This Month in M&A / Issue 8 / August 2015

M&A tax recent guidance

This month features:

- Proposed Section 707 regulations address 'disguised payments for services' (REG-115452-14)
- IRS issues final and proposed Section 706 regulations on 'varying interests' (T.D. 9728, REG-109370-10)
- Tax Court holds consolidated group members' excluded COD income, prior to 2003 regulations, reduced CNOL on a single-entity approach ('Marvel Entertainment')
- PLR provides distributing corporation may specifically allocate boot in spin-off (PLR 201527003)
- PLR provides that corporation expanded its business by acquiring interest in partnership that conducts a segment of its business (PLR 201528016)
- PLR addresses treatment of taxable distribution of partnership interest within consolidated group (PLR 201528007)
- Bill would amend certain provisions of the S corporation regime (H.R. 2788)
- IRS indicates it will support exam team's application of anti-abuse rule in Treas. Reg. sec. 1.367(b)-10(d) (ECC 201530020)
- IRS Guidance Plan lists forthcoming guidance that would affect corporate spin-off transactions

Did you know…?

The IRS issued proposed regulations under Section 707(a)(2)(A) addressing 'disguised payments for services' (compensation income). The regulations provide that in certain cases an arrangement with a service provider structured as an allocation and a distribution may be recharacterized as compensation income. While directed at management fee waiver arrangements, the regulations generally would apply to any type of disguised payment for services. The regulations are proposed to apply to any arrangement entered into or modified on or after the date final regulations are published. In the case of any arrangement entered into or modified before that date, the proposed regulations state that the determination of whether the arrangement is a disguised fee for services is to be made on the basis of the statute and the guidance in the Tax Reform Act of 1984 legislative history. The preamble states the IRS position is that the proposed regulations "generally reflect Congressional intent…"

Below is a brief summary of this proposed guidance. For a more detailed analysis, please refer to our July 24, 2015 WNTS Insight (Newly issued proposed regulations under Section 707(a)(2)(A) address disguised payments for services - Initial observations).

Background

A management fee waiver arrangement generally refers to the ability of a private equity or other fund manager to exchange all or a portion of its unearned fixed management fees for a profits interest in the fund. The mechanics and features of such an arrangement vary from fund to fund, but a common goal of such arrangements is to exchange unearned management fees (subject to ordinary tax rates) for a distributive share of the partnership's income (character flow-through and potential deferral). The IRS believes that some of these arrangements should not be respected as distributive shares of the fund's income and instead should be recharacterized as payments for services under Section 707(a).

Regulatory analysis

The key driver in the IRS analysis in determining when a fee waiver will be recharacterized as a payment for services is the entrepreneurial risk of the arrangement. The proposed regulations provide that an arrangement would be treated as a disguised payment for services if:

- a person, either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership;

- there is a related direct or indirect allocation and distribution to the service provider; and

- the performance of the services and the allocation and distribution when viewed together are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.

The proposed regulations require an analysis of all the facts and circumstances to determine whether an arrangement should be treated as a payment for services, and list six non-exclusive factors that may indicate that an arrangement constitutes, in whole or in part, a payment for services. The first five factors generally are derived from the legislative history of the statute. The proposed regulations would add a sixth factor specifically tailored to management fee waiver arrangements. The most significant factor appears to be whether the service provider is subject to entrepreneurial risk. The regulations include examples that illustrate when an arrangement would be respected as an allocation and distribution.

The proposed regulations also would amend Example 2 in the existing guaranteed payment regulations (Treas. Reg. sec. 1.707-1(c)). The amendment would change the current analysis regarding when an allocation is considered a guaranteed payment vs. when it will be treated as part of the partner's distributive share.

The preamble to the proposed regulations states that the IRS plans to issue guidance changing the safe harbor for the receipt of partnership profits interest currently set forth in Rev. Proc. 93-27. The preamble, suggests that the new safe harbor would not apply to the receipt of *any* profits interest issued in conjunction with a service provider forgoing its right to payment of an amount that is substantially fixed. With this proposed change it appears that the safe harbor no longer would apply to most (if not all) common management fee waiver arrangements. Further, it appears this guidance would apply to any service provider, not just private equity and investment fund managers. Note: the IRS requested comments by October 21, 2015, on various issues under the proposed regulations, including related guaranteed payment issues that arise under targeted capital account agreements.

Observations

The proposed regulations and the forthcoming guidance on profits interests will affect a broad spectrum of partnership service providers, not just private equity and investment fund managers. While all facts and circumstances of each arrangement will need to be assessed, but the significant factor appears to be whether the service provider is subject to sufficient entrepreneurial risk to be treated as receiving a distributive share of partnership income rather than a fee for services. Moreover, the proposed changes to Rev. Proc. 93-27 will narrow the class of service providers who may rely on that guidance. Thus, many profits interest recipients would have to value the interests they receive in order to recognize income on receipt.

The IRS business 2015-2016 Priority Guidance Plan includes a project to address targeted capital account agreements. This guidance, along with the proposed change to Reg. sec. 1.707-1(c) Example 2, could affect the tax characterization of preferred returns, catch-up allocations, and similar arrangements, possibly requiring annual ordinary income inclusions for preferred partners in years in which the partnership has no income. Such a change would have a significant impact on structuring preferred partnership interests.

For additional information, please contact Karen Lohnes, Todd McArthur, or Robert Honigman.

Treasury regulations

Final and proposed regulations on 'varying interests' (T.D. 9728 and REG-109370-10)

The IRS July 31 issued final regulations (T.D. 9728), governing the determination of a partner's distributive share of partnership items when the partner's interest changes during a partnership tax year. The regulations also modify the test for determining the required tax year of a partnership with foreign partners. The final regulations adopt, with changes, proposed regulations (REG-144689-04) issued in April 2009.

The final regulations generally apply to partnership tax years that begin after August 2, 2015. Certain special effective date rules are explained in the preamble. Also, the IRS July 31 issued proposed regulations (REG-109370-10) on determination of a partner's distributive share of some allocable cash-basis items and items attributable to an interest in a lower-tier partnership during a partnership tax year in which the partner's interest changes. These proposed regulations also contain specific rules impacting publicly traded partnerships (PTPs).

The regulations are proposed to apply to partnership tax years beginning on or after the date final regulations are published. The preamble states that until final regulations are issued, taxpayers may rely on Prop. Reg. secs. 1.706-4(e)(1) and 1.706-4(e)(2)(ix) (relating to a PTP's treatment of all amounts subject to withholding as defined in Reg. sec. 1.1441-2(a) that are not effectively connected with conduct of a US trade or business or withholdable payments under Reg. sec. 1.173-1(a)as extraordinary items).

Final regulations

Many of the changes from the April 2009 proposed regulations relate to reorganizing Reg. sec. 1.706-4 to clarify the scope of and exceptions to the varying interest rules, including guidance on partnership conventions, extraordinary items, and procedures for partnership decisions. Some notable changes from the proposed regulations made in the final regulations include:

- Addition of two extraordinary items and a *de minimis* exception for extraordinary items;
- Expansion of the scope of the contemporaneous partner exception to include allocations of items attributable to a particular segment of a partnership's year;
- Application of the service partnership exception to any partnership in which capital is not a material income-producing factor;
- Allowing a partnership to use the interim closing method for one variation and the proration method for another variation in the same year; and
- Clarifying that specified deemed dispositions are treated as a disposition of the partner's entire interest in the partnership *solely* for purposes of Section 706 (e.g., a member entering or leaving a consolidated group).

The final regulations make it easier for partnerships to make certain decisions in applying the varying interest rules. For example, the final regulations provide that the partnership may apply the proration method without specifying in the partnership agreement that the partners agree to use the proration method, as long as an authorized person includes a short statement with the partnership's books and records providing for the agreement to use the proration method.

In addition, the final regulations adopt without modification a proposed regulation that changed the minority interest rule in Reg. sec. 1.706-1(b)(6)(iii) which, applies to determine the required tax year of the partnership. Under this rule, which was published in 2002, a foreign partner generally is disregarded when determining the partnership's taxable year unless the foreign partner is allocated effectively connected income in connection with a US trade or business with respect to its partnership interest, or the regarded partners (partners that are not disregarded foreign partners under Reg. sec. 1.706-1(b)(6)(i)) held a minority interest. Minority interest partners are those that each hold less than a 10-percent interest, and in aggregate less than 20-percent interest, in capital or profits. The minority interest partners were disregarded when determining the tax year-end for the partnership, as long as the partners held, in the aggregate, a capital interest of less than 20-percent.

The final regulations provide that disregarded minority partners are those who hold in the aggregate less than a 20-percent interest in capital and profit. Thus, US partners that hold a 20-percent profits interest, such as a carried interest, are considered to be minority partners. Accordingly, the foreign partners' capital and profits interests must be considered in the determination of the partnership's required tax year-end. This final regulation does not apply to existing partnerships that were formed prior to August 3, 2015.

Proposed regulations

The issued proposed regulations would include two additional 'extraordinary items,' i.e., items that cannot be pro-rated and must be allocated solely to those partners in the partnership at the time the item is realized:

- The first new item generally would allow PTPs to treat as extraordinary items all items of income that are amounts subject to withholding as defined in Reg. sec. 1.1441-2(a) (excluding income effectively connected with the conduct of a trade or business within the United States) or amounts under Reg. sec. 1.1473-1(a). This rule would not apply unless the PTP had a regular practice of making at least four distributions (other than *de minimis* distributions) to its partners during each tax year.

- The second new item would provide that any partnership may treat as an extraordinary item a deduction for the transfer of partnership equity in connection with the performance of services. The proposed regulations would clarify that such an extraordinary item is treated as occurring immediately before the transfer or vesting of the partnership interest that results in compensation income to the service provider.

The proposed regulations also would provide guidance on the treatment of allocable cash-basis items and tiered partnerships.

The guidance on allocable cash-basis items contains an expanded list of allocable cash-basis items, such as a deduction previously deferred under Section 267(a)(2); a *de minimis* exception; and a request for comments on the interaction of Sections 706(d) and 755 with respect to cash-basis items allocable to a former partner. The guidance on tiered partnerships adopts the principle set forth in Rev. Rul. 77-311, providing that an upper-tier partnership's distributive share of items from the lower-tier partnership is considered to be realized by the upper-tier partnership at the same time and in the same manner as they are realized by the lower-tier partnership. Thus, the upper-tier partnership must take into account changes of interests in the upper-tier partnership in determining each partner's share of items from the lower-tier partnership, rather than allocating the lower-tier partnership items to the partners who were partners of the upper-tier partnership at the end of the lower-tier partnership's tax year.

Observations

Although the final regulations adopt substantially all the guidance in the 2009 proposed regulations, the modifications are significant enough to warrant meticulous attention. Expanding the definition of a service partnership and allowing use of both the interim closing method and the proration method in the same year are helpful. At the same time, companies in specific industries, such as asset management, may find that the final and proposed regulations may create significant compliance issues.

For additional information, please contact Robert Honigman or John Schmalz.

Court watch

Marvel Entertainment LLC v. Comm'r, 145 T.C. No. 2 (July 21, 2015)

In a case of first impression, the US Tax Court held that when members of a consolidated group exclude pre-2003 cancellation of indebtedness (COD) income under Section 108(a)(1)(A), the correlating reduction of tax attributes under Section 108(b)(1)(A) must be made on a consolidated single-entity basis (the single-entity approach), rather than on a separate company-by-company basis (the separate-entity approach). This issue can impact the availability of net operating loss carryforwards, or prior year taxable income of taxpayers that took a contrary position.

In 1996, Marvel Entertainment Group Inc. (MEG) and its subsidiaries were members of a US consolidated group (the MEG Group), with MEG as the parent. Members of the MEG Group filed voluntary petitions for bankruptcy under Chapter 11 of the Bankruptcy Code, such that certain members, including MEG, realized COD income. These members properly excluded COD income under Section 108(a)(1)(A).

Section 108(b) provides that COD income excluded under Section 108(a)(1)(A) must be applied to reduce certain tax attributes of the taxpayer, including net operating losses (NOLs). In reducing its consolidated net operating losses (CNOLs), each of the MEG Group members reduced their allocable share of the group's CNOL by its previously excluded income. This application of the separate-entity approach left the MEG Group with remaining CNOLs of approximately $96.3 million to carry forward (subject to the Section 382 limitation). If the MEG Group had applied the single-entity approach, it would have had to reduce the CNOLs of the entire MEG Group (not just the CNOLs of the members that excluded income under Section 108(a)(1)(A)), which would have left the MEG Group with remaining CNOLs of approximately $15.6 million to carry forward (subject to the Section 382 limitation).

On October 1, 1998, the MEG Group was acquired by Toy Biz, Inc. (Toy Biz), and carried over the remaining $96.3 million of CNOLs (the CNOL Carryforwards) into its new consolidated group. The sole issue addressed by the Tax Court was whether the MEG Group's CNOL subject to reduction under Section 108(b)(2)(A) was the entire CNOL of the consolidated group—the single-entity approach—or a portion of the CNOL allocable to each member of the consolidated group—the separate-entity approach.

Disagreeing with MEG's arguments, the Tax Court cited the Supreme Court's 2001 decision in *United Dominion Industries Inc. v. United States,* 532 US 822 (2001). *United Dominion* concerned the proper calculation of a consolidated group's product liability loss carryback. The Tax Court in *Marvel* found that *United Dominion* addressed the identical underlying critical issue: whether the pre-2003 consolidated return regulations allow for the separate-entity approach.

The Supreme Court in *United Dominion* first found that in the consolidated returns context, the only definition of NOL was a CNOL. Second, the Supreme Court found that a specific consolidated return regulation must allocate and apportion the CNOL to a consolidated group member in order for a consolidated group member to have a separate NOL for a consolidated return year. As no such regulation existed, the Supreme Court in *United Dominion* held that the separate-entity approach was improper.

In *Marvel*, the Tax Court applying the same reasoning as the Supreme Court in *United Dominion,* determined that the single-entity approach was required because there was no regulation that existed for MEG's short tax year ending on October 1, 1998 that allowed for the separate-entity approach. Thus, the Tax Court held that the NOL reduced under Section 108(b)(2)(A) should have been the entire consolidated group's CNOL.

Observations

Prior to adoption of Temp. Reg. sec. 1502-28T in 2003, the consolidated return regulations provided little direct guidance regarding proper application of Sections 108(a) and (b) when a corporation that was a member of a consolidated group excluded COD income under Section 108(a). Based on the state of the law in 1998 (the year that gave rise to the COD event), it appears reasonable for Marvel to have taken a separate-entity approach position. At that time, Congress seemed to reinforce the separate-entity approach as the default rule under Section 108(b) and only permitted the single-entity approach if Section 108(b) specifically provided for such treatment. For example, Section 108(b)(2)(E)(ii) provided a cross reference to Section 1017(b)(3)(D), which allowed debtors to reduce basis in the stock of an affiliate under the single-entity approach.

The Tax Court's holding in *Marvel* relates only to consolidated groups that have members with attribute reduction from excluded COD income under Sections 108(a) and (b) in consolidated return years prior to the 2003 adoption of Temp. Reg. sec. 1502-28T. Notably, the Reg. sec. 1.1502-28 rules were published as final regulations in 2005, with certain changes, and generally apply a hybrid approach such that the attributes (e.g., NOLs) attributable to the member that excluded COD income are reduced prior to the reduction of the consolidated attributes attributable to other members. *See* Reg. sec. 1.1502-28.

For additional information, please contact Dave Friedel or Sarah Hoyt.

Private letter rulings

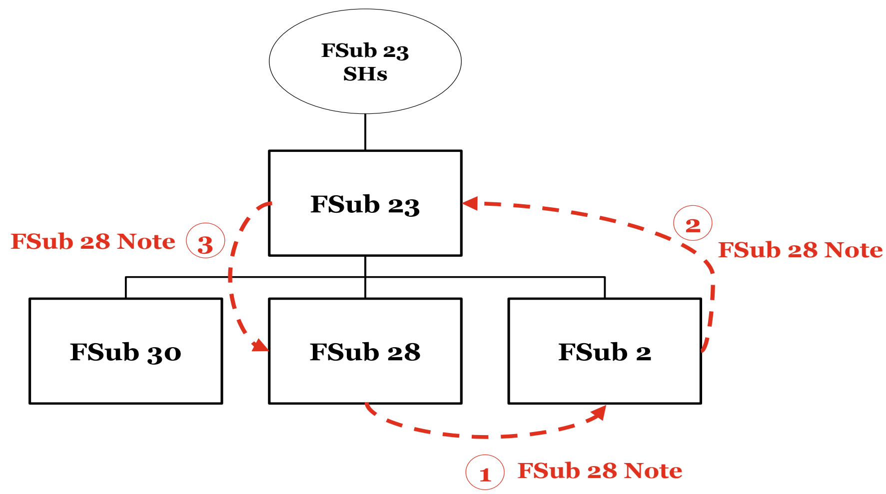
PLR 201527003

The IRS disregarded transitory notes issued in connection with a pre-spin-off restructuring of certain distributed business assets (Business 1 Assets). In addition, the IRS ruled that a shareholders' resolution regarding the mix of qualifying and non-qualifying consideration (boot) received in the spin-off would be respected.

Transitory Note

In the PLR, and as part of the pre-distribution restructuring steps, FSub 2 transferred all of its Business 1 Assets to FSub 28, a brother/sister corporation, in exchange for a note (FSub 28 Note). FSub 2 subsequently distributed the FSub 28 Note to FSub 23, the common parent of FSub 2 and FSub 28. FSub 23 then contributed the FSub 28 Note to FSub 28 in exchange for additional FSub 28 equity.

Transitory Note



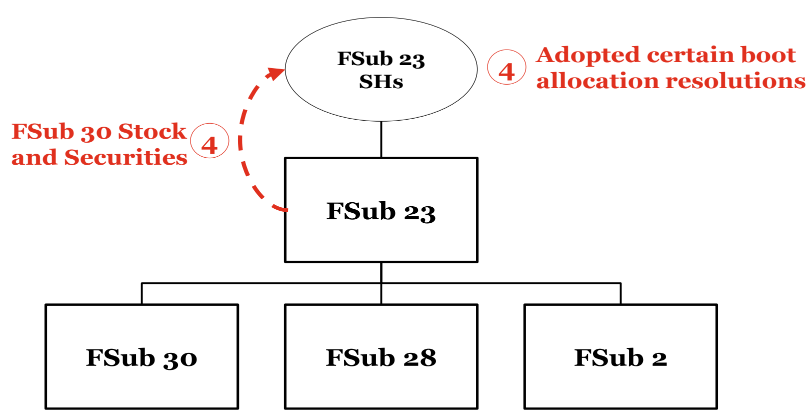
The IRS ruled that the circular flow of FSub 28 Note would be disregarded. Instead, the transfer would be viewed as a contribution by FSub2 of its Business 1 Assets to FSub 28 in exchange for FSub 28 stock, followed by a distribution of the FSub 28 stock to FSub 23.

The IRS appears to have permitted the taxpayer to dictate the fictional transactions that took place when the existence of FSub Note 28 was disregarded. These transactions potentially could be viewed as if FSub 28 first distributed the Business 1 Assets to FSub 23, and FSub 23 subsequently contributed the Business 1 Assets to FSub 28 in exchange for stock. *See* Rev. Rul. 77-191, in which the distribution of assets out to the distributing corporation's shareholders, followed by the contribution of those assets to a newly formed corporation, was held a reorganization and distribution under Sections 368(a)(1)(D) and 355.

Boot Allocation

Subsequently, FSub 23 distributed stock and securities of FSub 30 to FSub 23's shareholders in a distribution seeking to qualify as a distribution under Section 355 (the FSub 30 Distribution). In connection with the FSub 30 Distribution, FSub 23's shareholders adopted certain resolutions (Resolutions) specifying that although the total aggregate value of the consideration distributed on each share of FSub 23 stock would be the same, the mix of FSub 30 stock (qualifying property) and FSub 30 securities (non-qualifying property) to be distributed with respect to each share of FSub 23 stock would vary.

Boot Allocation



The IRS ruled that, provided the FSub 23 Distribution qualified under Section 355, the distribution of the FSub 30 securities would constitute a distribution of property with respect to the stock of FSub 23 to which Section 301 applies. Further, any excess of the amount of FSub 30 securities distributed with respect to a share of FSub 23 stock over the amount of such distribution treated as a dividend would be applied against and reduce the shareholder's basis in the share.

The IRS also ruled that for purposes of determining the shareholders' basis, the allocations in the Resolutions would be respected, implicitly ruling the allocation was reasonable within the meaning of Reg. sec. 1.358-2(a)(2)(v).

The ruling in the PLR respecting the allocation of controlled stock and securities received by each distributing shareholder may suggest the possibility of minimizing shareholder level gain on the distribution of boot in a Section 355 distribution to the extent distributing shareholders have varying bases in the distributing stock. An extension of this principle would be to likewise respect the allocation of boot and stock received by distributing shareholders in the case of a single distributing shareholder if the shareholder has blocks of stock in distributing (assuming the allocation is economically reasonable).

For additional information, please contact Timothy Lohnes or Patrick Phillips.

PLR 201528016

The IRS ruled that a corporation's (Distributing) acquisition of a significant interest in a partnership conducting a segment of Distributing's existing business constituted an expansion of Distributing's existing business within the meaning of Reg. sec. 1.355-3(b)(3)(ii) and not the acquisition of a new or different business.

Distributing was directly and indirectly engaged in the active conduct of Business 1 for more than five years. In a taxable transaction within the five-year period preceding a spin-off, Distributing acquired from third parties (the Founders) an interest of at least 33.33 percent in a partnership (Partnership), which itself conducted a business that was segment of Business 1.

For valid business reasons, the taxpayer proposed to spin-off the partnership business after reorganizing the business into corporate form.

The PLR concluded that Distributing's acquisition of an interest in Partnership constituted an expansion of the corporation's business and did not constitute the acquisition of a new or different business citing Reg. sec. 1.355-3(b)(3)(ii), Rev. Rul. 2007-42, Rev. Rul. 2003-38, and Rev. Rul. 2003-18.

Observations

While this PLR apparently is the first instance of the IRS providing a ruling on the acquisition of a partnership interest qualifying as an expansion of an active business, this result appears consistent with applying the expansion doctrine to the principles reflected in certain revenue rulings, including Rev. Rul. 2007-42 (described below), and also with the proposed active trade or business regulations that generally allow a taxpayer to rely on a business conducted through a partnership.

The proposed Section 355 regulations, issued on May 8, 2007, would provide that a partner in a partnership would be attributed the trade or business of that partnership if the partner owns a significant interest in the partnership (*see* example 23, Prop. Reg. sec. 1.355-3(d)(2)). Rev. Rul. 2007-42, released on June 21, 2007, provides guidance about when a corporation may rely on the business of a partnership for purposes of satisfying the Section 355 active conduct of a trade or business requirement. Specifically, where a distributing corporation (D) owns a 33.33-percent interest in a partnership that performs the required activities constituting an active conduct of a trade or business, D may be treated as engaged in the active conduct of the partnership's business for purposes of Section 355(b) (*see* situation 1 of Rev. Rul. 2007-42).

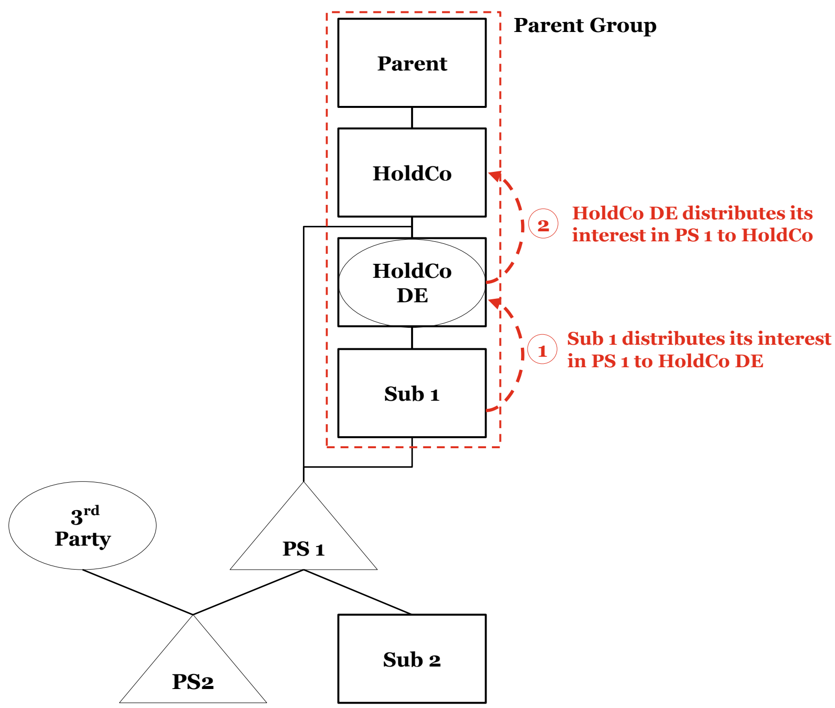
For additional information, please contact Rich McManus, Bruce Decker, or Sarah Hoyt.

PLR 201528007

In this ruling, the IRS addressed the treatment of a taxable distribution of a partnership interest within a consolidated group, the application of Rev. Rul. 99-6, and the application of the intercompany transaction rules (Reg. sec. 1.1502-13(b)(1)).

Parent, a corporation and common parent of an affiliated group (Parent Group), owns all the stock of Holdco, also a corporation and member of the Parent Group. Holdco owns all the interests in Holdco DE, a disregarded entity, and an interest in PS 1, a partnership for US federal income tax purposes. Holdco DE owns all the stock of Sub 1, a corporation, and Sub 1 owns the remaining interests in PS 1. PS 1 owns interests in PS 2, a partnership for US federal income tax purposes. The remaining interests in PS 2 are held by a third party. In the transaction described, Sub 1 distributes its interest in PS 1 to Holdco DE. Holdco DE then distributes the interests in PS 1 to Holdco (collectively, the Distribution).

Starting Structure



IRS analysis

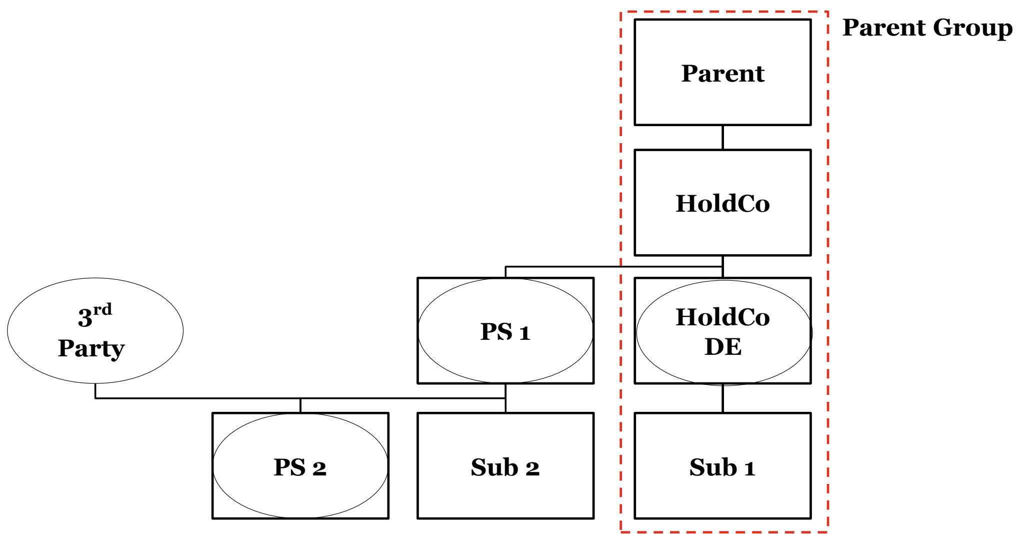
The PLR concluded that the distribution of Sub 1's interest in PS 1 resulted in gain to Sub 1 under Section 311(b) and a termination of PS 1 under Section 708(b)(1)(A). Following the distribution, Holdco owned 100 percent of the interests in PS 1. The IRS applied the principles in Rev. Rul. 99-6, stating that Sub 1 will be treated as making a distribution of a partnership interest and will determine its items of gain or loss under Sections 311(b), 741, and 751. From Holdco's perspective, PS 1 will be deemed to make a liquidating distribution of its assets to Sub 1 and Holdco. Holdco is then treated as acquiring Sub 1's portion of the PS 1 assets, including PS 1's interest in Sub 2, in a taxable distribution.

Holdco's tax basis in such assets is equal to their fair market value under Section 301(d). For purposes of applying the matching rule in Reg. sec. 1.1502-13(c) to Sub 1's taxable distribution of the PS 1 interest, Holdco's corresponding items are the basis recovery items from the assets Holdco is treated as acquiring from Sub 1, including the PS 2 interest that Sub 1 is deemed to distribute to Holdco. The deemed transfer of Sub 1's share of the PS 2 interest is treated as an exchange for Section 743(b) purposes, and thus gives rise to a Section 743(b) adjustment at PS 2.

Further, Holdco will not include the amount of the distribution in its gross income to the extent there is a corresponding negative adjustment under Reg. sec. 1.1502-32 in the basis of Sub 1 stock.

The IRS determined that the Distribution will be an intercompany transaction under Reg. sec. 1.1502-13(b)(1) and thus, the income, gain, or loss in the transaction will be intercompany items and will be accounted for under the matching rule. Note: The PLR does not state that the successor asset rules under Reg. sec. 1.1502-13(j) apply.

Final Structure



Observations

Holdco's basis in the PS 1 assets acquired from Sub 1 (including PS 1's interest in PS 2) is equal to fair market value. These assets would not be considered 'successor assets' under Reg. sec. 1.1502-13(j)(1) because Holdco's tax basis in the assets is not determined by reference to Sub 1's basis. Nonetheless, it appears the IRS treated the assets that Holdco was treated as acquiring from Sub 1 under Rev. Rul. 99-6 principles like successor assets in order to conclude that Holdco succeeds to the intercompany items of Sub 1.

The conclusion in this PLR is consistent with two previous ruling requests, PLR 200334037 and PLR 2007370067, which reached the same conclusion in the context of an intercompany sale. However, none of these rulings specifically states that the successor asset rules apply. Thus, taxpayers may want to seek a PLR about application of the successor asset rule in the context of a taxable transfer of a partnership interest.

For additional information, please contact Pat Pellervo, Gretchen Van Brackle, or Olivia Ley.

Legislative update

H.R. 2788 – 'S Corporation Modernization Act of 2015'

Rep. David Reichert (R-WA) and Rep. Ron Kind (D-WI), both members of the House Ways and Means Committee, on June 16 introduced H.R. 2788, which would make a number of changes to Subchapter S rules. The bill would make permanent two provisions:

- The reduced recognition period (from 10 years to five years) for net recognized built-in gain; and
- The rule requiring a basis adjustment to stock of an S corporation making charitable contributions of property.

Both these provisions also were included in H.R. 636, 'America's Small Business Tax Relief Act of 2015,' which passed the House on February 13, 2015. The two provisions of current law would be extended for two years under S. 1946, 'The Tax Relief Extension Act of 2015,' approved July 17, 2015 by the Senate Finance Committee.

As introduced, H.R. 2788 would also include the following:

- Repeal of excessive passive investment income as a termination event;
- Increase in the passive income limitation from 25 percent of gross receipts from passive investment income to 60 percent;
- Allow nonresident aliens to be potential current beneficiaries of an electing small business trust (ESBT);
- Allow individual retirement accounts to be S corporation shareholders; and
- Allow ESBTs to claim expanded charitable tax deductions.

Observations

Overall, the changes in H.R. 2788 generally would be a welcome relaxation to some of the more stringent S corporation rules. Each of these provisions has a proposed effective date of January 1, 2015.

For additional information, please contact Horacio Sobol, Patrick Phillips, or Brandon Fleming.

IRS update

ECC 201530020

The IRS, in an email communication dated July 24, 2015, indicated that it supported the exam team's application of the anti-abuse rule in Reg. sec. 1.367(b)-10 to the facts at issue.

In general, Reg. sec 1.367(b)-10 sets forth rules related to certain triangular reorganizations where the acquiring corporation or the issuing corporation (or both) is a foreign corporation. The final regulations, which were issued on May 17, 2011, set forth an anti-abuse rule (Reg. sec. 1.367(b)-10(d)) to prevent transactions engaged in with a view to avoid the regulations. The regulations include an example indicating that if the acquiring corporation is 'created, organized, or funded' to avoid the application of Reg. sec. 1.367(b)-10 with respect to the E&P of a corporation related to the acquiring corporation or its parent, the E&P of the acquiring corporation will be adjusted to include the E&P of the related corporation.

Based on the limited information in the IRS email, it appears that a newly formed domestic subsidiary acquired a target corporation in exchange for stock of the parent corporation. The IRS stated in the email that the exam team intends to assert that the transaction was entered into with a view to avoid the purpose of Section 367, and that all US accumulated E&P, including those of the target corporation, would be taken into account with respect to the parent's deemed dividend.

Observations

In Notice 2014-32, the IRS announced its intent to revise Reg. sec 1.367(b)-10 and included guidance on the anti-abuse rule, stating that it believes the rule is being interpreted too narrowly and that the rule can apply to include the E&P of the target corporation. The email appears to reflect this intent and the example indicated in the Notice. The email is the first application of the anti-abuse rule, and taxpayers should be aware of its potential application by the IRS in such transactions.

For additional information, please contact Timothy Lohnes or Brandon Fleming.

IRS Priority Guidance Plan

The IRS recently released its 2015-2016 Priority Guidance Plan (the Plan), listing 277 guidance projects anticipated for the year ending June 2016.

The Plan formalizes previous comments made by IRS officials with respect to the requirements of a tax-free distribution of stock under Section 355. The guidance plan reiterates a plan to issue regulations under the active trade or business requirement under Section 355(b) and includes a new plan to issue guidance relating to the business purpose, prohibition on device, and active trade or business requirements.

Observations

With respect to the active trade or business requirement, this inclusion coincides with the IRS's stated desire to review the rules under Section 355(b), which was expressed at a meeting of the Washington DC Bar Association. In particular, the IRS appears concerned with the relative size of the active trade or business assets of the controlled corporation as compared with the rest of its assets. Under Rev. Rul. 73-44, there is no requirement of a specific percentage of active trade or business assets. However, the relative size of the active trade or business assets in the controlled corporation could be viewed by the IRS as an indicator of concerns with the business purpose of the transaction and the whether the transaction was used as a device to distribute E&P.

For additional information, please contact Derek Cain, Bruce Decker, or Brandon Fleming.

Let's talk

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

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

Karen Lohnes, *Washington, DC*
+1 (202) 414-1759
karen.lohnes@us.pwc.com

David Friedel, *Washington, DC*
+1 (202) 414-1606
david.b.friedel@us.pwc.com

Henry Miyares, *Washington, DC*
+1 (202) 312-7595
henry.miyares@us.pwc.com

Derek Cain, *Washington, DC*
+1 (202) 414-1016
derek.cain@us.pwc.com

Pat Pellervo, *Washington, DC*
+1 (415) 498-6190
pat.pellervo@us.pwc.com

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

Robert Honigman, *Washington, DC*
+1 (202) 312-0696
robert.honigman@us.pwc.com

Horacio Sobol, *Washington, DC*
+1 (202) 312-7656
horacio.sobol@us.pwc.com

Richard McManus, *Washington, DC*
+1 (202) 414-1447
rich.mcmanus@us.pwc.com

Gretchen Van Brackle, *Washington, DC*
+1 (202) 414-4622
gretchen.vanbrackle@us.pwc.com

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

Bruce Decker, *Washington, DC*
+1 (202) 414-1306
bruce.a.decker@us.pwc.com

Olivia Ley, *Washington, DC*
+1 (202) 312-7699
olivia.ley@us.pwc.com

Meryl Yelen, *Washington, DC*
+1 (305) 978-6572
meryl.yelen@us.pwc.com

Patrick Phillips, *Washington, DC*
+1 (202) 414-1358
patrick.phillips@us.pwc.com

Sarah Hoyt, *Washington, DC*
+1 (202) 312-7509
sarah.k.hoyt@us.pwc.com

Brandon Fleming, *Washington, DC*
+1 (202) 346-5254
brandon.fleming@us.pwc.com