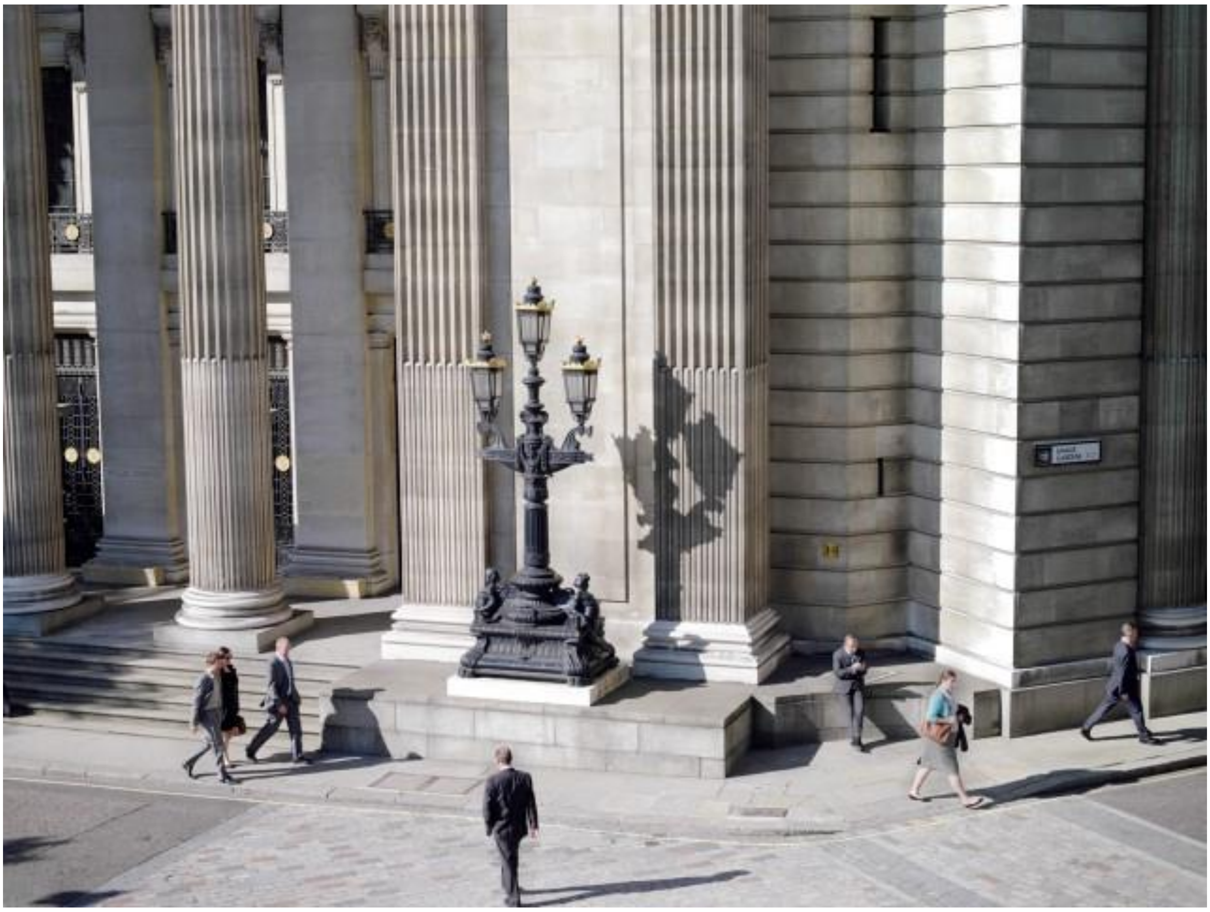
This Month in M&A / Issue 12 / December 2013

M&A Tax Recent Guidance



This month features:

- Final and proposed regulations under section 1411 address the new 3.8% net investment income tax on individuals, estates, and certain trusts (T.D. 9644; REG-130843-13)
- Preferred shares provide holder with control over a corporation (*Fish v. Comm'r* T.C. Memo. 2013-270)
- A US corporation will not recognize gain or loss upon its outbound liquidation (PLR 201348011)

Did you know…?

Just in time for filing season, the IRS issued eagerly anticipated regulations on the 3.8 percent tax on net investment income. These regulations help clarify a number of issues that will be important for the 2013 filing season. The IRS on November 26 issued final (T.D. 9644) and new proposed regulations (REG-130843-13) regarding the net investment income tax ("NIIT") under section 1411. Section 1411 imposes a 3.8 percent tax on the net investment income of individuals, estates, and trusts with income above certain statutory threshold amounts (e.g., $200,000 for single taxpayers and $250,000 for joint filers). The new tax is effective for tax years beginning after December 31, 2012. The final regulations ("Final Regulations") are effective for tax years beginning after December 31, 2013. The Final Regulations finalize the proposed regulations issued on December 5, 2012 (REG-130507-11 or the "2012 Proposed Regulations").

The new proposed regulations ("New Proposed Regulations") address issues that were not addressed in the 2012 Proposed Regulations and reproposed regulations with respect to sales and dispositions of S corporations and partnerships.

Background

Congress enacted section 1411 as part of the Health Care and Education Reconciliation Act of 2010. Section 1411 defines 'net investment income' as investment income less any deductions properly allocated to that income. Investment income includes gross income from interest, dividends, annuities, royalties, and rents (other than income derived from an active trade or business), and net capital gain. Income from working capital also is subject to the 3.8 percent tax, as is any income from limited partnerships or from other pass-through entities in which a taxpayer does not materially participate (as determined under section 469). Investment income under section 1411 also includes all income earned by traders of financial instruments or commodities (as defined in section 475(e)(2)).

Final Regulations

Section 1411 looks to section 469 for determining whether an individual, trust, or estate is active in a trade or business. The Final Regulations address a number of comments made with respect to the 2012 Proposed Regulations, including the ability to 'regroup' activities under section 469. The regulations under section 469 provide taxpayers with the ability to group activities qualifying as an appropriate economic unit. By aggregating similar activities, taxpayers can overcome certain material participation thresholds and avoid passive treatment. While a taxpayer's initial grouping is generally binding and cannot be changed unless the prior grouping was clearly inappropriate or if there is a material change in facts, the Final Regulations provide taxpayers the ability to regroup their activities. This regrouping only can be made once and may occur as early as 2013 if section 1411 applies and subject to certain disclosure requirements. In response to comments, the Final Regulations also allow for a one time regrouping on an amended return if the amended return causes section 1411 to apply.

Although a number of commentators requested that partnerships and S corporation be permitted to regroup under section 469 (similar to the 'fresh start' permitted for individuals, estates, and trusts), the final regulations do not allow regrouping by partnerships and S corporations.

The Final Regulations reserve on the treatment of sales or other dispositions of interests in partnerships and S corporations.

New Proposed Regulations

Adjustments to Gains and Losses from the Disposition of a Partnership Interest or S Corporation Stock

Section 1411 provides that in the case of a disposition of a partnership interest or S corporation stock, net investment income includes only the net gain attributable to property held by the entity that is not properly attributable to a trade or business.

Upon the sale or disposition of a partnership interest, the 2012 Proposed Regulations required taxpayers to use a 'Deemed Sale' method to bifurcate their share of partnership gain between that which is subject to and exempt from section 1411, if applicable. This method was applied on a property-by-property basis and assumed a hypothetical sale of all partnership assets at fair market value. The Deemed Sale method also applied upon the sale or disposition of an S corporation interest for which no section 338(h)(10) election is in effect.

In response to comments questioning the methodology of the 2012 Proposed Regulations, the New Proposed Regulations propose a new regime that would impose the NIIT on the lesser of (1) the gain recognized on the sale of the entity interest by the partner or the shareholder or (2) the gain that would have been subject to the NIIT if all of the entity's assets had been sold. The New Proposed regulations direct the transferor to rely on the valuation requirements under Reg. sec. 1.469-2T(e)(3) that allow the transferor to compute gain or loss activity by activity instead of valuing each asset. This helps to simplify the calculation of the NIIT.

The New Proposed Regulations propose an optional simplified reporting method that eliminates the need to apply valuations of an entity on an activity by activity basis. Rather, the proposal looks to historical data relating to the allocations to the selling partner or shareholder over the holding period (generally the current year of sale of the interest and the prior two tax years) to determine what percentage of the sale is subject to the NIIT. This optional method can be utilized only if either (1) the sum of the transferor's allocable share of total NIIT items over the holding period is 5% or less of the total allocations over that period to the partner or shareholder and the gain recognized by the partner or shareholder on the sale was $5 million or less, or (2) the gain recognized by the seller does not exceed $250,000.

Guaranteed Payments

The New Proposed Regulations exclude all guaranteed payments for services from net investment income, regardless of whether the payments are subject to self-employment income, because payments for services are not included in net investment income.

In contrast, the New Proposed Regulations treat guaranteed payments for the use of capital as an interest substitute and include these in net investment income.

Section 736 Payments

Section 736 applies to payments made by the partnership to a retiring partner in liquidation of the partner's entire interest in the partnership. The New Proposed Regulations provide detailed rules as to whether a section 736 payment is treated as net investment income. These rules follow the treatment of the payment under section 736.

Effective Dates

Section 1411 is effective for tax years beginning after December 31, 2012. The New Proposed Regulations generally are proposed to be effective for tax years beginning after December 31, 2013. However, the New Proposed Regulations state that taxpayers may rely on them until final regulations are effective. The IRS is accepting public comments on the New Proposed Regulations until March 3, 2014. If requested, a hearing on the New Proposed Regulations will be scheduled.

For additional information, please contact Todd McArthur, Brian Meighan, Audrey Ellis, or Dianna Miosi.

Court watch

Fish v. Comm'r, T.C. Memo. 2013-270 (Nov. 25, 2013)

Background

In *Fish v. Comm'r,* the Tax Court addressed whether boot received in a deemed Section 351 incorporation of a qualified subchapter S subsidiary ("QSub") was properly characterized as ordinary income or capital gain due to application of Section 1239.

Fish was the sole shareholder of Fish Holdings, an S corporation, and FishNet Security was its QSub. On the same day that FishNet Security issued preferred stock to a group of investors, it distributed a cash dividend to Fish Holdings (the "Distribution"). The issuance of the preferred shares caused FishNet Security to lose its status as a QSub. When a QSub election terminates, the S corporation under section 1361(b)(3)(C) is deemed to contribute all of the assets and liabilities of the QSub to a new corporation in a deemed section 351 transaction. When there is boot in a section 351 transfer, it generally is characterized as gain from the sale of the transferred assets to the transferee corporation. Section 1239 may recharacterize a portion of such gain as ordinary income when boot is received in exchange for certain depreciable assets in a section 351 exchange if the transferor and the transferee are treated as related parties under section 1239(b). Here, Fish Holdings' ownership of stock with more than 50 percent of vote or value in FishNet Security would satisfy this test.

FishNet Security was deemed to have transferred depreciable property in its deemed section 351 transfer that resulted from its QSub termination. The Distribution was treated as boot in the section 351 transfer and was reported by Fish as a capital gain. The IRS asserted that section 1239 applied to the Distribution because Fish Holdings and FishNet Security were related for purposes of section 1239(b). The IRS contended that Fish Holdings owned more than 50 percent of FishNet Security's voting stock and thus was required to treat the Distribution as ordinary income.

Tax Court Opinion

Although Fish Holdings owned approximately 60 percent of the outstanding voting shares of FishNet Security, Fish contended that under *Alumax* (and similar authorities) the parties were not related because Fish Holdings' ownership was reduced by the rights of the preferred stock. In relevant part, the rights of the preferred shares provided for: (i) one vote per share; (ii) the election of two out of five directors; (iii) the right to veto the election by Fish Holdings of a fifth "independent" director (subject to a reasonableness requirement); and (iv) the mandatory approval by a majority of the preferred shareholders over certain actions of the board of directors (the "Negative Covenants").

The Tax Court, looking beyond record ownership, focused on the election rights relating to the fifth "independent" director. In prior cases, courts have held that corporate voting power flows from the right to appoint directors and not mere record ownership. See *Hermes Consol., Inc. v. United States*, 14 Cl. Ct. 398 (1988); *Framatome Connectors USA, Inc. v. Comm'r*, 118 T.C. 32 (2002), aff'd, 108 Fed. Appx. 683 (2d Cir. 2004). Fish attempted to rely on *Hermes* and *Framatome*, on the basis that the holders of the preferred had approval rights over the fifth director, thereby limiting Fish's right to appoint the fifth director. Fish also relied on the independence of the fifth director as evidence of his reduced control. The Tax Court rejected Fish's arguments because, in *Hermes,* the preferred shareholders ultimately had the power to appoint the fifth director, but in the instant case the net effect of the preferred holder's right of approval and the independence requirement merely reduced the available pool of candidates and did not affect the voting power of Fish Holdings. Thus, the Tax Court held that Fish Holdings was entitled to elect 60 percent of the directors and therefore held more than 50 percent of the voting power of FishNet Security. Consequently, section 1239 applied and the Distribution was properly treated as ordinary income.

The Tax Court, analyzing the Negative Covenants, also distinguished prior cases on the basis that Fish Holdings had significantly more managerial control of FishNet Security by virtue of Fish's status as CEO and President. The Tax Court held that while the Negative Covenants did in fact reduce the voting power of Fish Holdings, the parties were still related taxpayers for purposes of section 1239. See *Alumax Inc. v. Comm'r*, 109 T.C. 133 (1997), aff'd, 165 F.3d 822 (11th Cir. 1999).

Observations

Under the *Hermes* and *Alumax* line of authorities, the power to elect or appoint directors is determinative of voting power, provided such power is not limited by other restrictions. Presumably, the Tax Court could have concluded that the Negative Covenants were insufficient limitations to override Fish's ability to appoint three of the five directors. However, the Tax Court's analysis of the Negative Covenants instead looked to Fish's role in the operation of FishNet Security. This approach raises a broader question as to whether a shareholder's involvement in the management of its indirect subsidiary should be relevant in determining the voting power of the parent corporation. While this portion of the Tax Court's analysis may be viewed as dicta, the language of the Tax Court indicates the court may go beyond the corporate documents and written agreements when determining voting power in future cases.

For additional information, please contact Jon Thoren, Art Sewall, or Brian Loss.

Private letter rulings

PLR 201348011

The IRS ruled that a U.S. subsidiary corporation ("USCo") will not recognize gain or loss under sections 332 and 367(e)(2) upon its complete outbound liquidation into its foreign parent ("FP"), except with respect to intangible assets as described in section 936(h)(3)(B). Prior to the liquidation, FP conducted business in the U.S. through USCo. The ruling states that FP's interest in USCo constituted a U.S. Real Property Interest (a "USRPI") as defined in section 897(c)(1). At the time of liquidation, the USCo group had lower levels of debt relative to its assets and earnings than FP and its foreign subsidiaries. Also, the USCo group was profitable and did not have any net operating loss carryovers.

Observations

Notably, this is the first PLR the IRS has issued with respect to section 367(e)(2) and the regulations thereunder in several years. Section 367(e)(2) denies nonrecognition treatment to a distributing corporation under section 337 when the 80 percent distributee is a foreign corporation. However, the regulations provide an exception to section 367(e)(2) for distributions of property used in a US trade or business, provided that the property will be used in a US trade or business for 10 years after the distribution and the domestic liquidating corporation agrees to recognize gain associated with the distributed property if the recipient shareholder stops using such property in the US trade or business during the 10-year period. The IRS also may require the distributing corporation to recognize gain if a principal purpose of the liquidation is the avoidance of US tax.

Because the USCo group was less leveraged than FP and its foreign subsidiaries, it would seem reasonable to expect that, following the liquidation, an increased amount of interest expense would be allocated to the US businesses, leading to a reduction in US taxable income. Although the IRS added a caveat noting they did not rule on the treatment or allocation of any interest expense, it may be possible to infer that such a reduction in US taxable income would not constitute the avoidance of US tax under the general anti-abuse rule in Reg. sec. 1.367(e)-2(d).

For additional information, please contact Carl Dubert or Matt Cotter.

PwC M&A publications

In the article titled "Whose Deduction Is It Anyway?," published as a *Bloomberg BNA Daily Tax Report* article on November 14, 2013, PwC National Tax authors T. Bart Stratton, Jennifer Kennedy, and Susan Lennon explore the location and timing of deductible liabilities in the context of an acquisition of a corporation and their tangible ramifications with respect to Target and Acquirer.

In the article titled "The Race for Last: Interaction between consolidated COD, loss disallowance, and circular basis adjustment rules," published in the *Journal of Corporate Taxation*, November/December 2013 issue, PwC M&A author Rob Melnick discusses three sets of consolidated return regulations with respect to the complete disposal of the shares of a consolidated group member at a loss in the same tax year the subsidiary recognizes COD income.

Let's talk

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

Tim Lohnes, *Washington, DC*
+1 (202) 414-1686
timothy.lohnes@us.pwc.com

Jon Thoren, *Washington, DC*
+1 (202) 414-4590
jon.thoren@us.pwc.com

Art Sewall, *Washington, DC*
+1 (202) 414-1366
arthur.w.sewall@us.pwc.com

Audrey Ellis, *Washington, DC*
+1 (202) 346-5234
audrey.ellis@us.pwc.com

DiAndria Green, *Washington, DC*
+1 (202) 346-5135
diandria.green@us.pwc.com

Brian Loss, *Washington, DC*
+1 (202) 346-5137
brian.r.loss@us.pwc.com

Matt Cotter, *Washington, DC*
+1 (202) 312-7558
matthew.j.cotter@us.pwc.com

This issue's contributors

Brian Meighan, *Washington, DC*
+1 (202) 414-1790
brian.meighan@us.pwc.com

Todd McArthur, *Washington, DC*
+1 (202) 312-7559
todd.y.mcarthur@us.pwc.com

Carl Dubert, *Washington, DC*
+1 (202) 414-1873
carl.dubert@us.pwc.com

Dianna Miosi, *Washington, DC*
+1 (202) 414-4316
dianna.k.miosi@us.pwc.com

Bart Stratton, *Washington, DC*
+1 (202) 312-7531
bart.stratton@us.pwc.com

Rob Melnick, *Washington, DC*
+1 (202) 312-7906
robert.s.melnick@us.pwc.com

Jennifer Kennedy, *Washington, DC*
+1 (202) 414-1543
jennifer.kennedy@us.pwc.com

Susan Lennon, *Washington, DC*
+1 (202) 414-4625
susan.m.lennon@us.pwc.com