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M&A Tax Recent Guidance

This month's features:

- Final regulations under Section 382 address exceptions to application of the segregation rules for certain transfers of loss corporation stock (T.D. 9638)
- Taxpayer receives favorable ruling regarding nature of payments received in recent First Circuit District Court STARS decision (*Santander*)
- In a Chief Counsel Advice, the IRS respects the characterization of an F reorganization followed by a leveraged triangular reorganization (CCA 201340016)
- In a legal memorandum, the IRS concludes that a redemption of foreign corporation stock requires a corresponding reduction of foreign income taxes (AM 2013-006)

Did you know…?

Newly issued final regulations (T.D. 9638) under Section 382 should ease the administrative burden and complexity of the segregation rules for loss corporations with small shareholders. The final regulations adopt the proposed regulations (REG-149625-10) published on November 23, 2011, with certain amendments. For a discussion of the proposed regulations, see the December 2011 edition of *This Month in M&A*.

Section 382 background

Section 382 generally restricts a loss corporation's utilization of its net operating losses (NOLs) after the loss corporation undergoes an ownership change. An ownership change occurs if one or more five-percent shareholders increase their ownership in the loss corporation's stock, in the aggregate, by more than 50 percentage points during a testing period, which generally is the three-year period preceding a testing date.

A five-percent shareholder is defined generally as any person or group holding, directly or indirectly, five percent or more of the loss corporation's stock at any time during the testing period. A five-percent entity is defined as an entity through which a five-percent shareholder owns an indirect interest in the loss corporation.

In the event of an ownership change, a loss corporation's utilization of its accumulated losses up to the date of the ownership change – so-called 'pre-change NOLs' — is limited for periods after the ownership change. This limitation is often referred to as a 'Section 382 limitation.' The Section 382 limitation generally is computed by multiplying the value of the corporation immediately before the ownership change by the long-term tax-exempt rate.

Section 382 was enacted to prevent 'trafficking' in NOLs. Absent a Section 382 limitation, an acquisition of the loss corporation's shares followed by either the contribution of income-producing assets or the diversion of income-producing opportunities to the loss corporation could accelerate the utilization of a loss corporation's NOL carryforwards.

Aggregation and segregation rules prior to final regulations

Under the former aggregation rules, all direct and indirect small shareholders of a loss corporation are aggregated into a public group that is itself viewed as a five-percent shareholder. Conversely, the former segregation rules, when applicable, create a new public group for purposes of determining whether an ownership change has occurred on the date of any segregation event (and on subsequent testing dates during the testing period). Segregation events include issuances of loss corporation stock, redemption or redemption-type transactions, and sales of stock by five-percent shareholders. The former aggregation and segregation rules also apply to equity transactions of a five-percent entity.

The former aggregation and segregation rules have contributed to administrative burdens and overall complexity in identifying owner shifts in determining whether an ownership change has occurred. These rules also are particularly burdensome to loss corporations owned in part by investment advisors or institutional shareholders that participate in frequent selling and purchasing.

The final regulations

The final regulations reduce the complexity and administrative burdens of the former segregation rules by providing three new taxpayer-favorable exceptions to the current segregation rules for small shareholders:

Secondary transfer exception: The secondary transfer exception renders the

segregation rules inoperative with respect to (1) direct transfers of loss corporation stock by a five-percent entity or a five-percent shareholder to public shareholders and (2) transfers of five-percent-entity stock by a five-percent shareholder or a five-percent entity to public shareholders. Under these circumstances, each public group of the loss corporation or the five-percent entity, as the case may be, existing at the time of the transfer is treated as acquiring its proportionate share of the stock exempted from the segregation rules.

Small redemption exception: The small redemption exception, modelled after the small issuance exception of Reg. sec. 1.382-3(j), exempts from the segregation rules an amount of stock acquired in redemption transactions, at the loss corporation's option, equal to either 10 percent of the loss corporation's stock at the beginning of the tax year or 10 percent of the number of shares of the redeemed class outstanding at the beginning of the tax year. When the small redemption exception applies, each public group existing immediately before the redemption is treated as having its proportionate share of exempted stock redeemed by the loss corporation.

In addition, the final regulations provide that the small redemption exception applies to redemptions of stock by a five-percent entity. In these circumstances, the amount of redemptions exempted from the segregation rules is determined with reference to the stock value and the stock classes of the redeeming five-percent entity and not with reference to the stock value and stock classes of the loss corporation.

General exception for five-percent entities: The general exception to the segregation rules for five-percent entities turns off the segregation rules for transactions involving a five-percent entity if the five-percent entity owns 10 percent or less (by value) of all the outstanding stock of the loss corporation after applying the attribution rules of Section 318(a) and taking into account all transactions occurring on the date of the transaction being tested.

In addition to the above requirement, the proposed regulations also required, for the general exception to apply, that the direct or indirect investment in the stock of the loss corporation not exceed 25 percent of the five-percent entity's gross assets. However, recognizing the difficulty taxpayers could encounter when attempting to verify the 25-percent asset threshold test as had been set forth in the proposed regulations, the IRS replaced that test with an anti-avoidance rule. Thus, this exception does not apply if the loss corporation, directly or through one or more persons, participated in planning or structuring the transaction with a view to avoid the application of the segregation rules.

Effective date: The final regulations generally are effective for testing dates on or after October 22, 2013. Taxpayers may apply the new rules to testing dates that are included in a testing period beginning before and ending on or after October 22, 2013. However, taxpayers may not apply these rules to (1) any date on or before the date of an ownership change that occurred prior to October 22, 2013, and (2) any testing date if such application would result in an ownership change occurring on a date before October 22, 2013, that did not occur under the former segregation rules.

Observations

The final regulations are helpful guidance for loss corporations faced with the unduly burdensome and complex segregation rules as applied to small shareholders. Because transactions involving these small shareholders pose no substantial Section 382 abuse potential, the final regulations allow loss corporations to disregard certain typical equity transactions, thus limiting the application of the segregation rules and simplifying the overall analysis under Section 382.

The limited retroactive feature of the new final regulations provides taxpayers with an immediate opportunity to apply these rules, thus potentially reducing the likelihood of future ownership changes.

For additional information, please contact Julie Allen, Rich McManus, Rob Melnick,

or Olivia Ley.

Court watch

Santander Holdings USA, Inc. & Subsidiaries v. United States, 2013 WL 5651414 (D.Mass.)

A recent round of Structured Trust Advantaged Repackaged Securities (STARS) litigation (*Santander Holdings USA, Inc. & Subsidiaries v. United States*, 2013 WL 5651414 (D.Mass.) (*Santander*)) has yielded a taxpayer-favorable ruling. In *Santander*, the court granted the taxpayer partial summary judgment, holding that certain payments received from a foreign bank in connection with a STARS arrangement were includable in pre-tax income in determining whether the taxpayer had a reasonable prospect of profit in the transaction. The court concluded that the transaction, which occurred prior to codification of the economic substance doctrine, satisfied the objective prong of the economic substance test and thus, there was no need to examine the taxpayer's subjective motivation.

Broadly, the STARS arrangement between Sovereign Bancorp Inc. (Sovereign or the Taxpayer) and Barclays Bank PLC (Barclays) featured two components: a contribution of assets to a trust and a loan transaction. Because the STARS arrangement as a whole resulted in substantial tax benefits for Barclays under UK law, Sovereign was able to borrow from Barclays at a below-market interest rate. The below-market interest rate resulted from a monthly credit to Sovereign, with respect to its interest costs, equal to approximately half the UK taxes paid by Sovereign on trust income (the Barclays Payment).

At issue was whether the Barclays Payment should be viewed in substance as a rebate or a subsidy of UK taxes paid, rather than income received by the taxpayer. If the Barclays Payment was determined to be a rebate, as contended by the government, the transaction at issue would not have objectively demonstrated a reasonable prospect of profit, and thus would be viewed as a sham. The *Santander* court determined the nature of the Barclays Payment to be a question of law rather than a question of fact (unlike the recent decisions in *Bank of New York Mellon v. Commissioner*). The court found no support under Section 901, the applicable regulations, existing case law, or prior IRS rulings for recharacterizing a transaction between private parties as occurring between a taxpayer and a taxing authority.

After determining that the Barclays Payment properly should be treated as pre-tax income to Sovereign, thereby satisfying the objective prong of the economic substance test, the court found that no further evaluation of the taxpayer's subjective motivation for undertaking the transaction was necessary. In evaluating First Circuit economic substance doctrine, the *Santander* court stated that just as the First Circuit dispenses with a subjective inquiry when the transaction at issue objectively *lacks* economic substance, the same should hold true when the transaction at issue is found to objectively *have* economic substance.

Observations

Santander diverges from recent lower court decisions in other circuits in which those courts found the STARS arrangement to be without economic substance in part on the basis that the Barclays Payment was an effective rebate of UK taxes, and thus not includable in the taxpayer's pre-tax income. We anticipate that each of these lower court decisions will be reviewed at the appellate level. However, it remains unclear whether these appellate decisions will result in a coordinated judicial approach to the manner in which foreign taxes affect the determination of a transaction's pre-tax profit potential.

With respect to transactions occurring prior to the codification of the economic substance doctrine, the *Santander* court views an examination of a taxpayer's subjective motivation as appropriate in the First Circuit only when it is unclear

whether the transaction at issue has objective economic substance. This application of the economic substance doctrine should apply only to pre-codification transactions. However, the codified economic substance doctrine specifically allows taxpayers to introduce evidence of pre-tax profit potential in substantiating post-codification transactions. As a result, the *Santander* court's reliance on the presence of substantial cash inflow in determining the existence of objective pre-tax profit potential retains practical value.

For a more in depth explanation of the structure of the STARS arrangement, see the articles *Bank of New York Mellon v. Commissioner*, 140 T.C. No. 2 (Jan. 2013) (*BNY I*) and *Bank of New York Mellon v. Commissioner*, T.C. Memo 2013-225 (Sept. 2013) (*BNY II*), as reported in the March 2013 and October 2013 editions of *This Month in M&A,* respectively. The *BNY I* and *BNY II* cases, evaluating substantially similar transactions to those undertaken in *Santander*, discuss the mechanics of the STARS arrangement in greater detail.

For additional information, please contact Chip Harter or Jon Lewbel.

Treasury regulations

Section 382 Final Regulations

See "Did You Know" above.

Private letter rulings

PLR 201342004

The IRS ruled that a post-reorganization asset transfer caused the transferee's net income, net capital gain or loss, and net contribution to the consolidated Section 38(c) credit limitation following the transfer to be included in the separate return limitation year (SRLY) subgroup register.

As part of an overall plan to combine two consolidated groups (the Integration), Sub 3 and Sub 4 (members of the SRLY subgroup) merged into Sub 1 (a member of the Surviving Group), and Sub 1 then transferred a substantial portion of the Sub 3 historic assets and liabilities (Business 2) to Sub 2, its wholly owned subsidiary (the Business 2 Transfer). The Integration resulted in the creation of a SRLY subgroup in the Surviving Group with respect to loss and tax credit carryover attributes of the Terminating Group.

The taxpayer represented that the Business 2 Transfer was undertaken to obtain regulatory approval for the Integration and that the book value of the general account assets of the Business 2 assets contributed to Sub 2 in the Business 2 Transfer exceeded the book value of Sub 2's general account assets immediately before the Business 2 Transfer.

Observations

For purposes of applying the SRLY subgroup anti-stuffing rules, a successor generally is, as the context may require, a transferee or distributee of assets in either a section 381(a) or an exchanged basis transaction. The SRLY subgroup anti-stuffing rules generally exclude the net positive income generated by a successor to a SRLY subgroup member from the computation of the SRLY subgroup register except where: (i) the successor acquires substantially all the predecessor assets and liabilities and the predecessor ceases to exist, (ii) at the time the SRLY subgroup members became members of the group, the successor was a SRLY subgroup member or 100 percent of the stock of the successor is owned directly by corporations that were members of the SRLY subgroup, or (iii) the Commissioner so determines.

This ruling illustrates the application of the successor and SRLY subgroup anti-

stuffing rules. Notably, Sub 2 is considered a successor and SRLY subgroup member by reason of receiving assets in a tax-free post-reorganization transfer.

In addition, it appears as though the IRS applied its discretion by including Sub 2's income in the SRLY subgroup register because the Business 2 Transfer did not meet the specific anti-stuffing exceptions contained in the regulations.

For additional information, please contact Julie Allen or Doug Skorny.

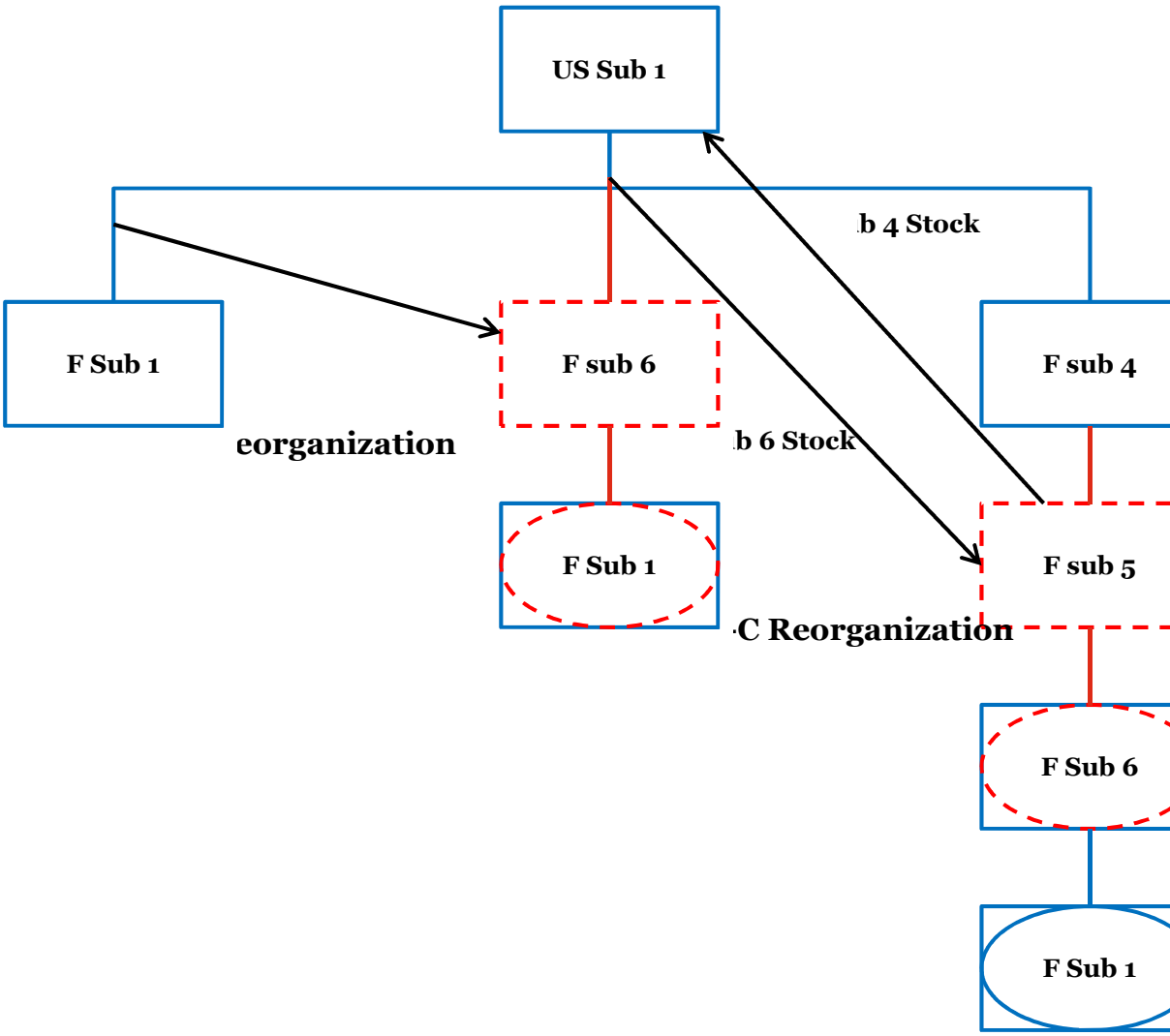
Other guidance

CCA 201340016

This Chief Counsel Advice (CCA) addresses the US federal income tax characterization of a two-stage foreign internal restructuring (the Restructuring) undertaken in a single tax year and facilitated, in part, through the use of a leveraged acquisition vehicle.

Prior to the Restructuring, Taxpayer, through US Sub 1, its wholly owned subsidiary, owned F Sub 1, a Country A operating corporation, and F Sub 4, a Country B corporation. For valid business reasons, US Sub 1 formed F Sub 6, a Country B corporation, and contributed F Sub 1 to F Sub 6, after which F Sub 1 elected to be treated as a disregarded entity for US federal tax purposes (the F Reorganization).

Thereafter, F Sub 4 created F Sub 5, a Country C corporation. F Sub 5 issued preferred equity certificates, a term note, and a demand note to F Sub 4 in exchange for F Sub 4 stock. F Sub 5 then used the F Sub 4 stock to acquire the stock of F Sub 6 from US Sub 1, after which F Sub 6 elected to be treated as a disregarded entity for US federal tax purposes (the Tri-C Reorganization). In Years 2 and 3, F Sub 5 repaid the term and demand notes to F Sub 4 (the Payments).



The IRS concluded that the F Reorganization and the Tri-C Reorganization should each qualify for nonrecognition treatment under Sections 368(a)(1)(F) and 368(a)(1)(C), respectively, and the F Reorganization should be treated separately from the Tri-C Reorganization under the principles of Rev. Rul. 96-29. The IRS notes that in the Tri-C Reorganization, F Sub 5 was capitalized with a substantial amount of debt, but stated that substantial leverage is considered normal in the context of leveraged buyouts.

The IRS also concludes that: (i) the demand note and the term note each qualified as debt for US federal income tax purposes, and (ii) the Payments should not be recharacterized as dividends or other subpart F income.

Observations

This CCA represents the IRS's first piece of published guidance addressing leveraged triangular reorganizations since the issuance of Reg. sec. 1.367(b)-10. However, based on the analysis in the CCA, the transaction at issue was executed prior to Treas. Reg. sec. 1.367(b)-10. For a discussion of the application of Reg. sec. 1.367(b)-10 to certain foreign triangular reorganizations when the final regulations were issued, see the June 2011 edition of *This Month in M&A*.

Notably, in this CCA, the IRS respects the notes issued by F Sub 5 (the leveraged acquisition vehicle) as debt in the Tri-C Reorganization noting that the use of substantial leverage to make an acquisition is not uncommon, while also acknowledging that a subsidiary (even a newly formed one) can purchase its parent's stock to use as acquisition currency.

For additional information, please contact Timothy Lohnes, Robert Black or Sarah Remski.

AM 2013-006

In this legal memorandum, the IRS addresses the effect of a foreign corporation's redemption of a minority shareholder's interest on the foreign corporation's post-1986 foreign income taxes. Section 312(n)(7) provides that, as a result of the redemption, the foreign corporation's earnings and profits are decreased by the amount of the distribution to the extent of the ratable share of the earnings and profits attributable to the stock so redeemed. At issue is whether a corresponding reduction of the foreign corporation's post-1986 foreign income taxes also is required when post-1986 undistributed earnings are reduced due to the redemption.

The IRS concludes that the language of Reg. sec. 1.902-1(a)(8), which requires a reduction to post-1986 foreign income taxes with respect to earnings "otherwise removed" from post-1986 undistributed earnings, is sufficiently broad to cover an earnings reduction related to a section 302(a) redemption. As a result, the IRS concludes that the foreign corporation is required to make a corresponding reduction to its post-1986 foreign income taxes when post-1986 undistributed earnings are reduced due to the redemption.

Observations

Taxpayers have taken the position that the "otherwise removed" language of Reg. sec. 1.902-1(a)(8) should be read narrowly to refer only to earnings removed by dividends or deemed distributions or inclusions. The IRS determined, however, that such an interpretation is contrary to the intent and text of the regulation and more generally to the principles and purpose of the Section 902 rules. While an AM has no precedential value, it is instructive to understanding the IRS's position.

Notably, the broad interpretation advocated by the IRS in AM 2013-006 mirrors a legislative proposal contained within the General Explanations of the Obama Administration's Fiscal Year 2014 Revenue Proposals (the Green Book), released by the Treasury Department in April 2013. The Green Book references redemptions reducing earnings under Section 312(n)(7) as one type of transaction for which foreign taxes would be reduced correspondingly under the proposed legislation, which would be effective for transactions occurring after December 31, 2013.

For additional information, please contact Henry Miyares, Robert Black, or Jon Lewbel.

PwC M&A publications

In the article titled "Half-Baked: Attribute Carryovers in Slowly Liquidating Asset Reorganizations", published as a Bloomberg BNA Tax Management Memorandum on October 21, 2013, PwC M&A Tax authors Michael Kliegman and Ryan D. Smith explore considerations with respect to the moment at which attribute carryover occurs in an asset reorganization when there is a delay between the transfer of target corporation assets or stock and the liquidation of the target corporation.

Let's talk

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