This Month in M&A / Issue 8 / August 2013

M&A Tax Recent Guidance

This month features:

- Related-party stock sale is treated as dividend-equivalent redemption notwithstanding target's subsequent taxable liquidation (PLR 201330004)
- Private equity fund ruled engaged in a trade or business for purposes of multiemployer pension termination liability rules (*Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*)
- Final section 108(i) regulations clarify partnership issues (T.D. 9622 and T.D. 9623)
- Divisive D reorganization utilizing a high-vote, low-vote structure followed by a recapitalization into a single class of equity satisfies section 355 requirements (PLR 201330007)

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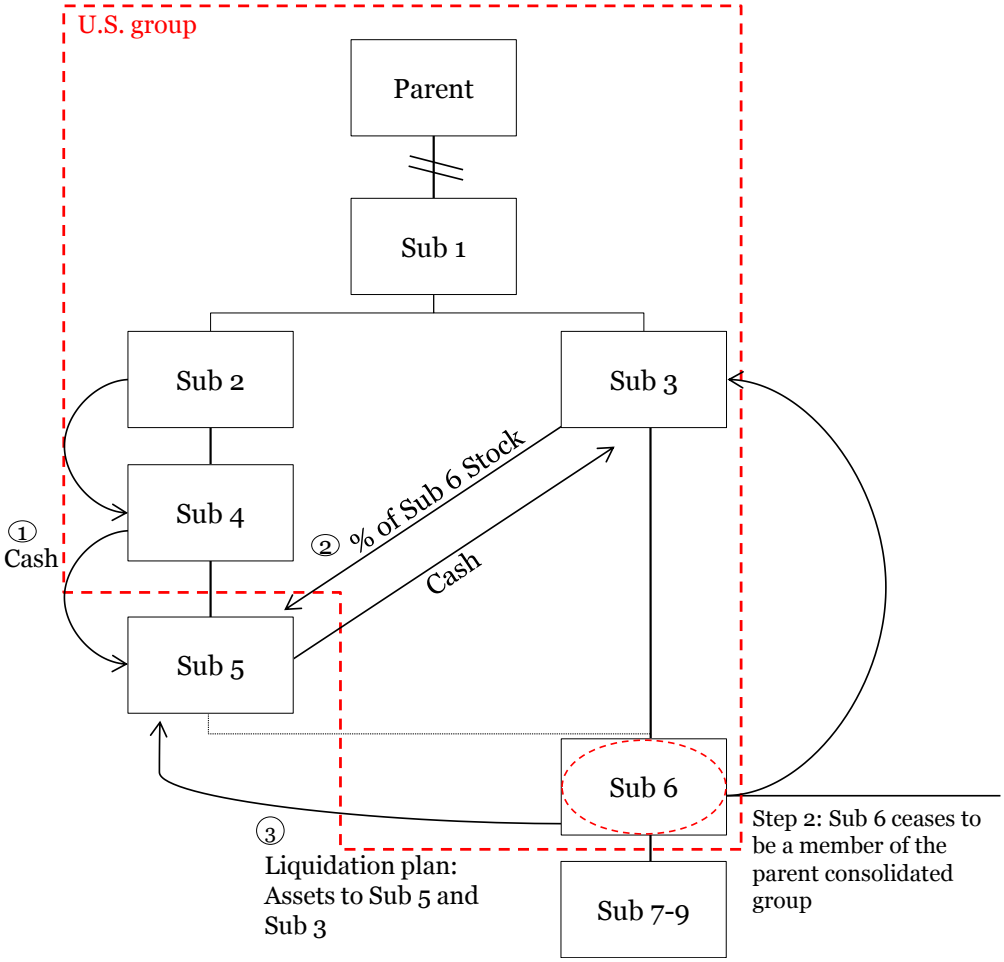
Did you know…?

A recent PLR reflects the IRS's willingness in appropriate circumstances to allow taxpayers to structure into a taxable liquidation and recognize a loss, while illustrating that the IRS does not believe the rationale in *Merrill Lynch* (discussed below) applies in a related-party stock sale, notwithstanding the target's subsequent taxable liquidation (PLR 201330004).

Transactions in PLR 201330004

In this ruling, a member of a consolidated group transferred cash down the chain to Sub 5, a non-consolidated member. Sub 5 used the cash to purchase a percentage of the stock of Sub 6 from Sub 3, after which Sub 6 ceased to be a member of the consolidated group. Subsequently, a plan of liquidation was adopted for Sub 6. The relevant structure and steps are depicted in the following graph (broken lines indicate scope of consolidated group):



The PLR treated the sale of Sub 6 stock from Sub 3 to Sub 5 as a dividend-equivalent redemption under section 304(a)(1) and treated the subsequent liquidation of Sub 6 as a taxable section 331 liquidation, resulting in Sub 3 and Sub 5 recognizing loss with respect to their Sub 6 shares.

Background – Dividend-equivalent redemptions

Section 304(a)(1) treats certain related-party stock sales as redemptions. Section 304 applies where one person (Transferor) is in control of two other corporations and in return for property, one of the controlled corporations (Acquiring) acquires stock in the other controlled corporation (Target) from the Transferor.

Once section 304 is applicable, it is necessary to determine whether the deemed redemption in the section 304 fictional transactions should be treated as a dividend-equivalent redemption or a sale or exchange transaction as a result of meeting one of the section 302(b) tests. The applicable test is whether the selling shareholder (Sub 3) continued to own a significant portion of the stock of the Target (Sub 6) after the transaction. For purposes of making this determination, the section 318 attribution rules apply to determine whether the Transferor has retained an indirect interest in the Target.

To the extent there is substantial continuing ownership of Target by the selling corporation the redemption generally is dividend-equivalent, and the following fictional transactions are deemed to occur: (i) Transferor transfers the stock of Target to Acquiring, in return for Acquirer's stock, in a qualifying section 351 exchange; and (ii) Acquiring redeems the stock it was treated as issuing in the section 351 exchange with the consideration it transferred in the stock sale. This treatment can result in characterizing the sale proceeds as dividend income.

Alternatively, if there is not continuing ownership of the Target corporation by the selling corporation the redemption generally is treated as a sale or exchange transaction, with the selling shareholder recognizing gain or loss upon the stock sale. Under the facts in the PLR, this treatment would result in the entire loss being recognized in Sub 3, with a portion of such loss deferred under section 267.

Where the target corporation goes out of existence in a taxable liquidation as part of the same plan as the section 304 transaction, relevant authorities do not directly address the characterization of the section 304 transaction as dividend-equivalent or sale or exchange. Since the Target no longer exists and doesn't have a clear successor, it is not clear whether the selling shareholder can have a continuing ownership interest in the Target.

'Merrill Lynch' decision

In the section 304(a)(1) context, *Merrill Lynch* illustrates that dividend-equivalent redemptions are tested by examining the relationship between the Transferor and Target corporation after applying step-transaction principles (*Merrill Lynch & Co., Inc. v. Comm'r*, 386 F.3d 464 (2d Cir. 2004), *aff'g in part*, 120 T.C. 12 (2003); *Merrill Lynch & Co., Inc. v. Comm'r*, 131 T.C. 293 (2008)).

In *Merrill Lynch*, the taxpayer engaged in a section 304 cross-chain sale of Target within a consolidated group and sought dividend-equivalent treatment to take advantage of certain consolidated return regulations and thereby receive a stepped-up basis in the Transferor and capital loss on the sale of the Transferor. At issue was whether the cross-chain sale should be 'stepped' together with a subsequent sale of the Transferor to an unrelated party to determine whether there had been a complete termination of interest in the Target under section 302(b)(3).

The court adopted the 'firm and fixed plan' test to integrate the two transactions for section 302(b)(3) purposes. Thus, the court concluded that at the time of the redemption, there was a plan to terminate ownership of the Target corporation. As a result, the section 304 sale was treated as a sale or exchange transaction; no basis increase was obtained; and the loss was disallowed.

Observations

In many instances, taxpayers prefer a section 301 distribution rather than sale or exchange treatment. For example, a taxpayer may want to utilize section 304 to access foreign cash from CFCs with no E&P or high-taxed earnings.

In the PLR, the taxpayer appears to have utilized a section 304 sale to engage in what is often called Granite Trust planning, whereby the taxpayer intentionally structures a subsidiary liquidation to be taxable, thereby allowing loss recognition (see Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956)). The taxpayer in the PLR avoided application of section 332 by selling an amount of Sub 6 stock sufficient to fail section 1504(a)(2) ownership (80 percent vote and value), placing Sub 6 outside of the consolidated group. This would avoid application of Treas. Reg. sec. 1.1502-34 and permit recognition of a loss in the section 331 liquidation.

Section 267(f) generally defers losses from the sale or exchange of property between members of the same controlled group, but does not apply to losses recognized as a result of a section 331 liquidation. Because the taxpayer in the PLR used a section 304 sale (which results in a deemed section 351 transfer), the taxpayer avoided the application of section 267(f) to the Sub 6 stock that was sold. Presumably, a section 362(e)(2)(C) election was made on the deemed section 351 exchange, allowing Sub 5 to take a carryover basis and preserve the built-in loss in the Sub 6 stock.

In the PLR, section 304 applies to the sale of Sub 6 stock because Sub 3 was in control of Sub 5 and Sub 6 (after applying the section 318 attribution rules) and Sub 3 received property from Sub 5 in exchange for the Sub 6 shares. If *Merrill Lynch* were applied to the facts of the PLR, the question arises whether the Sub 6 liquidation resulted in a complete termination of Sub 3's interest in Sub 6 and whether the section 304 sale of the Sub 6 stock to Sub 5 should be treated as a sale or exchange transaction. This would result in a capital loss on the Sub 6 stock that would be deferred under section 267(f).

Unlike *Merrill Lynch*, however, the liquidation described in the PLR leaves the assets of Sub 6 in the hands of Sub 3 and Sub 5 and not in the possession of an unrelated party. Presumably, the IRS differentiated the PLR from *Merrill Lynch* on this basis. Note, however, that there is no successor asset or section 381 attribute carryover as a result of the section 331 liquidation.

For a discussion of a prior ruling which reached a similar result, please see PLR 201252008 in *This Month in M&A* for January 2013.

For additional information, please contact Tim Lohnes or Bruce Decker.

Court watch

Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund et al., (No. 12-2312 (1st Cir. 2013))

Introduction

In a decision that could have broad implications for private equity funds, the U.S. Court of Appeals for the First Circuit ruled on July 24 that a private equity fund, Sun Capital Partners IV, LP (Fund IV), was engaged in a trade or business for purposes of ERISA withdrawal liability rules (29 U.S.C. sec. 1301(b)(1)). The case highlights a potential issue for private equity funds that invest in portfolio companies with unfunded pension liabilities. While not a tax case (the IRS was not involved and no tax liability was at issue), the decision has caught the attention of the tax community because of the First Circuit's surprising analysis of tax cases interpreting the term "trade or business."

On August 7, Sun Capital asked the First Circuit Court for a rehearing en banc. The court's decision on the petition is now pending.

Background

In 2008, one of Fund IV's portfolio companies, Scott Brass, Inc. (SBI), stopped making contributions to the New England Teamsters & Trucking Industry Pension Fund (TPF). As a result, SBI became liable for its proportionate share of TPF's unfunded vested benefits. Later that year, an involuntary Chapter 11 bankruptcy proceeding was brought against SBI.

Seeking a party with resources to satisfy SBI's pension obligation, TPF asserted that Fund IV had entered into a joint venture with SBI. TPF demanded payment for SBI's proportionate share of unfunded vested benefits from both SBI and Fund IV, claiming the entities were jointly and severally liable. TPF also claimed private equity fund Sun Capital Partners III, LP (Fund III) was jointly and severally liable under the same theory.

Either private equity fund would be subject to ERISA withdrawal liability if (1) the private equity fund were under common control with SBI and (2) the private equity

fund were a trade or business. In 2012, the U.S. District Court for the District of Massachusetts ruled that the Sun Capital funds were not engaged in a trade or business and granted summary judgment in their favor. TPF timely appealed that ruling. The Federal Pension Benefit Guaranty Corporation (PBGC), a wholly owned U.S. government corporation that insures thousands of pension funds (including the TPF), supported TPF on appeal.

The First Circuit decision acknowledged that there is no definition of trade or business under the ERISA regulations. Absent a clear definition, the First Circuit adopted an investment plus approach similar to the approach taken by the PBGC in an unpublished 2007 appeals letter and adopted by the U.S. Court of Appeals for the Seventh Circuit in *Central States, Southeast & Southwest Areas Pension Fund v. Messina Products, LLC*, 706 F.3d 874 (2013), which it reached without reference to the PBGC's 2007 analysis. The First Circuit did not define the word 'plus' in the 'investment plus' standard and narrowly ruled that based on all the facts and circumstances, Fund IV had met the investment plus standard. In its petition for rehearing, the plaintiffs asserted that the First Circuit's opinion announced "a multifactor 'we know it when we see it' test for trades or businesses," resulting in increased uncertainty as to the definition.

With respect to Fund IV, the First Circuit reversed the District Court's grant of summary judgment and ruled that Fund IV was engaged in a trade or business and remanded the case to the District Court for further factual development and for further proceedings under the common-control test. With respect to Fund III, the First Circuit vacated the District Court's grant of summary judgment and remanded the case for further factual development and for further proceedings to determine whether Fund III had a management fee offset and further proceedings under the common-control test.

Observations

The First Circuit conclusion that Fund IV was engaged in a trade or business was reached in the context of ERISA withdrawal liability rules. The opinion emphasizes that the phrase trade or business need not be uniformly interpreted for all purposes. In addition, the court noted that the ERISA withdrawal liability rules may have the effect of piercing the corporate veil and disregarding formal business structures. Accordingly, it is not clear that the rules imputing the activities of the general partner and management companies to the fund would be applied in the same manner by courts in other contexts.

Notwithstanding the court's focus on the ERISA issue, the First Circuit opinion cites in four places a recent, controversial income tax article (Article), which argues that gains of private equity funds should be taxed as ordinary income on the theory that many funds are engaged in the development, promotion, and sale of companies (Steven M. Rosenthal, *Taxing Private Equity Funds as Corporate 'Developers'*, Tax Notes, Jan. 21, 2013, at 361). In a footnote, the court rejects the TPF's attempt to rely on the developing business enterprise for resale theory advanced in the Article because the attempt was not timely as a procedural matter (footnote 26 of the opinion). Nevertheless, the decision cites one of the Article's key conclusions with approval: "private equity funds are active enough to be in a trade or business."

This citation follows a discussion in which the First Circuit distinguishes the Sun Funds' activities from those of the taxpayers in two key Supreme Court decisions - *Higgins v. Commissioner,* 312 U.S. 212 (1941); and *Whipple v Commissioner,* 373 U.S. 193 (1963) - on which advisors to private equity funds have long relied for the proposition that private equity funds, as mere investors, are not engaged in a trade or business. In distinguishing the Sun Funds' activities from those of the taxpayer in *Higgins*, the First Circuit noted that the "Sun Funds did participate in the management of SBI, albeit through affiliated entities." These affiliated entities apparently were the general partners and the management companies. In distinguishing *Whipple*, the First Circuit noted that the management fee offset provision provided the Sun Funds with a source of income not available to an ordinary, passive investor. In general, a management fee offset is a provision that

reduces the management fees paid by the fund to the management company by an amount equal to the fees that the management company receives directly from the portfolio companies.

The First Circuit also rejected the Sun Funds' argument that the activities of the Funds' general partners and affiliates should not be attributed to the Funds themselves for purposes of determining whether the Funds were in a trade or business. In the petition for rehearing, Sun Capital argues that the First Circuit "would better achieve its stated objective of *narrowly* resolving the case" by applying only the *Whipple* test for a trade or business and avoiding the investment plus analysis. Thus, if the petition is granted, the First Circuit's initial analysis of *Whipple* may become even more important.

For additional information, please contact Todd McArthur, John Schmalz, Michael Hauswirth, or Matthew Arndt, or Asset Management team members Gina Biondo, Alan Biegeleisen, Dan Feheley, or Judy Daly.

Treasury regulations

Final section 108(i) regulations

Section 108(i) generally allows taxpayers to elect to defer recognition of cancellation of indebtedness income (COD income) resulting from the reacquisition of an applicable debt instrument after 2008 and before 2011. An electing taxpayer must include the deferred COD income in gross income over a five-taxable-year period, beginning with the taxpayer's fourth or fifth taxable year following the year of reacquisition. Subsequent events, such as the liquidation or sale of substantially all the assets of the taxpayer or the cessation of business by the taxpayer, can accelerate the inclusion of any deferred COD income.

In August 2010, the IRS issued two sets of temporary regulations clarifying application of section 108(i) to corporations and pass-through entities (REG-14280-009 and REG-144762-09). The temporary regulations included a more detailed definition of events accelerating inclusion of deferred COD income. For prior coverage of the proposed regulations, please see *This Month in M&A* for September 2010.

Partnership issues

On July 3, 2013, the IRS published final section 108(i) regulations with no substantive modifications to the temporary regulations for corporations (T.D. 9622), but with some modifications for partnerships and S corporations (T.D. 9623).

As discussed in the preamble, the final regulations applicable to partnerships clarify the last sentence of section 108(i)(6) by adding an example. The example illustrates that the decrease in a partner's share of partnership liabilities under section 752 associated with deferred COD income—which may be deferred under section 108(i) until the deferred COD income is recognized—is treated as a deemed distribution under section 752(b). The deemed distribution occurs in a taxable year of the inclusion period to the extent that the deferred section 752 amount (less any deferred section 752 amount that already has been treated as a deemed distribution under section 752(b) in a prior taxable year of the inclusion period) is equal to or less than the partner's deferred COD income that is recognized in such taxable year.

In addition, the final regulations clarify that the exceptions to acceleration for (1) distributions of entire separate interests under Reg. sec. 1.108(i)-2(b)(6)(iii)(E) and (2) section 381 transactions under Reg. sec. 1.108(i)-2(b)(6)(iii)(F) do not apply if the electing partnership terminates under section 708(b)(1)(A)—that is, where no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. (Note that a technical termination of a partnership under section 708(b)(1)(B) does not accelerate deferred COD income.)

Observations

The election under Section 108(i) no longer is available, having expired at the end of 2010. However, taxpayers that made the election still will be dealing with its effects on their returns for many years. For this reason, final regulations in this area are a welcome development.

For additional information, please contact Karen Lohnes, Megan Stoner, Mike Hauswirth, or John Quint.

Private letter rulings

PLR 201330007

In a spin-off ruling, the IRS concluded that Controlled's potential post-distribution recapitalization of its high-low voting structure into a single class of voting stock would not prevent the distribution from qualifying under section 355.

Steps of transaction

As part of an overall plan to separate Business B from Business A, the taxpayer proposed, in part, the following steps:

1. Distributing formed Controlled, authorizing two classes of Controlled common stock with identical rights, except for voting and conversion rights (the High-Vote Stock and the Low-Vote Stock);
2. Distributing will contribute all of the Business B assets to Controlled in exchange for all of Controlled's High-Vote Stock (the Contribution);
3. Controlled will issue all its Low-Vote Stock to the public in an IPO;
4. Controlled intends to reduce the votes per share of the High-Vote Stock for either or both of (a) the election of directors or (b) all matters other than the election of directors to the minimum number of whole votes per share (but not less than one) necessary to preserve Distributing's section 368(c) control of Controlled (the Pre-Distribution Conversion); and
5. Distributing will distribute a portion of the Controlled voting stock to its shareholders in a pro rata distribution (the Distribution). Distributing will retain an uncertain amount of Controlled's common stock (the Retained Shares).

The PLR states that Distributing will have section 368(c) control after the IPO and before the Distribution to the public. With respect to any Controlled High-Vote stock that remains outstanding following the Distribution, the PLR acknowledges that Controlled's board of directors may consider a proposal to convert the High-Vote Stock to Low-Vote Stock, subject to shareholder approval (the Post-Distribution Conversion).

Additionally, under the plan, Distributing may monetize a portion of its interest in Controlled by issuing short-term debt (the Distributing Debt) to one or more investment banks (the Investment Banks) in exchange for cash. Thereafter, Distributing would transfer some or all of the Retained Shares in repayment of the Distributing Debt (the Debt Exchanges). The taxpayer represented that Distributing will dispose of any Retained Shares no later than five years after the Distribution.

Observations

The Pre-Distribution and Post-Distribution Conversions may raise questions whether (i) the initial dual-class equity structure of Controlled should be respected under step-transaction principles and (ii) there was a distribution of the requisite amount of Controlled stock to receive tax-free treatment under section 355.

Historically, the IRS has required that a recapitalization must permanently realign a corporation's voting power to be respected (*see* Rev. Rul. 69-407). However, the facts

in the PLR arguably are distinguishable because the high-low vote structure resulted from the formation of Controlled, not the recapitalization. Consistent with authorities in which the IRS concluded that it would not apply step-transaction principles to certain transactions following a section 355 spin-off (*see* Rev. Ruls. 98-27 and 2003-79), the IRS viewed the Distribution and Post-Distribution Conversion as separate transactions. Thus, the IRS indicated its willingness to allow Controlled to collapse its dual-class structure following a section 355 transaction without adverse tax consequences.

This analysis appears to be supported by the representation that Controlled had no legally binding obligation or commitment to consider or present the Post-Distribution Conversion and that the conversion, even if presented, was subject to shareholder approval. Based on the foregoing, it appears that the IRS may not require that a high-low vote structure remain in effect for any specified length of time following a section 355 spin-off.

This PLR also illustrates another iteration of a section 355 monetization strategy similar to PLRs 201123030 and 201216023, in which Distributing monetized a portion of Controlled shares by exchanging them for short-term debt. *See also* PLR 201330002 for another recent variation of a spin-off involving a high-low vote structure and monetization of Controlled.

In Rev. Proc. 2013-3, the IRS announced that it no longer will rule on whether a corporation is a controlled corporation within the meaning of section 355 if the corporation underwent a recapitalization in anticipation of a distribution described in section 355. In addition, the IRS no longer will rule on whether section 355 (or section 361) will apply to a distribution of Controlled stock in exchange for, or in retirement of, Distributing's debt issued in anticipation of a distribution. Thus, this PLR appears to have been submitted before the effective date of Rev. Proc. 2013-3, and could be one of the last PLRs containing these particular issues.

For additional information, please contact Tim Lohnes, Bruce Decker, or DiAndria Green.

PwC M&A Publications

In the article titled "Opportunity to Eliminate Certain Intercompany Gain" published in The Tax Adviser (July 2013), WNTS authors Pat Pellervo and Annette Smith, and PwC San Francisco M&A Senior Associate Charmaine Lee discuss recent IRS developments that may provide an opportunity to eliminate intercompany gain in certain circumstances.

In the article titled "Tax-Free Exchanges of Debt Instruments: Defining Securities Under Sec. 354" published in the Corporate Business Taxation Monthly (July 2013), PwC New York Principal Michael Kliegman discusses authorities and practical approaches to making the determination on whether modified debt instruments are 'securities' for tax-free reorganization purposes.

In the article titled "The Consolidated Return Aspects of Notice 2012-39" published in the Journal of Corporate Taxation (July/August 2013), WNTS authors Neha Prabhakar and Wade Sutton discuss several consolidated return issues raised by Notice 2012-39 in connection with outbound reorganizations of consolidated group members.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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