This Month in M&A

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This Month's Features

- Proposed regulations on allocation of E&P following reorganizations
- Supreme Court rules that basis overstatement does not trigger extended statute of limitations (*United States v. Home Concrete & Supply, LLC*)
- Final section 267(f) regulations on deferral of losses on transactions between controlled group members
- Final section 1248(a) regulations treating section 301(c)(3) distributions as a sale or exchange of stock
- Subsidiary's recapitalization followed by parent's liquidation treated as downstream D reorganization (PLR 201214013)
- Amortizable section 743(b) adjustment treated as separate asset from a partnership's non-amortizable section 197(f)(9) intangible asset upon partnership incorporation (PLR 201214014)
- Securities partnerships allowed to aggregate section 704(c) gains and losses (PLR 201216019)
- Exchange of Controlled stock and securities for newly issued Distributing debt is tax-free under section 361(c) (PLR 201216023)
- Acquisition qualifies as a QSP even though shares were acquired in violation of local country securities law (PLR 201216026)
- Coordination procedures on review of the application of the economic substance doctrine (Chief Counsel Notice 2012-008)

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Did you know…?

Recently issued proposed regulations regarding the allocation of earnings and profits (E&P) would require, following a tax-free reorganization, the ultimate recipient of all of a target corporation's assets to succeed to all of the target corporation's E&P. No E&P would be allocated to any corporation that received only a portion of the target's assets in a tax-free transfer (e.g., a section 351 transfer) pursuant to the same plan. The proposed regulations provide a much needed clarification to ambiguous current regulations that appear to require E&P allocations following many post reorganization asset drop-downs.

The new rules are proposed to apply to transactions that occur on or after the date they are published as final regulations in the Federal Register.

Background

Generally, section 381 provides that if one corporation acquires the assets of another corporation in certain tax-free liquidations or reorganizations, the acquiring corporation succeeds to certain tax attributes of the target, including E&P. By its terms, section 381 does not apply to section 351 exchanges.

Under the section 381 regulations, only one corporation can be the acquiring corporation. The acquiring corporation is the corporation that, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the target's assets, taking into account asset transfers to subsidiary corporations pursuant to the same plan. If no one corporation ultimately acquires all of the target's assets, the corporation that directly acquires the assets is treated as the acquiring corporation, even if such corporation ultimately retains none of the target's assets.

Uncertainty in the current regulations

While the general rules may seem clear, there have been differing views on whether a target's E&P may be allocable to one or more controlled corporations that receive a portion of the target's assets following a reorganization. This is because the section 381 regulations expressly provide that section 381 does not apply to determine the appropriate allocation of E&P where a portion of a target's assets are transferred by the acquiring corporation to one or more controlled corporations, or where all the acquired assets are transferred to two or more controlled corporations. Reg. sec. 1.381(c)(2)-1(d).

Instead, the section 381 regulations provide a cross reference to Reg. sec. 1.312-11(a), which states that a "proper adjustment and allocation of the earnings and profits of the transferor corporation shall be made as between the transferor and transferee." The section 312 regulation then refers to

section 381 and the regulations thereunder for guidance on the allocation, but section 381 does not appear to support such an allocation.

Prior to the proposed regulations, the IRS had expressed the view in limited informal guidance that a target's E&P account is not divided if the target's assets are transferred by the acquiring corporation to multiple corporations following a reorganization. See, e.g., PLR 201026010 and CCA 200911010, discussed in the August 2010 and April 2009 editions of This Month in M&A, respectively.

The proposed regulations

The proposed regulations would modify Reg. sec. 1.312-11(a) and clarify that in a transfer described in section 381(a), the acquiring corporation, as defined in Reg. sec. 1.381(a)-1(b)(2) - and only that corporation - succeeds to the E&P of the target. Thus, the E&P account is not divided if the acquiring corporation subsequently transfers the target's assets to one or more controlled subsidiaries in a tax-free transfer unless the transferee meets the definition of the acquiring corporation (i.e., unless the transferee succeeds to all of the target's assets pursuant to the same plan).

The preamble states that this rule is appropriate because E&P measures the capacity of a corporation to pay dividends, and the corporation that has an interest, directly or indirectly, in all of the target's assets has the dividend-paying capacity that is most comparable to that of the target. This rule also would conform the treatment of E&P to that of other section 381 attributes.

The proposed regulations do not alter the treatment of asset transfers following a type F reorganization. In such a case, all attributes remain at the acquiring corporation, regardless if all assets are contributed to a controlled subsidiary pursuant to the same plan.

Observations: The proposed regulations would bring needed clarity by adopting a "bright line" rule. Under this rule, it appears the acquiring corporation could retain the target's E&P by retaining one percent of the target's assets while transferring 99 percent to a controlled subsidiary pursuant to the plan of reorganization.

Some commentators have suggested that a better approach would be to allocate the target's E&P to the corporation that ultimately receives "substantially all" of the target's assets. This approach might align the E&P with the underlying assets more closely, but more guidance would be required with respect to the definition of "substantially all" than currently exists to make the rule administrable.

Notwithstanding the clarification that would be made by the proposed regulations, there would still be ambiguity surrounding the allocation of E&P in other areas, such as divisive reorganizations and spin-offs under Reg. sec. 1.312-10. For example, in a divisive reorganization under section 355 where assets are contributed to a newly formed controlled corporation, Reg. sec. 1.312-10 provides that the distributing company generally should allocate its E&P based on the proportionate fair market value of the businesses of the

distributing and controlled corporations; however, "in a proper case," E&P may be allocated based on the proportional net asset basis. The regulation is silent as to what constitutes a "proper case," and at least one court has ruled that the fair market value method is prima facie to be applied. *See Bennett v. U.S.*, 427 F2d 1202 (Ct. Cl., 1970). *For additional information, please contact Julie Allen, Arthur Sewall, or Meryl Yelen.*

Court Watch

United States v. Home Concrete & Supply, LLC (April 25, 2012)

The U.S. Supreme Court affirmed the Fourth Circuit's decision that the overstatement of basis of an asset does not give rise to an omission of gross income for purposes of establishing a six-year period of limitations for assessment under section 6501(e).

Under section 6501(e)(1)(A), the IRS has six years from the filing of a return to assess additional taxes "[i]f the taxpayer omits from gross income an amount properly includible therein [which]... is in excess of 25 percent of the amount of gross income stated in the return...." The question presented in *Home Concrete* was whether an overstatement of basis of an asset that causes the understatement of gain from the disposition of that asset constitutes an omission from gross income that would invoke this provision. The Supreme Court in 1958, interpreting the predecessor provision to section 6501(e) in *Colony, Inc. v. Commissioner,* concluded that it did not. However, in 2010, the IRS issued Reg. sec. 301.6501(e)-1, which interpreted the key phrase contrary to the decision in *Colony*.

The Supreme Court in *Home Concrete* struck down the regulation, holding that "there is no longer any different construction that is consistent with *Colony* and available for adoption by the agency."

Observations: This is a unique situation in that the Supreme Court had decided in the *Colony* case prior to issuance of the regulations that the statute did not apply to overstated basis or costs. Accordingly, the Court believed that the issue was already resolved and could not be changed by subsequent regulations. The opinion does not address more generally under what circumstances courts should defer to administrative interpretations of the law in the vast majority of situations where the Court has not previously provided the meaning of the statute. *For additional information, please contact Dan Wiles, Matthew Lamorena, or Matthew Manning.*

Treasury Regulations

Proposed Section 312 Regulations - See Did You Know

Final Section 267(f) Regulations (T.D. 9583)

The IRS recently issued final regulations (Final Regulations) addressing the time for taking into account losses on the sale or exchange of property

between members of a controlled group. In general, the Final Regulations focus on a transaction in which a corporation sells at a loss more than 20 percent of a wholly owned subsidiary to another corporation within the same controlled group before liquidating the subsidiary. This planning often occurs in connection with avoiding the application of section 332 to the liquidating subsidiary (a so called "granite trust" transaction").

The Final Regulations adopt the rules set forth in proposed regulations (Proposed Regulations) issued April 21, 2011, with two changes. (For prior coverage, see the April/May 2011 edition of This Month in M&A.)

The Proposed Regulations provided that the selling member's section 267(f) deferred loss would continue to be deferred to the extent the loss would be redetermined to be a noncapital, nondeductible amount under the principles of Reg. sec. 1.1502-13. To determine whether a loss is a noncapital, nondeductible amount, taxpayers would be required to take into account stock held by the selling member, the buying member, and all members of the seller's consolidated group, as well as stock held by any member of a controlled group of which the seller is a member that was acquired from a member of the seller's consolidated group. Thus, if the stock of the sold subsidiary held by the persons described above exceeded 80 percent of the vote and value of the subsidiary's stock, then the loss recognized on the sale would continue to be deferred.

The first change made by the Final Regulations is that stock issued to a member of the controlled group by a target corporation is taken into account for purposes of determining whether a loss would be treated as a noncapital, nondeductible amount. The second change removed a rule that would have directed the seller to take its loss into account to the extent the buying member recognized any corresponding income or gain with respect to the property.

Observations: The IRS explained that the first change made by the Final Regulations described above is intended to prevent taxpayers from circumventing the rule on loss deferral by issuing target corporation stock to controlled group members. The second change was made because the rule permitting the loss to be taken into account when corresponding gain is recognized already is embodied in Reg. sec. 1.1502-13.

The Final Regulations apply to transactions in which the event that would cause a loss to be redetermined as a noncapital nondeductible amount under the principles of Reg. sec. 1.1502-13 occurs on or after April 16, 2012. *For additional information, please contact Bruce Decker or Michelle Estrada.*

Final Section 1248 Regulations (T.D. 9585)

The IRS recently issued final regulations treating distributions from foreign corporations resulting in capital gain under section 301(c)(3) as a sale or exchange of such foreign corporation's stock for purposes of section 1248(a). Section 301(c)(3) gain with respect to foreign stock is subject to dividend recharacterization under the final regulations "in order to ensure that the

earnings and profits of lower-tier foreign subsidiaries described in section 1248(c)(2) are taken into account." These final regulations adopt, without substantive change, the rules set forth in temporary regulations issued on February 11, 2009, and apply to distributions occurring on or after that date.

Observations: When section 301(c)(3) gain with respect to foreign stock is recharacterized as a dividend under section 1248(a), the recharacterization creates previously taxed income in the foreign company under section 959(e). However, such gain does not create basis under section 961. As a result, subsequent distributions of the previously taxed earnings to the U.S. shareholder may result in recognition of additional gain if the distribution is in excess of basis. See section 961(b)(2). To the extent section 301(c)(3) gain is recharacterized, the deemed distribution brings up section 902 deemed paid foreign tax credits under Reg. sec. 1.1248-1(d). *For additional information, please contact Sean Mullaney or Arthur Sewall.*

Private Letter Rulings

PLR 201214013 – In a chain of wholly owned corporations, Holdco owned Parent, which owned Target Parent, which owned Target Sub. The IRS ruled that Parent's exchange of all the stock of Target Parent for newly issued Target Parent stock (Share Exchange), immediately followed by Parent's conversion to a disregarded entity (Conversion), was a downstream D reorganization. Immediately following the conversion, Target Parent merged downstream into Target Sub (Merger).

Observations: The IRS respected the form of the transaction by treating the Share Exchange as a section 361 exchange by a target corporation. The Share Exchange might have been viewed as transitory because the shares issued were cancelled in the Merger; if so, the Conversion could have qualified as a section 332 liquidation into Holdco. Thus, by virtue of the Share Exchange, the section 381 tax attributes of Parent were transferred ultimately to Target Sub rather than to Holdco. The ruling demonstrates the importance of form controlling transactions that could be viewed as downstream reorganizations versus section 332 liquidations. *For additional information, please contact Timothy Lohnes or Michelle Estrada.*

PLR 201214014 – As part of an assets-over incorporation, a partnership was deemed to contribute non-amortizable intangibles that were subject to the anti-churning rules under section 197(f)(9) to the newly formed corporation in exchange for shares. Two years prior to the incorporation transaction, the tax basis of the intangibles had been adjusted under section 743(b) and the adjustment was amortizable under section 197. The PLR concludes that the partnership is treated as contributing two separate intangibles to the corporation: the portion of the intangibles that were not adjusted under section 743(b) and the portion of the intangibles that were adjusted under section 743(b).

At the time of the incorporation, the partnership's liabilities were in excess of its tax basis in its assets, causing the partnership to recognize gain under section 357(c). Relying on its conclusion that the partnership was deemed to

contribute two intangibles to the partnership, the PLR concludes that any basis increase as a result of the section 357(c) gain that is allocated to the portion of the intangibles that were adjusted under section 743(b) will not be subject to the anti-churning rules of section 197(f)(9).

Observations: The PLR treated the corporation as receiving two section 197 assets as part of its incorporation: an amortizable intangible and a non-amortizable intangible. While Reg. sec. 1.197-2(g)(3) provides that a partnership should treat the section 197(f)(9) property and the section 743(b) adjustment as separate intangibles, it is unclear whether the bifurcation would be respected in the hands of a transferee corporation. Also, although the PLR does not address how the section 357(c) gain is allocated between the corporation's two intangible assets, it is notable that the IRS ruled without providing analysis that any additional basis increase to the portion of the intangibles that was adjusted under section 743(b) is amortizable despite the transferee and transferor being wholly related. The PLR did not address the impact, if any, of a section 743(b) basis offset to the section 357(c) gain under Reg. sec. 1.743-1(h)(2) on the conclusion. *For additional information, please contact Susana Noles, Elizabeth Amoni, or Kristel Glorvigen Pitko.*

PLR 201216019 – To align business objectives, two securities partnerships within the meaning of Reg. sec. 1.704-3(e)(3)(iii) merged in an assets-over merger for U.S. federal income tax purposes. The IRS allowed the merging partnerships under Reg. sec. 1.704-3(e)(4)(iii) to aggregate the built-in gains and losses inherent in the contributed assets held by the transferor partnership with gains and losses from revaluations of the assets held by the transferee partnership for purposes of making section 704(c) allocations. The partnerships also received permission to continue to utilize the established aggregation methodology of the transferee partnership. The taxpayer provided the representations necessary to submit a ruling request under Rev. Proc. 2001-36 applicable to certain Qualified Master-Feeder Structures.

Observations: Section 704(c) generally applies on a property-by-property basis; therefore, built-in gains and built-in losses inherent in contributed or revalued property generally cannot be aggregated. However, under an exception in Reg. sec. 1.704-3(e)(3), certain securities partnerships may make section 704(c) allocations arising from revaluations of property on an aggregate basis. Reg. sec. 1.704-3(e)(4)(iii) permits the aggregation by a securities partnership of gains and losses inherent in contributed property by letter ruling or published guidance only. This PLR illustrates that the IRS continues to issue rulings to securities partnerships to allow them to aggregate built-in gains and built-in losses inherent in contributed assets with gains and losses from revaluations of the assets. For an explanation of two previous similar section 704(c) aggregation rulings, see This Month in M&A August 2010. *For additional information, please contact Susana Noles, Elizabeth Amoni, or Kristel Glorvigen Pitko.*

PLR 201216023 – The IRS re-affirmed its position first set forth in PLR 201123030 (see This Month in M&A July/August 2011) that debt issued by a

Distributing corporation in anticipation of a section 355 transaction can be exchanged for Controlled stock or securities tax-free under section 361(c).

In this ruling, Distributing formed Controlled by contributing assets in exchange for Controlled shares, Controlled securities, and newly borrowed cash (Controlled Formation). Distributing distributed at least 80 percent of Controlled stock to its shareholders (Distribution) and borrowed money (Distributing Debt) from investment banks (Debt Holders) around the time of the Distribution. After holding the Distributing Debt for at least 14 days, certain Debt Holders will exchange Distributing Debt for Controlled stock or securities.

The IRS ruled that the Controlled Formation and Distribution constituted a D/355 transaction, and no gain or loss will be recognized to Distributing or its shareholders provided the retained Controlled shares are transferred to Distributing's creditors in exchange for Distributing Debt or to Distributing shareholders within 12 months of the Distribution.

Observations: This PLR describes a section 355 monetization strategy similar to the one in PLR 201123030, in which Distributing monetized Controlled shares by exchanging them for non-security indebtedness. As in PLR 201123030, the investment banks did not acquire the Distributing Debt from existing creditors. Rather, Distributing issued new debt to the investment banks in the transaction, raising the possibility of viewing this as a sale by Distributing of Controlled stock or securities. The Distributing Debt was respected presumably because it remained outstanding for at least 14 days, subjecting the holders to risk of loss. Consistent with prior rulings, the IRS required the taxpayer to represent, generally, that the aggregate amount of Distributing Debt that will be repaid will not exceed Distributing's weighted quarterly average of external debt for the previous 12-month period. *For additional information, please contact Tim Lohnes or Jerry Towne.*

PLR 201216026 – The IRS ruled that the acquisition by an affiliated group of corporations of greater than 80 percent of a publicly traded foreign target corporation (Foreign Target) constituted a qualified stock purchase (QSP) notwithstanding that local country securities law required the affiliated group to dispose of a quantum of the stock to bring the group's ownership of Foreign Target below 80 percent.

***Observations*:** A QSP is defined as the acquisition by one corporation of stock representing at least 80 percent (by vote and value) of another corporation by purchase from an unrelated person during the 12-month acquisition period. In this PLR, the IRS respected the transfer of the benefits and burdens of stock ownership to the buyer for purposes of finding a QSP notwithstanding the buyer was legally prohibited from retaining the minimum 80-percent ownership required for a QSP. *For additional information, please contact Tim Lohnes, Bart Stratton or Meryl Yelen.*

Other Guidance

Chief Counsel Notice 2012-008 – In this notice, the IRS Office of Chief Counsel provided (i) instructions regarding its role during an examination that involves the application of the economic substance doctrine under common law or section 7701(o); (ii) instructions for reviewing a statutory notice of deficiency or a notice of final partnership administrative adjustment if a Business Operating Division concludes that a transaction lacks economic substance; and (iii) coordination procedures for litigating either the common-law or codified economic substance doctrine and a related penalty.

Observations: This notice should be read in conjunction with the IRS implementation procedures identified in directives issued by the LB&I Division on September 14, 2010 (LMSB-20-0910-024) and July 15, 2011 (LB&I-4-0711-015). While the notice does not provide rights a taxpayer can specifically invoke, it should help ensure consistency by coordinating procedures and control how economic substance is raised in the future during an examination. *For additional information, please contact Susana Noles or Monte Jackel.*

PwC M&A Publications

WNTS authors Monte A. Jackel and Audrey Ellis discuss the proposed May Company regulations and argue that the time has come to either finalize or revoke them. Jackel, Monte A.; Ellis, Audrey, "Perpetually Proposed: The May Company Regulations Revisited," 2012 Tax Notes Today 63-12 (April 2, 2012).

WNTS author Wade Sutton discusses the application of Reg. sec. 1.1001-3 to the deemed liquidation of an insolvent corporation as discussed in the generic legal advice memorandum, AM 2011-003. Wade Sutton, "Check-the-Box Elections of Insolvent Entities," 2012 Tax Notes Today 79-5 (April 24, 2012).

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