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M&A Tax Recent Guidance

This month features:

- No liquidation-reincorporation where reincorporated assets spun-off as part of overall plan (PLR 201315016)
- Obama Administration FY2014 budget focuses on tax reform, business tax proposals, and new tax initiatives
- Insolvent corporate partner includes distributive share of partnership's gross receipts for section 165(g)(3)(B) purposes (PLR 201314005)
- Tax Court holds that funds received through a controlled foreign corporation were in substance dividend payments (*Barnes Group)*

Did you know...?

A recent PLR demonstrates the IRS's willingness to restrict application of the liquidation-reincorporation doctrine when the reincorporated assets are distributed in a tax-free spin-off. (PLR 201315016).

Liquidation-reincorporation doctrine

Historically, if the assets of a liquidated corporation were transferred to a related corporation, the two transfers generally were recharacterized under the step-transaction doctrine and treated as a reorganization under sections 368(a)(1)(D) or 368(a)(1)(F) (a "D" or an "F" reorganization, respectively), with any assets that were not reincorporated treated as other property or "boot" in the reorganization. See e.g., *American Manufacturing Co. v. Commissioner*, 55 T.C. 204 (1970). The theory is that a reincorporation of a liquidated corporation's assets may prevent the purported liquidating distribution from being in "complete liquidation."

In evaluating application of liquidating-reincorporation authorities, both the quantum and nature of the liquidated assets is relevant. A reincorporation of non-business assets or assets representing less than 10 percent of the liquidating corporation's value may preclude application of the liquidation-reincorporation doctrine. Further, the reincorporation of between 10 and 20 percent of the liquidated company's assets can leave taxpayers with concerns under the Tax Court's decision in *Telephone Answering Service Co.,* 63 T.C. 423 (1974) (TASCO). In *TASCO,* the court held that a reincorporation of approximately 15 percent of the liquidating company's total assets in a newly formed subsidiary was neither a D nor F reorganization, while at the same time not meeting the requirements of a tax-free liquidation under sections 332 and 337.

The liquidation-reincorporation doctrine generally applies less frequently as a result of significant changes made to Treas. Reg. sec. 1.368-2(d)(4) and Treas. Reg. sec. 1.368-2(k) in 2000 and 2007, respectively. Under these regulations, a liquidation may be treated as an "upstream" reorganization under section 368 (and not recharacterized into another form of reorganization) if the subsequent reincorporation qualifies as a permissible transfer under section 368(a)(2)(C) and Treas. Reg. sec. 1.368-2(k). In very general terms, these provisions allow for transfers of liquidated assets to entities controlled by the shareholder corporation (the "qualified group"). However, if a significant portion of the corporation's assets are transferred outside of the "qualified group," the liquidation-reincorporation doctrine still may apply.

The IRS also has seemed willing to restrict the scope of the liquidation-reincorporation doctrine in the context of certain liquidations and transfers preceding a section 355 spin-off. In the case of transfers between the distributing and controlled corporations (and transfers between distributing's subsidiaries and controlled's subsidiaries), the IRS appears to test the applicability of the liquidation-reincorporation doctrine after the completion of the entire transaction (i.e., the spin-off), rather than immediately after a contribution of assets to a controlled company (see PLRs 201149012, 201123022, and 201017031 discussed in This Month in M&A, January 2012, July/August 2012, and June 2010, respectively). But see, PLR 201037026 (discussed in This Month in M&A, October/November 2010), in which two entities were sold in "check and sell" transactions from the distributing group to the controlled group; the IRS ruled the check and sell transactions were "Cash D" reorganizations, apparently applying the liquidation-reincorporation doctrine.

PLR 201315016

In this recent ruling, a subsidiary ("Sub1") of Distributing 4 ("Dist 4"), a publicly traded corporation, merged upstream into Subsidiary 1 LLC ("Sub1 LLC"), a newly formed disregarded entity of Dist 4 (the "Merger"). Prior to the Merger, Sub1 took multiple steps in order to separate its business A assets from its business B assets. Specifically, Sub1 sold and/or transferred certain business A assets to various related entities within the Dist 4 affiliated group. The IRS treated the Merger as a tax-free liquidation under Section 332. Following the liquidation, Dist 4 contributed Sub1 LLC to Controlled and subsequently spun-off Controlled to its public shareholders.

Observations

Neither PLR 201315016 nor the other private letter rulings cited above indicate the percentage of the liquidated corporation's assets that were reincorporated in connection with the respective section 355 transaction. In this new PLR, application of the liquidation-reincorporation doctrine would be further complicated because multiple entities acquired the liquidated subsidiary's assets.

In determining that the liquidation of Sub1 qualified under section 332, it appears that the IRS concluded that, because the assets were sold to multiple entities, no single entity that continued to be held by Dist 4 could have been viewed as either the alter ego of Sub1 and that no single entity held by Dist 4 acquired "substantially all" of Sub1's assets at the conclusion of the overall transaction. Thus, the requirements for a D or F reorganization could not be satisfied. In addition, the IRS may have concluded that an insufficient amount of assets were either directly acquired by Dist 4 and/or retained by the Dist 4 COBE group — i.e., entities that Dist 4 controls, directly or indirectly, within the meaning of section 368(c) — to qualify the Merger as an upstream reorganization.

This PLR is further confirmation that the IRS views assets reincorporated in a controlled corporation in connection with a section 355 distribution as unique. The IRS has discussed the liquidation-reincorporation doctrine in the context of a section 355 spin-off in recent public forums. In transactions involving the liquidation of a subsidiary into a parent corporation followed by a contribution of a portion of the subsidiary's assets to a controlled corporation that is spun-off, the IRS has articulated its view that the controlled corporation is essentially the same person as the parent corporation for purposes of the liquidation-reincorporation analysis. As such, any restrictions that apply to the parent would similarly apply to the controlled corporation.

Ultimately, by ruling that the Merger was a liquidation under section 332, it appears the IRS remains receptive to restricting application of the liquidation-reincorporation doctrine to liquidations that are followed by spin-offs.

For more information, please contact Tim Lohnes, Henry Miyares, Bruce Decker, or Ciara Foley.

Legislative Update

Administration's FY2014 budget tax proposals

The Treasury Department on April 10 released its General Explanation of the tax relief and revenue-raising proposals included in the Obama Administration's FY2014 budget submission to Congress (Green Book).

The budget submission includes several business tax proposals also made in earlier prior years, including proposals to —

- prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment (applicable to distributions occurring after 2013);
- repeal the nonqualified preferred stock designation under section 351(g);
- repeal the "boot-within-gain" limitation under section 356(a)(2) for dividends received in reorganization exchanges;
- tax gain from the sale of a partnership interest on look-through basis; and
- tax 'carried interest' partnership income as ordinary income.

The Administration's FY2014 budget also includes a new proposal to impose a liability on shareholders who enter into 'Intermediary Transaction Tax Shelters,' to be defined in Treasury regulations. In general, these transactions involve a sale of at least 50 percent of the stock of a C corporation that is undertaken as part of a plan to cause the corporation to recognize income or gain from the sale of its assets shortly before or shortly after the stock sale, with the result that the C corporation ultimately is left with insufficient assets to pay the tax owed from the asset sale. An intermediary entity typically is involved.

Other newly introduced tax measures include proposals that would repeal technical terminations of partnerships as well as the anti-churning rules of section 197.

Unlike in previous Administration budgets, extensions of CFC look-through, active financing, and certain other temporary business tax provisions are not included in the President's FY2014 budget. Congress extended most of the "traditional" business tax extenders through the end of 2013 as part of the American Taxpayer Relief Act of 2012. (For prior coverage, see This Month in M&A - January 2013.) The budget proposes to make permanent certain provisions, including a modified research credit, as part of tax reform.

Observations

The Administration's proposals, if enacted, could impact planning and structuring for multinational corporations with US and foreign operations. Although President Obama and Congressional leaders have expressed strong support for significant tax reform legislation, the outlook for action on the Administration's budget proposals remains uncertain. Businesses have been providing input to the tax-writing committees on tax reform proposals.

For more information, please contact Tim Lohnes, Larry Campbell, or Matthew Manning.

Private Letter Rulings

PLR 201314005

The IRS ruled a taxpayer could look through a partnership to determine whether the gross receipts of a foreign corporate partner satisfied the 90-percent gross receipts test under section 165(g)(3)(B) and therefore treat a worthless stock deduction with respect to the stock of the foreign corporate partner as ordinary in character. In the ruling, domestic corporation ("Z") caused its wholly-owned insolvent subsidiary ("FC2") to make a check-the-box election to be treated as a disregarded entity (the "FC2 Election"). FC2's primary asset was an interest in a foreign partnership ("FP2"), from which it derived the majority of its revenue. The PLR stated that FC2 could satisfy the 90-percent gross receipts test under section 165(g)(3)(B) only if its distributive share of FP2's gross receipts were included. The IRS ruled that FC2 should include its distributive share of FP2's gross receipts.

Observations

To qualify a worthless stock deduction as ordinary in character (instead of capital) under section 165(g)(3), a two-part test must be satisfied:

- An ownership test requires direct ownership of stock representing section 1504(a)(2) control; and

- More than 90 percent of the aggregate of a worthless corporation's gross receipts for all taxable years must be from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stock and securities.

In concluding that the deduction qualified under section 165(g)(3), the IRS had to determine whether FP2 should be treated as an entity or in the aggregate – i.e., in which each partner has an undivided interest in the assets of the partnership and takes into account, separately, its distributive share of partnership items – for purposes of determining the partner's gross receipts. The IRS applied the aggregate approach, citing Rev. Rul. 71-455. In that revenue ruling, the IRS concluded that an S corporation's distributive share of gross receipts from a partnership should be included for purposes of a passive income test under section 1372(e)(5), as then in effect. The revenue ruling's conclusion was based on Treas. Reg. sec. 1.702-1(a)(8), which generally adopts an aggregate approach.

By adopting the aggregate approach, each item of income (including the character of each item) of FP2 was treated as if FC2 had earned such items directly and thus, FC2 satisfied the 90-percent gross receipts test.

For additional information, contact Derek Cain, David Friedel, Colin Zelmer, or DiAndria Green.

Court Watch

Barnes Group Inc. v. Commissioner, T.C. Memo 2013-109 (April 16, 2013)

Background

As part of Barnes Group's (Barnes) strategic objective to expand the company primarily through acquisitions, Barnes entered into a domestic and foreign finance structure (the 'reinvestment plan') to facilitate efficient financing of future acquisitions. The reinvestment plan was structured to occur in two parts and involved two wholly owned subsidiaries (Bermuda and Delaware).

<u>Part I of the plan</u> consisted of the following steps:

1. In a section 351 transaction, ASA (a foreign subsidiary of Barnes generating excess cash) and Barnes transferred foreign currency to Bermuda in exchange for Bermuda common stock;

2. In another section 351 transaction, Bermuda and Barnes transferred foreign currency and Bermuda common stock to Delaware in exchange for Delaware stock (Barnes received common stock and Bermuda received preferred stock); and

3. Delaware converted the foreign currency into U.S. dollars and lent the funds to Barnes.

<u>Part II of the reinvestment plan</u> involved the same series of steps, although ASA would first borrow funds from a Singaporean bank prior to completing the section 351 transactions.

Tax Court opinion

The Tax Court applied substance over form and step-transaction doctrine principles to the entire reinvestment plan and held that the plan in substance constituted dividend payments from ASA to Barnes in 2000 and 2001, taxable under section 301.

Barnes argued that the form of the reinvestment plan should not be challenged because the company reasonably relied on Rev. Rul. 74-503, in which the IRS concluded that where treasury stock is exchanged for newly issued stock of another corporation in a section 351 transaction, the basis of the stock received by both corporations is zero. The 1974 ruling was revoked by Rev. Rul. 2006-2, where the IRS said it would not challenge a position taken before December 20, 2005 in reasonable reliance on the conclusions of the 1974 ruling. The Tax Court determined that the reinvestment plan "far exceeded the scope of the stock-for stock exchange addressed in Rev. Rul. 74-503," and stated that, "[e]ven if [the court] were to respect the form of the reinvestment plan, Rev. Rul. 74-503 ... still would not preclude [the Service's] challenge because there are substantial factual differences between Rev. Rul. 74-503, supra, and the reinvestment plan." Specifically, according to the court, the reinvestment plan involved two newly formed wholly owned subsidiaries, one of which was a controlled foreign corporation, and the exchanges resulted in the transfer of cash from a foreign country to the United States, which differed from the revenue ruling. The Tax Court also determined that Barnes did not adequately support its business rationale for the establishment of the entities participating in the reinvestment plan.

Observations

The Tax Court invoked the substance over form and the step-transaction doctrines. Therefore, the court did not need to address the taxpayer's reliance on Rev. Rul. 74-503 and whether, if the reinvestment plan was respected, it resulted in a potential subpart F inclusion. The Court's consideration of the issue may raise a broader question of how close the facts of a taxpayer's transactions must be to the facts of an existing Revenue Ruling in order to justify reliance as that ruling in the view of the Court. Also, by disregarding the form of the taxpayer's transaction, the Tax Court may have made its own analysis of the taxpayer's reliance on Rev. Rul. 74-503 moot.

For more information, please contact Mark Boyer, Tim Lohnes, or Doug Skorny.

PwC M&A publications

WNTS author Wade Sutton wrote an article published in the March/April 2013 issue of the Journal of Corporate Taxation titled "Should Hook Stock Prevent Affiliation?." This article explores whether hook stock can prevent corporations from forming part of an affiliated group and discusses a recent PLR that sheds some light on this historically vexing question.

WNTS authors Laura Nadeau and Audrey Ellis wrote an article published in the Bloomberg BNA Tax Management Memorandum (April 8, 2013) titled "The Net Investment Income Tax: Elections to Start Thinking About Now." The article explores the 3.8-percent tax on net investment income imposed by section 1411 and elections that can be made to plan for the impacts of the tax.

Let's talk

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