately characterized as debt or equity.

***Observations*:** Generally, the IRS has sought to recharacterize corporate debt, where interest payments are deductible to the corporation paying the interest, to equity, where dividend payments are not deductible to a distributing corporation. The IRS and the courts generally have respected a taxpayer's equity classification position. However, the holding in the current case may result in uncertainty regarding the proper characterization of financial instruments. The result also may prove to be a double-edged sword in certain circumstances because characterization as debt may provide unintended benefits to taxpayers, such as interest deductions on investments that previously had been considered equity interests. *For additional information, please contact Timothy Lohnes, Wade Sutton, or Kasey Kimball.*

Private Letter Rulings

PLR 201220010 - The IRS ruled that in a multi-step transaction, an indirect transfer of all of F Sub's assets to TopCo was an F reorganization even though some F Sub shares held by one of its shareholders were redeemed during the course of the transaction. While authorities have previously discussed distributions prior to or after an F reorganization, there has generally been a lack of authority addressing distributions within a series of steps constituting an F reorganization.

Prior to the transaction, 50 percent of the F Sub voting stock appears to have been held by D Sub, and the remaining 50 percent appears to have been held by F Co 1 and F Co 2. In undisclosed proportions, F Co 1, F Co 2, D Sub, Management, and Trust all own Class B non-voting F Sub shares, and Management owns 100 percent of Class C non-voting F Sub shares.

As part of the transaction, F Co 1, F Co 2, and D Sub transferred all their interests in F Sub to a newly formed foreign entity, TopCo, in exchange for an undisclosed amount of TopCo common stock. Subsequently, the Class C F Sub shares owned by Management were redesignated as partly Class B non-voting stock and partly Class E stock. The Class E stock then was redeemed and cancelled by F Sub. Thereafter, Management and Trust transferred their remaining interests in F Sub to TopCo in exchange for an undisclosed amount of TopCo common stock.

F Sub then elected to be treated as a disregarded entity for U.S. federal income tax purposes. The IRS ruled that these series of steps qualified as a reorganization under section 368(a)(1)(F) (an "F reorganization").

Observations: Historically, to qualify as an F reorganization, the reorganization must have identity of shareholders and identity of assets immediately before and immediately after the purported reorganization. See Rev. Rul. 58-422. In making this determination, Rev. Rul. 96-29 provides that step transaction principles do not apply to F reorganizations. That is, transactions occurring immediately before and immediately after a purported F reorganization may not be integrated to disqualify the F reorganization. In this PLR, the taxpayer represented that immediately before and immediately after the reorganization, TopCo possessed the same assets and liabilities as those possessed by F Sub immediately before the reorganization. However, following the F reorganization, TopCo did not hold the property used by F Sub to redeem the Class E stock.

Assuming the redemption occurred within the F reorganization, the ruling is silent with respect to whether the redemption qualified for sale or exchange treatment under section 302(a) or dividend treatment under section 301 by reason of section 302(d). In the latter case, the redemption would not be subject to the rules under Reg. sec. 1.301-1(l), which treats a distribution as a separate distribution from the reorganization. However, under Prop. Reg. sec. 1.368-2(m)(4), effective at the time the proposed regulations are adopted as final, a redemption transaction occurring in an F reorganization would receive similar treatment as distributions governed by Reg. sec. 1.301-1(l). *For additional information, please contact Tim Lohnes, Jerry Towne, Olivia Ley, or Kasey Kimball.*

PLR 201220020 - See "Did You Know" above.

PLR 201220022 - The IRS ruled that a regulated investment company's ("RIC") declaration of a special dividend of either cash or stock, at the election of its shareholders, was a taxable dividend distribution under section 301 by reason of section 305(b)(1). The taxpayer represented that the total amount of cash to be distributed would not be less than 20 percent of the total value of any given distribution.

Observations: To maintain its status as a RIC or a Real Estate Investment Trust ("REIT"), a RIC or REIT must satisfy the statutory requirements under sections 852(a) and 857(a), respectively. Under these requirements, RICs and REITs must have 90 percent of their yearly taxable income offset by deductions resulting from dividends paid during the taxable year.

With respect to a taxable year ending on or before December 31, 2011, Rev. Proc. 2010-12, 2010-3 I.R.B. 302, provides that a stock dividend by a RIC or a REIT will be treated as a taxable dividend to which section 301 applies and that the amount of such distribution of stock would be considered to equal the amount of money that a shareholder could have alternatively received, if the taxpayer satisfied certain requirements. One of those requirements was that the amount of cash to be distributed in the aggregate to all shareholders could not be less than 10 percent of the aggregate declared distribution.

It appears that the taxpayer in the PLR expected to make special dividends of either cash or stock with respect to tax years ending after December 31, 2011, and, therefore, was not covered by the safe harbor protection provided in Rev. Proc. 2010-12 regarding distributions of stock. Because the taxpayer appears to have been required to make a representation that the total amount of cash to be distributed in connection with its special dividends would not be less than 20 percent of the total value of any given distribution, the PLR may indicate that the IRS currently requires taxpayers to represent that not less than 20 percent of a declared stock distribution will be paid in the form of cash to qualify as a taxable dividend distribution to which section 301 applies. *For additional information, please contact Jerry Towne, Olivia Ley, or Kasey Kimball.*

Advice Memorandum

AM 2012-003 - This AM addresses a generic fact pattern and concludes that a consolidated group cannot meet the standard of worthlessness for claiming a worthless stock loss deduction under Reg. secs. 1.1502-80(c)(1) and -19(c)(1)(iii)(A), where the purported worthless subsidiary has a claim to group tax refunds.

Reg. sec. 1.1502-80(c)(1) defers the application of section 165 within a consolidated group. Under that rule, subsidiary stock is not treated as worthless until immediately before the earlier of the time (i) the stock is worthless within the meaning of Reg. sec. 1.1502-19(c)(1)(iii) or (ii) the subsidiary for any reason ceases to be a member of the group. Reg. sec. 1.1502-19(c)(i)(iii)(A) provides, in pertinent part, that stock is treated as disposed of by virtue of worthlessness at the time:

> "All of S's assets (other than its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence) are treated as disposed of, abandoned, or destroyed for Federal income tax purposes ...."

Under the generic fact pattern posited in the legal advice memorandum, M is a holding company and is the common parent of a consolidated group, which includes member S1. In Year A, the M group incurs a large consolidated net operating loss, all of which is attributable to S1. The group had significant consolidated taxable income in the two consolidated return years prior to Year A. Before the end of Year A, S1 ceases operation of its business, disposes of its operating assets, and uses the proceeds to satisfy certain of its liabilities. However, at the end of Year A, S1 continues to hold certain assets, including legal claims against its directors and officers, and a right to a portion of the M group's claims for refund of federal income taxes. The total value of the legal and refund claims is less than S1's remaining outstanding liabilities. The stock of S1 meets the requirements for treatment as worthless under section 165(g), applied without consideration of the consolidated return regulations.

Because S1 held a claim to a portion of the M Group's tax refund and claims against its directors and officers, the IRS determined that, in Year A, S1 did not dispose of all its assets and therefore failed to satisfy the worthlessness test under Reg. sec. 1.1502-19(c)(1)(iii)(A).

Observations: This AM serves as a reminder to consolidated groups attempting to take a worthless stock loss that assets not traditionally accounted for on a corporation's balance sheet should be considered when determining whether a subsidiary has disposed of all its assets for purposes Reg. sec. 1.1502-19(c)(1)(iii)(A). Note that, under the facts of the AM, it appears that the taxpayer could have secured the worthless stock deduction by liquidating S1 in Year A. *For additional information, please contact Tim Lohnes, Bart Stratton, or DiAndria Green.*

PwC M&A Publications

In an article titled "Section 165(g)(3) Gross Receipts Test for Stock of a Worthless Consolidated Subsidiary: To Infinity and Beyond (Or Not)" published in the Journal of Corporate Taxation (May/June 2012), WNTS author Howard Braithwaite discusses the gross receipts test under section 165(g)(3).

In an article titled "What's Next After Codification Falls?" published in Tax Notes, May 7, 2012, WNTS author Monte Jackel discusses what should happen if section 7701(o) is held unconstitutional as part of the Supreme Court's holding on the healthcare reform legislation.

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