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This Month in M&A

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This Month's Features

- Proposed regulations provide initial guidance on corporate equity reduction transactions (CERTs)
- Tax Court treats related-party advance agreements as equity rather than debt (*PepsiCo, Inc. v. Comm'r*)
- US District Court concludes entities were sham partnerships even if transactions had economic substance (*Broadwood Investment Fund LLC v. United States*)
- Supplemental ruling respects back-to-back F reorganizations that occurred pursuant to an overall plan (PLR 201239003)
- CCA treats preferred stock as common stock for purposes of section 302(b)(2) (CCA 201236025)

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Did you know...?

It has been 23 years since Congress enacted the corporate equity reduction transaction (CERT) rules set forth in sections 172(b)(1)(E) and 172(h). On September 13, the IRS finally issued proposed regulations addressing the CERT provisions (the Proposed Regulations).

In general, the CERT rules limit a corporation's ability to carry back a net operating loss (NOL) to the extent the NOL is attributable to interest deductions allocable to certain leveraged buyout transactions. The CERT rules are intended to prevent taxpayers from obtaining income tax refunds from NOL carrybacks created from interest deductions from leveraged financing. The CERT rules are often overlooked and can serve as a trap for the unwary.

The new rules (REG-140668-07) are proposed to apply to CERTs occurring on or after the date final regulations are published, except they would not apply to CERTs occurring pursuant to a written agreement that is binding before that date. The IRS notes that rules are not proposed addressing application of sections 172(b)(1)(E) and 172(h) to transactions occurring before final regulations are published (transitional issues). The IRS continues to study, and requests comments on, transitional issues. For example, the IRS seeks comments on the application of those Code provisions if a taxable year constitutes a loss limitation year with regard to more than one CERT, one occurring before and the other after adoption of final rules.

As drafted, the proposed regulations would apply to C corporations and consolidated groups. However, the IRS stated that it is studying the circumstances under which related parties, pass-through entities, or intermediaries should be subject to sections 172(b)(1)(E) and 172(h). The IRS requests comments regarding the parameters and computational rules for applying those sections to indirect corporate acquirers.

Background

A CERT includes (1) a major stock acquisition (MSA), or (2) an excess distribution (ED), defined as follows:

- An MSA is an acquisition by a corporation of stock in another corporation representing 50 percent or more (by vote or value) of stock in the target corporation pursuant to a plan of the acquiring corporation (or any group of persons acting in concert with such corporation).

- An ED is the excess of the aggregate distributions (including redemptions) made during a taxable year by a corporation with respect to its stock over the greater of (1) 150 percent of the average of those distributions during the three taxable years immediately preceding the taxable year, or (2) 10 percent of the fair market value of the stock of the corporation at the beginning of the taxable year.

The portion of an NOL carryback disallowed by the CERT rules is termed a Corporate Equity Reduction Interest Loss (CERIL). After a corporation determines that the CERT rules apply to its NOL carryback claim—i.e., the corporation is an "applicable corporation" that engaged in a CERT during a loss limitation year (a LLY)—the next step is to determine the amount of the CERIL.

An applicable corporation's CERIL is the excess of (1) the total NOL for a LLY over (2) the NOL for the LLY computed without regard to the allocable interest deductions (AID). The AIDs are the portion of the NOL that is generated by interest deductions allocable to a CERT. The allocation of interest deductions to a CERT is based on the UNICAP model under Treas. Reg. sec. 1.263A-9, subject to certain limitations. The limitations include a (1) *de minimis* threshold of $1 million for AID; (2) a cap amount pursuant to which AID cannot exceed the three-year base period amount (i.e., average interest deductions for three years preceding the CERT); and (3) no tracing of debt (and interest expense) to a non-CERT.

Proposed Regulations

In general

The Proposed Regulations provide guidance for determining whether a CERT occurred, including confirmation that certain tax-free transactions—e.g., sections 351, 355 and 368(a)(1)(A) and (a)(2)(E)—are subject to the CERT rules. These regulations also clarify that an integrated plan with multiple steps that previously could have been tested as an MSA and an ED would be treated as a single MSA.

Special rules are provided for calculating costs associated with a CERT (CERT costs) in determining AID. For instance, certain borrowing costs and transaction costs are included in CERT costs.

Successor corporations

The Proposed Regulations offer guidance regarding the treatment of successor corporations in determining CERT costs. In general, the CERT taint from the predecessor would carry over to the successor. Rules for determining the limitation on AID are provided for circumstances when the applicable corporation is not in existence for the entire look back period.

Consolidated groups

A consolidated group is treated under the Proposed Regulations as a single corporation for computing CERT costs. Debt and interest deductions of all members would be taken into account when determining the group's CERIL. Generally, intercompany transactions would be disregarded unless a member deconsolidated in that transaction.

The new regulations also provide rules for members that join or depart a consolidated group. The debt and interest deductions of new group members would be included in a consolidated group's CERIL, even if the group could not have paid off the debt of the acquired corporation if the CERT had not occurred. If a member deconsolidates, either after the group engaged in a CERT or on the date that the group acquired a new member with a pre-existing CERT, the deconsolidating member must take a pro-rata allocation based on fair market value of the CERT costs. In essence, the CERT taint remains with the group and the deconsolidating member. An election is available for a deconsolidating member to opt out of this general apportionment rule and not be allocated any CERT costs.

In determining the three-year average of a consolidated group's interest history, a joining member's history is included. If a member deconsolidates, it is allocated a portion of the interest history based on relative fair market value of the deconsolidating member and the consolidated group. However, for EDs, the deconsolidating member takes its actual non-intercompany distribution history instead of an apportioned amount.

In summary, a consolidated group cannot cleanse itself of CERT taint. A consolidated group that engages in a CERT or acquires a corporation that engaged in a CERT is subject to the CERT rules. A deconsolidating member, irrespective of whether it has any debt, absent a special election, should be subject to the CERT rules after it departs the group.

Comments requested on three-year average computation

The IRS notes that to avoid complexities, the Proposed Regulations do not address increases attributable solely to interest rate fluctuations for purposes of applying the three-year average computation. However, the IRS is studying a rule that would factor out interest deductions attributable to increases in the taxpayer's interest rate that occur after the date of a CERT. Under such a rule, "the measurement of a baseline interest rate after the CERT occurs would take into account the fact that CERT activity often will decrease a taxpayer's creditworthiness and increase its average cost of borrowing, and accordingly that the existence of a CERT, in and of itself, will increase a taxpayer's borrowing expenses." The IRS requests comments on such a rule.

Observations

The Proposed Regulations would provide some welcome guidance on the CERT rules. Although Congress intended the CERT provisions to be broadly construed, the reach of the Proposed Regulations raises some questions such as why tax-free transactions would be subjected to the CERT rules. As noted above, these regulations do not address the impacts related to fluctuations in interest rates or whether the CERT rules should apply to related parties and pass-through entities. *For additional information, please contact Pat Pellervo, Marcie Barese, or Rob Melnick.*

Treasury Regulations

Proposed Regulations on Corporate Equity Reduction Transactions (REG- 140668-07) - See "Did You Know" above.

Court Watch

***PepsiCo Puerto Rico, Inc. v. Comm'r* T.C. Memo 2012-269 (September 20, 2012)**

The Tax Court, ruling in favor of the taxpayer (PepsiCo and its subsidiary PPR), held that certain related-party advance agreements (the Advance Agreements) were characterized more appropriately as equity than debt for U.S. federal income tax purposes..

Background

During the tax years before the court, PepsiCo was the US parent of an affiliated group of corporations that included PPR and multiple US subsidiaries (BFSI, Frito-Lay, and Bottling). PepsiCo also wholly owned a Dutch company (DutchCo) tasked with expanding PepsiCo's business into new foreign markets through multiple foreign entities (collectively, the Foreign Entities) that were disregarded for US federal income tax purposes. DutchCo was expected to suffer losses and have limited earnings and profits for the foreseeable future while it established itself in the new markets.

PepsiCo, Frito-Lay, and Bottling paid interest to DutchCo under a series of related-party notes (the Frito-Lay Notes). DutchCo, in turn, made payments to PPR and BFSI under the Advance Agreements. DutchCo secured a Dutch tax ruling to treat the Advance Agreements as debt for Dutch tax purposes based, in part, on the parties' statements in internal memoranda and before the Dutch Revenue Service that DutchCo would use the interest it received on the Frito-Lay Notes to fund its payments under the Advance Agreements. In the United States, PPR and BFSI treated the Advance Agreements as equity.

Taxpayer, IRS positions

PepsiCo treated the overall tax consequences of the payments as (i) an interest expense deduction for PepsiCo, Bottling, and Frito-Lay on their payment of interest under the Frito-Lay Notes; (ii) an interest expense deduction for DutchCo on its payments under the Advance Agreements; and (iii) distributions to PPR and BFSI from DutchCo treated as return of capital given DutchCo's limited earnings and profits. The IRS, however, argued that the Advance Agreements should be treated as debt for US federal income tax purposes.

Tax Court Analysis

The Tax Court applied a 13-factor debt vs. equity analysis as outlined in *Dixie Dairies Corp. v. Comm'r*, 74 T.C. 476 (1980), focusing heavily on the rights and obligations of the parties under the Advance Agreements.

The court found that DutchCo's use of interest received on the Frito-Lay Notes to make payments on the Advance Agreements was indicative of debt. However, the fact that the Advance Agreements did not mature for at least 40 years—i.e., beyond the term of the Frito-Lay Notes—suggested an equity interest, particularly given the speculative nature of DutchCo's expansion into unestablished markets. The court also found that there was a realistic possibility the terms of the Advance Agreements could become perpetual under a provision in the agreements. Moreover, the absence of legitimate creditor safeguards to protect PPR and BFSI in the event of DutchCo's default was a factor indicative of equity, notwithstanding that the parties were related and that DutchCo's receipt of the Dutch tax ruling was premised on DutchCo making payments on the Advance Agreements. Ultimately, the court concluded that the Advance Agreements exhibited more qualitative and quantitative indicia of equity than debt.

Observations

This case reflects the IRS's continuing focus on related-party instruments. Taking into account its opinion in *NA General Partnership v. Comm'r*, T.C. Memo. 2012-172 (see the July 2012 edition of This Month in M&A), the Tax Court appears to be developing a position that related-party instruments should be interpreted based on the rights and obligations of the instruments without placing undue weight on the interrelatedness of the parties.

This case also highlights the importance of a taxpayer's efforts to document the intent of the parties to create an equity interest, a debtor-creditor relationship, or, as here, a hybrid instrument. As illustrated by the opinion, the court may glean intent from internal correspondence and negotiations between the taxpayer and relevant taxing authorities. *For additional information, please contact Timothy Lohnes, Jon Thoren, or Matt Lamorena*.

***Broadwood Investment Fund LLC v. United States*, 2012 WL 4840703 (C.D. Cal. 2012)**

The US District Court granted summary judgment in favor of the government, disallowing millions in tax losses reported by five entities involved in distressed asset/debt investments, on the ground that the taxpayers were sham partnerships.

The taxpayers argued they entered into the transaction with the intent of profitability and expected that profits could be realized. The IRS pointed to the marketing materials the sponsor of the transaction provided to investors as an indication that the entities were arranged without risk of economic loss to the investors.

The court concluded that the taxpayers did not provide evidence supporting that the entities were formed in good faith or with a business purpose of joining together for carrying on the business and sharing in the profits and losses. Pointing to *Southgate Master Fund LLC v. United States*, 659 F.3d

(5th Cir. 2011), the court said that the taxpayers' arguments support establishing economic substance, not whether the partnerships were shams, and that a sham partnership can exist despite the transaction having economic substance.

Observations: The court's conclusion that the created entities were sham partnerships follows the holding in *Southgate Master Fund*, providing that the presence of economic substance of an entity, standing alone, does not prove that a partnership is not a sham. This latest sham partnership court decision continues to undermine the holding in *Moline Properties Inc. v. Comm'r*, 319 U.S. 436 (1943), that as long as a business entity has either a business purpose or conducts business activity, courts should recognize the entity for federal tax purposes. *For additional information, please contact Craig Gerson, Jennifer Bennett, or Kelvin Hsu.*

Private Letter Rulings

PLR 201239003

In this supplemental ruling to PLR 201220010 (May 21, 2012), the IRS ruled that the proposed modified transaction (the Modified Transaction) qualified as two separate reorganizations under section 368(a)(1)(F) (F reorganizations). (For further discussion on PLR 201220010, see This Month in M&A, June 2012).

Prior to the Modified Transaction, Parent indirectly owned D Sub. D Sub and other unrelated parties owned all the stock of F Sub, which was not a CFC. F Sub redeemed part of its stock from certain shareholders, and D Sub also purchased additional F Sub stock from some shareholders, so that F Sub's only remaining shareholders were D Sub and two unrelated foreign corporations (the Remaining Shareholders).

The initial ruling contemplated an F reorganization of F Sub into a newly formed corporation, followed by an initial public offering. The Modified Transaction contemplates two separate F reorganizations, followed by an asset sale. As a preliminary step in the Modified Transaction, the Remaining Shareholders subscribed for shares in two newly formed foreign corporations, Top Co 1 and Top Co 2.

The Remaining Shareholders next transferred all their interests in F Sub to Top Co 1, in exchange for additional Top Co 1 common stock. F Sub then elected to be treated as a disregarded entity. The IRS ruled that these steps qualified as the first F reorganization.

Immediately thereafter, the Remaining Shareholders transferred all their Top Co 1 shares to Top Co 2 in exchange for additional shares of Top Co 2 common stock. Top Co 1 then elected to be treated as a disregarded entity, completing the second F reorganization, and most of F Sub's subsidiaries also elected to be treated as disregarded entities after the Top Co 1's check-the-box election.

Top Co 2 next sold all the stock of Top Co 1 to an unrelated third party for cash (the Sale). The IRS ruled that the Sale was a sale of Top Co 1's assets. Part of the proceeds from Sale were used by Top Co 2 to redeem the Top Co 2 shares held by the two unrelated foreign corporations, leaving D Sub as the sole shareholder of Top Co 2.

Observations: In this PLR, the IRS respected back-to-back F reorganizations and treated the sale of the stock of Top Co 1 as an asset sale. This is one piece of limited guidance addressing back-to-back F reorganizations, where the acquiring party in the first F reorganization goes out of existence as part of the second F reorganization The holding in this PLR appears contradictory to the holding in PLR 201122002, where the back-to-back F reorganizations were treated as a single F reorganization for purposes of filing a gain recognition agreement under section 367(a). *For additional information, please contact Tim Lohnes, Robert Melnick, or Dorothy Lo.*

Other Guidance

CCA 201236025

In this Chief Counsel Advice (CCA), the IRS concluded that certain preferred stock should be treated as common stock for purposes of section 302(b)(2).

The corporate taxpayer engaged in a transaction (the Transaction) in which it first issued shares of voting convertible preferred stock (VCPS) to an unrelated party in exchange for cash. The terms of the VCPS included (i) voting rights; (ii) convertibility into common stock; (iii) noncumulative dividends in the same amount declared on the common stock (if any); and (iv) a liquidation premium equal to the purchase price, plus a share of the liquidation proceeds equal with the common shareholders. The taxpayer had earnings and profits and paid dividends with regard to its common stock over three of the four years before the Transaction.

After issuing the VCPS, the taxpayer redeemed a portion of its outstanding common stock for cash. The shareholders that were redeemed treated their redemption as a section 302(b)(2) exchange. To qualify for exchange treatment under that provision, the redemption must be "substantially disproportionate"—i.e., greater-than-20-percent reduction in the shareholder's proportionate interest in both the corporation’s voting stock and common stock (whether voting or nonvoting).

Noting that the label of preferred stock is not determinative and that common stock is not defined in the Code or regulations, the IRS concluded that “common stock” should include stock that does not fall within the definitions of preferred stock under sections 305(e)(5)(B), 351(g), and 1504(a)(4). Under those definitions, preferred stock generally must be limited and preferred as to dividends and not participate in corporate growth to any significant extent.

The IRS concluded that the VCPS should be treated as common stock for purposes of section 302(b)(2) because it (1) was not limited or preferred as to dividends; (2) was entitled to receive dividends along with the common stock; and (3) was not limited as to liquidating distributions in that it was entitled to share in liquidation proceeds with the common shareholders after receiving a liquidation premium. In light of these features, the VCPS was deemed to participate in the corporate growth of the taxpayer to a significant extent. *Note*: The taxpayer's profitability and history of paying dividends suggested that there was a real and meaningful likelihood of such participation. This indicates that the issuer's financial situation should be considered when determining whether instruments labeled preferred stock should be respected as such.

Observation: Given the limited IRS determinations on the characterization of preferred stock, this CCA is a helpful addition. Although the CCA deals specifically with section 302(b)(2), it may be instructive as to the IRS viewpoint in any situation where the distinction between common and preferred stock is at issue, such as under sections 305, 351(g), or 382. *For additional information, please contact Tim Lohnes, Jon Thoren, or Matt Lamorena.*

PwC M&A Publications

In an article titled "A Look at the Treatment of Foreign Taxes Under Reg. 1.1502-76," published in the Journal of Corporate Taxation (September/October 2012), WNTS author Lisa Brown discusses the treatment of foreign taxes under Treas. Reg. sec. 1.1502-76.

In an article titled "The Separate Limitation of Code Sec. 904(d)(6)," published in the International Tax Journal (September–October 2012), David J. Sotos, G. Paul Glunt, and Benjamin M. Willis discuss section 904(d)(6), which coordinates Code-based sourcing rules with US tax treaties.

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