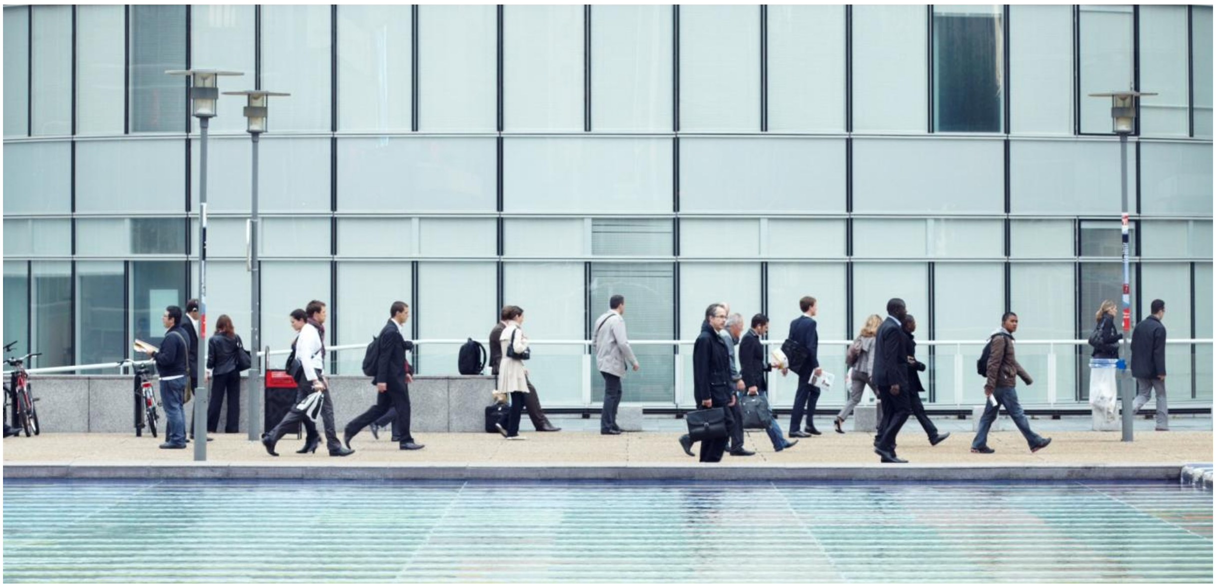
M&A Tax Recent Guidance



This month features:

- Final section 336(e) regulations allow certain stock dispositions to be treated as asset dispositions
- Unidentified trust beneficiaries treated as qualified creditors under section 382(l)(5) (PLR 201322032)
- IRS grants section 9100 relief for Treas. Reg. sec. 1.1502-13(l)(3) election (PLR 201322001 and PLR 201322002)
- Third Circuit reverses bankruptcy court decision, rules that QSub status is not debtor's property interest (*Majestic Star Casino LLC v. Barden Dev. Inc.*)
- Outbound F reorganization treated as transfer and indirect disposition of intangible property under section 367(d) (CCA 201321018)
- Court's granting of joint motion to dismiss creditor suit constitutes identifiable event for discharge of indebtedness purposes (TAM 201321019)

Did you know...?

Final regulations under section 336(e) permit taxpayers to elect to treat certain dispositions of a target corporation's stock as a sale of the target corporation's underlying assets. The final regulations provide more flexibility to taxpayers than proposed regulations issued in 2008, and are effective for any qualified stock disposition (QSD) on or after May 15, 2013.

Background

Section 336(e) was enacted in 1986 to provide relief to taxpayers from potentially being taxed multiple times on the same economic gain. Following the repeal of *General Utilities*, such double taxation could occur when a disposition of appreciated corporate stock is taxed without providing a corresponding step-up in the basis of the assets.

Final regulations

Under the final regulations, a domestic corporation or S corporation shareholder (Seller) can make a section 336(e) election when there is a QSD.

A QSD generally is any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) (generally 80 percent vote and value) of a domestic corporation (Target) is either sold, exchanged, or distributed by a domestic corporation or S corporation shareholder during a 12-month period. The disposition cannot be to a related party and does not include a nontaxable disposition of the stock, with the exception of certain section 355 transactions (discussed below).

Section 338(h)(10) vs. section 336(e)

The election under section 336(e) is similar to a section 338(h)(10) election. Each election requires a transfer of target stock; however, a section 336(e) election looks to the disposition of stock, while a section 338(h)(10) election looks to the purchase of stock. If a disposition of stock satisfies the definition of a QSD and the definition of a qualified stock purchase (QSP) in section 338(d)(3), the disposition generally will be treated as a QSP and not a QSD; as a result, only a section 338(h)(10) election is available with respect to the transaction.

The following table highlights some key differences and similarities between the elections.

Section 338(h)(10)	**Section 336(e)**
Election jointly made by Seller and Buyer	Election jointly made by Seller and Target
Seller must be a member of a consolidated group or Target must be an S Corporation	Seller must be a corporation or S corporation shareholder
Buyer must be a corporation	Buyer need not be a corporation and there can be several Buyers
Requires a purchase or series of purchases totaling 80 percent	Requires any combination of sales, exchanges, and distributions totalling 80 percent
Sale	Sale/Exchange – treated similarly to section 338(h)(10)
Distributions do not qualify as a QSP	Distributions qualify as a QSD
Not available for a disposition to related parties	Not available for a disposition to related parties
Not available if Seller or Target is foreign	Not available if Seller or Target is foreign

Mechanics of the deemed asset sale

If a section 336(e) election is made, the regulations provide two different models for the deemed asset sale: the basic model and the model applicable only to distributions described in either section 355(d)(2) or section 355(e)(2).

Basic model

The basic model applies to all QSDs other than certain distributions described in section 355. This model is similar to the fiction of a section 338(h)(10) election. Under the basic model, a section 336(e) election results in the target (Old Target) being treated as selling its assets to an unrelated person in a single transaction, in exchange for the aggregate deemed asset disposition price (ADADP). Old Target is subsequently deemed to liquidate into Seller. The tax consequences of the liquidating distribution from Old Target to Seller are characterized in the same manner as if the parties had actually engaged in the transactions deemed to occur. In most cases, the transfer should be treated as a distribution in complete liquidation under section 331 or section 332.

A new corporation (New Target) is treated as acquiring all its assets from an unrelated person in a single transaction for an amount equal to the adjusted grossed-up basis (AGUB). If Seller distributes any Target stock, it is deemed to purchase such stock from an unrelated person and then to make the distribution.

Old Target generally recognizes gains and losses on the deemed asset sale, but the recognition of losses is limited in QSDs that involve a distribution. If there is an overall net loss on the deemed disposition of assets, the net loss is disallowed in proportion to any Target stock distributed in the 12-month disposition period of the QSD.

Section 355 model

The section 355 "sale-to-self" model applies to a QSD that qualifies as a tax-free distribution under section 355, but where gain is recognized to the distributing corporation under section 355(d) or (e). If a section 336(e) election is made with respect to a distribution described in either section 355(d)(2) or section 355(e)(2), Old Target is treated as selling its assets to an unrelated person, and then repurchasing them, in exchange for the ADADP. In contrast to the basic model, Old Target is generally not deemed to liquidate.

Key changes from proposed regulations

The final regulations incorporate many of the provisions included in the proposed regulations, with some key differences.

Treatment of losses

Under the proposed regulations, if the QSD consisted solely of a distribution of stock and losses were realized in the deemed asset disposition, no losses would be recognized in accordance with section 311(a). Further, a proportionate amount of losses would be disallowed on a partial distribution. Commentators argued that the proposed disallowed loss rule was too harsh and that it frustrated the intent of section 336(e), which is to mitigate multiple levels of taxation.

The IRS agreed and modified the loss disallowance rules to generally permit Target's realized losses to offset Target's realized gains in the deemed asset disposition. However, any realized losses in excess of realized gains are permanently disallowed in proportion to the amount of Target stock disposed of by Seller in one or more distributions made within the 12-month disposition period.

S corporation targets

The final regulations expand the application of section 336(e) to S corporation targets. As with the section 338(h)(10) election, all S corporation shareholders, including those who do not sell their S corporation stock, must consent to the section 336(e) election.

When the section 336(e) election is made for the S corporation Target, the Old Target's S corporation election continues in effect through the disposition date, but will terminate when Old Target is deemed to liquidate. A new S corporation election must be made if New Target wishes to operate as an S corporation.

Form of the election

Under the proposed regulations, only Seller would be required to make the section 336(e) election. However, after receiving comments that a unilateral election by

Seller could result in an unfair surprise to Target or Buyer, the IRS modified the proposed regulations to require Seller and Target to enter into a written binding agreement to make a section 336(e) election. The final regulations and preamble contain rules as to the time and manner for making a section 336(e) election.

Treatment of related parties

The proposed regulations provide that a transaction is not a disposition (and thus not a QSD) if target stock is sold, exchanged, or distributed to a related person. The definition of related person, as for section 338 purposes, refers to the section 318 attribution rules. The IRS modified the related-party rules in the final regulations because it determined that the application in the proposed regulations of the section 318 constructive ownership rules with respect to partnerships would be too restrictive. As applied to partnerships, there is no minimum ownership threshold in section 318(a). If one partner held a minimal ownership interest in both the Buyer and the Seller through two unrelated partnerships, a section 336(e) election could be prohibited.

The IRS concluded that the attribution rules should be modified to allow for minimal cross-ownership as it pertains to partnerships. The final regulations include a modification to the general attribution rules of section 318(a) that limits the attribution of stock ownership from a partnership to a partner or from a partner to a partnership if the partner owns, directly or indirectly, less than five percent of the value of the partnership. The IRS still is considering whether section 336(e) should apply to other related-party transactions not addressed in the final regulations.

Other items

The final regulations also clarify certain intercompany transaction issues, the treatment of any Target stock retained by Seller, and the section 901(m) implications.

Observations

The final regulations provide more flexibility to taxpayers than the proposed regulations. Additional provisions, such as those addressing the ability of Old Target to offset losses to the extent of gains when there is a stock distribution and the ability of S corporation shareholders to make 336(e) elections, as well as the modifications to the treatment of related parties under section 318(a), are taxpayer-friendly revisions that should allow more Buyers and Sellers to take advantage of the section 336(e) election. The IRS is still studying how section 336(e) should apply to foreign corporations and to nontaxable transactions, and may consider expanding the scope of the regulations to address these transactions in the future.

Taxpayers should consider whether to make a protective section 336(e) election in connection with a section 355 distribution. The election will have no effect if the transaction does not meet the qualifications of a QSD, but otherwise will be binding and irrevocable. For example, if a purported section 355 distribution subsequently is disqualified, the section 336(e) election will become effective and provide a step-up for the inside basis of the assets of the distributed corporation. However, protective elections may not be advisable when gain on Old Target's assets exceeds gain on Old Target's stock. *For more information, please contact Henry Miyares, Bart Stratton, Bruce Decker, Arthur Sewall, or Lisa Brown.*

Court Watch

Majestic Star Casino LLC v. Barden Development Inc., 111 AFTR 2d 2013-2028 (3d Cir. 2013)

In this case, the Third Circuit reversed a bankruptcy court decision holding that S corporation status under section 1361(a) was property of the bankruptcy estate.

Majestic Star Casino II, LLC (MSC II) was a qualified subchapter S subsidiary, the assets and liabilities of which were treated as those of its sole owner (BDI), an S corporation, pursuant to section 1361(b)(3)(A). MSC II filed for bankruptcy along with certain other affiliates and effectively was controlled by creditors.

After the bankruptcy filing, the sole shareholder of BDI (the estate of Don H. Barden, hereafter "Barden") successfully petitioned the IRS to revoke the S corporation status of BDI. This prevented cancellation of indebtedness income of MSC II from flowing up to Barden, but also resulted in MSC II's loss of QSub status and a reduction of its attributes under section 108.

Because the revocation decreased the value of MSC II and subjected it to an additional level of US tax, the creditors sought to have the S corporation revocation reversed, on the ground that the revocation caused an unlawful postpetition transfer of property of the MSC II bankruptcy estate. The bankruptcy court agreed and ordered BDI's status as an S corporation and MSC II's status as a QSub to be reinstated.

The Third Circuit, however, found that S corporation status and QSub status were not "property," and that the QSub status of MSC II was not "property" of the MSC II bankruptcy estate. The Third Circuit emphasized that a QSub's use and enjoyment of its tax status could be terminated by factors outside the control of either the QSub or its S corporation parent. Rather, the QSub's shareholder can elect QSub status under section 1361(b)(3)(B), just as the S corporation's shareholders can elect S corporation status and revoke the same under section 1362(d)(1)(B).

Observations

Taxpayers should consider whether a state law conversion to an LLC, resulting in the loss of net operating losses of an insolvent company, also could be challenged by creditors; there may be a potential argument that an entity's organization as a corporation could be considered property of the estate, such that creditors might be able to estop a taxpayer from converting a worthless corporation in order to claim a worthless stock deduction.

The decision also may raise questions as to whether the bankruptcy exception in section 108(a) could have been relied upon, particularly in view of the fact that the liabilities in question were not those of the taxpayer (BDI), but rather those of its disregarded entity (MSC II). Possible implications with respect to other entities that may be disregarded for U.S. federal income tax purposes, such as LLCs, should be considered. *For more information, please contact Horacio Sobol or Neha Prabhakar.*

Private Letter Rulings

PLR 201322032

In PLR 201322032, the IRS ruled that for purposes of section 382(l)(5), the beneficiaries of a qualified settlement fund trust should be treated as qualified creditors of a bankrupt corporate taxpayer, the stock of which was acquired by the trust, even though not all the persons who were beneficiaries of the trust had been identified or were identifiable at the time bankruptcy was declared.

The taxpayer in the PLR was a defendant in numerous lawsuits claiming damages for physical sickness, illness, or death caused through use of the taxpayer's product. The taxpayer filed a petition for relief under Chapter 11 of the Bankruptcy Code to resolve the liabilities arising from the lawsuits, and filed a plan of reorganization with the bankruptcy court pursuant to which all the shares of the taxpayer would be transferred to a trust. The trust's purpose was to resolve all present and future claims against the taxpayer related to the use of the product. The taxpayer contributed assets to the trust to fund the settlement and satisfaction of the claims.

Section 382(l)(5) generally provides that there is no section 382 limitation with respect to an ownership change if the old loss corporation is under the jurisdiction of the court in a title 11 case, and the shareholders and creditors of the old loss corporation own at least 50 percent of the stock of the new loss corporation. A qualified creditor is defined in Treas. Reg. sec. 1.382-9(d) as the beneficial owner immediately before the ownership change of qualified indebtedness of the loss corporation.

Observations

Based on a strict reading of the definition of a qualified creditor set forth in the statute and regulations, the trust arguably would not be a qualified creditor as not all the persons who are beneficiaries of the trust had been identified at the time the company filed for bankruptcy. At the same time, this PLR does not appear to be at odds with either the general purpose of section 382 – to prevent companies from trafficking in net operating losses – or the policy of providing relief for bankrupt taxpayers under the special rule of section 382(l)(5). *For additional information please contact Rich McManus or Lisa Brown.*

PLR 201322001 and PLR 201322002

In PLR 201322002, the IRS granted the taxpayer an extension to file an election under Treas. Reg. sec. 1.1502-13(l)(3) more than 16 years after the original due date. This extension was important to the taxpayer in order to apply Treas. Reg. sec. 1.1502-13(c)(6) to avoid the recognition of a deferred gain on subsidiary stock (PLR 201322001).

On July 12, 1995, new intercompany transaction rules went into effect under Treas. Reg. sec. 1.1502-13. Deferred intercompany items that were in existence as of that date would be subject to the old intercompany transaction regulations unless an election was made to have the newly adopted regulations apply to certain stock elimination transactions. To make the stock elimination transaction election under Treas. Reg. sec. 1.1502-13(l)(3), taxpayers had to attach the election to their consolidated return for the year-end that included July 12, 1995.

In the PLR, the taxpayer filed for section 9100 relief and was granted an extension to file the Treas. Reg. sec. 1.1502-13(l)(3) election. This allowed pre-July 12, 1995 deferred intercompany items to be subject to the current intercompany transaction regulations.

Observations

When Treas. Reg. sec. 1.1502-13(c)(6)(ii)(C) was finalized, the IRS stated that it would consider taxpayer requests for an extension of time to make an election under Treas. Reg. sec. 1.1502-13(l)(3) in order to take advantage of the new final rules to eliminate an existing deferred intercompany gain on member stock. As a result of the PLR, the taxpayer could file the stock elimination transaction election and liquidate a subsidiary without triggering a deferred intercompany item under Treas. Reg. sec. 1.1502-13(c)(6)(ii)(C)(1).

Taxpayers that have pre-July 12, 1995 deferred intercompany items should consider whether it makes sense to be under the new regulations or the former regulations if the election has not already been made. *For more information contact Dave Friedel, Bart Stratton or Lisa Brown.*

Other guidance

CCA 201321018

In this CCA, the IRS addressed the treatment, on a domestic corporation's final US income tax return, of intangibles deemed transferred in an outbound F reorganization.

<u>Facts of the transaction</u>

The parent (US Parent) of a consolidated group indirectly acquired an unrelated domestic corporation (Target) to expand an existing business line. US Parent caused its wholly owned domestic first-tier subsidiary to acquire a percentage of the Target's stock, with the remainder acquired by an affiliated foreign holding company. Both acquisitions were solely in exchange for cash.

Thereafter, Target engaged in an outbound F reorganization, thereby becoming Foreign Target. In the outbound F reorganization, Target was deemed to transfer all its assets, including intangible property described in section 367(d), to Foreign Target, and then was treated as distributing the Foreign Target stock to its shareholders, US Parent and foreign holding company.

In applying section 367(d) to its outbound transfer of intangible property, Target did not report income under section 367(d) on its final US income tax return. Rather, US Parent reported royalty income attributable to the outbound transfer of intangible property under section 367(d).

Subsequent disposition rule

The section 367(d) provisions require a US transferor to include in gross income each year a deemed royalty with respect to intangible property it transfers offshore (to a non-US corporation). Thereafter, if the stock received in the initial transfer and exchange of the intangible property is transferred to an unrelated person, the regulations provide that the intangible is deemed sold at the time of the subsequent transfer, and the US transferor is required to recognize any gain.

This subsequent disposition rule effectively accelerates income into the year of disposition. Generally, the exceptions for subsequent dispositions to related persons in the regulations are illustrated in the context of an initial section 351 transfer of the intangible property, followed by a later transfer of the stock of the foreign corporation.

Section 367(d)(2) sets forth the subsequent disposition rule on which the regulations elaborate. What has been uncertain under the regulations is the treatment under section 367(d) of a US transferor (target corporation) in an outbound reorganization if it is wholly or partly owned by a foreign corporation. Regulations do not address whether a foreign parent corporation could recognize a deemed royalty under section 367(d), or perhaps a domestic entity, such as US Parent in the CCA, could choose to recognize the entire deemed section 367(d) royalty to avoid immediate gain recognition.

CCA conclusion

The CCA concluded that since Target was owned in part by a foreign corporation, its section 361(c) distribution of Foreign Target stock to its foreign corporate shareholder was a disposition of Foreign Target stock that resulted in a deemed sale of a portion of the intangible property, as reflected in the stock distributed to the foreign holding company. The IRS stated that the exceptions provided in the Treasury regulations for subsequent transfers to a related foreign person did not apply, and that the statutory language under section 367(d)(2)(A)(ii)(II) encompassed a section 361(c) distribution of stock to a foreign shareholder.

Observations

The IRS' analysis is predicated on the separation of the section 361(a) transfer of the intangible property by Target, and Target's section 361(c) distribution. The result reached in the CCA seems consistent with the new rules found in Notice 2012-39, which provide that a so-called 'qualified successor' under section 367(d) must be a domestic corporation. *For more information please contact Tim Lohnes, David Sotos, Judy Kwok, or Neha Prabhakar.*

TAM 201321019

This TAM considers the appropriate timing of a discharge of indebtedness for purposes of section 108 where there were multiple possible dates on which to consider the discharge effective.

The taxpayer, an S corporation, defaulted on third-party debt, resulting in litigation that ultimately was settled. The timing of the discharge of indebtedness was crucial for tax purposes because it determined whether the taxpayer's shareholders could increase their basis in their S corporation stock by the amount of excluded discharge of indebtedness income under *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), or were prohibited from doing so under a 2002 amendment to section 108(d)(7)(A), effective for discharges of indebtedness after October 11, 2001.

The IRS considered various possible dates for the discharge of indebtedness, including –

- the date on which the parties executed the settlement agreement;
- the date on which the creditor received final payment under the settlement agreement;
- the date on which the parties filed a joint motion to dismiss the litigation pursuant to the settlement agreement; and
- the date on which the court granted the joint motion.

In addition, because the creditor was concerned that the taxpayer's payments could be recoverable as preferential payments if the taxpayer filed for bankruptcy, the settlement agreement contained a "creditor effective date" five months after the final payment, which would be delayed if certain specified events (e.g., the taxpayer filing for bankruptcy) occurred in the meantime.

The TAM concluded that the court's granting of the joint motion to dismiss was the most appropriate identifiable event marking the discharge of indebtedness for purposes of section 108. The IRS reasoned that the court's order locked the parties into the compromised amount negotiated and received under the settlement agreement, and made it clear that the taxpayer would never have to pay the discharged indebtedness.

The IRS rejected other dates – i.e., the execution date of the settlement agreement, the date of final payment, and the date on which the parties filed the joint motion to dismiss – because certain conditions under the settlement agreement remained unsatisfied on each of those dates. The IRS also noted that the creditor effective date was not an appropriate date because that provision had no effect on the finality of the court's order, did not give the creditor any rights above other creditors, and was subject to events the IRS deemed remote.

Observations

Although the TAM focuses on whether a 2002 amendment to section 108(d)(7)(A) should apply to a discharge of indebtedness, the analysis of when a discharge of indebtedness occurs may have more general applicability. As indicated in the TAM, parties to a settlement agreement may have considerable control in defining the events that constitute a discharge of indebtedness, namely through the drafting of the agreement. As a result, it may be possible to set the timing of a discharge of indebtedness event in order to achieve an advantageous tax result, e.g., to take advantage of net operating losses, foreign tax credits, asset basis, or other attributes that are available in one taxable year but not another. *For additional information, please contact Bart Stratton or Matt Lamorena.*

PwC M&A publications

In the article titled "Applying Intercompany Transaction Rules to Partnership Terminations" published in the Journal of Corporate Taxation (May/June 2013), WNTS authors Jack Quint and Wade Sutton discuss applications of the intercompany transaction regulations.

Let's talk

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