This Month in M&A / Issue 16 / July 2014

M&A tax recent guidance

This month features:

- Tax Court treats goodwill used by corporation as owned by sole shareholder (*Bross Trucking, Inc.*)
- Section 355 active trade or business requirement met with non-affiliated partnership employees (PLR 201426007)
- PLR addresses basis implications of contingent liabilities assumed in a section 351 exchange (PLR 201424007)
- Spin-off ruled tax-free where controlled corporation may elect REIT status (PLR 201423010)
- Losses denied where partnership's section 475 dealer activities not attributed to partner (ILM 201423019)

Did you know…?

The Tax Court recently held that appreciated goodwill used by a corporation (Bross Trucking) was owned by its sole shareholder (Bross); as a result, the corporation could not be treated as making a taxable distribution of the goodwill upon the winding down of its operations (*Bross Trucking, Inc. v. Comm'r*, T.C. Memo. 2014-107 (June 5, 2014)).

Background

Bross used Bross Trucking to haul materials for his road construction company (Bross Construction) but decided to wind down Bross Trucking's operations. To create another business that could supply hauling services to Bross Construction, Bross's sons formed a new corporation in the same state (LWK Trucking). LWK Trucking primarily serviced the same customers and leased the same vehicles for its hauling services as had Bross Trucking. 50 percent of LWK Trucking's employees formerly worked at Bross Trucking.

Although Bross did not have an ownership interest in LWK Trucking and did not conduct any management activities on its behalf, the IRS asserted, in part, that Bross Trucking had distributed appreciated goodwill to Bross for which it was required to recognize gain under section 311(b).

Ownership of goodwill

The Tax Court, defining goodwill as 'the expectation of continued patronage,' reasoned that the facts and circumstances must be analyzed in determining whether the goodwill utilized by Bross Trucking was developed at the corporate level, resulting in a distribution from Bross Trucking, or at the shareholder level.

With respect to goodwill developed at the shareholder level, the Tax Court first considered *Martin Ice Cream Co. v. Comm'r*, 110 T.C. 189 (1998). In that case, the Tax Court held that a shareholder's personal development of a wholesale distribution business, driven by his expertise and personal relationships, could not be attributed to the corporation benefitting from the goodwill if the shareholder had no employment contract or non-compete agreement with the corporation. In contrast, the Tax Court considered *Solomon v. Comm'r*, T.C. Memo. 2008-102, where it concluded that when the success of a corporation's business was not dependent on the development of goodwill by its shareholders (i.e., was attributable to the corporation's processing, manufacturing, and sales functions), the goodwill existed at the corporate level. The court said that "these two cases suggest there are two regimes of goodwill: (1) personal goodwill developed and owned by shareholders; and (2) corporate goodwill developed and owned by the company."

The Tax Court concluded that Bross personally owned most of the goodwill used by Bross Trucking, based on its analysis of the following factors:

- **Lack of employment contract or non-compete agreement**: Bross did not have an employment contract or non-compete agreement with Bross Trucking. Thus, the corporation did not have an ownership interest in Bross's personally developed goodwill.
- **Corporation's reputation**: Bross Trucking had a history of regulatory infractions and was in jeopardy of receiving a cease-and-desist order, which would adversely affect the loyalty of its customers. As a result, with the exception of workforce in place, Bross Trucking had no corporate goodwill because the company "could not expect continued patronage . . . [if] its customers did not trust it and did not want to continue doing business with it." Thus, Bross Trucking's customers decided to use LWK Trucking based on its own merits as a result of Bross Trucking's declining reputation.
- **Shareholder development of business relationships**: Bross had a

reputation as a successful businessman in the industry and performed significant functions on behalf of Bross Construction and Bross Trucking, such as arranging projects and maintaining customer relationships. Therefore, Bross Trucking's expectation of continued patronage was based solely on Bross's efforts.

- **Percentage of employees and hiring procedures**: There was no evidence that LWK Trucking's employees were directly transferred to that company as opposed to being hired on their own merit. Although none of Bross Trucking's employees had non-compete agreements, in this instance, LWK Trucking's use of 50% of Bross Trucking's previous employees was not considered a transfer of 'most' of the workforce in place.

In addition to these factors, the Tax Court found it relevant that Bross Trucking (1) remained a going concern by retaining assets, and (2) hired new employees and offered new services to establish an independent workforce.

Observations

Where employees or other business relationships used by a corporation shift to a related party, the determination of whether a transfer of goodwill occurred between the parties is based on all the facts and circumstances. The decision in *Bross Trucking* reinforces the Tax Court's holding in *Martin Ice Cream* that the development of goodwill at the shareholder level generally cannot be attributed to the corporation benefitting from such goodwill if there is no employment contract or non-compete agreement in place.

Generally, goodwill may be associated with assets or workforce in place, where the assets or workforce in place constitute an independent segment of a business (*see Webster Investors, Inc. v. Comm'r*, 291 F.2d 192 (2d Cir. 1961)). In the context of intercompany restructurings, the goodwill component may be separated from the assets and/or workforce in place being transferred through the execution of non-compete agreements with the acquiring company.

The *Bross Trucking* decision demonstrates that in some instances the use of a non-compete agreement is not necessary to separate assets or workforce in place from goodwill. This result is consistent with prior decisions of the Tax Court indicating that in certain situations the value of a workforce is so insignificant in comparison to its other assets (e.g., the trade name and trademarks) that the workforce is not considered goodwill (*see Canterbury v. Comm'r*, 99 T.C. 223 (1992)). Here, it appears that the court viewed LWK Trucking's use of 50 percent of Bross Trucking's former employees (some of whom may have been independent contractors) as insignificant where LWK Trucking offered additional services and hired new key employees who were not previously employed by Bross Trucking. Although not clear from the court's opinion, consider whether the utility and value of Bross Trucking's workforce, and essentially their job function, also played a role in the court's decision and whether a transfer of a high-value workforce would affect the Tax Court's determination regarding whether 'most' of a company's workforce in place was transferred.

The impact of the holding that there was no transfer of workforce in place (and, thus, no deemed distribution and contribution) also may be relevant in the context of companies engaging in migration strategies where a corporation winds down its operations and offers its existing employees the ability to relocate to an affiliated corporation with similar business functions. Thus, when undergoing a migration strategy, companies should consider the facts and circumstances analyzed by the Tax Court, including the percentage of employees rehired, the affiliated hiring corporation's additional service offerings, any non-compete agreements in place, and the employees' job functions.

As evident from the above, whether there is a deemed transfer of goodwill is a very fact intensive inquiry, without much guidance from the courts or IRS. This case provides some guidance that should be analyzed by taxpayers when evaluating these issues.

For additional information, please contact Tim Lohnes, Rich McManus, or Brian Loss.

Private letter rulings

PLR 201426007

The IRS ruled that a split-off by a closely held corporation (Distributing) qualified as a tax-free section 355 distribution notwithstanding Distributing's and the controlled corporation's (Controlled) post split-off utilization of employees of a related but non-'affiliated' partnership (Partnership) for operational functions.

In this PLR, individuals A, B, and C performed all the management functions for Distributing's business (Business A), as its officers and directors. Distributing had no employees, and utilized Partnership's employees in conducting Business A, for which it reimbursed Partnership.

Prior to the transaction, A, B, and C each owned an equal interest in Partnership, which in turn owned all of the stock of Distributing. Partnership made a non-liquidating pro rata distribution of Distributing to A, B, and C. In connection with the transaction, Distributing formed Controlled and contributed property, cash, and a note and distributed all of Controlled's stock to C in complete redemption of C's stock in Distributing. Following the split-off, Distributing and Controlled will continue to use Partnership's employees or hire their own employees, or the officers and directors of each may begin performing operational activities.

Observations

Section 355 requires that both the distributing and controlled corporations be engaged in the active conduct of a trade or business (ATOB) immediately following a section 355 distribution. The current section 355 regulations state that an ATOB requires the performance of substantial management and operational functions, which generally must be performed by a corporation's own employees.

Activities performed by independent contractors or employees of other corporations, except employees of corporations within the affiliated group, generally are not taken into account (*see* Rev. Rul. 79-394). However, proposed ATOB regulations provide that in certain cases, in addition to activities performed by employees of affiliates, activities performed by shareholders of a closely-held corporation are considered activities performed by the corporation (Prop. Reg. sec. 1.355-3(b)(2)(iii)). Further, the proposed ATOB regulations adopt the rationale of Rev. Rul. 2007-42 that a partnership's conduct of the managerial or operational activities of a business may be attributed to a partner owning a significant interest in the partnership (e.g., a one-third ownership interest) (*see* the June 2007 edition of *This Month in M&A* for a discussion of the proposed ATOB regulations).

Unlike Rev. Rul. 2007-42 and the examples under the proposed ATOB regulations, in the PLR, Partnership was not owned by either Distributing or Controlled. Nevertheless, it appears that the IRS attributed the operational activities of Partnership to A, B, and C. As a result, because Distributing and Controlled were closely held, A, B, and C's management functions and (attributed) operational functions were considered the activities of each of Distributing and Controlled, respectively.

This PLR suggests that, under certain circumstances, the IRS may be amenable to expanding the rules regarding attribution of an ATOB and employees in line with the proposed regulations. Further, this PLR may indicate an IRS willingness to broaden the

rule in the proposed ATOB regulations regarding a distributing and/or controlled corporation's use of the employees of affiliates.

For additional information, please contact Rich McManus, Meryl Yelen, or Brian Loss.

PLR 201424007

In connection with a section 368(a)(1)(C)/368(a)(2)(C) transaction, the IRS analyzed the basis implications of potential contingent liabilities assumed in a section 351 exchange.

Under simplified facts, USP, the parent of a US consolidated group that includes S1, undertook a series of steps to insulate latent liabilities from S1's discontinued Business A from the assets and operations of Business B, which was operated by S1 and other consolidated subsidiaries of USP. All on the same day, S1 converted to a limited liability company under state law (LLC); and LLC distributed certain disregarded subsidiaries to its parent, USP; LLC then reincorporated under state law (New Sub 1).

The IRS ruled that (1) S1's conversion to a wholly owned limited liability company under state law was a valid reorganization under sections 368(a)(1)(C) and 368(a)(2)(C), and (2) that the reincorporation of LLC's remaining Business A assets into New Sub 1 was an exchange described in section 351.

The IRS also ruled that New Sub1's payment of a Business A liability that is treated as a constructive distribution by New Sub 1 to USP will not result in a negative adjustment to USP's basis in New Sub 1 until the cumulative amount of such constructive distributions exceeds the amount by which USP's basis in New Sub 1's stock is reduced by section 358(d) (considering Treas. Reg. secs. 1.1502-32(a)(2) and 1.1502-80(a)(2), which generally prevent the duplication of basis adjustments). Thus, to the extent New Sub 1's payments of any Business A liabilities are treated as deemed distributions, there will not be any adjustment to USP's basis in New Sub 1 until the payments exceed the amount of the basis adjustment for liabilities assumed under section 358(d) as of the time of the original transfer.

Observations

While not explicit in the PLR, it appears that the Business A liabilities contain some contingent component that was not reflected in USP's basis in New Subs 1's stock under section 358(d) by virtue of being considered section 357(c)(3) liabilities (liabilities the payment of which would give rise to a deduction).

The PLR appears to provide the taxpayer a backstop to the general basis rules to the extent any Business A liabilities *not* reflected in USP's basis in New Sub 1 are subsequently satisfied by New Sub 1. To the extent (1) these liabilities are deemed to remain at USP after the reincorporation of LLC, and (2) a liability payment results in a deemed distribution to USP, the taxpayer is prevented from duplicating any basis adjustments related to this deemed distribution. This result may reflect IRS concerns over the transfer of the latent Business A liabilities after the business to which they relate was discontinued. The PLR facts also bear a resemblance to the first step in Notice 2001-17, in which the IRS stated its position regarding certain contingent liability tax shelter transactions.

The PLR appears silent on the potential application of Rev. Rul. 95-74 to the taxpayer's facts in order to determine which legal entity is entitled to any deductions in connection with the payment of contingent Business A liabilities. Generally, under section 381(c)(16) and the regulations, the acquiring corporation in a reorganization steps into the target's shoes and may deduct otherwise deductible payments assumed from the target. Although this section 381 rule does not extend to section 351 transfers, Rev. Rul. 95-74 generally extends this concept to exchanges described in section 351.

For example, from a separate company perspective, if the amount of the liability as of the time of the contribution was $50, this would result in a reduction in USP's basis in New Sub 1 stock of $50 under sections 358(d) and 358(a)(1)(A)(ii). If the liability ultimately paid by New Sub 1 is $100 due to some contingencies, New Sub1 either should be entitled to a deduction for the additional $50 liability paid under Rev. Rul. 95-74, or the IRS may instead view that liability as never having been assumed in the original exchange and thus treat it as a constructive distribution to USP (although Rev. Rul. 95-74 does not specifically discuss how to treat the contingent liability once incurred).

Though not specifically enumerated in the rulings provided to the taxpayer, the ruling impliedly offers insights into the IRS's position on the timing of formless legal conversions. While all the transactions described in the PLR take place on the same day, the PLR respects the order of the steps as contemplated by the taxpayer. Thus, the IRS seems to agree in the PLR that in the case of formless legal conversions from corporate status to limited liability company status (and vice versa) under local law, the time of those legal conversions will be respected. By contrast, under the entity classification regulations, a check-the-box election to change classification of an eligible entity is treated as occurring at the start of the day for which the election is effective, and any transactions that are deemed to occur as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. Note that in Rev. Rul. 2009-15, the IRS treated the timing of a state law formless conversion consistently with the treatment of fictional transactions under the entity classification regulations.

For additional information, please contact David Friedel, Rich McManus, or Patrick Phillips.

PLR 201423010

The IRS ruled favorably on a tax-free spin-off where it is anticipated that after the distribution the controlled corporation will elect to be treated as a Real Estate Investment Trust (REIT).

In the PLR, Distributing, a publicly traded corporation, is a holding company and the parent of a group of US and foreign entities. Distributing conducts Business A and Business B.

In a series of transactions, Distributing formed Controlled and contributed the Business A entities to Controlled in exchange for Controlled stock, cash, and the assumption of certain liabilities. Thereafter, Distributing either (1) distributed the Controlled stock to Distributing's shareholders on a pro rata basis, or (2) on one or more occasions, offered to Distributing's shareholders the right to exchange shares of Controlled stock for currently outstanding shares of Distributing (the Spin-off). Distributing used the cash received from Controlled to repay Distributing's creditors within a certain number of months following the Spin-off.

Although Distributing determined that it will proceed with the Spin-off based on valid business motivations, after the Spin-off Controlled may elect to be taxed as a REIT under section 856(c)(1) based on applicable business and market considerations. On the facts of the PLR, the IRS ruled that the Spin-off qualified as a tax-free transaction under sections 355 and 368(a)(1)(D).

Observations

This is the third recently issued PLR (*see* October 2013 and April 2014 editions of *This Month in M&A* for a discussion of PLR 201337007 and PLR 201411002, respectively) in which Controlled may elect to be taxed as a REIT following a section 355 distribution. One section 355 requirement is that a distribution must be carried out for one or more

non-federal income tax corporate business purposes. The potential for avoidance of federal taxes by the distributing or controlled corporation is relevant in determining the extent to which an existing corporate business purpose is deemed to motivate the distribution. While this PLR does not address the business purpose requirement, the IRS presumably would not have issued a favorable PLR if it had determined that the potential reduction in federal income tax associated with the anticipated REIT election would outweigh the corporate business purposes. Notably, the discussion draft of comprehensive tax reform legislation released on February 26, 2014 by House Ways and Means Committee Chairman Dave Camp (R-MI) includes a provision to restrict REITs from engaging in tax-free spinoffs. The proposal would make a REIT ineligible to participate in a spin-off and would prohibit a distributing or controlled corporation, with respect to any section 355 distribution, from electing REIT status for a period of 10 years.

For additional information, please contact Tim Lohnes, Rich McManus, or Andrew Gottlieb.

Other guidance

ILM 201423019

In this ILM, the IRS applied an entity view to conclude that the dealer activities of a partnership are not attributable to its partners. The ILM indicates that while the ordinary character of the gains and losses of the partnership flows through to the partners under section 702, dealer status does not.

Taxpayer is a holding company that owns interests in two partnerships and a residual interest in DE Trust, a disregarded entity. Taxpayer has no employees. One partnership is a dealer under section 475(c)(1) that originates and purchases mortgage loans on the open market and participates in mortgage-backed securitizations. DE Trust holds mortgage loans and issues notes to third-party investors as mortgaged-backed securities. The second partnership, through a disregarded entity, services the mortgage loans held by and on behalf of the DE Trust. Taxpayer claimed dealer status under section 475(a) by attributing to itself the dealer and loan modification activities performed by the partnerships, and claimed mark-to-market losses of the DE Trust on its return.

The IRS denied the Taxpayer's mark-to-market losses on the grounds that:

- The partnerships are separate entities and are not disregarded entities of Taxpayer, and thus the partnerships' dealer and loan modification activities are not attributed to Taxpayer;
- The loan modification activities did not rise to the level of dealer activities;
- Agency principles did not attribute the partnership's loan modification activities to Taxpayer; and
- Taxpayer did not satisfy the definition of dealer in securities under section 475(c)(1) and did not elect trader status under section 475(f).

Observations

The IRS's rationale for denying attribution on entity principles—rather than applying an aggregate approach and respecting attribution—is unclear as the ILM does not cite guidance other than section 475 in rendering its conclusion. The denial of Taxpayer's losses stems from the IRS's interpretation of the dealer requirements under section 475: the Taxpayer must satisfy the definition of dealer or elect to be a trader in securities in order to mark-to-market its securities not specifically identified as held for investment. Consequently, the Taxpayer's mark-to-market loss was denied because it did not satisfy the definition of a dealer in securities under section 475(c)(1) and did not elect trader

status under section 475(f). It is unclear whether the IRS will cite this ILM in support of its application of the entity view in other attribution scenarios because of the limited analysis in the ILM and reliance on the definition of dealer under section 475.

For additional information, please contact Jennifer Wyatt, Kristel Glorvigen Pitko, or Vincent Cataldo.

Let's talk

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

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