This Month in M&A

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This Month's Features

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- Proposed regulations for redetermining consolidated NUBIG/NUBIL
- Proposed regulations removing the de minimis partner rule
- District Court rules lease restructuring transaction lacked economic substance
- District Court rules foreign tax credit generating transaction lacked economic substance
- IRS respects rescission of intercompany stock sales (PLR 201140008)
- Taxpayer deemed to satisfy active trade or business requirement for exception to section 367(a)(1) (PLRs 201141011 and 201141012)

Did you know...?

On October 20, the IRS issued final regulations (T.D. 9548) (the "Final Regulations") that harmonize the application of section 355(a)(3)(B) (the "Hot Stock Rule") with the active trade or business ("ATB") rules in section 355(b), but at the same time leave several key questions unanswered.

Temporary hot stock regulations were issued on December 15, 2008 (T.D. 9435) (*see* the "Did you know . . .?" in the January 2009 edition of This Month in M&A). The Final Regulations adopt without substantive change the rules set forth in the temporary regulations. The Final Regulations are effective for distributions occurring after October 20, 2011.

Background

In general, under the Hot Stock Rule, stock of a controlled corporation ("Controlled") acquired by the distributing corporation ("Distributing") in a taxable transaction within five years of the distribution of Controlled stock is treated as other property or "boot" to Distributing's shareholders ("hot stock"). In such a situation, the spin-off may be partially tax-free, but the receipt of the "hot stock" is taxable to the shareholders and to the Distributing corporation.

Final Regulations

Like the temporary regulations, the Final Regulations limit the impact of the Hot Stock Rule by providing three exceptions where gain is not recognized:

- Distributing acquires the stock of Controlled from another member of Distributing's separate affiliated group ("DSAG");
- Controlled becomes a member of the DSAG any time after the acquisition but before the distribution; or
- Distributing acquires the stock of Controlled from another member of the affiliated group of which Distributing is a member (e.g., Distributing buys Controlled stock from Distributing's parent).

For purposes of these exceptions, the term "DSAG" is defined generally as the affiliated group that would be determined under section 1504(a) if Distributing were the common parent and section 1504(b) (generally excluding foreign corporations and other specified entities from affiliated groups) did not apply. For this purpose, the term "affiliated group" means an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term "stock" includes “vanilla” preferred stock described in section 1504(a)(4).

Observations

The main issue under the Hot Stock Rule has been whether it applies to a stock acquisition that otherwise qualifies as a permissible acquisition under

the active trade or business (ATB) rules, which would cause an otherwise tax-free spin-off transaction to be taxable to Distributing's shareholders. The Final Regulations re-affirm that, provided one of the exception requirements outlined above is met, the Hot Stock Rule does not apply.

Several questions regarding application of the Hot Stock Rule continue to remain unanswered following the issuance of the Final Regulations, including:

- Whether the DSAG is treated as acquiring the Controlled stock in a taxable transaction in a situation in which a corporation that owns Controlled stock joins the DSAG in a taxable transaction;
- Whether the DSAG is treated as making any acquisition made by a predecessor of a DSAG member;
- Whether issuances by Controlled of its stock to Distributing in taxable transactions create hot stock;
- Whether a redemption by Controlled of its stock from unrelated parties causes any portion of Distributing's Controlled stock to become hot stock; and
- The treatment of cash paid to acquire Controlled stock in lieu of fractional shares.

While the regulations provide a welcome relief to taxpayers of the consequences of "hot stock," a myriad of other requirements must still be satisfied in order to obtain tax-free treatment under section 355. *For additional information, please contact Derek Cain, Tim Lohnes or Olivia Ley.*

Treasury Regulations

Final Hot Stock Regulations – See "Did You Know" above.

Proposed Consolidated NUBIG/NUBIL Regulations – Current Reg. sec. 1.1502-91(g) provides rules for determining whether a loss group has a consolidated net unrealized built-in gain ("NUBIG"), consolidated net unrealized built-in loss ("NUBIL"), or both at the time of a section 382 ownership change. In general, for purposes of calculating consolidated NUBIG/NUBIL, the regulations disregard the gain or loss built-in to member stock under the premise that such amount generally is reflected in the member's assets and should not be duplicated in the NUBIG/NUBIL calculations. Under the current regulations, if the unrecognized gain or loss on member stock exceeds the member's gain or loss in its assets, disregarding this unduplicated gain or loss on the stock understates the amount that the group may take into account.

To address this issue, the IRS has proposed regulations under Reg. sec. 1502-91 requiring the redetermination of NUBIG or NUBIL whenever a member of

a consolidated group directly or indirectly takes any amount of gain or loss into account with respect to a share of a member's stock (the "transferred member") during the five-year recognition period. At that time, NUBIG/NUBIL is redetermined to include the "unduplicated built-in gain or loss." The unduplicated built-in gain or loss is the portion of the built-in gain or loss on the member's stock that was not originally reflected in the loss group's NUBIG/NUBIL as unrealized gain or loss in such member's assets.

The proposed regulations use the following three-step approach to determine the unduplicated built-in gain or loss on transferred member stock immediately before the section 382 ownership change date:

1. Treat the separate unrealized built-in gain or loss items of each lower-tier member as having been recognized and absorbed immediately before the change date.

2. Take into account the amounts deemed recognized as stock basis adjustments that tier-up and tentatively adjust the basis of the transferred member's stock.

3. Calculate the transferred member's unduplicated gain or loss as the difference between the tentatively adjusted stock basis and the fair market value of the transferred member immediately before the change date.

The group will redetermine NUBIG/NUBIL as of the date gain or loss is taken into account (whether or not absorbed) with respect to the transferred member by including its unduplicated gain or loss. This redetermination has no effect on the treatment of built-in gain or loss that was recognized and taken into account prior to the event that caused the redetermination.

The regulations are proposed to apply to amounts taken into account with respect to a share of stock of an included subsidiary on or after the date that the final regulations are published, but only for ownership changes occurring on or after October 24, 2011.

Observations: The approach in the proposed regulations should reflect more accurately the built-in gains as well as losses in a consolidated group and therefore should be taxpayer neutral. The proposed regulations generally apply only if within the five-year recognition period under section 382 (i) member stock is sold to a nonmember, (ii) member stock becomes worthless, or (iii) a member takes an intercompany item into account with respect to such stock. From a practical perspective, taxpayers will need to know both the value and the stock basis of each subsidiary member on an ownership change date in order to apply these rules. *For additional information, please contact David Friedel or Michelle Estrada.*

Proposed De Minimis Partner Regulations - Proposed regulations would remove the de minimis partner rule of Reg. sec. 1.704-1(b)(2)(iii)(e) in order to prevent unintended tax consequences.

Section 704(a) provides that a partner's distributive share of income can be determined by the partnership agreement. However, section 704(b) provides that a partner's distributive share shall be redetermined in accordance with the partner's interest in the partnership if the allocation does not have substantial economic effect.

Reg. sec. 1.704-1 sets forth a two-prong test for substantial economic effect. The first prong - economic effect - is tested under Reg. sec. 1.704-1(b)(2)(ii). The second prong - substantiality - is tested under Reg. sec. 1.704-1(b)(2)(iii), which provides generally that an allocation is not substantial if the after-tax economic consequences of at least one partner are enhanced while the after-tax economic consequences of no partner are expected to be diminished as a result of the allocations provided for in the partnership agreement.

In its current form, Reg. sec. 1.704-1(b)(2)(iii)(e), provides an exception with respect to the testing of substantiality for de minimis partners. The de minimis partner rule in that regulation was promulgated on May 19, 2008, as part of final regulations with respect to partners that are look-through entities. It provides that for purposes of applying the substantiality rules, the tax attributes of a de minimis partner need not be taken into account.

The regulation defines a de minimis partner as any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of gain, loss, deduction, and credit. The section 318 attribution rules are applied to determine ownership, so partners that are related to other partners generally are not considered to be de minimis partners.

The effective date of the proposed regulation is the date that final regulations are published in the Federal Register.

Observations: The de minimis rule was intended to reduce the administrative burden of determining substantiality by a partnership when the final regulations related to look-through entities were promulgated. However, by not limiting its application to de minimis look-through partners, it may have allowed certain partnerships to avoid the application of the substantiality rules entirely. Under the existing regulation, a partnership owned by 11 equal and unrelated partners would be comprised entirely of de minimis partners and therefore presumably not be subject to the application of the substantially rules.

The proposed removal of the de minimis rule would add an administrative burden to partnerships, which would have to test the allocations for all partners if the regulation is finalized as proposed. The IRS has requested comments on how a narrower de minimis rule might be applied in practice. *For additional information, please contact Gretchen Van Brackle or Matthew Arndt.*

Court Watch

***WFC Holdings Corporation v. U.S.*, 108 AFTR 2d 2011-6531 (Sept. 30, 2011)** – The U.S. District Court for the District of Minnesota disallowed WFC Holding Corp.'s ("WFC") capital loss in holding that WFC's transaction lacked economic substance and should be disregarded for U.S. tax purposes. The transaction was a lease restructuring transaction ("LRT"), which was similar to a transaction subsequently described as a "listed transaction" in Notice 2001-17.

WFC was the parent of a U.S. consolidated group that included Wells Fargo N.A., Wells Fargo Texas, and Charter (collectively, the "WFC group"). Following the acquisition of another financial services company, the WFC group held numerous underwater leases with a present value of negative $425.9 million ("underwater leases"). The WFC group transferred the underwater leases, along with U.S. government securities with a tax basis of $427.8 million and a fair market value of $429.9 million, to Charter in exchange for 4,000 shares of Charter preferred stock. Shortly thereafter, WFC sold the Charter preferred shares to a third party for $3.75 million and claimed a $423.9 million capital loss.

WFC argued it had three business purposes for the transaction. First, WFC had transferred the underwater leases to Charter in order to remove those leases from the oversight of the Office of the Comptroller of the Currency (the "OCC") and avoid regulatory penalties. Second, transferring underwater leases to a subsidiary with an outside investor would permit WFC to cite fiduciary duties to that investor when negotiating leases with its bank clients, so as to prevent clients from leveraging their customer status into favorable lease terms. Third, the LRT helped avoid bureaucracy, increased efficiency, and would assist in creating an equity sharing program to incentivize leasing officers.

Observations: The court applied the two-prong test for economic substance set forth in *Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985), and adopted for the Eighth Circuit by *IES Indus., Inc. v. U.S.,* 253 F.3d 350, 353 (8th Cir. 2001). In discussing business purpose, the court observed that what WFC purported to do was not what was actually done, because the majority of the leases transferred to Charter were not at risk from the OCC and the debt-like preferred stock transferred to Lehman did not appear to create a significant fiduciary relationship. The court held the taxpayer failed to establish a legitimate business purpose for the transaction other than tax benefits.

The court briefly addressed whether the profit potential, apart from the tax benefits, could exceed the transaction costs. As in *Coltec Indus., Inc. v. U.S.,* 454 F.3d 1340 (Fed. Cir. 2006*),* the court noted it must view the transaction as a whole (i.e., the transfer of property to Charter and the sale of Charter preferred stock). The court concluded that the goal of the LRT was to enable WFC to claim two deductions for a single economic loss, once upon the

deduction for the lease payments and once upon the sale of the preferred stock (representing the present value of future deductible lease payments).

While finding for the government on economic substance, the District Court - consistent with other liability management transaction decisions involving section 351 and preceding section 358(h) - rejected the government's statutory arguments. Specifically, the court rejected the IRS argument that section 357(b) extends to the basis calculation by reducing stock basis by the amount of liabilities transferred for a tax-avoidance purpose. The court also rejected the argument that an integrated transaction should be bifurcated into a part sale / part section 351 transaction for purposes of denying section 351 treatment to a portion of the transaction. *For additional information, please contact Tim Lohnes, Doug Skorny or Ruben Conitzer.*

Pritired 1, LLC v U.S., 108 AFTR 2d 2011-6605 **(Sept. 30, 2011) –** The U.S. District Court for the Southern District of Iowa denied a request for a refund of taxes paid with respect to a complex structured transaction that was designed to shift foreign tax credits from a foreign bank to a U.S. taxpayer. A simplified outline of the facts in *Pritired* is as follows.

Principal Life Insurance Co. and Citibank formed Pritired 1, LLC ("Pritired"), which contributed $300 million to a French partnership ("SAS") in exchange for $291 million of perpetual certificates ("PCs") stapled to $9 million of class B shares. Pritired treated the PCs and class B shares as equity for U.S. tax purposes but as debt for regulatory accounting purposes. The other partners in SAS were two French banks, which collectively contributed $930 million. After formation, SAS held a $1.23 billion portfolio of high quality debt securities. SAS incurred French corporate income taxes on its portfolio earnings.

Under the terms of the PCs, Pritired received stated payments on the PCs of Libor plus one percent. However, Pritired immediately entered into a Swap Agreement with SAS under which Pritired exchanged its stated payments on the PCs for payments of LIBOR plus five percent minus French income taxes incurred by SAS. The purpose of this Swap was to allocate the burden of the French taxes to Pritired; accordingly, Pritired claimed nearly all the French income taxes SAS paid on the income earned from its $1.23 billion portfolio.

The IRS disallowed both Pritired and Principal's share of these foreign taxes, claiming that the PCs and Class B shares were debt, rather than equity in SAS. In addition, the IRS challenged the transaction under the economic substance doctrine and partnership anti-abuse rules and claimed that the allocation of foreign tax credits did not have substantial economic effect. Principal paid $21 million of tax for the years 2002 and 2003 and sued for a refund in the District Court.

The District Court agreed with the IRS that the PCs and Class B shares were debt and therefore Pritired was not a partner in SAS. The court determined that Pritired bore no entreprenurial risk with respect to its investment because the agreements and bylaws of SAS ensured Pritired would recover a

fixed-dollar amount (its $300 million investment) in approximately five years.

The court also held that the transaction lacked economic substance because Principal did not articulate a valid business purpose for the PC Swaps and the transaction did not produce a reasonable amount of pre-tax economic profits, disregarding the foreign tax credits. Principal argued that the transaction had economic substance because its projected ratio of foreign taxes to economic profits was acceptable based on examples provided in Notice 98-5 (although ultimately as a result of a significant drop in interest rates, the economic profits were lower than anticipated and the majority of the return was derived from foreign taxes). The court concluded that the examples in Notice 98-5 did not create a safe harbor, but rather served as notice that the IRS would challenge transactions where credits were effectively purchased.

The court further determined that the transaction violated the partnership anti-abuse rules because Principal's principal purpose was to obtain foreign tax credits; SAS was not a bona fide partnership because Pritired and the French Banks did not intend to be partners; and the transaction inappropriately shifted foreign tax credits to Pritired for no economic reason. The District Court indicated that it was not necessary to determine whether the allocation of the foreign tax credits had substantial economic effect, since the PCs and Class B shares were treated as debt.

The transaction occurred prior to issuance of Notice 2004-19 and the temporary regulations governing the allocation of a partnership's foreign tax credits (Temp. Reg. § 1.704-1T).

Observations: The District Court could have denied Pritired's foreign tax credits based solely on its conclusion that Pritired's PCs and Class B shares were debt rather than equity. Instead, the court went on to rule on whether this arrangement lacked economic substance and violated the partnership anti-abuse rules. Although the Pritired transaction occurred prior to the codification of the economic substance doctrine, this decision creates some uncertainty as to when the economic substance doctrine is relevant. Note, however, the July LB&I directive (LB&I-4-0711-015) provides guidance for examiners to use in determining whether and when to seek high-level review in asserting the codified economic substance doctrine and may restrict the IRS's ability to apply the economic substance doctrine to similar transactions that are executed after the effective date of section 7701(o).

This is the first of five foreign tax generator cases expected to be decided. *For additional information, please contact Susy Noles or Gretchen Van Brackle.*

Private Letter Rulings

PLR 201140008 – The IRS approved a taxpayer's rescission of a series of transactions that could have resulted in a deemed section 301 distribution. The taxpayer had undertaken a series of intercompany stock sales at book

value rather than fair market value. The impact of these transactions could have resulted in deemed distributions.

Parent decided to rescind the stock sale transactions after it realized that these transactions would require fair market valuations, which would be administratively burdensome.

Observations: At the time of the transaction, the taxpayer was unaware of the amount of assets being sold and did not execute value-for-value exchanges. By rescinding the transfer of the shares, the taxpayer unwound the actual sale consequences as well as any potential deemed distributions or contributions. The IRS has not applied the rescission doctrine to an actual dividend distribution (*see* FSA 200124008); however, this PLR is another example of the IRS's willingness to rescind a deemed distribution that arises from an exchange of property (*see also* PLR 200813028). *For additional information, please contact Tim Lohnes, Richard McManus or Matthew Michaelangelo.*

PLRs 201141011 and 201141012 – In these identical rulings, the IRS ruled that an outbound transfer of stock of a U.S. corporation ("UST") to a newly formed foreign corporation ("F Holdco") pursuant to a reverse subsidiary merger (the "Merger") qualified for the exception to section 367(a)(1) in Reg. sec. 1.367(a)-3(c)(1) (the "Exception").

The Exception generally exempts U.S. persons from recognizing gain under section 367(a)(1) as long as, among meeting other requirements, the active trade or business test of Reg. sec. 1.367(a)-3(c)(3) is satisfied (the "ATOB Requirement"). One element of the ATOB Requirement is that the transferee foreign corporation or any qualified subsidiary (ownership of at least 80 percent vote and value) must have been engaged in the active conduct of a trade or business outside the U.S. for the entire 36-month period immediately preceding the exchange of target stock.

In this PLR, simultaneous with F Holdco's acquisition of UST, F Holdco will acquire shares of a publicly traded foreign corporation ("FC") and will be obligated to cause FC to become its wholly owned subsidiary as soon as practicable after the Merger. FC will have been engaged in the active conduct of a trade or business outside the U.S. for the entire 36-month period immediately preceding the Merger.

The IRS ruled that the transfer of UST stock to F Holdco will qualify for the Exception, provided F Holdco acquires at least 80 percent (by vote and value) of the FC shares within 36 months from the date of the Merger.

Observations: F Holdco will not directly satisfy the ATOB Requirement because it will be newly formed. However, the ATOB Requirement can be applied at the subsidiary level as long as the subsidiary is connected through stock ownership constituting 80 percent of the voting power and 80 percent of the value. If F Holdco acquires at least 80 percent of FC at the time of, or prior to the Merger, FC will be a qualified subsidiary allowing F Holdco to satisfy the ATOB Requirement. In this ruling, the IRS applied the Exception

notwithstanding that less than 80 percent of FC may be acquired by F Holdco at the time of or prior to the Merger.

Under Reg. sec. 1.367(a)-3(c)(9), the IRS may permit a taxpayer to qualify for the Exception if the taxpayer is unable to satisfy all aspects of the ATOB Requirement, but is in substantial compliance with that test and meets other shareholder requirements. These PLRs are rare instances of the IRS analyzing the ATOB Requirement and ruling that a taxpayer was substantially in compliance. It appears these PLRs are the first rulings in which the IRS has expressly limited the grace period for satisfying the ATOB Requirement to three years following the outbound stock transfer. *For additional information, please contact Jay Haksar or Olivia Ley.*

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