This Month in M&A

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This Month's Features

- Recent PLR allows section 351 treatment despite prearranged stock transfer (PLR 201133006)
- Final section 381 regulations address accounting methods (T.D. 9534)
- Spin-off ruled tax-free even though section 355(b)(2)(D) may not have been satisfied (PLR 201133003)
- Section 355 monetization transaction (PLR 201132009)
- Controlled, rather than Distributing, deemed to borrow funds in a D/355 spin-off (PLR 201132010)
- Check-the-box election converting a corporation to a partnership triggers a section 165(g) deduction (AM2011-003)
- Dual consolidated loss allowed to offset taxable income in the current year (AM2011-002)
- RBIL in excess of the section 382 limitation disallowed for purposes of section 382(h)(4) (ILM 201132022)

Did you know...?

In a recent private letter ruling (PLR 201133006), stock received in exchange for property was immediately transferred to a partnership in a section 721 contribution. In spite of the potential impact of the step transaction doctrine, the IRS concluded under the facts of the PLR that the initial exchange would be respected and governed by section 351.

Background

Section 351(a) generally provides that no gain or loss will be recognized by the transferors of property that is transferred to a corporation in exchange for stock in that corporation, if immediately thereafter the transferors are in control of the transferee corporation (the "control immediately after" requirement). For this purpose, control is determined under section 368(c), which requires ownership of at least 80 percent of the voting stock and at least 80 percent of each class of non-voting stock of the corporation.

A section 351 exchange generally differs from a sale in that the transferors continue to have a beneficial interest in the transferred property and retain dominion over the property through their interest in the corporation. Generally, Courts and the IRS have stated that the purpose of section 351 is to allow nonrecognition when a taxpayer has not economically "cashed in" investments but merely has changed the form of its ownership in such investments. *See*, for example, *Portland Oil Company v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940), cert. denied, 310 U.S. 650, and CCA 200840040.

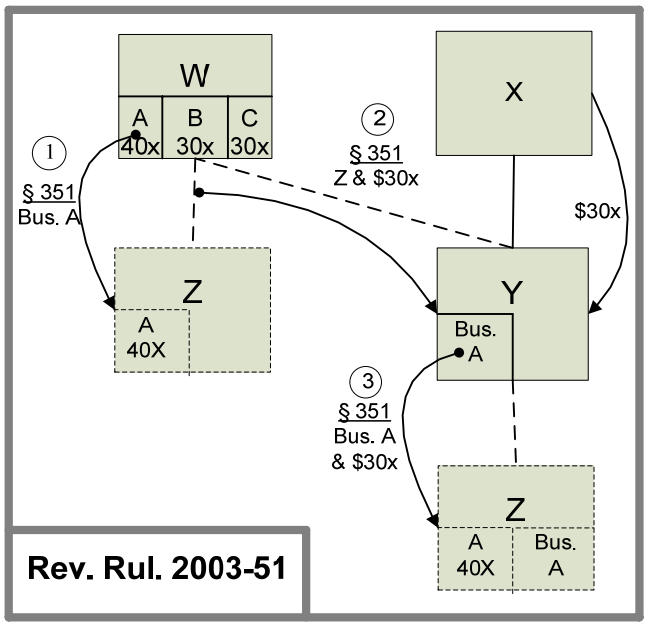
Step Transaction Doctrine in the Section 351 Context

Applying the step transaction doctrine, courts and the IRS generally agree that if a transferor has a binding commitment to transfer the transferee's shares following a section 351 exchange, the "control immediately after" requirement may not be satisfied. *See*, for example, *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976), and Rev. Rul. 79-70.

Notwithstanding this general rule, the IRS has determined that the form of a transaction will be respected if property is transferred to a corporation in a section 351 exchange, and, as part of the same plan, the property is transferred again through one or more tiers of corporations or partnerships. *See*, for example, Revenue Rulings 77-449, 83-34, 83-156, and 84-111. The IRS respected each transfer as a separate transaction in these circumstances because the taxpayer retained its investment in the property through its direct or indirect ownership of the new owner. Importantly, the step transaction doctrine also was viewed as inapplicable when an otherwise busted section 351 exchange could have qualified under an alternate form of tax-free transaction.

Rev. Rul. 2003-51

In Rev. Rul. 2003-51, the IRS provided a limited exception to application of the step transaction doctrine in a section 351 transaction involving a prearranged loss of "control." The following illustration depicts the three separate section 351 exchanges described in that ruling:



The IRS ruled that W's transfer of business A's assets to newly formed Z in exchange for stock representing section 368(c) control would be respected as a nontaxable section 351 exchange, even though pursuant to a binding commitment with a third party, all of Z's stock is transferred by W to Y. Following the transactions, W owned 60 percent of the stock of Y.

The ruling distinguished these facts from other situations where a transferor loses control of the transferee corporation pursuant to a binding commitment, stating that "[t]reating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in [section] 351 is not necessarily inconsistent with the purposes of [section] 351."

The IRS said that the taxpayer had not "cashed in" and was still beneficially interested in the transferred property. Importantly, the IRS noted that the taxpayer could have undertaken an "alternate form of transaction," by reordering the steps, that would have qualified for nonrecognition. Accordingly, the IRS ruled that the first transfer would qualify as a section 351 exchange notwithstanding the prearranged transfer of the shares received in seeming violation of the "control immediately after" requirement.

PLR 201133006

The recently released PLR 201133006 expands the context in which the Rev. Rul. 2003-51 principles may be viewed as applicable. In the PLR, Partnership and Trust (collectively, the "Partners") owned all the membership interests in LLC, an entity classified as a partnership for U.S. federal income tax purposes.

In a proposed transaction with valid business purposes, the Partners would transfer their interests in LLC to New REIT, a limited liability company that elected to be treated as a corporation for U.S. federal income tax purposes, in exchange for New REIT membership interests. Contemporaneously, approximately 120 investors ("Preferred Shareholders") would transfer cash to New REIT in exchange for a separate class of nonvoting preferred interest in New REIT (the "New REIT

Formation"). The Partners and Preferred Shareholders collectively would have section 368(c) control of New REIT immediately after the New REIT Formation. Following the New REIT Formation, and pursuant to a prearranged plan, the Partners would transfer their interests in New REIT to a newly formed LLC ("New LLC") in a section 721 contribution, solely in exchange for membership interests in New LLC (the "New LLC Formation"). New LLC would be treated as a partnership for U.S. federal income tax purposes.

Citing Rev. Rul. 2003-51, the IRS ruled the New LLC Formation would not cause the New REIT Formation to fail to qualify under section 351.

Observations: As with the transaction in Rev. Rul. 2003-51, the transaction at issue in PLR 201133006, which may not have satisfied the "control immediately after" requirement, could have been achieved under an "alternate form of transaction." For example, the steps of the transaction could have been reordered so that the Partners first would transfer their LLC interests to New LLC in a section 721 contribution; then, New LLC and the Preferred Shareholders could transfer the LLC interests and cash to New REIT in an exchange qualifying under section 351.

In line with the previously cited policy reasons behind section 351, the Partners and the Preferred Shareholders in PLR 201133006 retain an interest in the property transferred to New REIT in the initial section 351 transfer. Further, the Partners and the Preferred Shareholders, who received only equity interests in the transactions, could not be viewed as having "cashed in." It is unclear, however, what ownership interests the Partners and Preferred Shareholders ultimately received.

In Rev. Rul. 2003-51, the transfer of stock received in the first section 351 exchange occurred while there was a binding commitment to transfer the shares received to another corporation, as was the case in *Intermountain Lumber Co.* It is unclear whether the prearranged plan in PLR 201133006 rises to the level of a binding commitment.

This is the first PLR holding that a prearranged section 721 contribution of stock received in an initial section 351 exchange did not violate the "control immediately after" requirement. The ruling indicates an IRS willingness, under particular facts, to expand the principles of Rev. Rul. 2003-51. *For additional information, please contact James Prettyman, Rich McManus, Colin Zelmer, or Ben Willis.*

Treasury Regulations

Accounting Methods after Certain Reorganizations and Liquidations - Final regulations (T.D. 9534) under section 381 clarify and simplify the rules regarding the accounting methods to be used by corporations that acquire the assets of other corporations in certain corporate reorganizations and tax-free liquidations. Section 381(c)(4) authorizes the IRS to issue regulations on the method of accounting to be used in such corporate combinations. The final regulations, which adopt the proposed regulations with modifications, apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

The key test in the final regulations is whether the acquiring corporation operates the trades or businesses ("businesses") of the parties in the section 381(a) transaction as separate and distinct businesses following the date of distribution or transfer.

When the acquiring corporation continues to operate the businesses separately following the date of distribution or transfer, a carryover method should be used.

However, if businesses are integrated, the principal method should be used. In the later case, the regulations provide alternative tests to determine the principal method to be used by the integrated businesses, including, for example, tests based on the fair market value of inventories, the adjusted basis in assets, and gross receipts. All these tests are aimed at determining the method used by the larger business.

All parties to a section 381(a) transaction may request permission to change their accounting methods for the tax year in which the transaction occurs or is expected to occur under section 446(e). However, the acquiring corporation generally does not need to secure IRS consent to continue a carryover method or use the principal method unless such method constitutes an impermissible method. Under the final regulations, the rules governing accounting method changes under section 446(e) apply to determine: (1) whether the section 381(a) accounting method change is implemented with a section 481(a) adjustment or on a cut-off basis; (2) the computation of the section 481(a) adjustment; and (3) the appropriate period of tax years over which the adjustment is included in taxable income. *For additional information please contact Jim Martin or Jared Douds.*

Private Letter Rulings

PLR 201133003 - Parent held all the common stock of Controlled, and unrelated third parties held a class of mandatorily redeemable preferred stock ("MRPS"). Parent, Controlled, and Distributing all joined in the filing of a consolidated return. Within the 5-year pre-distribution period Controlled redeemed the MRPS giving Parent, and subsequently Distributing in a nonrecognition transaction, section 368(c) control of Controlled. The IRS ruled that Distributing's spin-off of Controlled qualified under section 355.

Observations: Section 355(b)(2)(D) precludes satisfaction of the active trade or business requirement if section 368(c) control of a corporation was acquired in a taxable transaction within the five-year pre-distribution period. For this provision, a taxable transaction includes a redemption. *See* Rev. Rul. 57-144 and *McLaulin v. Commissioner*, 276 F.3d 1269 (11th Cir. 2001).

Section 355(b)(3), applicable to distributions made after May 17, 2006, provides that for purposes of determining whether a distributing corporation or a controlled corporation is engaged in an active trade or business, members of the corporation's affiliated group may be treated as one corporation. Proposed regulations under section 355(b)(3) would allow a redemption of a controlled corporation's stock without violating the requirements of section 355(b), as long as the controlled corporation is or becomes a member of the distributing corporation's separate affiliated group following the redemption. *See* Prop. Reg. sec. 1.355-3(b)(4)(iv)(F).

This PLR appears to be consistent with section 355(b)(3) and the proposed regulations. *See* 72 FR 26012-01 and Example 4 of Prop. Reg. sec. 1.355-3(d)(2). It is unclear, however, that the proposed regulations, issued in 2007, can be relied upon by taxpayers or the IRS until finalized. *For additional information, please contact Derek Cain, Ben Willis, or Meryl Yelen.*

PLR 201132009 - In this PLR, third-party financial institutions would acquire Distributing's debt either in the open market or directly from Distributing and enter into agreements with Distributing to exchange the debt for Controlled stock. After

the exchanges, the financial institutions would facilitate a secondary offering of the Controlled stock to the public in conjunction with Distributing's subsequent distribution of its Controlled stock to its shareholders. The IRS ruled that the distribution of Controlled stock was part of an overall D/355 transaction involving Distributing and Controlled.

Observations: This PLR describes a section 355 monetization transaction similar to the one considered in PLR 201123030, covered in the July/August 2011 edition of This Month in M&A. The same monetization strategies were employed by the taxpayers in the two PLRs, but the facts may differ in other respects. For example, PLR 201123030 specified that the execution of the debt exchange agreements and the actual debt exchanges would be separated by at least 14 days. In PLR 201132009, the IRS redacted the specified number of interim days. In addition, in PLR 201132009, the IRS indicated that the financial institutions may enter into hedging arrangements to manage the risk associated with acquiring Distributing debt. The significance of these distinctions, if any, is not clear and may indicate that hedges which minimize the risk of loss may alter the days debt must be held to qualify for tax-free exchange treatment under section 361(c)(3). *For additional information, please contact Tim Lohnes, Rich McManus, or Matt Lamorena.*

PLR 201132010 - Immediately before engaging in a D/355 spin-off of Controlled, Distributing (through a disregarded entity) borrowed funds from a third-party lender to repay certain historic creditors. As part of the D/355 transaction, Distributing contributed the disregarded entity to Controlled. The IRS recast the transaction and treated Controlled as borrowing the funds and then distributing them to Distributing during the D/355 transaction.

Observations: The IRS characterization of the transaction appears to prevent Distributing from circumventing both the gain recognition rule in section 357(c) as well as the limitation imposed by section 361(b)(3).

Section 357(c) provides that a transferor of property in a section 351 exchange or a D/355 spin recognizes gain from the sale or exchange of property to the extent that the sum of the amount of liabilities assumed exceeds the total adjusted basis of the property transferred. Absent the IRS's recast in this PLR, it may have been unclear whether Controlled had assumed any liabilities of Distributing for section 357(c) purpose as a result of receiving the interests in the disregarded entity.

Under section 361(b)(3), Controlled can make a tax-free distribution of cash or property to Distributing in the context of a D/355 spin-off as long as (i) Distributing uses the cash or property to repay its creditors, and (ii) the sum of cash and the fair market value of the other property transferred to such creditors does not exceed the adjusted bases of the assets transferred by Distributing to Controlled (reduced by the amount of liabilities assumed within the meaning of section 357(c)). *For additional information, please contact Tim Lohnes, Rich McManus, or Matt Lamorena.*

Other Guidance

AM2011-003 - This general legal advice memorandum ("GLAM") addresses the tax consequences of a check-the-box election by an insolvent foreign subsidiary ("Foreign Sub") to be classified as a partnership. In the GLAM, U.S. Corp owns 100 percent of Foreign Corp and 80 percent of Foreign Sub (satisfying the stock ownership test under section 1504(a)(2)). Foreign Corp owned the remaining 20 percent of Foreign Sub. In two alternative situations, Foreign Sub had either (i) recourse liabilities owed to U.S. Corp, or (ii) nonrecourse liabilities owed to a third party.

The IRS first determined that U.S. Corp and Foreign Corp may be entitled to a worthless security deduction under section 165(g) because the deemed liquidation of Foreign Sub as a result of the check-the-box election constitutes an identifiable event that fixes a shareholder's loss with respect to the liquidating corporation's stock. The IRS relied on Rev. Rul. 2003-125, which provides that if a liquidating corporation's liabilities exceed its assets, section 165(g) applies, since a shareholder does not receive payment for its stock, a requirement for sections 331 and 332 exchange treatment. Therefore, U.S. Corp and Foreign Corp were entitled to a worthless security deduction equal to their basis in Foreign Sub stock.

However, the IRS concluded that Foreign Sub's creditors are not entitled to a bad debt deduction under section 166 based solely on the election to be classified as a partnership because there was no section 1001 exchange. The IRS stated that because the Foreign Sub's liabilities survive the deemed liquidation, they are not treated as exchanged for new debt of the partnership as a result of the check-the-box election.

The IRS explained that under either the recourse or nonrecourse liabilities situation, the substitution of a new obligor (the partnership) did not result in a significant modification of the debt instrument, and therefore did not trigger gain or loss under section 1001. In reaching this conclusion where the debt was recourse, the IRS relied on an exception to the general rule that the substitution of a new obligor on recourse debt is a significant modification.

Specifically, the IRS concluded that since the new obligor acquired substantially all the assets of the original obligor, and the transaction did not result in a change in payment expectations or a significant alteration, there was not a significant modification of the recourse debt. *See* Reg. sec. 1.1001-3(e)(4)(i)(C). The fact that the liabilities survived the deemed liquidation, through the deemed distribution and contribution, was the sole criterion used to determine that Insolvent Foreign Sub's creditors are not entitled to a bad debt deduction under section 166.

Observations: Rev. Rul. 2003-125 involved a similar situation to the one presented in this Advice Memorandum, but involved an insolvent corporation that checks the box to become a disregarded entity rather than a partnership. Within its analysis, Rev. Rul. 2003-125 stated that the insolvent corporation's creditors "may be entitled to a deduction for a partially or wholly worthless debt under [section] 166." GLAM 2011-003 distinguishes Rev. Rul. 2003-125 on the ground that a corporation's liabilities survive the check-the-box deemed liquidation, which then is followed by a deemed contribution to a partnership.

In the GLAM, the IRS appears to have treated the assets of the insolvent entity as transferred directly from it to the partnership for purposes of testing for a significant modification. This approach does not appear to reflect the tax fiction described in Reg. sec. 301.7701-3(g)(1)(ii), which provides for a distribution in liquidation of the corporation making the election followed by a contribution of the distributed assets and liabilities to a newly formed partnership.

It seems surprising that the deemed liquidation did not give rise in the GLAM to a section 166 deduction, as it did in Rev. Rul. 2003-125; particularly since the IRS stated that "the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps," citing the check-the-box regulations preamble (62 FR 55768). *For additional information, please contact James Prettyman or Jared Douds.*

AM2011-002 - The IRS addressed application of the separate return limitation year ("SRLY") rules to a dual consolidated loss ("DCL") when no domestic use election is made. The IRS allowed a U.S. group dual resident member to use a DCL to compute its consolidated taxable income on a current basis to the extent of the dual resident corporation's SRLY cumulative register.

The memorandum describes a U.S. consolidated group that owns a foreign hybrid entity separate unit ("FEX"). The U.S. group generates income in each of its first two years of operation.

FEX generates income in Year 1 but incurs a loss in Year 2. FEX's Year 2 loss is a DCL under section 1503(d). Because the U.S. group does not file a domestic use election under Reg. sec. 1.1503(d)-6(d) and no other exceptions under Reg. sec. 1.1503(d)-6 apply, the DCL is subject to the domestic use limitation rules of Reg. sec. 1.1503(d)-4.

The IRS concluded, under the principles of Reg. sec. 1.1502-21(c), that the U.S. group may use FEX's DCL to compute its consolidated taxable income in Year 2 to the extent of FEX's SRLY cumulative register. Any remaining DCL remains subject to the domestic use limitation rule. Alternatively, the U.S. group could file a domestic use election to use FEX's entire DCL in Year 2, irrespective of its cumulative register.

Observations: Reg. sec. 1.1503-4(c)(2) could be interpreted to require that a current DCL can be absorbed only in a carryback or carryforward year and not in a current year. The IRS conclusion in the GLAM seems to rely on a straightforward application of the SRLY rules, which the DCL regulations incorporate by reference. Accordingly, the memorandum's conclusion is not surprising and is a welcome clarification of current IRS thinking on this issue. *For additional information, please contact David Friedel or Janine De Gregorio.*

ILM 201132022 - The IRS concluded that only the amount of a taxpayer's recognized built-in loss ("RBIL") equal to its section 382 limitation may be taken into account in computing taxable income. The ILM concludes that a section 382(h)(4) "disallowed" loss which is not taken into account currently but is carried-forward, was intended to refer to the portion of an RBIL that exceeds the section 382 limitation.

The taxpayer included an RBIL in its computation of its NOL in a post-ownership change recognition year in which the taxpayer had no taxable income prior to taking into account the RBIL. The taxpayer took the position that no portion of the RBIL should be considered "disallowed" under section 382(a) and, accordingly, section 382(h)(4) should not prevent the RBIL from being included in the computation of its NOL.

The IRS permitted the taxpayer to include in its NOL carryback computation only an amount equal to its section 382 limitation. The IRS's decision hinged on its interpretation of the legislative history of section 382(h)(4), which indicates that Congress intended any RBIL in excess of a taxpayer's section 382 limitation to become a special attribute that may be carried forward only.

Observations: This guidance expands on the IRS's conclusion reached in CCA 200926027, in which the IRS indicated that it would not accept an identical position taken by a taxpayer under similar facts. The result of this guidance puts the taxpayer in a worse position than if the loss had been recognized prior to an ownership change date since it could have been carried back without restriction. *For additional information, please contact Rich McManus or Janine De Gregorio.*

PwC M&A Publications

WNTS authors DiAndria Green and Douglas Skorny wrote an article published in the July/August 2011 issue of the Corporate Taxation Journal entitled "Coaching the Dream Team - A Survey of Cross-Border Integration Techniques." This article addresses four alternative cross-border integration techniques and certain associated U.S. federal income issues.

WNTS authors Benjamin Willis, Pat Grube, and Henry Miyares wrote an article published in Tax Notes on June 13, 2011 entitled "Bottoms Up: Tiered D Reorganizations." This article explores the mechanics of tiered reorganizations in conjunction with Reg. sec. 1.368-2(l) (the so-called cash D regulations).

WNTS authors Bart Stratton and Janine De Gregorio wrote an article published in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "IRS Applies Reverse Acquisition Regulations: A Substance-Over-Form Approach." This article focuses on the tax implications of reverse acquisitions and reviews private letter rulings in which the IRS applied a substance-over-form approach to transactions that may not fit within the literal definition of a reverse acquisition in Reg. sec. 1.1502-75(d)(3).

WNTS author Meryl Yelen wrote an article in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "One Reorganization, Two Tax Years, One Practical Solution." This article addresses the appropriate time to report a reorganization that spans different tax years.

WNTS authors Julie Allen, Robert Black, and Jason Malinowski wrote an article in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "The Impact of Unified Loss Rules on Earnings and Profits." This article explores whether a corresponding adjustment is made for E&P purposes when a member of a consolidated group (S1) is required under Reg. sec. 1.1502-36 (the unified loss rules) to reduce its basis in the stock of another member (S2) for regular tax purposes upon S1's disposition of the S2 stock at a loss for regular tax purposes.

WNTS author Benjamin Willis wrote an article in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "Ordinary Worthless Stock Deductions: Characterizing Subsidiary Receipts." This article discusses whether a subsidiary's various gross receipts should qualify as active operating income for purposes of section 165(g)(3).

WNTS authors Nancy Langdon and John Schmalz wrote an article in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "LLC Member Debt: Recourse or Nonrecourse?" This article discusses how deductions should be allocated that are funded by a general obligation of a limited liability company (LLC) if the obligation is guaranteed by or borrowed from a member and is recourse debt under section 1001.

WNTS authors Lisa Wamboldt and Gretchen Van Brackle wrote an article in the July 2011 'Tax Clinic' publication of The Tax Adviser entitled "Partnership Determination of Eligible Basis For Energy Grants." This article discusses whether a partnership should take a partner's section 743(b) adjustment into account in determining eligible basis of qualified energy property that the partnership has not yet placed in service.

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