

# WNTS Insight

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## IRS business plan includes important corporate tax guidance

The recently released 2011-2012 IRS-Treasury Priority Guidance Plan, commonly referred to as the "business plan," includes 17 guidance projects addressing either consolidated return issues or issues relating to corporations and their shareholders. Most of these items have been carried over from previous business plans. This WNTS Insight will address several of the corporate tax projects in the new business plan.

### *Consolidated returns*

The most noteworthy of the four consolidated returns projects is item 3, "Regulations under § 1502 affecting consolidated groups, including regulations regarding loss transfers of member stock."

This item refers to technical corrections to the final unified loss rules issued in 2008. Soon after those regulations were issued, practitioners called attention to aspects of the regulations that require changes. While this project seems to be expanding in scope, the specific issues that it will address are unclear.

### *Corporations and Their Shareholders*

#### **Earnings and profits**

New to the business plan this year is item 2, "Regulations under § 312 regarding the allocation of earnings and profits between a transferor and transferee corporation when assets are transferred in connection with a reorganization."

The current earnings and profits (E&P) regulations under section 312 were promulgated soon after enactment of the 1954 Code, and various issues now merit revisions.



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First, under the current regulations, E&P following a stand-alone tax-free section 351 contribution transaction is treated differently from E&P following a section 351 transaction that takes place immediately after an asset reorganization. The issue of whether the parent's E&P should be transferred to the subsidiary would be useful for the IRS to address in its review of these regulations.

Second, in a tax-free spin-off transaction, E&P -- unlike other tax attributes -- is allocated to the controlled subsidiary. The key issue is the proper allocation formula to use. The current regulations do not provide a clear answer. Instead, they simply provide two formulas -- one based on fair market value of assets, the other based on basis in assets -- with no guidance on which to use.

By contrast, in the strictly international context -- that is, similar transactions involving two controlled foreign corporations -- under proposed section 367(b) regulations, allocation of E&P based on basis is the preferred method. The preamble to those regulations says taxpayers may use any reasonable method, but taxpayers would have to justify the use of another method.

**Observation:** Regulations covered by this item presumably will clarify the proper adjustment and allocation of E&P in the domestic contexts described above.

### Section 355 issues

Item 5 is "Final regs regarding the application of section 355(a)(3)(B) to stock of a controlled corporation." The temporary regulations regarding so-called "hot stock" will expire on December 12, 2011. They were issued in response to the 2005 section 355(b) active-trade-or-business (ATOB) amendments to section 355(b), which in part directed Treasury to modify the rules on recently purchased stock of a controlled corporation (Controlled).

**Observations:** We believe that the IRS should finalize the temporary regulations, which provide a sensible approach that the hot stock rule should not apply to an acquisition of Controlled if Controlled is a member of the distributing corporation's separate affiliated group (DSAG) after the acquisition but prior to the spin-off and that transfers of Controlled within the DSAG are disregarded. It also would be helpful for the IRS to address the issues raised by commenters with regard to the temporary regulations, including clarification of indirect acquisitions of Controlled stock and transfers of Controlled within an affiliated group .

Item 6 -- "Regulations relating to the active trade or business requirement under §355(b)" -- refers to IRS efforts to finalize proposed regulations (REG-123365-03) that provide guidance on the ATOB requirement under section 355(b) and that were issued mainly to address amendments made to section 355(b)(3).

**Observations:** Guidance that clarifies this complex area would be extremely helpful. One approach would be to adopt the proposed ATOB regulations but address two important open issues that have been discussed in comments:

- Prop. Reg. sec. 1.355-3(b)(4)(ii) contains a strict prohibition against use of a corporation's assets to acquire an ATOB in a tax-free transaction. This could be replaced with a facts-and-circumstances test implemented through the section 355 device regulations.
- Taxpayers will be watching to see if the IRS retains the "affiliate exception" in the current ATOB regulations (Reg. sec.1.355-3(b)(4)(iii)), rather than adopt the more limited SAG exception in the proposed regulations for transactions in which an ATOB is acquired and gain or loss is recognized.

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## Section 382 issues

Item 10 -- "Guidance regarding the treatment of non-stock under § 382" -- refers to an anti-abuse rule in the regulations under which certain instruments are treated as stock to prevent taxpayers from avoiding the section 382 limits on the use of losses following an ownership change. IRS officials have indicated that under this item, the IRS is developing guidance regarding cases in which these regulations would treat non-stock debt trading at a deep discount as stock for purposes of section 382.

Item 11 is "Regulations regarding the application of the segregation rules to small shareholders under § 382. A request for comments was published in Notice 2010-49..." **Observation:** This project is a mechanical correction that would simplify the existing rules, which are extremely complex.

One noteworthy project remains off the current business plan. This project, which last appeared on the 2008-2009 business plan, involves "Guidance under §382 and §384, including regulations regarding built-in items under §382(h)(6). Built-in items under §382(h)(6) were previously addressed in Not. 2003-65. Temporary regulations regarding the treatment of prepaid income were published on June 13, 2007." Notice 2003-65 is taxpayer-favorable guidance regarding how to determine which items of income and deduction are built-in as of the date of an ownership change. It provides two safe harbors as well as other reasonable methods taxpayers may use. This project would involve converting Notice 2003-65 into regulations that, we understand, could be less flexible. **Observation:** It is therefore a taxpayer-favorable development that this item has now been off the business plan for three years.

## Basis allocation

Item 13 -- "Regulations regarding the recovery and allocation of basis in redemptions and reorganizations. Proposed regulations were published on January 21, 2009" -- addresses a controversial issue with consequences for transactions involving CFCs owned directly by a U.S. parent.

The proposed regulations, following the Fourth Circuit's 1971 decision in *Johnson v. United States*, would require taxpayers, following certain tax-free transactions, to use "a single model for stock basis recovery by a shareholder that receives a constructive or actual distribution to which section 301 applies and a single model for sale and exchange transactions to which section 302(a) applies, including certain elements of a reorganization exchange." Essentially, this model would require taxpayers to track basis in each individual share of stock. Taxpayers could not, under the proposed regulations, simply allocate basis among shares on a pro-rata basis. **Observation:** Because the proposed regulations, which would generally apply prospectively when finalized, could reduce tax-planning opportunities for taxpayers, taxpayers considering engaging in transactions that would be covered by the regulations may wish to consider doing so before the regulations are finalized.

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