This Month in M&A

A Washington National Tax Services (WNTS) Publication

September 2012

This Month's Features

- Section 355 monetization transaction subject to section 367(a) ruled not a "device" (PLR 201232014)
- Equity investor held not a bona fide partner in partnership *(Historic Boardwalk Hall, LLC v. Comm'r)*
- Preferred stock found to be non-qualified preferred stock, thereby denying intended capital loss planning (*Gerdau MacSteel v. Comm'r)*
- Transferor met the section 351(a) control requirement notwithstanding the transferee corporation's shares were directly issued to unrelated persons (PLR 201232030)
- PwC highlights issues in guidance on outbound asset reorganizations (PwC comment letter to Notice 2012-39)

Did you know...?

The IRS ruled favorably on a tax-free spin-off followed by an inversion of the Controlled corporation where Distributing repaid intercompany debt to foreign subsidiaries of Controlled with Controlled debt securities, and gain recognized by the Controlled shareholders under section 367(a) presumably did not give rise to a "device" problem.

Facts of PLR 201232014

Parent, a widely held, publicly traded corporation ("Distributing"), was the obligor on certain loans held by controlled foreign subsidiary creditors ("Controlled Intergroup Debt"). Additionally, at least five days prior to declaration of the spin-off, Distributing issued securities to third-party investors ("New Distributing Securities"). At least 14 days after issuance of the New Distributing Securities, Distributing transferred assets to newly formed Controlled in exchange for Controlled common stock and securities. Distributing then distributed Controlled's common stock to its shareholders and exchanged the Controlled securities for the Controlled Intergroup Debt and the New Distributing Securities.

Following the spin-off and pursuant to the same plan, a foreign corporation ("Forco") acquired all the common stock of Controlled in a reverse subsidiary merger that qualified as a B reorganization. The shareholders of Controlled recognized gain on this transaction under section 367(a).

Observations:
Intercompany debt transaction

Section 361(a) enables the tax-free receipt by Distributing of Controlled debt securities; section 361(c)(3) enables Distributing to repay creditors with the Controlled securities without gain recognition. Other than debt versus equity limitations, current law does not limit the amount of Controlled securities that may be exchanged under section 361.

By structuring the transaction in the PLR as an exchange of Controlled securities for Controlled Intergroup Debt rather than as an assumption of the debt by Controlled, Distributing was able to avoid the liability limitation under section 357(c). Under section 357(c), if the amount of Distributing liabilities assumed by Controlled in a D/355 transaction exceeds the adjusted basis of the assets transferred by Distributing to Controlled, Distributing must recognize gain to the extent of the excess liabilities.

Had Distributing caused Controlled to directly assume Distributing debt in the transaction, instead of having Controlled issue its securities to Distributing which then repaid Controlled foreign affiliates with the Controlled securities, section 357(c) would have applied to limit the amount of the debt that could be assumed tax-free to the adjusted basis in the assets transferred to Controlled. However, the exchange of the Controlled securities for the Controlled Intergroup Debt was not treated as an assumption of a liability under section 357(c); instead, it was treated as a non-taxable exchange under section 361(c). Thus, Controlled was able to effectively assume the Controlled Intergroup Debt in a transaction that was not subject to section 357(c).

Notably, the IRS accepted the taxpayer's representation that Controlled securities exchanged in the transaction were "securities" within the meaning of section 361. This suggests an IRS view that an intergroup debt can fall within the meaning of a "security" for this purpose.

The assumption of a Distributing debt by Controlled and the exchange of a Distributing debt for Controlled debt are economically similar transactions; however, the Code treats these transactions differently. Proposed legislation would amend the statute to limit the amount of Controlled securities that may be distributed under section 361(c)(3) to the basis in the assets transferred by Distributing to Controlled in the transaction. If enacted, this legislation would provide a similar result to that of an assumption of a Distributing liability under section 357(c). See This Month in M&A July/August 2011, "Did you know...?"

Device element

Generally, a sale or exchange of Distributing or Controlled stock following a spin-off is evidence of the spin-off being a device for the distribution of earnings and profits, and a prearranged sale or exchange is substantial evidence of device. The section 355 regulations provide that a post-distribution exchange of the stock of either Distributing or Controlled for stock of another corporation in a tax-free reorganization is not treated as a sale or exchange of the Distributing or Controlled stock for purposes of determining whether the transaction was used principally as a device for the distribution of earnings and profits, if no gain or loss, or only an insubstantial amount of gain, is recognized on the exchange.

Although the IRS no longer rules on the device issue, this favorable PLR appears to reflect an IRS view that a transaction in which shareholders recognize gain under section 367(a), in an otherwise wholly tax-free transaction, should not be the type of transaction that is evidence of device. Presumably this is because the gain recognized under section 367(a) is not the result of a sale of, or cashing in of, an asset, but rather the last chance for the United States to tax the inherent gain in the asset that inured to the owner prior to being transferred outside the U.S. taxing jurisdiction.

Although the steps of the PLR describe an acquisition of Controlled, a U.S. corporation, by a newly formed foreign corporation, the PLR does not address or otherwise rule on the implications under section 7874 or the qualification of such transaction as tax-free. *For more information, please contact Mark Boyer, Tim Lohnes, Jerry Towne, or Ciara Foley.*

Court Watch

Historic Boardwalk Hall v. Comm'r, 2012 WL 3641769 (3rd Cir. 2012)

The U.S. Court of Appeals for the Third Circuit (the "Third Circuit") has reversed a taxpayer friendly Tax Court decision by holding that an investor was not entitled to historic rehabilitation tax credits claimed through a partnership. The Third Circuit reasoned that the investor was not a partner for tax purposes and rejected a state governmental instrumentality's attempt to transfer historic rehabilitation tax credits through the partnership.

In January 2011, the Tax Court held that the transaction had economic substance, the partnership was not a sham, the investor was a bona fide partner, and the arrangement should not be recast under the Subchapter K anti-abuse regulations. In assessing the economic substance of the transaction, the Tax Court determined that the investor had profit potential (*i.e.*, three-percent preferred return and the tax credits) and faced certain risks (*e.g.,* environmental liability and the risk that the rehabilitation would not be completed). The Tax Court used similar reasoning to conclude that the investor was a bona fide partner. Citing the "totality of the circumstances" test in *Commissioner v. Culbertson*, 337 U.S. 733 (1989), the Tax Court found that the executed transaction documents supported that the parties entered into the arrangement in good faith and with a business purpose of rehabilitating the historic structure.

On appeal, the IRS argued that the investor was not, in substance, a bona fide partner for tax purposes. Alternatively, it argued that the partnership was a sham and the benefits and burdens of ownership of the property did not transfer to the partnership. The IRS relied on two cases, which it described as guideposts and influenced the Third Circuit's decision, namely, a 2006 decision from the U.S. Court of Appeals for the Second Circuit in *TIFD III-E, Inc. v. United States*, 459 F.3d 220, (2d Cir. 2006) and a 2011 decision from the U.S. Court of Appeals for the Fourth Circuit in *Virginia Historic Tax Credit Fund 2001 v. Commissioner,* 639 F.3d 129 (4th Cir. 2011).

In support of its argument that the investor was not, in substance, a partner in the partnership, the IRS asserted that the investor had no meaningful downside risk because (1) the investor was assured of receiving the benefit of its bargain through a tax benefits guaranty agreement and put and call options secured by a guaranteed investment contract, and (2) the investor faced no risk of incurring any obligations beyond its capital contributions because the New Jersey Sports and Exposition Authority (the "NJSEA") agreed to fund all construction cost overruns and all operating deficits, to indemnify the investor against environmental liability, to purchase insurance for the investor's benefit to bolster that indemnity, and to make the investor whole not only for lost tax benefits but also for additional expenses and liability associated with any audit. In addition, the IRS asserted that the investor did not share in any upside potential with respect to the development of the project. Although the investor had a 99.9-percent interest in residual cash flow, the financial projections for the project indicate that there would not be any available cash flow for at least forty years because the project was highly leveraged.

The Third Circuit focused on the IRS' argument that the investor was not a bona fide partner in the partnership and agreed with the IRS. Reversing the Tax Court, the Third Circuit found that the investor lacked a meaningful stake in either the success or failure of the partnership. According to the court, the investor's interest in the partnership provided no meaningful risk or potential upside. There was no completion risk because the NJSEA was a state agency which had deep pockets and insolvency was remote. The NJSEA's agreement to fund construction cost overrun and operating deficits and the tax benefit guarantee eliminated any investment or audit risk. The court explained that any potential upside represented by the 99.9-percent partnership interest was illusory, reasoning that the investor realistically could not expect to receive any amounts in excess of the tax benefits and the preferred return. The court believed that any upside potential would be captured by the NJSEA by exercising one of the call options that it held.

Observations: The decision in *Historic Boardwalk Hall, LLC* may have surprised some advisors and participants involved in historic rehabilitation projects in light of the longstanding Congressional policy to promote the very activities that were undertaken by the NJSEA. As noted by the syndicator, the guarantee provisions of the NJSEA's agreement with the investor are common in historic rehabilitation projects. The Third Circuit acknowledged that its decision may jeopardize the viability of future historic rehabilitation projects. It, however, professed that it was not challenging the historic rehabilitation tax credit provision, but instead the sale of the historic rehabilitation tax credits.

We do not believe that the Third Circuit was challenging the allocation of historic rehabilitation tax credits to bona fide partners. Rather, it was unwilling to relax the definition of a bona fide partner, regardless of the bona fide activities of the partnership. The court referred to "entrepreneurial risk" as a proxy for a bona fide partner, but we believe that reference should be interpreted in context. The court simply did not believe that the investor had any risk relevant to the historic rehabilitation project at issue.

We understand that participants in historic rehabilitation projects are considering their response to the decision in *Historic Boardwalk Hall, LLC.* Prudent participants may want to consider introducing more risks to investors, absent further guidance from the government reconciling the policies underlying the historic rehabilitation tax credit and the potential fallout from *Historic Boardwalk Hall, LLC. For additional information, please contact Todd McArthur, Gretchen Van Brackle, Dianna Miosi, or Matthew Arndt.*

Gerdau MacSteel, Inc. v. Comm'r, 139 T.C. No. 5 (August 30, 2012)

The Tax Court recently held that a class of stock was nonqualified preferred stock ("NQPS") under section 351(g) because it did not participate in corporate growth to any significant extent within the meaning of section 351(g)(3)(A). The Tax Court further held that the transactions lacked economic substance and a business purpose.

In *MacSteel*, the taxpayer ("P") was a publicly traded common parent of an affiliated group of corporations (the "Group"). P wholly owned S1, S2, and certain other subsidiaries. In 1997, P was actively pursuing the sale of two of its other subsidiaries, from which it expected significant capital gains.

With an objective to offset those gains, P entered into a multistep transaction to generate capital losses. The key steps were:

- P recapitalized S2 and authorized it to issue three classes of stock — class A voting common stock, class B voting preferred stock, and class C voting preferred stock ("Class C Stock");
- P transferred $38 million to S1 and assigned certain contingent obligations to pay medical plan benefits ("MPBs"), which were valued at $37,989,000, to S1 in exchange for one share of S1 stock ("Transfer 1");
- S1 transferred the $38 million it received from P to S2 and assigned to S2 the contingent liabilities P had assigned to S1 in exchange for 110 shares of S2's Class C Stock ("Transfer 2" and together with Transfer 1, the "Transfers"); and
- S1 sold the 110 shares of S2's Class C Stock to a former employee of P for $11,000 (the "Sale").

The Group took the position that the Transfers qualified for nonrecognition treatment under section 351. Accordingly, the Group asserted that S1's tax basis in the Class C Stock was equal to the cash transferred to S2 (i.e., $38 million), and the amount should not be reduced by the contingent liabilities assumed because the contingent liabilities transferred were deductible liabilities under section 358(d). The Group claimed a short-term capital loss of $37,989,000 (i.e., $38 million less $11,000) recognized as a result of the Sale and used such loss to offset capital gains.

Section 351(g)

As a general rule, section 351(g) provides that the issuance of NQPS stock is not eligible for nonrecognition treatment under section 351(a). As a result, a transferor's basis in NQPS stock is not determined by reference to the basis in the property exchanged under section 358, but instead generally is its fair market value. In general terms, NQPS is stock that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, and has certain put, call, or redemption rights.

The Tax Court disallowed the loss on the grounds that the Class C Stock was NQPS and therefore did not take a carryover basis. At issue was whether the Class C Stock "participated in corporate growth to any significant extent" within the meaning of section 351(g)(3)(A). The Tax Court analyzed the relevant terms of the Class C Stock, which provided that: (1) each share was entitled, and limited to, annual dividends of $9.50; and (2) upon redemption, holders of Class C Stock were entitled to receive the greater of $125 or an amount equal to the lesser of (a) 45 percent of any cumulative cost savings in the MPBs or (b) 50 percent of S2's net equity ("Formula Value"). A redemption of the Class C Stock could be caused by S2 through a call option five years after the stock's issuance or by holders of Class C Stock through a put option seven years after the stock's issuance.

The Tax Court concluded that the expected return on each share of Class C Stock was "capped at, and was intended and understood to be, 9.5 percent annually and $125 upon its redemption in five to seven years." As a result of the limited likelihood that the Class C Stock would meaningfully participate in corporate earnings and growth, the Tax Court determined that the Class C Stock satisfied the definition of "preferred stock" under section 351(g)(3)(A). As each of the requirements of section 351(g) was satisfied, the Tax Court held that the Class C Stock was NQPS and had a fair market value basis in the hands of S1 prior to the Sale. As a result, the Group's claimed loss was disallowed.

Economic substance

The Tax Court disallowed deductions for fees associated with effectuating the transactions on the ground that the fees were not ordinary and necessary expenses because the transactions lacked economic substance.

In applying the economic substance doctrine, the Tax Court stated that the transactions, as structured and implemented, served no purpose other than to create high-basis stock with low value that would generate an artificial multimillion-dollar tax loss that the Group could use to offset capital gains of a similar amount, and was motivated without serious regard to reducing medical benefit costs. Specifically, the Tax Court asserted the following reasons for holding that the transactions lacked economic substance:

- S2 did not serve any meaningful purpose;
- Nothing of substance changed as a result of the transactions;
- S2 did not conduct any type of business;
- The administration of the transferred MPBs was carried on by the Group as if S2 did not exist; and

- The transactions did not have a reasonable possibility of creating meaningful nontax benefits for the Group.

Observations: This is the third contingent liability case decided, in part, on economic substance grounds. *See*, e.g., *Coltec Industries, Inc. v. U.S.,* 454 F.3d 1340 (2006), and *Black & Decker Corp. v. U.S.,* 436 F.3d 431 (2006). However, this is the first such case to assert application of section 351(g). The decision illustrates the level of factual review a court may undertake to determine whether an instrument participates in corporate growth to any significant extent.

The enactment of section 358(h) in 2000 eliminated the type of tax planning involved in *MacSteel* by addressing the treatment of contingent liabilities assumed in connection with certain non recognition transactions. Generally, section 358(h) provides that if basis of the stock received in a section 351 exchange exceeds the fair market value of the stock, the basis of the stock must be reduced (but not below fair market value) by the amount of the contingent liabilities assumed in the section 351 exchange. *For additional information, please contact Tim Lohnes, Horacio Sobol, or DiAndria Green.*

Private Letter Rulings

PLR 201232030 — section 351(a) control requirement

A state government ("Government"), through an unincorporated agency ("Fund"), conducted an insurance business. Government wanted to convert ownership of Fund from public to private. The following steps were undertaken by Government in privatizing the insurance business conducted by Fund: (1) all of Fund's assets and liabilities were transferred to a newly formed corporation ("Newco"); (2) Newco issued its interests directly to Fund's policyholders (no rights or property were issued or transferred by Newco directly to Fund); and (3) Fund ceased to exist.

In the ruling, the IRS treated the proposed transactions as follows: (1) Government, through Fund, transferred assets (i.e., the insurance business and subsidiaries) to Newco in exchange for all of Newco's interests; and (2) Government, through Fund, transferred the Newco interests to the policyholders. The IRS ruled that the Newco interests that Government was treated as receiving in the exchange were treated as stock for purposes of section 351, that Government controlled Newco for purposes of section 351, and, therefore, the transactions qualified under section 351(a).

Observations: In general, section 351 requires that the transferors of property to a corporation be in control of the corporation to which the assets were transferred, measured immediately after the property transfer. Absent a binding commitment to sell or otherwise transfer the stock received in exchange for the property, the fact that a transferor retransfers on the same date stock it receives (or is deemed to receive) generally does not prevent such transferor from being in control immediately after the transfer within the meaning of section 351.

With respect to the control requirement, the IRS, citing *D'Angelo Associates, Inc. v. Comm'r*, 70 T.C. 121 (1978), ruled that Government possessed the requisite amount of stock to be in control of Newco immediately after the exchange within the meaning of section 351. In *D'Angelo*, the Tax Court held that a transferor was in control of a transferee corporation when the transferor directed stock issued in the exchange to be issued directly to relatives.

The IRS applied the "freedom of action" principles of *D'Angelo* in determining whether Government was in control of Newco immediately after the exchange. The IRS specifically acknowledged that the power to designate who receives shares is sufficient for purposes of "the requirement of section 351(a) that [G]overnment (through Fund) control Newco immediately after the [e]xchange ... because [G]overnment (through Fund) has the right, in choosing the method of privatizing the [i]nsurance [b]usiness conducted by [G]overnment (through Fund), either to retain the [i]nterests or to designate other persons to receive the [i]nterests." *For additional information, please contact Tim Lohnes, Wade Sutton or DiAndria Green.*

PwC M&A Publications

PwC Comments on Notice 2012-39

PwC recently submitted comments to Treasury and the IRS (the "Letter") concerning the treatment of certain subsequent transfers by "qualified successors" under Notice 2012-39 (the "Notice").

The Notice (which was described in greater detail in This Month in M&A, August 2012) provides that in an outbound transfer of intangible property described in section 936(h)(3)(B), boot received by the U.S. transferor will be treated as a prepayment of the section 367(d) royalty, and thus currently includible in income, to the extent the boot is attributable to the intangible property. In subsequent years, any "qualified successor" to the U.S. transferor--i.e., any shareholder of the U.S. transferor that is a domestic corporation (other than a regulated investment company, a real estate investment trust, or an S corporation) that receives stock in the transferee foreign corporation ("qualified stock") in the reorganization or immediately after the reorganization owns qualified stock other than qualified stock received in the reorganization--will receive a credit, on a first-in, first-out basis, against future section 367(d) inclusions.

The PwC Letter focuses specifically on Section 4.04 of Notice 2012-39, which states that qualified successors are subject to the rules of Reg. sec. 1.367(d)-1T, as modified by that paragraph. The Notice then states that, "for example, if a qualified successor subsequently transfers qualified stock to a U.S. person *that is unrelated to the qualified successor or to a person that is not a U.S. person,* [Reg. sec.]1.367(d)-1T(d) will apply to such transfer." (Emphasis added). This language in the Notice would seem to require an acceleration of the 367(d) royalty upon a tax-free 351 transfer of the qualified stock to a wholly owned foreign subsidiary. Other similar transfers could also be caught under the provision.

The Letter expresses PwC's view that such language, indicating that subsequent transfers of qualified stock to a foreign related person are subject to immediate taxation under Reg. sec. 1.367(d)-1T, is in error and should be corrected as soon as possible. PwC sets forth two key arguments to support its view.

First, the Letter notes that the last paragraph of Notice Section 4.04 clearly was intended to restate the general principles of Reg. secs. 1.367(d)-1T(d) and (e) and convey that those rules generally would continue to apply to a U.S. person that is a "qualified successor" with respect to the U.S. transferor in an outbound asset reorganization. Contrary to the existing regulations, however, the highlighted language in Section 4.04 states that Reg. sec. 1.367(d)-1T(d)--which imposes immediate taxation on transfers of transferee foreign corporation stock by a qualified successor to an *unrelated* person--applies to transfers by a qualified successor of transferee foreign corporation stock to a foreign *related* person. Such language therefore is incompatible with the purpose of Section 4.04.

Second, the Letter points out that applying Reg. sec. 1.367(d)-1T(d) to a transfer of qualified stock (i.e., transferee foreign corporation stock) to a foreign related person would lead to discrepancies in treatment between outbound section 367(d) transfers, which are covered by the Notice, and outbound section 351 transfers, which are not. It is commonly accepted that if intangible property were transferred outbound in a section 351 transfer and in a later transaction the U.S. transferor transfers its qualified stock in a nonrecognition transfer to a related foreign person (e.g., a subsequent section 351 transfer), the entire section 367(d) value would not be immediately taxed; instead, the U.S. transferor would continue to include in its income the annual section 367(d) inclusion. The Letter asserts that regardless of whether the initial outbound transfer of the intangible property occurs pursuant to a section 351 transfer or an asset reorganization, so long as the proper amount of section 367(d) income continues to be reported and recognized as income by the U.S. transferor or a qualified successor, there should not be an immediate taxing event as a result of a subsequent transfer of qualified stock among related corporations.

Because subsequent transfers of qualified stock to related foreign corporations are not uncommon, the PwC Letter urges Treasury and the IRS to promptly correct the language in Section 4.04 of the Notice that indicates that transfers to related corporations are subject to the immediate taxation treatment described in Reg. sec. 1.367(d)-1T. *For additional information, please contact Marty Collins, Tim Lohnes, Sean Mullaney, or Judy Kwok.*

This Month's WNTS Editors

Tim Lohnes, Partner	*(202) 414-1686*
Rob Black, Director	*(202) 414-1870*
Judy Kwok, Director	*(202) 414-3866*
Dianna Miosi, Director	*(202) 414-4316*
Arthur Sewall, Manager	*(202) 414-1366*
Matt Arndt, Senior Associate	*(202) 312-7633*
Ciara Foley, Senior Associate	*(202) 414-1347*
DiAndria Green, Senior Associate	*(202) 346-5135*

This Month's WNTS Contributors

Mark Boyer, Principal	*(202) 414-1629*
Marty Collins, Partner	*(202) 414-1571*
Todd McArthur	*(202)312-7559*
Horacio Sobol, Partner	*(202) 312-7656*
Monte Jackel, Managing Director	*(202) 346-5189*
Gretchen Van Brackle, Managing Director	*(202) 414-4622*
Sean Mullaney, Director	*(202) 346-5098*
Wade Sutton, Director	*(202) 312-5188*
Jerry Towne, Director	*(202) 346-5153*