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M&A tax recent guidance

This month features:

- Proposed regulations would clarify definition of real property for REIT purposes (REG-150760-13)
- Proposed anti-inversion legislation would significantly strengthen the threshold for applying section 7874 (Stop Corporate Inversions Act of 2014)
- Proposed regulations would limit ability to choose tax attribute location following asset reorganizations (REG-131239-13)
- Section 355 spin-off PLR applies section 355(e) where corporations are owned by partnerships (PLR 201422004)
- IRS grants 9100 relief to make a late election under section 362(e)(2)(C) (PLR 201418034)
- Loan from CFC to US parent corporation does not mitigate section 956 income inclusion to US parent (CCA 201420017)

Did you know…?

The IRS recently issued proposed regulations (REG-150760-13) that define real property for purposes of determining whether an entity qualifies as a real estate investment trust (REIT) under section 856. The regulations, which treat a broad range of assets as real property, should provide helpful guidance to taxpayers in several industries.

With the expanded guidance in the regulations, if finalized, there may be an increase in the public company REIT conversions and spin-offs. At the same time, as noted below, legislation has been proposed that would prohibit either the distributing or controlled corporation from electing REIT status for 10 years following a tax-free spin-off.

Background

Although generally taxed similarly to a domestic corporation, a REIT can eliminate corporate-level taxation by deducting the amount of dividends paid to its shareholders. Under section 857(a), a REIT generally must distribute at least 90 percent of its taxable income to its shareholders annually.

The definition of real property is crucial to REIT status. For example, under section 856(c)(4) at least 75 percent of the value of a REIT's assets must include some combination of real estate assets (including real property), cash and cash items, and government securities (the "REIT Asset Requirement"). Also, REITs must derive a minimum amount of income from certain specified sources, including rents from real property.

The current regulations (Reg. sec. 1.856-3(d)) provide a relatively brief definition of "real property" as "land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures)" and include some examples.

Proposed regulations

The proposed regulations would clarify the definition of real property by providing safe harbors, factors to consider when making real property determinations, and numerous examples. Similar to the current regulations, the proposed regulations define real property as land, inherently permanent structures, and structural components (each of which is described in greater detail below). Unlike the current regulations, however, the proposed regulations would include certain intangible assets within the definition of real property (e.g., the goodwill associated with a hotel).

The new regulations are proposed to be effective for calendar quarters beginning after final regulations are published. In the preamble, the IRS states that it views the proposed regulations as a "clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property" and requests comments regarding the proposed effective date.

Land

Land would be defined to include water, air space directly above land, natural products, and deposits that are unsevered from the land, such as crops, water, ores, and minerals.

Inherently permanent structures

Inherently permanent structures would be defined as any permanently affixed building or other structure that does not have an active function. Under a proposed safe harbor, the following assets automatically would qualify as inherently permanent structures: apartments; hotels; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; stores; microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges;

tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; stationary wharves and docks; and outdoor advertising displays for which an election has been properly made under section 1033(g)(3).

For all other assets, the proposed regulations would provide a five-factor test in determining whether the asset should be treated as an inherently permanent structure.

Structural components

The proposed regulations would define a structural component as any asset that is a constituent part of and integrated into an inherently permanent structure, that serves the inherently permanent structure in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, does not produce or contribute to the production of such income. Under a proposed safe harbor, the following assets qualify as structural components: wiring; plumbing systems; central heating and air conditioning systems; elevators and escalators; walls; floors; ceilings; permanent coverings of walls, floors, and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; integrated security systems; and humidity control systems.

For all other assets, the proposed regulations provide a nine-factor test in determining whether such asset should be treated as a structural component.

Intangibles

The proposed regulations also would provide that certain intangible assets may be treated as real property if they derive their value from real property or an interest therein, are inseparable from that real property or interest therein, and do not produce or contribute to the production of income other than consideration for the use or occupancy of space. The proposed regulations provide examples that indicate that goodwill that derives value and is inseparable from real property and certain land use permits should qualify as real property. Unlike the proposed rules for inherently permanent structures and structural components, the proposed regulations do not provide a factor test to analyze whether an intangible asset should be treated as real property.

Examples

The proposed regulations provide several useful examples of nontraditional assets that qualify as real property for REIT purposes, including solar energy generation facilities, cold storage warehouses, and data centers.

Observations

As noted above, a REIT can avoid corporate level taxation by paying dividends to shareholders. This tax benefit has prompted several corporations with sizable real estate assets to engage in REIT conversions and tax-free spin-off transactions to place real estate assets into an efficient capital structure. For a discussion of two recent REIT spin-offs, see the write-ups on PLR 201337007 and PLR 201411022 in the October 2013 and April 2014 editions of *This Month in M&A*, respectively.

With the expanded guidance provided in the proposed regulations, if finalized, this activity may increase, particularly in industries involving nontraditional REIT assets (e.g., data centers). These clarifications would make REIT conversion and spin-off opportunities available to a broader range of companies.

A recent legislative proposal could deter some of these transactions, however. In the tax reform discussion draft released earlier this year, House Ways and Means Committee Chairman Dave Camp (R-MI) included a provision that would prohibit either the

distributing or the controlled corporation from electing REIT status for 10 years following a tax-free spin-off. The proposal generally would apply to distributions on or after February 26, 2014. For a discussion of the draft, see the "Did you know . . . ?" in the March 2014 edition of *This Month in M&A*.

For additional information, please contact Adam Handler, Wade Sutton, or Viraj Patel.

Legislative Proposals

Stop Corporate Inversions Act of 2014

On May 20 Carl Levin (D-MI) and Rep. Sander Levin (D-MI) introduced almost identical bills (the "Stop Corporate Inversions Act of 2014") in the Senate and House, respectively, intended to further limit corporate expatriations or inversions (the "Levin inversion bills"). The stated intention of the Levin inversion bills is to "significantly reduce a tax loophole that allows US companies that merge with foreign companies to reincorporate offshore in lower-tax jurisdictions . . . to avoid being subject to US tax on their overseas earnings." The bills each include a retroactive effective date to transactions occurring after May 8, 2014.

The Levin inversion bills are broadly similar to a proposal in the Obama Administration's FY 2015 budget. The bills would change the threshold for applying section 7874 (generally, treatment of a foreign company as a US company) from 80% continuity of ownership by the predecessor US company's shareholders to more than 50% continuity of ownership. In addition to the level of shareholder continuity of ownership, a foreign company would be treated as a US company for US federal income tax purposes if (i) its primary management and control and (ii) any significant business activities occur in the United States, but it does not have substantial business activities in the relevant foreign country.

Background

Section 7874 governs treatment of "expatriated" (i.e., inverted) US entities. Foreign entities subject to section 7874 may be treated as US entities for federal income tax purposes. Under the Levin inversion bills, the definition of an "inverted domestic corporation" would be broadened to include any entity:

- that acquires, after May 8, 2014, substantially all the properties of a domestic corporation, or all the assets (or a trade or business) of a domestic partnership;
- for which, after the acquisition, more than 50% of the stock (by vote or value) is held by former shareholders of the domestic corporation (or former partners of the domestic partnership), or the management and control of the expanded affiliated group that includes the entity occurs primarily in the United States and such group has significant domestic business activities; and
- that does not have substantial business activities in the relevant foreign country.

The Levin inversion bills would codify existing regulations regarding the standard for "substantial business activities," meaning that 25% or more of a company's employees (by headcount and compensation), sales, and assets are located in the foreign country. A similar but broader standard would apply for purposes of defining "significant domestic business activities," looking at 25% or more of employees, sales, income, or assets. Note that the Levin inversion bills provide authority permitting regulations to stiffen the requirements by raising the 25% threshold for business activities in the foreign country.

The bills would also delegate regulatory authority to determine what constitutes "management and control." However, the Levin inversion bills would deem management and control to be in the United States if substantially all the executive officers and senior management of the expanded affiliated group are located in the United States.

The Levin inversion bills would apply retroactively to any transactions occurring after May 8, 2014. The Senate bill would only be effective for two years, anticipating comprehensive US federal income tax reform, while the House bill would be effective indefinitely.

Observations

Members of Congress and the Administration have renewed their calls for tax changes in response to recent transactions in which US companies would change their place of incorporation as part of foreign mergers or acquisitions. While there appears to be bipartisan agreement on the long-term need to lower the corporate tax rate and reform US international tax rules to improve US global business competitiveness, the two political parties disagree on whether near-term legislation is needed to prevent additional corporate "inversion" transactions.

In a May 8 Wall Street Journal op-ed, Finance Committee Chairman Ron Wyden (D-OR) said he is committed to tightening existing anti-corporate inversion rules as part of comprehensive tax reform. Chairman Wyden said he would modify section 7874, effective for transactions occurring from May 8, 2014, to reduce the continuity of shareholder ownership threshold from 80 percent to 50 percent. "I don't approach retroactivity in legislation lightly, but corporations must understand that they won't profit from abandoning the US," wrote Chairman Wyden.

By contrast, in a May 8 floor speech, Finance Committee Ranking Member Orrin Hatch (R-UT) said the best way to address inversion transactions is through tax reform that lowers the corporate tax rate and adopts competitive US international tax rules. "Instead of imposing arbitrary inversion restrictions on companies retroactively and thereby further complicating the goal of comprehensive tax reform, we should first keep our focus on where we can agree," Senator Hatch said. "By uniting around the goal to create an internationally competitive tax code, we can keep American job-creators from looking to leave in the first place," he said.

For additional information, please contact Mike DiFronzo, Carl Dubert, or Tim Lohnes.

Proposed Treasury Regulations

Proposed section 381 regulations

The IRS on May 6 issued proposed regulations (REG-131239-13) under section 381 that would modify the definition of an "acquiring corporation" for purposes of that provision. This change, if finalized, would limit the ability of taxpayers to choose the location of tax attributes inherited from a target corporation in an asset reorganization.

The new rules are proposed to apply to transactions occurring on or after the date of publication in the Federal Register. The preamble states that the IRS anticipates that these proposed regulations and proposed section 312 regulations published April 16, 2012 will be concurrently published as final regulations.

Background

Section 381 provides that the acquiring corporation in an asset reorganization succeeds to certain tax attributes, including earnings and profits, of the target corporation. In an asset reorganization, the acquiring corporation generally is the last corporation that directly or indirectly acquires all the assets transferred by the transferor corporation. If pursuant to a plan of reorganization, no one single corporation ultimately acquires all the assets transferred by the transferor corporation, the acquiring corporation is the first corporation that directly acquires the transferor corporation's assets, regardless of whether such corporation retains any of the assets transferred.

Thus, under current rules, if a transferor corporation (T) were to merge into an acquiring corporation (A) and, subsequent to the merger, A transferred all of T's assets acquired in

the merger to its wholly owned subsidiary (S), then S would be treated as the acquiring corporation that succeeds to T's tax attributes. On the other hand, if only a portion of the T assets were transferred to S, then A would be treated as the acquiring corporation that succeeds to T's attributes.

Proposed changes

The proposed regulations would modify the definition of the acquiring corporation under section 381. Under the proposal, the acquiring corporation would be defined as the corporation that directly acquires the assets transferred by the transferor corporation, regardless of whether that corporation retains any of the assets transferred. In both scenarios described above, A would be the acquiring corporation under the proposed regulations.

Observations

Although the proposal would curtail taxpayer's ability to choose the location of tax attributes, it would not eliminate such electivity. For example, taxpayers could cause a subsidiary to inherit a target corporation's tax attributes by structuring an acquisition as a triangular merger (e.g., by having T merge directly into S for A shares).

For additional information, please contact Julie Allen, Olivia Ley, or Viraj Patel.

Private letter rulings

PLR 2014220004

Under simplified facts, one corporation (Distributing) owned 100% of the stock of another (Controlled). Distributing was owned by several tiered partnerships, which were ultimately owned by a group of individuals (the D1 Group). The individuals in the D1 Group also owned, through another chain of tiered partnerships, an interest in P1, a partnership for US federal tax purposes.

The IRS ruled that Distributing's distribution of 100% of the stock of Controlled to its shareholders qualified as a tax-free section 355 distribution notwithstanding the subsequent contribution by Distributing's shareholders of 100% of the Controlled stock to P1. In ruling in the taxpayer's favor, the IRS presumably concluded that the subsequent contribution of Controlled to P1 did not result in a violation of section 355(e), which applies upon certain acquisitions of a 50% or greater interest in either Distributing or Controlled (generally, as measured at the individual shareholder level). Had the transaction violated section 355(e), Distributing would have recognized gain with respect to its distribution of the stock of Controlled.

There are no rules specifying how to apply section 355(e) where the relevant corporations are owned through tiers of partnerships. The PLR set forth the taxpayer's section 355(e) counting methodology, which applied a 'look through' methodology to determine the ownership of Controlled before and after the distribution by looking to the economic and voting entitlements based on the various ownership interests held through the chain of partnerships. The taxpayer applied the section 355(e)(3)(A)(iv) exception, which provides that stock of Controlled acquired subsequent to the distribution is ignored for purposes of section 355(e) to the extent it equals the acquiror's interest in Controlled before the acquisition (the 'net decrease' methodology).

For additional information, please contact Derek Cain, Olivia Ley, or Viraj Patel.

PLR 201418034

In PLR 201418034, the IRS granted an extension of time for a transferor and a transferee corporation that were members of a US consolidated group to jointly elect under section 362(e)(2)(C) to reduce the basis of the transferee corporation's stock received in a section 351 transaction that involved the transfer of built-in loss property (property whose tax basis exceeds its fair market value).

Section 362(e)(2) applies to transfers of built-in loss property in section 351 transactions. Section 362(e)(2) generally requires the transferee corporation to reduce its aggregate adjusted basis in the property received to the aggregate fair market value of such property immediately after the transaction.

Section 362(e)(2)(C) provides that the transferor and the transferee corporation may collectively elect to not apply the general rules of section 362(e)(2) to the transferred property. If such an election is made, the transferor's aggregate adjusted basis in the transferee corporation's stock received in the transaction is reduced by the excess, if any, of the aggregate basis in the stock received over the aggregate fair market value of the stock immediately after the transfer.

Prior to issuance of final regulations under section 362, Notice 2005-70 provided guidance on how to make a valid section 362(e)(2)(C) election. Under certain circumstances, the IRS previously had granted '9100 relief' to taxpayers allowing an extension of time to make such an election (see the discussion of PLR 200808021 in the March 2008 edition of *This Month in M&A*).

The final section 362 regulations issued on August 30, 2013, expanded the guidance provided in Notice 2005-70. Those regulations provide that taxpayers generally may make a section 362(e)(2)(C) election by attaching the election statement to their return for the year of the transfer and entering into a written, binding agreement, executed by the transferor and the transferee corporation, to elect to apply section 362(e)(2)(C) prior to the time they file the election statement. For a detailed discussion of the final regulations, see the "*Did you know . . .?*" in the September 2013 edition of *This Month in M&A*.

Generally, Reg. sec. 1.1502-80(h) provides that the special rules under section 362(e)(2) do not apply to section 351 transfers between members of a consolidated group. The question that arises is why consolidated taxpayers would request 9100 relief to make an election under section 362(e)(2)(C).

Observations

In this PLR, the transferor and transferee corporations likely were required to file state tax returns in certain states that adopt section 362(e)(2), but do not follow Reg. sec. 1.1502-80(h). The parties may have sought to obtain 9100 relief to make a section 362(e)(2)(C) election for the sole purpose of preserving for state tax purposes the transferee corporation's high basis in the built-in loss property. This PLR is significant because it indicates an IRS willingness to grant 9100 relief for late elections that have no US federal income tax impact, but may have other ancillary consequences (e.g., state tax depreciation or financial accounting implications).

The transaction in this PLR occurred prior to the effective date of the final section 362 regulations. However, the final regulations provide that taxpayers may apply the provisions of the final regulations to transactions occurring after October 22, 2004. The PLR indicates that for the transaction at issue, the time for filing the election under section 362(e)(2)(C) is provided by Notice 2005-70 or, if applicable, Reg. sec. 1.362-4(d)(3)(ii); thus, the IRS has discretionary authority under Reg. sec. 301.9100-3 to grant an extension of time to file the election. The PLR did not indicate whether the transferor and transferee corporations previously entered into a written, binding agreement electing to apply section 362(e)(2)(C). Query whether 9100 relief would be available to perfect a section 362(e)(2)(C) election for failure to enter into a written, binding agreement prior to filing the election statement.

For additional information, please contact David Friedel or Nathan Jerkins.

Other guidance

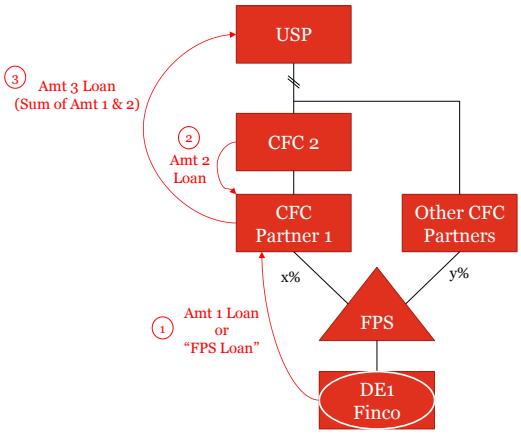
CCA 201420017

The IRS Chief Counsel's Office recently released CCA 201420017 (CCA), applying the so-called "formed or funded" anti-abuse regulation under section 956 to treat a section 956 loan held by a CFC that is a partner in a partnership (CFC Partner 1) as being held indirectly by other CFCs that are partners in the same partnership (Other CFC Partners), even though the Other CFC Partners did not appear to have provided funding (through loans or contributions) to CFC Partner 1 or the partnership itself.

According to the CCA, USP headed a US consolidated group, which, throughout Tax Year 1, wholly owned several CFCs. A number of the CFCs, including CFC Partner 1, were partners in FPS, a Country A entity treated as a partnership for US federal income tax purposes. During Tax Year 1, FPS owned DE1, a Country B disregarded entity that operated as an internal finance company. USP's US group wholly owned CFC 2. CFC 2 directly owned almost all of the shares of CFC Partner 1.

On Date 1, DE1 loaned Amount 1 to CFC Partner 1 (the FPS Loan), and CFC 2 loaned Amount 2 to CFC Partner 1. On the same day, CFC Partner 1 loaned Amount 3 (the sum of Amounts 1 and 2) to USP (the CFC Partner 1 Loan). On Date 2, USP repaid the CFC Partner 1 Loan and CFC Partner 1 repaid the FPS Loan.

The CCA does not specify the amounts of the three loans, but for ease of discussion assume that Amount 1 (the FPS Loan), Amount 2, and Amount 3 (the CFC Partner 1 Loan) equal $40x, $60x, and $100x, respectively.



The CCA states the E&P of the CFC partners of FPS were such that USP's section 956 income inclusion would have been substantially greater had DE1 loaned Amount 1 ($40x) directly to USP, rather than having CFC Partner 1 lending the much larger Amount 3 ($100x) to USP. Under Reg. sec. 1.956-2(a)(3), had FPS (through DE1) directly loaned to USP, all of the CFC partners of FPS, including the Other CFC Partners, would have been treated as holding a proportionate interest in a section 956 loan through their ownership in FPS, even though the Other CFC Partners did not hold the relevant section 956 investment (the Amount 3 Loan) directly. As a result, under Reg. sec. 1.956-2(a)(3) the E&P of the Other CFC Partners, not just CFC Partner 1, would have been potentially subject to income inclusion under section 956. The CCA's statement that a direct loan from FPS (through DE1) to USP would have resulted in more section 956 inclusion to USP than a direct loan of a much larger amount from CFC Partner 1 to USP implies that, based on the hypothetical amounts used for discussion here, CFC Partner 1's E&P was substantially less than $40x.

But since FPS did not directly loan to USP, the CCA applied the so-called "formed and funded" anti-abuse rule of Reg. sec. 1.956-1T(b)(4) to impute CFC Partner 1's section 956 loan to the Other CFC Partners. Under the formed or funded regulation, the IRS may exercise discretion to treat a CFC as holding, indirectly, a section 956 investment held by another foreign corporation that is "controlled" by the CFC, if one of the principal purposes for "creating, organizing, or funding" such other foreign corporation is to avoid the application of section 956 with respect to the CFC. For purposes of this rule, the Other CFC Partners are considered to be in "control" of CFC Partner 1. "Funding" for this purpose refers to funding via capital contribution or loan.

In this case, the IRS concluded, or rather inferred, that such a "principal purpose" of section 956 avoidance existed simply by virtue of the fact that a direct loan from FPS to USP would have resulted in a substantially greater amount of section 956 income inclusion to USP.

By invoking the formed or funded regulations, the CCA asserts that FPS held an amount of the CFC Partner 1 Loan equal to the amount of the FPS Loan (Amount 1, or $40x in our example). Consequently, each CFC Partner, pursuant to Reg. sec. 1.956-2(a)(3), held an interest in Amount 1 equal to its interest in FPS. Accordingly, up to $40x of CFC Partner 1's loan to USP was treated as invested from the E&P of all the CFC Partners, and thereby caused USP to have a larger section 956 income inclusion (up to $40x) than if the entire amount of CFC Partner 1's loan ($100x) were treated as a section 956 investment held solely by CFC Partner 1.

Observations

This CCA illustrates the IRS's views on the potential reach of section 956 in structures that involve CFCs and partnerships, but its formed and funded analysis is not entirely clear. While the regulation provides the IRS the discretion to treat a CFC (e.g., one or more of the Other CFC Partners) that has "created, funded, or organized" another CFC as holding a section 956 investment through the other CFC (e.g., CFC Partner 1) if a principal purpose for creating, funding, or organizing the other CFC is the avoidance of section 956, the CCA acknowledges that the Other CFC Partners did not create, organize, or fund (through capital contribution or loan) CFC Partner 1. The facts of the CCA also do not suggest that the Other CFC Partners have created, organized, or funded FPS for purposes of avoiding section 956. Thus, the facts of the CCA do not indicate that the Other CFC Partners have funded CFC Partner 1 either directly or through FPS. The Other CFC Partners are connected to CFC Partner 1 through their common ownership in a partnership entity, FPS, but there is no indication in the regulations that such a common ownership is considered a "funding" for these purposes. The CCA asserts that the application of the formed or funded regulation does not depend on a direct funding by one CFC to another, yet it does not seem to explain how the Other CFC Partners might have otherwise indirectly funded CFC Partner 1 through FPS. Finally, CFC Partner 1 was funded through a loan by FPS, but FPS is a partnership and the relevant regulation does not provide the IRS with the authority to impute a CFC's section 956 investment to a partnership.

In contrast, the CCA did not discuss whether the formed or funded rule in connection with CFC 2's Amount 2 loan to CFC Partner 1 ($60x for purposes of our discussion), even though for purposes of this rule CFC 2 clearly has "funded" CFC Partner 1 through a loan. The significance of the CCA's silence on this point is unclear.

For additional information, please contact Matthew Chen, David Sotos, or Greg Lubkin

Let's talk

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

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