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This Month in M&A

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This Month's Features

- Application of section 367 to transfers of stock subject to section 304 (Notice 2012-15)
- "Technical Taxpayer" Final Regulations (T.D. 9576)
- Section 909 Temporary Regulations (T.D. 9577)
- Application of section 382 in bankruptcy (PLR 201208002)
- Application of former intercompany transaction regulations to proposed restructuring (PLR 201208034)
- Electronic furnishing of Schedule K-1 (Rev. Proc. 2012-17)
- Highlights of Treasury "Blue Book" explanation of Obama Administration's FY 2013 business tax proposals

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Did you know...?

The IRS has shifted its view regarding the application of section 367 to outbound section 304(a)(1) transactions. Under Notice 2012-15 (the "Notice"), section 367(a)(1) now applies when stock is sold outbound (i.e., U.S. seller and foreign buyer) in a section 304 transaction, implicating many related party stock sales. By making such outbound section 304 transactions subject to section 367(a)(1), taxpayers now must enter into a gain recognition agreement ("GRA") to avoid gain recognition on the outbound sale.

The Notice is effective for transfers occurring on or after February 10, 2012. The IRS states that the section 367 regulations will be amended to reflect the new guidance.

Background

In general, section 304 recharacterizes a related party (generally at least 50 percent vote or value, including broad attribution rules) stock sale to treat the sales proceeds as a section 301 distribution. To the extent section 304 deems the sales proceeds to be a 301 distribution, the following fictional transactions are deemed to occur: (i) the Seller transfers the stock of the target corporation ("Target") to the acquiring corporation ("Acquiring") in exchange for Acquiring stock in a transaction to which section 351(a) applies; and (ii) Acquiring redeems the stock it was treated as issuing in exchange for the consideration furnished in the stock "sale."

The IRS view as to whether and how section 367 should apply to a section 304 transaction has evolved over time. In 2006, the IRS issued regulations that precluded application of section 367 to section 304 transactions. The preamble to those regulations stated that the IRS believed that the policies underlying sections 367(a) and (b) would be preserved if the deemed section 351 transfer was not subject to sections 367(a) and (b) because, generally, the income recognized by the transferor should equal or exceed the built-in gain in the Target stock.

In early 2009, the IRS revised its view and issued temporary regulations (Reg. secs. 1.367(a)-9T, 1.367(b)-4T(e), and 1.1248-1T(b) (the "Temporary Regulations")). The Temporary Regulations provided that sections 367(a) and (b) generally did not apply to outbound transfers of stock subject to section 304(a)(1), except in cases where a taxpayer recovered basis in stock other than the stock deemed issued and redeemed in the section 304(a)(1) transaction (generally, the basis of pre-existing stock of Acquiring). In such cases, the Temporary Regulations required the taxpayer to recognize the entire gain under section 367(a)(1). That is, taxpayers could not enter into a GRA to defer the gain on the Target stock transferred outbound in the deemed section 351 transfer. The regulations also contained a similar rule under section 367(b).

The Temporary Regulations expired on February 10, 2012.

Section 304(a)(1) transactions under Section 367(a)

Under the Notice, all outbound section 304(a)(1) transfers are subject to section 367(a). Consequently, the outbound transfer of Target stock in the deemed section 351 transaction is subject to potential gain recognition under section 367(a). Because section 367(a) applies, the Notice provides that a taxpayer may enter into a GRA with respect to the transferor's gain in the Target stock.

To be effective, the GRA must address the deemed redemption of Acquiring stock, which generally is a triggering event unless a new GRA is filed. The Notice states that taxpayers may resolve this procedural issue by filing a single GRA with respect to the entire transaction, i.e., the deemed section 351 transfer and the deemed redemption of Acquiring stock. If the U.S. transferor does not enter into a GRA, the transferor's built-in gain in the Target stock is recognized under section 367(a)(1) and the gain may be subject to dividend recharacterization under section 1248(a).

Section 304(a)(1) transactions under Section 367(b)

Under the Notice, all section 304 exchanges in which the Target is a CFC will be subject to potential dividend inclusion under section 367(b). A section 367(b) dividend (or an increase in the exchanging shareholder's earnings and profits in the case of an exchanging shareholder that is a foreign corporation) will occur if the exchanging shareholder receives stock in the deemed section 351 transfer in a corporation that is not a CFC or if the exchanging shareholder loses its status as a U.S. shareholder of the Target. As a practical matter, such instances are rare, since in order for section 304(a)(1) to apply, the exchanging shareholder must be in control (generally defined in section 304(c) as at least 50 percent of the vote or value, applying section 318 attribution rules) of both Acquiring and Target. However, such instances are possible in structures with a foreign parent and a U.S. corporation that owns CFCs.

Sections 301(c)(3) and 1248(a)

The Temporary Regulations, specifically Reg. sec. 1.1248-1T(b), had provided that gain recognized by a U.S. shareholder under section 301(c)(3) in connection with a distribution of property by a CFC with respect to its stock is subject to dividend recharacterization under section 1248(a). The Notice indicates that final regulations will include this rule effective as of February 10, 2009 (the date of the Temporary Regulations).

Observations: It appears that the GRA amount should not be affected by the section 301(c)(2) basis recovery because the basis recovery does not impact Acquiring's basis in Target. Therefore, the amount of gain to be recognized upon an ultimate disposition of Target by Acquiring should be preserved in Acquiring's hands. However, if Target's shareholder(s) recognize any section 301(c)(3) gain, it appears the amount of the GRA and section 367(a)(1) gain should be reduced under Reg. sec. 1.367(a)-8(o)(3). *For additional information, please contact Carl Dubert, Tim Lohnes, Jay Haksar, or Doug Skorny.*

Treasury Regulations

"Technical Taxpayer" Final Regulations (T.D. 9576) - On February 9, the IRS issued final regulations providing so-called "technical taxpayer" rules and adopting 2006 proposed regulations with minor modifications (Reg. Sec. 1.901-2(f)).

In 2006, the proposed regulations had been drafted to provide rules to determine which taxpayer gets the benefit of a foreign tax credit. The IRS was concerned that liability for foreign taxes for U.S. foreign tax credit purposes was not being appropriately matched to the related income. The proposed regulations were aimed specifically at foreign tax credit planning using foreign consolidated groups and hybrid or reverse hybrid entities. It was believed that the proposed regulations were issued in large part in response to the taxpayer victory in the *Guardian Industries* case.

In the case of foreign consolidated groups and combined income regimes, the rules provide for a proration method under which each person would be considered the technical taxpayer with respect to foreign taxes that correspond to that person's portion of the combined income.

The IRS did not finalize the portion of the 2006 proposed regulations relating to determination of the person that paid a foreign income tax with respect to the income of a reverse hybrid. Rules relating to reverse hybrid entities are dealt with under section 909 regulations discussed below.

With respect to partnerships that are taxed under foreign law, the final regulations provide that the partnership is considered legally liable for an entity-level tax under foreign law. The final regulations also provide rules on allocating the foreign tax if a partnership's U.S. taxable year closes even though the foreign taxable year has not closed. The rule allocates the foreign tax based on the principles of Reg. sec. 1.1502-76(b).

With respect to disregarded entities, the final regulations provide that the owner of the disregarded entity is considered legally liable for any income tax imposed on the disregarded entity under foreign law. The foreign tax liability is allocated between a transferor and transferee if the disregarded entity has a change in ownership that closes the U.S. taxable year but not the foreign taxable year.

Reg. secs. 1.901-2(f)(3), (4), and (5) are effective for foreign taxes paid or accrued in taxable years beginning after February 14, 2012. The final regulations permit, but do not require, taxpayers to apply the combined income rules of the final regulations to taxable years beginning after December 31, 2010, and on or before February 14, 2012.

Observations: The approach in the final regulations (in combination with temporary regulations under 909) appears to reflect an IRS goal of attaining a more accurate matching of foreign taxes to related income. Before allocating foreign tax, the technical taxpayer regulations should be applied to ascertain whether a taxpayer is entitled to the allocable foreign taxes. In addition, the list of splitter arrangements under the section 909 regulations should be consulted to determine whether the foreign taxes are considered "split" and therefore noncreditable until reunited with the related income. *For additional information, please contact Karen Lohnes, Rebecca Rosenberg, or Dianna Miosi.*

Section 909 Temporary Regulations (T.D. 9577) - Section 909, enacted in August 2010, is intended to match foreign taxes with the relevant foreign income for purposes of taxpayers qualifying for U.S. foreign tax credits. Under section 909(a), if there is a foreign tax credit "splitting event" with respect to foreign income tax paid or accrued by a taxpayer, the tax is not taken into account before the related income is taken into account by the taxpayer.

On February 9, the IRS released temporary regulations under section 909 addressing foreign tax credit splitter transactions, including application of these rules to partners and partnerships. The temporary regulations set forth an exclusive list of arrangements that will be treated as giving rise to a foreign tax credit "splitting event," i.e., an event in which foreign income is split from the relevant foreign taxes.

The temporary regulations provide rules whose applicability depends on when the foreign income taxes are paid or accrued:

- For foreign income taxes paid or accrued by section 902 corporations in taxable years beginning on or before December 31, 2010, the temporary regulations adopt the exclusive list of "pre-2011 splitter arrangements" described in Notice 2010-92.

- For foreign taxes paid or accrued in taxable years beginning on or after January 1, 2011, and before January 1, 2012, the temporary regulations refer to the exclusive list of splitter arrangements described in Notice 2010-92 and, in addition, provide that partnership inter-branch payments also create splitter arrangements.

- For foreign income taxes paid or accrued in taxable years on or after January 1, 2012, the temporary regulations provide an exclusive list of arrangements that are considered "splitter arrangements": (1) reverse hybrid splitter arrangements, (2) loss-sharing splitter arrangements, (3) hybrid instrument splitter arrangements, and (4) partnership inter-branch payment splitter arrangements.

A reverse hybrid splitter arrangement arises when a payor pays or accrues foreign income taxes with respect to income of a reverse hybrid entity.

A loss-sharing splitter arrangement arises under a foreign group relief or other loss-sharing regime to the extent a shared loss of a U.S. combined group could have been used to offset income of that group but instead is used to offset income of another U.S. combined group.

A hybrid instrument splitter arrangement includes both U.S. equity hybrid instruments - treated as equity for U.S. federal income tax purposes but creates deductible payments for foreign tax purposes - and U.S. hybrid debt instruments - treated as equity for foreign tax purposes but debt for U.S. federal income tax purposes.

A partnership inter-branch splitter arrangement arises when the allocation of a tax with respect to a payment between branches of a partnership results in foreign income taxes being allocated to the partners in a different ratio than the ratio applicable to the related income underlying the payment. Notice 2010-92 has provided advance notice that the rules for inter-branch payments in Reg. sec. 1.704(b)(4)(viii)(d)(3) and example 24 of Reg. sec. 1.704-1(b)(5) would be changed to conform to section 909.

Under the rules in effect before publication of the section 909 regulations, an inter-branch payment was treated as part of the payee branch's foreign tax credit expenditure categories and was not part of the payor's credit expenditure grouping/pool. Those rules effectively allowed a separation of the U.S. income from the foreign taxes in the pools.

Those regulations also allowed the taxpayer to trace the effects of the inter-branch payment, either by looking to the income allocation in the payor's pool after the inter-branch payment or by looking to the income allocation in the payee's pool. The former allocation also appeared to permit a splitting arrangement, whereas the latter arrangement seemed to conform and match the income with the taxes.

Under the section 909 regulations, the rule of Reg. sec. 1.704(b)(4)(viii)(d)(3) has been deleted. The effect of this deletion is that under the general rule, the foreign tax expenditures in the payor pool are allocated based on how the U.S. income in that pool is allocated, but in determining the foreign tax credit pool of the payor branch, the taxes on the inter-branch payment are included. Under a special exception, the taxes on the inter-branch payment can be treated as part of the payee branch's foreign tax credit expenditure pool if the associated income is also so treated.

An arrangement satisfying either the general rule or the special rule will not be a foreign tax credit inter-branch splitter arrangement under the temporary regulations. However, the temporary regulations make clear that there must be a covered-person relationship between the relevant partners for section 909 to apply. The temporary regulations provide a special transition rule for pre-February 14, 2012 partnership agreements; however, this special rule is of limited effect because the foreign tax credit inter-branch splitter regulation rule applies for the 2011 tax year.

Under the temporary regulations, any foreign taxes paid or accrued in any of the four splitter arrangements may not be taken into account until the income related to such tax is taken into account.

However, it is important to note that no "new" splitter arrangements were introduced in the temporary regulations. The preamble to the temporary regulations states that any subsequent guidance providing new splitter arrangements will apply prospectively only.

Observations: The temporary regulations provide an exclusive list of splitter arrangements. Transactions not described as a splitter arrangement in the temporary regulations are not subject to section 909. Thus, other transactions that give rise to base or timing differences are not addressed in the temporary regulations and do not give rise to splitter arrangements. *For additional information, please contact Karen Lohnes, Rebecca Rosenberg, or Dianna Miosi.*

Private Letter Rulings

PLR 201208002 - This ruling addresses the application of section 382(l)(6) in determining the value of a loss corporation ("T") emerging from bankruptcy. T, a domestic holding company, owned an interest in, and was the managing partner of, a partnership ("P") that owned a chain of disregarded entities (the "DEs"). T, P, and the DEs jointly filed a bankruptcy petition. As part of the plan of restructuring, which T represented would result in an ownership change, one of the DEs would transfer to its creditors new T common stock and the right to purchase additional new T common stock upon T's emergence from bankruptcy (the "Rights Offering").

The IRS ruled that T was eligible to apply section 382(l)(6) and Reg. sec. 1.382-9(j) to determine its value. Under those provisions, the value of a loss corporation is the lesser of (i) the fair market value of its outstanding stock immediately after an ownership change, or (ii) the fair market value of its pre-change assets.

The IRS ruled that for purposes of determining the value of T's outstanding stock *immediately after* the ownership change, such value included the value of T stock issued pursuant to the Rights Offering. Also, the IRS ruled that the value of T's *pre-change assets* included T's allocable share of the aggregate value of the assets of P and the DEs determined without regard to liabilities and excluding any proceeds of the Rights Offering.

Observations: In general, there is limited guidance as to valuation of a taxpayer's stock in situations involving rights offerings in connection with bankruptcy filings, or as to whether taxpayers must apply an aggregate or entity approach to value its pre-change assets when the taxpayer holds a partnership interest. Existing guidance, while generally taxpayer-favorable, leaves unresolved questions such as whether a partner must own a certain percentage of the partnership to apply an aggregate approach, e.g., is there any correlation with the PLR's look-through approach and requirements under the continuity of business enterprise or proposed active trade or business regulations? Because a private letter ruling can by relied on only by the taxpayer to which it was issued, taxpayers with valuation issues under section 382(l)(6) and Reg. sec. 1.382-9(j) should consider seeking IRS rulings. *For additional information, please contact Richard McManus or Matt Lamorena.*

PLR 201208034 - The IRS ruled under the former intercompany transaction regulations, - i.e., as in effect for consolidated return years beginning before July 12, 1995 (the "Former Intercompany Transaction Regulations") - a deferred gain arising from a pre-1995 intercompany sale/distribution of CFC stock ("Target") was not restored as a result of completed transactions or certain proposed transactions. The ruling addressed the following transactions: (1) a completed inbound F reorganization of Target; (2) a completed E reorganization of Target; and (3) a proposed merger of another member of the consolidated group with and into Target, followed by a proposed E reorganization of the Target.

Observations: In general, whether a deferred gain under the Former Intercompany Transaction Regulations (e.g., Former Reg. secs. 1.1502-13 and 1.1502-14T) is restored into the group's income is determined solely by reference to those regulations. Thus, taxpayers generally must continue to track and restore deferred intercompany transactions by reference to the rules in effect at the time of the transaction.

The Former Intercompany Transaction Regulations generally were more mechanical in nature than the current intercompany transaction regulations, which apply to consolidated return years beginning after July 12, 1995. For example, the prior rules did not include the concept of a successor asset, ie., an asset, the basis of which is determined by reference, directly or indirectly, in whole or in part, to the basis of a first asset. Under the current intercompany regulations' successor asset concept, a group generally continues to defer an intercompany gain if the property subject to that gain is replaced in a tax-free transaction and the basis from the intercompany transaction is not reflected by a non-member. Because the Former Intercompany Transaction Regulations did not contain a successor asset concept, taxpayers may be unable to achieve a high level of confidence that certain tax-free transactions subject to those rules result in the continued deferral of intercompany gains.

However, while the Former Intercompany Transaction Regulations continue to remain relevant, many taxpayers avoided their continued application to certain stock elimination transactions by making a one-time election under Reg. sec. 1.1502-13(l)(3) (the "(l)(3) Election"). The (l)(3) Election enables taxpayers to apply the current intercompany transaction regulations to stock elimination transactions to which prior law otherwise would apply. A stock elimination transaction is a transaction in which stock transferred in an intercompany transaction is (1) cancelled or redeemed, (2) treated as cancelled or redeemed pursuant to a section 338(h)(10) election, (3) distributed, or (4) exchanged for stock of a member in a transaction that would cause the deferred gain or loss from the transfer to be taken into account under prior law.

Generally, to benefit from this relief, the (l)(3) Election must have been made on the group's 1995 consolidated return. However, if no such election was made, a corporation can petition the IRS for "9100 relief" to make a retroactive (l)(3) Election. This PLR indicates that the IRS may be willing to enter into a closing agreement in conjunction with a PLR with respect to prospective transactions. *For additional information, please contact David Friedel or Matthew Manning.*

Other Guidance

Notice 2012-15 - *See* "Did You Know" above.

Electronic furnishing of Schedule K-1 - Any partnership that must file a tax return also must inform each partner of its distributive share of partnership income, gain, loss, deduction, or credit that is applicable to that year's partnership return (sec. 6031(b)). On February 13, the IRS eased this additional requirement in certain cases by providing guidance (Rev. Proc. 2012-17) on how furnishing electronic K-1's to partners can satisfy the sec. 6031(b) requirement.

Rev. Proc. 2012-17 sets out requirements for electronic K-1's, including the following:

- <u>Affirmative consent</u> - In order to furnish a K-1 electronically, the partner receiving the K-1 must give affirmative consent to receive the information electronically. (Consent can be withdrawn if done so before the K-1 is furnished.) Consent should be obtained prior to furnishing the K-1. A new consent is not required if a partnership undergoes a technical termination under section 708(b)(1)(B).

- <u>Required disclosures</u> - Seven required disclosures must be included on the consent form.

- <u>Format</u> - An electronically furnished K-1 must contain all required information and comply with K-1 instructions.

- <u>Notice</u> - If the K-1 is posted on a website, the furnisher must notify the partner that it is posted, how to access the K-1, and how to print the K-1.

- Amended K-1 - An amended K-1 must be furnished within 30 calendar days of the date that the K-1 is amended.

- Access period - K-1's that are furnished through a website must be retained on the website for the longer of 12 months from the end of the partnership's tax year to which the K-1 relates or six months after the date of issuance of the K-1 or amended K-1.

Observations: The new revenue procedure sets forth a checklist of requirements to satisfy section 6031(b). For large partnerships with many K-1's to furnish, this guidance may be positive news from an administrative aspect.

Rev. Proc. 2012-17 is effective for K-1's distributed on or after February 13, 2012. Failure to comply with the revenue procedure may result in penalties under sec. 6722. A partnership that plans to furnish electronic K-1's will be deemed compliant with section 6031(b) if all steps in Rev. Proc. 2012-17 are followed. *For additional information, please contact Karen Lohnes or Matthew Arndt.*

Legislative Update

"Blue Book" explanation of Administration budget - The Treasury Department last month released its general explanation (the "Blue Book") of the tax relief and revenue-raising proposals included in the Administration's FY2013 budget submission to Congress. The budget submission includes several business tax proposals from the Administration's budget submission last year, including:

- repealing the non-qualified preferred stock designation under section 351(g);
- repealing the "boot-within-gain" limitation under section 356(a)(2);
- modifying the definition of control for purposes of section 249; and
- taxing a partner's share of income from an "investment services partnership interest" as ordinary income, regardless of the character of income that flows through from the partnership (see March 2011 edition of "This Month in M&A")

The Administration also proposes extending, through December 31, 2013, the active financing and CFC look-thru exceptions to Subpart F income. Under present law, those exceptions expired for tax years beginning on or after January 1, 2012.

The Administration's FY2013 budget submission includes a new item that would impact the rules governing a foreign corporation's distribution to a U.S. shareholder. Under current law, the determination of whether a foreign corporation's distribution to a U.S. shareholder is a dividend is based solely by reference to the distributing corporation's earnings and profits and stock basis under section 301. The Administration proposal would effectively modify the application of section 301 by providing that where the distribution is funded by a related foreign corporation and there is a principal purpose of avoiding dividend treatment, the U.S. shareholder's basis in the distributing corporation would not be taken into account. The proposal, which would apply to distributions after December 31, 2012, is estimated to raise $3 billion over 10 years.

Observations: The Administration's proposals, if enacted, could impact planning and structuring for multinational corporations with U.S. and foreign operations. In particular, the new proposal could impact a corporation's ability to repatriate its capital investment from a foreign subsidiary. At this time, the outlook for action on the Administration's tax increase proposals remains uncertain. *For additional information, please contact Jayant Haksar or Matt Lamorena.*

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