

## ***M&A tax recent guidance***



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**This month features:**

- Principles of Commissioner's Discretionary Rule applied for taxpayer favorable result on noncapital, nondeductible intercompany loss (PLR 201411007)
  - Trust holding rental real estate property held to qualify for Section 469(c)(7) passive activity exception (*Frank Aragona Trust*)
  - Section 355 ruling permits distributed corporation to elect classification as REIT after distribution (PLR 201411002)
  - IRS pauses consideration of ruling requests on publicly traded partnerships satisfying qualifying income requirements.
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## Did you know...?

In appropriate cases, the IRS may expand the principles of the Commissioner's Discretionary Rule (CDR) in Reg. sec. 1.1502-13(c)(6)(ii)(D) beyond the CDR's literal terms (see the January 2014 edition of *This Month in M&A* for a detailed discussion of the CDR).

In PLR 201411007, the IRS applied CDR principles to rule that a deferred intercompany loss (DIL) created by an intercompany distribution of stock and taken into account under Reg. sec. 1.1502-13(c)(1) as a noncapital, non-deductible amount would not be taken into account in computing the earnings and profits (E&P) of any member, and would not trigger basis adjustments under Reg. sec. 1.1502-32(b) to any member. By its terms, the CDR applies solely to intercompany gain and income; previously, the IRS had exercised its CDR authority only to exclude deferred intercompany gains on member stock.

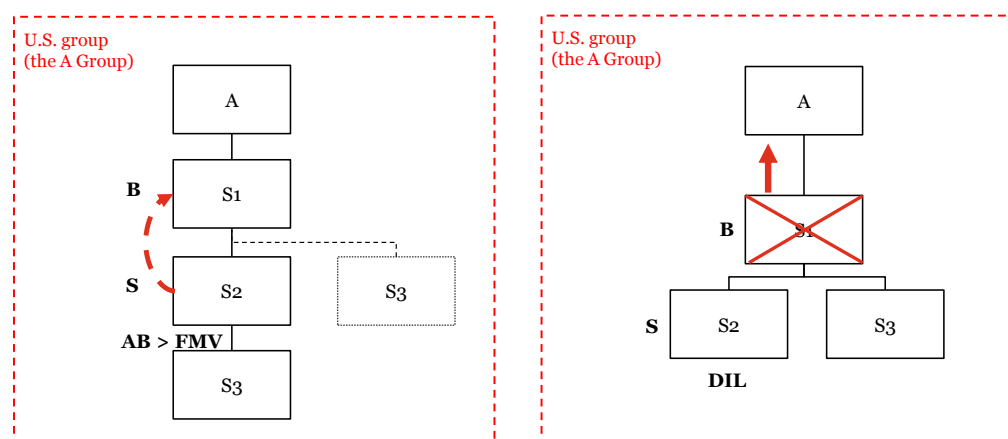
### Outline of relevant transaction

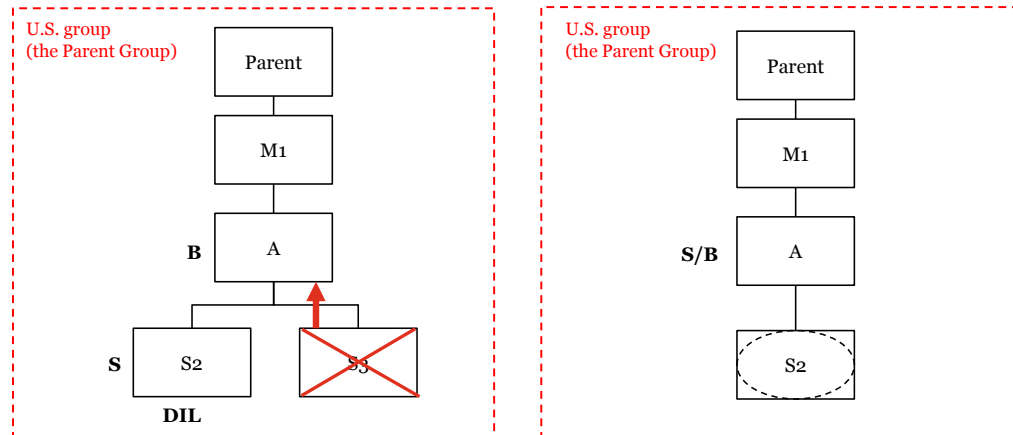
A was the common parent of a consolidated group (the A Group) that wholly owned Sub 1. Sub 1 wholly owned Sub 2, which in turn wholly owned Sub 3. Sub 1, Sub 2, and Sub 3 all were members of the A Group.

Sub 2 distributed the stock of S3 to S1 at a loss in a taxable distribution under Section 301 and Reg. sec. 1.1502-13(f)(2) (the Distribution), creating the DIL. Sub 1 subsequently liquidated (the Sub 1 Liquidation), causing A to become the successor to S1 for purposes of applying the intercompany transaction rules.

A then was acquired by M-1, a wholly owned subsidiary of Parent, the common parent of a consolidated group (the Parent Group), resulting in the A Group terminating and the members of the A Group becoming members of the Parent Group. Parent then caused Sub 3 to liquidate into A (the Sub 3 Liquidation) thus eliminating A's basis in the Sub 3 stock, which reflected the DIL.

Sub 2 then was liquidated for federal income tax purposes in a transaction that qualified as a Section 332 liquidation (the Sub 2 Liquidation), causing A to become the successor to Sub 2 for purposes of applying the intercompany transaction rules.





### *Application of intercompany transaction rules*

As a result of the Sub 3 Liquidation, the DIL was taken into account under Reg. sec. 1.1502-13(c)(1) as a noncapital, nondeductible amount in the hands of Sub 2. Under the normal operation of Reg. sec. 1.1502-32, the Sub 3 Liquidation would cause A to reduce its basis in its S2 stock, and the basis reduction would tier up the chain under Reg. sec. 1.1502-32(a)(3)(iii), even though the DIL would not be deductible for tax purposes. However, the PLR held that the DIL would not be taken into account in computing the E&P of any Parent Group member, and would not be treated as a noncapital, nondeductible amount for purposes of Reg. sec. 1.1502-32(b)(2)(iii) by any Parent Group member.

Neither the CDR nor the Automatic Relief Rule (ARR) in Reg. sec. 1.1502-13(c)(6)(ii)(C) – neither of which literally applied in the transaction – were specifically referenced in the PLR. The ARR could have applied and no ruling would have been required under the CDR if (1) the Sub 2 Liquidation had occurred prior to the Sub 3 Liquidation and (2) the Distribution had resulted in a deferred intercompany gain (DIG). Even without changing the sequence of the Liquidations, the taxpayer could have sought relief under the CDR if the Distribution had resulted in a DIG.

Despite not specifically referencing the CDR, this PLR appears to extend the IRS' reach under the CDR to apply to DILs on member stock. The taxpayer made the following representations, which are specifically required in order to seek relief under the CDR:

- The effects of the Distribution had not previously been reflected, directly or indirectly, on any A Group or any Parent Group consolidated US federal income tax return; and
- Neither the A Group nor the Parent Group had derived, and no taxpayer will derive, any US federal income tax benefit from the Distribution, or from the Liquidations that eliminated the parties to the Distribution for US federal income tax purposes and resulted in redetermination of the DIL as a noncapital, nondeductible amount (including any adjustment to basis in member stock under Reg. sec. 1.1502-32).

### *Observations*

The result in this PLR is consistent with Reg. sec. 1.1502-13's stated purpose of clearly reflecting the taxable income of the group as a whole. The basis in Sub 3 that resulted from the Distribution was eliminated by the Sub 3 Liquidation before its effects had been reflected by either the A Group or the Parent Group. Thus, negative basis adjustments under Reg. sec. 1.1502-32 and negative E&P adjustments under Reg. sec. 1.1502-33 would

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not be necessary to clearly reflect the taxable income of the Parent Group. Further, the result in this PLR also would have been appropriate if the relevant transaction had been effected without distributing the Sub 3 stock but instead by simply liquidating Sub 1, Sub 2, and Sub 3, with Sub 3's liquidation being the final step.

*For additional information, please contact David Friedel or Robert Black.*

## **Court watch**

### ***Frank Aragona Trust et al. v. Commissioner, 142 T.C. No. 9 (March 27, 2014)***

The Tax Court recently issued an important decision addressing the application to trusts of the material participation rules under Section 469. The court concluded that a trust (Trust) holding rental real estate property qualifies for the Section 469(c)(7) passive activity exception, finding that Trust was able to perform personal services through its individual trustees, that Trust materially participated in a real property trade or business, and that Trust's rental activities were not passive activities.

Trust engaged in real estate activities such as owning rental real estate property and developing real estate. Trust's six trustees acted as a management board for Trust, made all major decisions regarding the Trust's property, and received fees paid directly from the Trust for attending board meetings. Three of the trustees served as employees of a limited liability company (LLC) wholly owned by Trust and received wages for their services provided to the LLC. The LLC managed most of the Trust's rental real estate properties.

Generally, rental activities are considered passive activities regardless of the taxpayer's material participation in the activity. However, Section 469(c)(7) provides an exception if (1) more than one half of the 'personal services' performed in trades or businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

The regulations define 'personal services' as work performed by an individual in connection with a trade or business. Therefore, the IRS determined that Trust did not qualify for the exception under Section 469(c)(7).

In rejecting the IRS determination, the Tax Court concluded that Trust, through its individual trustees, is capable of performing personal services and therefore can satisfy the Section 469(c)(7) exception. The Tax Court also determined that the activities of the trustees, including their activities as employees of the LLC, should be considered for purposes of determining whether Trust materially participated in real estate operations, even if the activities of Trust's non-trustee employees should be disregarded.

Considering the activities of all six trustees in their roles as trustees and as employees of the LLC and the state law fiduciary requirements of a trustee, the Tax Court concluded that Trust materially participated in the real estate operations. The court did not address certain other aspects of qualifying for the Section 469(c)(7) exception because the IRS did not base its position on those tests.

## **Observations**

The Tax Court decision concludes that services provided by trustees, including services provided by trustees serving as employees of the LLC, may be counted for purposes of establishing material participation for Trust. The decision does not address whether services performed by non-trustee employees of Trust may be considered for purposes of establishing material participation. Thus, an unanswered question is whether a trust

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could establish material participation solely through the activities of non-trustee employees (see *Mattie K. Carter Trust v. US*, 256 F. Supp. 2d 536 (ND TX 2003), which concludes a trust may establish material participation by counting activities of its employees and trustees).

The Tax Court decision, if upheld on any appeal, significantly affects the application of the 3.8% net investment income tax under Section 1411. That tax does not apply to taxpayers (individuals, estates, or trusts) who materially participate in a trade or business. The more favorable material participation standards provided in the Tax Court decision could allow more trusts to establish material participation and therefore not be subject to the net investment income tax.

*For additional information, please contact Brian Meighan, Dianna Miosi, or Elizabeth Amoni.*

## **Private letter rulings**

### **PLR 201411002**

The IRS ruled that an external distribution of stock of a controlled corporation qualifies for nonrecognition treatment under Section 355 even though it is anticipated that after the distribution the controlled corporation will elect to be treated as a real estate investment trust (REIT). In connection with the distribution and REIT election, Controlled is expected to elect jointly with certain of its subsidiaries to treat such subsidiaries as taxable REIT subsidiaries (TRSs).

This is the second PLR in the last several months (see the October 2013 edition of *This Month in M&A* for a discussion of PLR 201337007) in which Controlled elected to be taxed as a REIT following a Section 355 distribution. Of particular interest is the potential reduction in federal income tax resulting from such an election. One requirement under Section 355 is that the distribution must be carried out for one or more non-federal income tax corporate business purposes. While the PLR does not address whether the business purpose requirement is satisfied, the IRS presumably would not have issued a favorable ruling if it had determined that the potential reduction in federal income tax associated with the REIT election outweighed the corporate business purposes for undertaking the distribution.

Proposals included in the draft tax reform legislation released by House Ways and Means Committee Chairman Dave Camp (R-MI) in February (see the March 2014 edition of *This Month in M&A*) include amendments aimed to (1) prohibit the application of Section 355 if either a distributing corporation or controlled corporation is a REIT and (2) prevent both a distributing corporation and a controlled corporation from making a REIT election during the 10 years following a Section 355 distribution.

*For additional information, please contact Derek Cain or Rich McManus.*

## **Other guidance**

### **Ruling policy on publicly traded partnership qualifying income**

Special counsel to the IRS associate chief counsel announced on March 28 that the IRS has stopped considering any PLR requests on whether a publicly traded partnership satisfies the 'qualifying income' requirements under Section 7704. There was no indication of when the IRS might start reconsidering these ruling requests.

*For additional information, please contact Brian Meighan, Dianna Miosi, or Elizabeth Amoni.*

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### ***PwC's M&A publications***

In an article titled *Duquesne and Ifeld: A Risen Phoenix or an Entirely Different Animal?*, published in Corporate Taxation (March/ April 2014), PwC's author Wade Sutton examines the history of *Ifeld* and concludes that the Tax Court's recent interpretation of the decision is a minority view.

In an article titled *Chasing Basis in Cross-Chain Stock Sales*, published in Tax Notes on March 24, 2014, PwC's M&A authors Gabe Gartner and Neha Prabhakar explore the inconsistent authorities on the location of unrecovered basis in cross-chain Section 304 transactions.

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## ***Let's talk***

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

Tim Lohnes, *Washington, DC*

+1 (202) 414-1686

[timothy.lohnes@us.pwc.com](mailto:timothy.lohnes@us.pwc.com)

David Friedel, *Washington, DC*

+1 (202) 414-1606

[david.b.friedel@us.pwc.com](mailto:david.b.friedel@us.pwc.com)

Derek Cain, *Washington, DC*

+1 (202) 414-1016

[derek.cain@us.pwc.com](mailto:derek.cain@us.pwc.com)

Gabe Gartner, *San Jose, CA*

+1 (408) 808-2901

[gabe.gartner@us.pwc.com](mailto:gabe.gartner@us.pwc.com)

Brian Meighan, *Washington, DC*

+1 (202) 414-1790

[brian.meighan@us.pwc.com](mailto:brian.meighan@us.pwc.com)

Rich McManus, *Washington, DC*

+1 (202) 414-1447

[rich.mcmanus@us.pwc.com](mailto:rich.mcmanus@us.pwc.com)

Dianna Miosi, *Washington, DC*

+1 (202) 414-4316

[dianna.k.miosi@us.pwc.com](mailto:dianna.k.miosi@us.pwc.com)

Robert Black, *Washington, DC*

+1 (202) 414-1870

[robert.s.black@us.pwc.com](mailto:robert.s.black@us.pwc.com)

Wade Sutton

+1 (202) 346-5188

[wade.sutton@us.pwc.com](mailto:wade.sutton@us.pwc.com)

Elizabeth Amoni, *Washington, DC*

+1 (202) 346-5296

[elizabeth.amoni@us.pwc.com](mailto:elizabeth.amoni@us.pwc.com)

Jamal Razavian, *Washington, DC*

+1 (202) 414-4559

[jamal.a.razavian@us.pwc.com](mailto:jamal.a.razavian@us.pwc.com)

Nathan Jerkins, *Washington, DC*

+1 (202) 414-1357

[nathan.t.jerkins@us.pwc.com](mailto:nathan.t.jerkins@us.pwc.com)

Simona Raulea, *Washington, DC*

+1 (202) 346-5202

[simona.raulea@us.pwc.com](mailto:simona.raulea@us.pwc.com)

Brian Corrigan, *Washington, DC*

+1 (202) 414-1717

[brian.t.corrigan@us.pwc.com](mailto:brian.t.corrigan@us.pwc.com)

Neha Prabhakar, *Washington, DC*

+1 (202) 346-5244

[neha.prabhakar@us.pwc.com](mailto:neha.prabhakar@us.pwc.com)

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