Legislative Developments
Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312

- Signed into law on December 17, 2010.
- The bill was enacted without any revenue offsets, as it was exempt from pay-go requirements because it was designated as emergency legislation.
- The enacted bill includes the following provisions:
  - Extends for two years (through 2012) all of the 2001 and 2003 individual income tax cuts.
  - Extends the current capital gains and dividend rates for all individual taxpayers for an additional two years (through 2012).
  - Provides a 2-percent reduction in payroll taxes for 2011.
  - Provides a one-year reauthorization of federal unemployment insurance benefits.
  - Extends individual alternative minimum tax relief for two years (through 2011).
  - Increases the estate tax exemption to $5 million and reduces the top rate to 35 percent for 2011 and 2012.
  - Extends bonus depreciation allowed for investments in new business equipment (through 2012).
  - Extends for one year the Section 1603 grants in lieu of credits program for renewable energy in the American Recovery and Reinvestment Act.
  - Reinstates for two years (through 2011) the section 41 research credit.
  - Extends for two years (through 2011) the active financing exception from Subpart F of the Code.
  - Extends for two years (through 2011) the current law look-through treatment of payments between related controlled foreign corporations.
Education Jobs and Medicaid Assistance Act, P.L. 111-226

- Signed into law on August 10, 2010.
- Revenue offsets in the bill include several changes to U.S. international tax rules, including:
  - Rules to prevent splitting foreign tax credits from income to which they relate,
  - Denial of foreign tax credit with respect to foreign income not subject to U.S. tax by reason of covered asset acquisitions,
  - Separate application of foreign tax credit limitation to items resourced under treaties,
  - Limitation on the amount of foreign taxes deemed paid with respect to section 956 inclusions,
  - Modification of affiliation rules for purposes of allocating interest expense,
  - Termination of special rules for interest and dividends received from persons meeting the 80-percent foreign business requirements, and
  - A special rule with respect to Section 304 deemed redemptions by foreign subsidiaries.
Section 304 Redemptions by Foreign Subsidiaries

Background – General Rules Under Section 304

- When Sub 2 purchases stock of Sub 1 from Parent, Section 304(a)(2) deems the cash received by Parent to be the proceeds of a redemption of the stock of Sub 1.
- Since Parent directly or indirectly owns 100% of the stock of Sub 1 both before and after the deemed redemption, the cash is essentially equivalent to a dividend under Section 302(d).
- Under Section 304(b), the dividend received by Parent is sourced first from the E&P of the acquiring corporation (Sub 2) and then from the E&P of the target corporation (Sub 1).
  - The portion of the deemed dividend sourced from the acquiring corporation (Sub 2) is considered to “hopscotch” over Sub 1 and be paid directly by Sub 2 to the transferor (Parent).
  - If Sub 2 is foreign, Section 304(b)(5)(A) limits the amount of its E&P deemed to be distributed to Parent to prevent a U.S. Parent from claiming excessive foreign tax credits.
Section 304 Redemptions by Foreign Subsidiaries

Using Section 304 to Avoid U.S. Tax on the Earnings of a Non-U.S. Subsidiary

- If Foreign Parent owns a U.S. corporation (U.S. Sub 1) that in turn owns a foreign subsidiary (Foreign Sub 2), the earnings of Foreign Sub 2 are generally subject to U.S. tax at two levels:
  - When the earnings are distributed as a dividend to U.S. Sub 1 they are subject to corporate income tax.
  - When U.S. Sub 1 distributes the earnings to Foreign Parent, a 30-percent withholding tax generally applies (absent a specific treaty provision).
- Under Section 304, if Foreign Parent sells stock in U.S. Sub 1 with no E&P to Foreign Sub 2 with lots of E&P, the cash received by Foreign Parent is generally treated as a dividend directly from Foreign Sub 2 to Foreign Parent.
  - This deemed dividend hopscotches directly from Foreign Sub 2 to Foreign Parent, thus bypassing U.S. Sub 1 and avoiding U.S. tax.
  - The deemed dividend also depletes the E&P of Foreign Sub 2 so it is not available to be taxed on a future distribution of cash from Foreign Sub 2 to U.S. Sub 1 (or under Section 1248 on a future sale by U.S. Sub 1 of its stock in Foreign Sub 2).
Section 304 Redemptions by Foreign Subsidiaries

New Section 304(b)(5)(B)

- New Section 304(b)(5)(B) eliminates this planning opportunity by generally preventing Foreign Sub 2’s E&P from being included in the deemed dividend to Foreign Parent. As a result, the deemed dividend would include only the E&P of the target corporation (U.S. Sub 1).
  
  - This makes more of U.S. Sub 1’s E&P available to be included in the deemed dividend to Foreign Parent, thereby increasing the potential for U.S. withholding tax to apply to the transaction.
  
  - It also preserves Foreign Sub 2’s E&P to be taxed in the U.S. on a future distribution of cash from Foreign Sub 2 to U.S. Sub 1 (or under Section 1248 on a future sale by U.S. Sub 1 of its stock in Foreign Sub 2).

- Section 304(b)(5)(B) applies to a Section 304 acquisition by a foreign corporation unless 50% or more of the deemed dividend would be either (i) subject to current taxation in the U.S. or (ii) includable in the E&P of a CFC.

- Regulations are anticipated to provide a rule that would prevent the avoidance of this provision through the use of partnerships, options, or other arrangements to cause a foreign corporation to be treated as a CFC.

- This provision applies to acquisitions after August 10, 2010.
Administration’s Fiscal Year 2012 Revenue Proposals

- Repeal “boot-within-gain” limitation
- Repeal “nonqualified preferred stock” provision
- Tax carried interests as ordinary income
Repeal of Boot-Within-Gain Limitation

Current Law

• In general, gain or loss is not recognized with respect to exchanges of stock and securities in corporate reorganizations.

• Under section 356, a recipient of money or other property ("boot") in a tax-free reorganization recognizes gain (if any) on the transaction in an amount not in excess of the sum of such money and the fair market value of such other property.
  – Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder’s ratable share of the corporation’s E&P.
  – The remainder of the gain (if any) is treated as gain from the exchange of property.

• Accordingly, if a shareholder receives boot in connection with a corporate reorganization, the amount that the shareholder is required to recognize as income is limited to the amount of gain realized in the exchange (i.e., the boot-within-gain limitation).
  – This rule applies regardless of whether the property received would otherwise be considered to be a dividend for tax purposes.
Repeal of Boot-Within-Gain Limitation

Example of Perceived Abuse

- In cross-border transactions, U.S. shareholders can utilize the boot-within-gain limitation to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences.
- The above transaction should be treated as a valid “D” reorganization. See Treas. Reg. § 1.368-2(l).
  - U.S. Parent will recognize gain under Section 356 on the lesser of (i) the cash it receives in the liquidation of CFC1 and (ii) its gain in its CFC1 stock.
  - If U.S. Parent’s stock in CFC1 has little or no built-in gain, U.S. Parent will recognize little or no gain.
    - This is the result regardless of whether the boot is potentially taxable as a dividend or as capital gain under Section 356.
    - This is the result even if CFC2 has previously untaxed earnings and profits equal to or greater than the boot.
Repeal of Boot-Within-Gain Limitation

Proposal

• The proposal would repeal the boot-within-gain limitation in the case of any reorganization transaction (domestic or cross-border) if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2).
  – The amount of money or other property distributed would generally be treated as a dividend to the extent of the corporation’s E&P.

• The proposal would be effective for taxable years beginning after December 31, 2011.
Repeal of Nonqualified Preferred Stock Provision

Current Law

• In 1997, Congress added section 351(g), which treats nonqualified preferred stock as taxable “boot” in corporate organizations and in certain shareholder exchanges relating to a corporate reorganization.
  
  – Nonqualified preferred stock is stock that (i) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (ii) has a dividend rate that varies with reference to an index, or, in certain circumstances, a put right, a call right, or a mandatory redemption feature.

Proposal

• According to Treasury’s explanation of the Administration’s proposal, nonqualified preferred stock has become “a staple of affirmative corporate tax planning” due to its hybrid nature.
  
  – Treasury states that the issuance of nonqualified preferred stock often occurs in loss-recognition planning, where nonqualified preferred stock is treated as debt-like boot, or to avoid the application of a provision that treats a related-party stock sale as a dividend.

• The proposal would repeal section 351(g) and other cross-referencing provisions that treat nonqualified preferred stock as boot.

• The proposal would be effective for stock issued after December 31, 2011.
Facts: T merges into P. In connection with the merger, T’s shareholders receive $60 cash and $40 of P nonqualified preferred stock in exchange for their T stock.

Result: Can there be a tax-free reorganization? What is the result for T’s shareholders?
**Facts:** P merges into T. In connection with the merger, T’s shareholders exchange their T common stock for $60 cash and $40 of T nonqualified preferred stock. P’s shareholders exchange their P common stock for T common stock.

**Result:** Can there be a tax-free reorganization? What is the result for T’s shareholders?
Carried Interest Proposal

Current Law

- Partners who receive partnership interests in exchange for services may receive interests in future partnership profits, i.e., a “profits” or “carried” interest.
  - A partnership is not subject to federal income tax, and an item of income or loss of the partnership retains its character and flows through to the partners, who include the item on their tax returns.
  - Consequently, to the extent a partnership recognizes long-term capital gain, partners who provide services reflect their shares of such gain as long-term capital gain.

- Allowing service partners to receive capital gains treatment is viewed by some policymakers as creating an unfair and inefficient tax preference.
  - The increased activity among large private equity firms and hedge funds has increased the cost of this preference.
  - Thus, a service provider’s share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because the income is derived from the performance of services.
Carried Interest Proposal

Proposal

• The proposal would tax as ordinary income a partner’s share of income on an “investment services partnership interest” (ISPI) in an investment partnership, regardless of the character of the income at the partnership level.
  – Gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not capital gain.
• Under the proposal, an ISPI is defined as a carried interest in an investment partnership that is held by a person who provides services to the partnership.
  – A partnership is an investment partnership if the majority of its assets are investment-type assets, but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property held for the production of income.
• To the extent that a partner who holds an ISPI contributes “invested capital” and the partnership reasonably allocates its income and loss between such invested capital and the remaining interest, income attributable to the invested capital would not be recharacterized.
  – A similar rule would apply to the portion of any gain recognized on the sale of an ISPI that is attributable to the invested capital.
  – “Invested capital” is defined as money or other property contributed to the partnership, although contributed capital that is attributable to the proceeds of any loan or other advance made or guaranteed by any partner or the partnership is not treated as invested capital.
• The proposal also includes an anti-abuse rule that applies to any person who performs services for an entity and holds a “disqualified interest.”
  – A “disqualified interest” is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest or stock in certain taxable corporations).
  – If the anti-abuse rule applies, the person is subject to ordinary income tax rates on any income or gain received with respect to the interest.
• The proposal would be effective for taxable years beginning after December 31, 2011.
Carried Interest Proposal

Proposal

• The Administration’s carried interest proposal appears to take an approach similar to recent congressional proposals but with an additional requirement aimed at some of the overbreadth issues in those proposals.
  – Recent carried interest proposals in Congress had the potential to capture corporate joint ventures, including joint ventures that involved operating businesses. See, e.g., Job Creation and Tax Cuts Act of 2010, S. 3793.

• The additional requirement in the Administration’s budget proposal is that, in order for a partnership to constitute an "investment partnership," over half of the partnership's contributed capital must be from partners in whose hands the partnership interests constitute property held for the production of income (i.e., held as an investment asset rather than as a trade or business asset).
  – However, it is not entirely clear what this additional requirement adds.

• Presumably, this additional requirement is intended to exclude from carried interest treatment interests in partnerships conducting a trade or business (as opposed to investment management operations).
  – This may exclude corporate joint ventures involving operating businesses.
  – However, it seems the additional requirement would not exclude corporate joint ventures involving investment activities.
Carried Interest Proposal –
Job Creation and Tax Cuts Act of 2010

Proposal

• The bill would have enacted new section 710, which is generally intended to treat net income from an investment services partnership interest (“ISPI”) as ordinary income, regardless of the character of the income at the partnership level, except to the extent it is attributable to a return on invested capital.

• An ISPI is a partnership interest held by any person if it was reasonably expected (at the time the person acquired the partnership interest) that the person would provide, or already has provided, a substantial quantity of certain services with respect to specified assets held by the partnership.
  – Such services include (i) advising as to the advisability of investing in, purchasing, or selling any specified asset, (ii) managing, acquiring, or disposing of any specified asset, (iii) arranging financing with respect to acquiring specified assets, and (iv) any activity in support of any of the foregoing services.
  – For this purpose, specified assets include (i) securities, (ii) real estate held for rental or investment, (iii) interests in partnerships, (iv) commodities, or (v) options or derivative contracts with respect to such securities, real estate, partnership interests, or commodities.

• The provision provides a narrow exception for items of income, gain, loss, and deduction that are allocated to the portion of an ISPI that is a qualified capital interest.
  – This exception is intended to apply to capital invested in the partnership by the service provider if the investment is made on the same terms as investments of capital by partners not providing services.
  – The exception for qualified capital interests is only applicable if:
    • (i) items are allocated to the service providing partner’s qualified capital interest in the same manner as the items are allocated to other qualified capital interests of partners that do not provide any of the identified investment management services and that are not related to the service-providing partner, and
    • (ii) the allocations made to the qualified capital interests of unrelated nonservice providing partners are significant compared to the allocations made to the service partner’s qualified capital interest.
  – An additional, but equally narrow, exception is contained in the most recent Senate amendment if all distributions and allocations of a partnership are made pro rata based on capital.
Carried Interest Proposal –
Job Creation and Tax Cuts Act of 2010
Proposal (cont’d)

• The operative rules of section 710 extend beyond the recharacterization of income as ordinary.
  – Gain on the disposition of an ISPI is treated as ordinary income and is generally recognized notwithstanding any other non-recognition provision provided in the Code.
  – Ordinary income is generally triggered on the distribution of property to a holder of an ISPI.
  – Although losses would be ordinary to the extent of aggregate net income, losses in excess of such income would be deferred until a future allocation of income (or a sale or redemption of the ISPI).

• Some of the rules applicable to ISPIs can also apply if (i) a person performs investment management services for any entity in which such person holds a disqualified interest, and (ii) the value of the interest is substantially related to the amount of income or gain from the assets with respect to which the investment management services are performed.
  – A disqualified interest means (i) any interest in such entity other than indebtedness, (ii) convertible or contingent debt of such entity, (iii) any option or other right to acquire property described above, and (iv) any derivative instrument entered into with such entity or any investor in such entity.
  – A disqualified interest generally does not include a partnership interest or an interest in a corporation.

• With respect to individual taxpayers, the general rule recharacterizing income and loss as ordinary applies only to the applicable percentage of the net income or net loss.
  – Under the most recent House-passed bill, the applicable percentage would initially be 50 percent, but would increase to 75 percent for taxable years beginning after December 31, 2012.
  – Under the most recent Senate amendment, the applicable percentage would be 75 percent. However, the applicable percentage is reduced to 50 percent for carried interests that are attributable to the sale of assets held for 5 or more years.

• The provision provides the Secretary with authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of new section 710.

• The provision was estimated to raise $13.594 billion over 10 years.
Analysis of Carried Interest Proposal in Job Creation and Tax Cuts Act of 2010

• Proposal would apply beyond the classic “carry” business structure
  • Does not require managing other people’s money
  • Not just to individuals
  • Corporations and partnerships
  • Across all industries
• Expansive application results from:
  • Broad definition of ISPI
  • Narrow exception for Qualified Capital Interests (QCIs)
  • Inclusion of Disqualified Interests
Investment Services Partnership Interest (ISPI)

• Definition: any interest in a partnership which is held (directly or indirectly) by any person if it was reasonably expected (at the time that such person acquired such interest) that such person (or any person related to such person) would provide (directly or indirectly) a substantial quantity of any listed services with respect to the assets held by the partnership.
Definition of ISPI is broad

• “Specified assets”
  – Securities, including stock, certain partnership interests, notes, bonds, other debts
  – Real estate held for rental or investment
  – Partnership interests
  – Commodities
  – Options
  – Derivative contracts
  – No de minimis rule for size of holdings

• “Listed services”
  – Advising on purchasing or selling specified assets
  – Managing, acquiring, or disposing of specified assets
  – Arranging financing regarding specified assets
  – Reasonably expected that services would be provided at the time partnership interest is acquired
  – Change in services provided can cause an interest to become an ISPI

• Performance of a “substantial quantity” of listed services
  – Services can be provided directly with respect to specified assets or indirectly with respect to operating businesses of entities owned by such partnership
Potential ISPIs in ordinary course business structures

- Non-service providers
  - Services of related persons taint non-service providers
  - A partnership solely among members that holds a specified asset if any related party provides a substantial quantity of listed services

- Tiered structures
  - Lower-tier partnership (LTP) treated as a specified asset (of the upper-tier partnership) even if LTP holds no specified assets
  - Subsidiary stock treated as a specified asset

- Partners of operating joint ventures

- Certain corporate structures with no partnerships
Tiered structure

- P, S1 and S2 are members of a consolidated group
- PRS’s only asset is the stock of OpCo
- OpCo is a manufacturing company
- All the officers and directors in OpCo are also the officers and directors of PRS, S1 and S2
Partners of operating joint ventures

- Corp A and Corp B enter into an arrangement to jointly develop technology which is treated as a partnership for federal tax purposes
- Corp A and Corp B will both be involved in managing the operation of the PRS business
Qualified capital interest (QCI) exception is narrow

- QCI - generally the portion of an ISPI attributable to cash and property contributions and undistributed net income/gain allocations
- QCI is not always usable
  - Applies only if allocations attributable to the ISPI holder’s QCI are made in the same manner as allocations to other QCI partners:
    - Who do not provide any services
    - Who are not related to the ISPI holder and
    - Whose allocations are significant relative to the allocations made to the ISPI holder’s QCI
- An ISPI is not a QCI if the ISPI holder’s capital interest is acquired with proceeds from a loan made, or guaranteed, by another partner or the partnership (or a person related to another partner or the partnership)
QCI Exception – No help without a non-service provider

- Corp A and Corp B enter into an arrangement to jointly develop technology which is treated as a partnership for federal tax purposes
- Corp A and Corp B will both be involved in managing the operation of the PRS business
QCI Exception – No help for controlled group partnership

- S2 is involved in managing the OpCo business
Consequences relevant to corporations

- Limits allowable net losses to the extent of post-enactment net income
- Most “nonrecognition” transfers are taxed
  - Includes pre-enactment appreciation
  - Limited exception available for transfers to partnerships, and partnership mergers, divisions and technical terminations
- Recharacterizes certain amounts of non-ordinary items as ordinary items
- Significant penalties for “avoidance” transactions
Loss limitation / suspension

- P, S1 and S2 are members of a consolidated group
- Assume S1’s and S2’s interests in PRS are ISPIs
- For the year ending 12/31/2010 PRS has $200 of loss
Nonrecognition transfers are taxed
Section 351 transfers

- S2 contributes its PRS interest to Newco in a transaction qualifying under Section 351
- At the time of the contribution the fair market value of S2’s interest in PRS exceeds its basis
“Tax-free” acquisition of target

- T merges into P with P surviving
- At the time of the merger, the FMV of T’s interest in PRS exceeds its basis therein
Codification of Economic Substance
Economic Substance Codification

- On March 30, 2010, the Health Care and Education Reconciliation Act of 2010, H.R. 4872 (the “Health Care Reconciliation Act”) was signed by President Obama.
  - Section 1409 of the Health Care Reconciliation Act “codified” the economic substance doctrine (the “ES doctrine”).
  - The statute adds new subsection 7701(o), “Clarification of Economic Substance Doctrine.”
  - The statute provides for a strict liability penalty for transactions that lack ES.
- The statute generally applies to transactions entered into after the date of enactment. See section 1409(e) of the Health Care Reconciliation Act.
Economic Substance Codification

- The Health Care Reconciliation Act does not as a technical matter codify the ES doctrine but rather codifies standards for the ES doctrine, if the doctrine is first determined to be “relevant.” Further, the provision imposes penalties, which is a critical feature of the enactment.

- The codification ultimately results from a combination of influences: (1) it carries a $4.5B revenue estimate (over 10 years) and so was used to help offset the cost of the health care bill, of which it was a part; (2) eliminates differences among courts in applying the ES standard; (3) politically it is viewed as part of a crack down on abusive taxpayers; and (4) it was a political football, first in favor during the last days of the Clinton administration, then out of favor during the Bush administration, then Senator Obama co-sponsored one of the earlier bills in 2007, then it passed during the Obama administration, after having been included in the President’s 2010 Budget proposal.


- The JCT explanation was continuously refashioned as various bills were introduced, ultimately resulting in JCX-18-10 (3/21/2010), with the final bill; see also H. Rep. No. 111-443 (3/17/2010) (describing a prior version of the ES provision, and less detailed, but containing a “reasons for change” section).
Economic Substance Codification

The JCT 9/09 Description stated the goals of codification as follows:

• provide partial certainty by resolving the lack of uniformity in different judicial versions of the tests;

• possibly lead to more IRS success in asserting ES doctrine by overruling courts that require taxpayers to satisfy only one “prong” of test;

• increase level of profit and business purpose required relative to some tests stated by courts;

• not change the “existing judicial framework” under which applicability of ES doctrine is determined;

• no intent to modify the application or development of other interpretive rules or prevent the IRS from proceeding on multiple grounds;

• change taxpayers’ cost-benefit analysis and deter some aggressive taxpayer behavior; and

• not displace the common law ES doctrine in cases to which the statute is inapplicable (such as individual non business/investment activities).
Economic Substance Codification

• The statute does not contain certain provisions that were included in prior versions:
  – A statement that other common law doctrines are not affected by codification of the ES doctrine,
  – A grant of general authority to issue regulations to carry out the purposes of the codified ES doctrine,
  – A revision of the penalty rules for certain large and publicly-traded corporations,
  – A prerequisite that a court determine that the ES doctrine is relevant, and
  – A requirement that IRS Chief Counsel assert the strict-liability penalty (which applied to understatements rather than underpayments).
Economic Substance – Section 7701(o)
New Section 7701(o)

(o) CLARIFICATION OF ECONOMIC SUBSTANCE DOCTRINE.—

(1) APPLICATION OF DOCTRINE.—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

(2) SPECIAL RULE WHERE TAXPAYER RELIES ON PROFIT POTENTIAL.—

(A) IN GENERAL.—The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs (A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

(B) TREATMENT OF FEES AND FOREIGN TAXES.— Fees and other transaction expenses shall be taken into account as expenses in determining pre-tax profit under subparagraph (A). The Secretary shall issue regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases.
(3) STATE AND LOCAL TAX BENEFITS.—For purposes of paragraph (1), any State or local income tax effect which is related to a Federal income tax effect shall be treated in the same manner as a Federal income tax effect.

(4) FINANCIAL ACCOUNTING BENEFITS.—For purposes of paragraph (1)(B), achieving a financial accounting benefit shall not be taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax.

(5) DEFINITIONS AND SPECIAL RULES.—For purposes of this subsection—

   (A) ECONOMIC SUBSTANCE DOCTRINE.— The term ‘economic substance doctrine’ means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

   (B) EXCEPTION FOR PERSONAL TRANSACTIONS OF INDIVIDUALS.—In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

   (C) DETERMINATION OF APPLICATION OF DOCTRINE NOT AFFECTED.—The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

   (D) TRANSACTION.—The term ‘transaction’ includes a series of transactions.
Notice 2010-62
Notice 2010-62

• On September 13, 2010, the IRS issued Notice 2010-62, which provides interim guidance under section 7701(o).

IRS Position on Section 7701(o) Guidance
• Notwithstanding concerns regarding the need for guidance on section 7701(o), the IRS and Treasury “do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.”
• Further, the IRS will not issue a private letter ruling or determination letter regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of section 7701(o).
• Notice 2010-62 provides that “the IRS will continue to analyze when the economic substance doctrine will apply in the same fashion as it did prior to the enactment of section 7701(o).”
  – Thus, according to the IRS, if authorities provided that the economic substance doctrine was not relevant to whether certain tax benefits were allowable prior to the enactment of section 7701(o), the IRS will continue to take the position that the economic substance doctrine is not relevant to whether those tax benefits are allowable.
• The IRS anticipates that the case law regarding the circumstances in which the economic substance doctrine is relevant will continue to develop, and states that the codification of the economic substance doctrine should not affect the ongoing development of authorities on this issue.

Application of Conjunctive Test
• In Notice 2010-62, the IRS states that it will continue to rely on relevant case law under the common-law economic substance doctrine in applying the two-prong conjunctive test in section 7701(o)(1).
• The IRS will challenge taxpayers who seek to rely on prior case law for the proposition that a transaction will be treated as having economic substance because it satisfies either prong of the two-prong test.
Reasonably Expected Pre-Tax Profit

- Under section 7701(o)(2)(A), a transaction’s profit potential is taken into account in determining whether the two-prong economic substance test is met if the present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected for tax purposes.
  - According to Notice 2010-62, the IRS will apply existing relevant case law and other published guidance in performing this calculation.
- The IRS and Treasury also intend to issue regulations pursuant to section 7701(o)(2)(B) on the treatment of foreign taxes as expenses in determining pre-tax profit in appropriate cases.
  - In the interim, the IRS notes in Notice 2010-62 that the enactment of section 7701(o) does not restrict the ability of courts to consider the appropriate treatment of foreign taxes in economic substance cases.

Accuracy-Related Penalties

- Notice 2010-62 provides details on what constitutes adequate disclosure under section 6662(i) for purposes of reducing the no-fault penalty from 40 to 20 percent.
- The disclosure will be considered adequate under section 6662(i) if made on a Form 8275 or 8275-R, or in a manner consistent with Rev. Proc. 94-69.
- If a transaction lacking economic substance is a reportable transaction, the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if (i) the taxpayer meets the disclosure requirements described above, and (ii) the disclosure requirements under the section 6011 regulations.
When Does the Doctrine Apply --
In General

• A number of considerations must be taken into account in applying the ES doctrine –
  – Whether the ES doctrine is relevant
    • Does the transaction tested satisfy the terms of the Code and Treasury regulations
    • Whether the benefits claimed are consistent with a Congressional purpose or plan
    • What step(s) of the transaction are to be tested
    • Whether any “safe harbors” can be applied
    • Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
    • Whether the transaction falls under the exception for individual transactions
  – How the IRS will audit transactions and assert the ES doctrine in light of codification
  – Where the burden of proof will fall on the taxpayers and the IRS
  – Whether it is the ES doctrine that may be relevant (as, for example, compared to other judicial doctrines)

• If the ES doctrine is determined to be relevant, then it must be decided whether the transaction satisfies the codified ES statute:
  – The taxpayer’s economic position must change in a meaningful way
  – The taxpayer must have a substantial non-tax purpose
When Does the Doctrine Apply -- In General

• Definition of ES doctrine
  – The statute defines the ES doctrine as the “common law doctrine” under which benefits “under subtitle A” are not allowable if the transaction does not have “economic substance or lacks a business purpose.” (emphasis added.) See section 7701(o)(5)(A).
  – What is the purpose of this definition? The statute says that the determination of whether the ES doctrine is relevant shall be made as if the statute was never enacted. See section 7701(o)(5)(C).
When Does the Doctrine Apply – Congressional Plan or Purpose

• The statute does not define when the doctrine will be treated as relevant.

• Statute and JCT report (JCX-18-10) states that “[t]he determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted.”
  – The JCT report further confirms that the provision “does not change present law standards in determining when to utilize an economic substance analysis.”

• Footnote 344 in the JCT report states that “[i]f the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed.” (emphasis added.)
  – JCT reports for prior versions of ES codification used the term “clearly consistent.”
  – In effect, the “safe harbor” defines the ES doctrine as applying to tax benefits that IRS perceives not to be consistent with purposes of the particular Code provision the taxpayer relies on for the tax benefits.
When Does the Doctrine Apply – Congressional Plan or Purpose

• What does being consistent with Congressional purpose or plan mean?
  – Congress may not use language that reflects its intent and purpose.
  – Without an explicit statement by Congress, its intent and purpose may be defined narrowly or broadly.
  – Will the IRS view all benefits that are “unintended” or even “not contemplated” by Congress to be inconsistent with Congressional purpose and intent and subject to the ES doctrine?
  – If a taxpayer satisfies the technical requirements of the Code and regulations, should the ES doctrine apply if no clear statutory purpose or plan is circumvented?

• How does the IRS agent determine the intent or plan?
  – Rev. Proc. 64-22, 1964-1 C.B. 689: “It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.”
  – “The proper method for conveying the positions of the Office and the policies of the Service is through published guidance. In contrast, litigation should be used as an enforcement tool to advance and defend established positions, not as a vehicle for making policy.” I.R.M. 31.1.1.1.3(1).
When Does the Doctrine Apply — Congressional Plan or Purpose

Application of the ES doctrine to landmark cases won by taxpayers:

- **Cottage Savings Assn. v. Commissioner**, 499 U.S. 554 (1991): Overall transaction of mortgage pool interest swaps had no possible economic profit and no business purpose; motivated entirely by desire for tax benefit of loss recognition, and losses were not booked for accounting purposes. [may be an allowed “longstanding choice” discussed below]

- **Esmark, Inc. v. Commissioner**, 90 T.C. 171 (1988), aff’d 886 F.2d 1318 (7th Cir. 1989): Overall transaction had business purpose and economic effect, but arguably not the steps by which Mobil purchased Esmark stock from public, followed by stock’s redemption for stock of Vickers subsidiary of Esmark; not economically different from sale of Vickers by Esmark.

- **Chamberlin v. Commissioner**, 207 F.2d 462 (6th Cir. 1953): No business purpose to distribute preferred pro rata on common, with plan for preferred to be bought by friendly insurance company. Ruled for taxpayer; Congress had to change law (section 306).

- **United States v. Cumberland Public Service Co.**, 338 U.S. 451 (1950): Same overall business purpose as in **Gregory v. Helvering**, but no business purpose for step of distributing assets before their sale, allegedly by shareholders; no economic impact of steps on either corporation or shareholders other than tax reduction.

- **Frank Lyon v. United States**, 435 U.S. 561 (1978): Business purpose for Lyon’s seller/lessee (the bank) not to have borrowed the money and built its own building; alleged lease economically similar to that result; no economic savings but tax savings.

- **Gitlitz v. Commissioner**, 531 U.S. 206 (2001): Taxpayer allowed to deduct presumably real losses on account of phantom income providing basis; is this protected from ES doctrine simply because taxpayer and S corp. did not engage in any “transaction” that they could control in the year at issue? Should the timing of the discharge of indebtedness of the S corp in that year have been questioned?
When Does the Doctrine Apply - Certain Credits

- The JCT report (JCX-18-10) footnote 344 further provides that “it is not intended” that certain tax credits (e.g., section 42, 45, 45D, 47, and 48 credits) be disallowed in a transaction “pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.”
  - The footnote does not cite, but is similar to Rev. Rul. 79-300 (section 183 not applicable to low income housing partnership even though cannot make any money, but depends on tax benefit of losses).

- Does the structure of the investment or the taxpayer’s intent matter if an investment encouraged by Congress is made?

- Does the same standard for credits apply for deductions and other tax benefits?
When Does the Doctrine Apply – “Safe Harbors”

• According to the JCT report: “The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are:]

(1) the choice between capitalizing a business enterprise with debt or equity;

(2) a U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;

(3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and

(4) the choice to utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.”

• What does the choice between meaningful economic alternatives require?

• Will the IRS expand the list of “safe harbor” transactions?

• Noteworthy that these four “safe harbors” provide taxpayers with the ability to avoid or defer US tax.

• Often, these “safe harbors” may form part of a larger transaction that will (or will not) pass the two prong test in the codified ES statute.
When Does the Doctrine Apply – “Safe Harbors”

1. The choice between capitalizing a business enterprise with debt or equity --
   – The use of debt is the biggest “tax shelter” there is, due to the interest deduction; why is it excluded? What does this say about perceived Congressional view of debt? Will this be useful in future debt/equity disputes? Does it matter that the creditor is related (not according to later “safe harbor”)?
   – Note that the “safe harbor” applies to using debt to capitalize an entity rather than the use of debt in transactions that the IRS has viewed as “tax shelters” -- e.g., Knetsch; Rice’s Toyota; ACM.
   – What is a “business enterprise”? Is the term limited to entities or does it include sole proprietorship -- what if the undertaking being financed is an investment and not a business?
   – Does this “safe harbor” support the disaggregation approach since capitalizing a business enterprise may form part of an integrated transaction that passes the two prong test?

2. A U.S. person’s choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;
   – Once again, this “safe harbor” shows the ES doctrine dodging the 2nd biggest “tax shelter”: the ability to defer tax on foreign income.
   – Does this mean that the “reality” of foreign corporations will be unquestioned?
     • JCX-18-10 fn. 347 indicates Bollinger applies to prevent subsidiary from being parent’s agent except for specific cases.
When Does the Doctrine Apply – “Safe Harbors”

3. The choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;
   – How does this square with IRS position when it cites Caruth, 688 F. Supp. 1189, for “business purpose” requirement for section 351?
   – How about Mrs. Gregory, cited in footnote 348 in JCX-18-10?
   – JCX-18-10 justifies this “safe harbor” by fact that IRS Chief Counsel will not give comfort rulings on these transactions.
   – Does the “choice” for tax-free treatment include transactions structured to avoid such treatment?
   – Are the reasons for protecting reorganizations and organizations the same? Corporate reorganizations are subject to several case law and regulatory anti-abuse rules, and could be viewed as exempt from the economic substance doctrine for that reason. Conversely, a thin set of authority purports to require business purpose for section 351 exchanges and the Treas. Reg. § 1.701-2 anti-abuse rule applies to partnership formation.
   – What about Treas. Reg. § 1.1002-1 strict construction for nonrecognition rules?
4. The choice to “utilize a related-party entity in a transaction, provided that the arm’s length standard of section 482 and other applicable concepts are satisfied.”
   - Why are not all related party transactions particularly suspect?
     • This “safe harbor” appears inconsistent with Coltec analysis.
   - Is a related party partnership safer to use than a related party corporation?
   - Doesn’t section 482 rule for intangibles assume that arm’s length prices cannot be trusted between related parties?
   - Does ES doctrine defer totally to section 482?
   - Who determines whether the arm’s length standard and the applicable concepts are satisfied – the IRS, a court?
   - Footnote 349 in JCX-18-10 cites to National Carbide and Moline Properties and contrasts Aiken Industries (back-to-back loans); section 7701(l) and the conduit regulations; and Bollinger (losses imputed to shareholder from nominee corporation).
     • Are these examples of the “other applicable concepts” referred to in the footnote?
     • Note Reg. 1.881-3(a)(4) (being related is primary way to trigger conduit financing regs)
     • How about Gregory, Higgins v. Smith (sale of loss property to wholly-owned corporation), McWilliams (“indirect” sales of loss shares between related parties)?
When Does the Doctrine Apply -- Disaggregation

- The statute defines the “transaction” as including a series of transactions.
- The JCT report supports not only the aggregation of a series of steps but also a disaggregation of multiple steps to an isolated step.
- According to the JCT report: “The provision does not alter the court’s ability to aggregate, disaggregate, or otherwise recharacterize a transaction when applying the doctrine. For example, the provision reiterates the present-law ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow those tax-motivated benefits.”
  - The statute as enacted does not provide for a disaggregation approach.
  - Does the JCT report accurately summarize how courts have historically applied the ES doctrine?
    - If not, can the disaggregation approach be squared with the general principle that “present law standards” of applying the ES doctrine not be changed?
    - The IRS will likely assert a narrow definition of the transaction.
    - Will the IRS approach and legislative history lead courts to shift toward a disaggregate approach (i.e., will a court be more likely to disaggregate post-codification as compared to prior periods)?
    - See Sala v. United States, 613 F.3d 1249 (10th Cir. 2010) (only the portion of the transaction that gave rise to the loss should be evaluated for economic substance; this is the first appellate case after codification but did not refer to the statute).
If the ES Doctrine is Determined to be Relevant

The Two Prong Test --

The Objective Component

- The transaction must change the taxpayer’s economic position in a meaningful way (apart from Federal income tax effects). See section 7701(o)(1)(A).
- The taxpayer can rely on profit potential to satisfy the objective prong only if the “present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.” See section 7701(o)(2)(A).
  - Satisfaction of the substantial net profit standard in section 7701(o)(2)(A) does not ensure that objective component is met.
  - Note that can rely on profit potential if profit is “reasonably expected” but need to show “actual” economic change to satisfy the objective prong.
  - What else would a taxpayer be required to show? Can a taxpayer satisfy the prong without actual profit?
  - See Sala v. United States, 613 F.3d 1249 (10th Cir. 2010) (1:50 profit potential to tax savings not enough on relative basis; this is the first appellate case after codification but did not refer to the statute).
The Two Prong Test --
The Objective Component

- A taxpayer may rely on measures other than profit potential to establish that the objective prong is satisfied.
  - When would a taxpayer need to rely on an alternative measure to show meaningful change in economic position?
    - Examples given in JCS-3-09, but not in the final JCT explanation: financial transactions and reorganizations may not have quantifiable profit aims.
      - A tax free-reorganization should already fall within the “safe harbor” in the JCT report.
      - What about “financial transactions”? Wouldn’t this normally refer to straddles, hedges, notional principal contracts?
    - Transactions designed to claim tax credits may also present difficulties in proving a pre-tax profit.
      - Like tax-free reorganizations, however, these transactions may have another basis to avoid ES analysis (i.e., consistent with statutory intent and plan).
      - If necessary, how would a taxpayer show a meaningful change in economic position absent profit potential?
The Two Prong Test --
The Objective Component

- Reliance on pre-tax profit
  - How much profit is required?
    - There is no absolute minimum dollar amount of profit required.
    - However, a small amount of profit may not be treated as substantial in relation to the tax benefits claimed.
  - What does “reasonably expected” mean?
    - JCS-3-09, p. 45, indicates intended to be higher standard than “reasonable possibility,” used in Rice’s Toyota;
    - Note: “reasonable possibility” is too high a standard for section 183, which requires only “objective to make a profit”
  - How to calculate present value amounts?
    - What is the appropriate discount rate?
    - Can the taxpayer rely on its normal internal method?
  - What does it mean for net profit to be “substantial” relative to net Federal tax benefits?
    - Treas. Reg. § 1.170A-9(f) defines substantial as 1:3.
    - Notice 98-5 – 1:12 and ~ 1:8 deemed insubstantial.
    - Old “tax shelter” cases in 1980s – any amount of profit may be sufficient
    - Con Ed decided on relatively small profit.
The Two Prong Test --
The Objective Component

• Reliance on pre-tax profit (con’t)
  – Fees and transaction expenses must be counted in determining net pre tax profit. See section 7701(o)(2)(B).
    • Consistent with historic approach to ES doctrine.
  – Statute provides that the Secretary “shall” issue regulations to treat foreign taxes as expenses and transaction fees in “appropriate cases.”
    • Treatment of foreign taxes changed repeatedly during days up to codification: “shall be” treated as expenses, to no reference, to “shall” treat in appropriate cases.
    • JCT explanation (JCX-18-10) indicates belief that foreign taxes should be treated as expenses.
      – However, there is no clarity as to what the “appropriate cases” will be. Transactions described in Notice 98-5?
      – The “shall” delegation in the statute should not be treated as self-executing. But see footnote 357 in JCX-18-10.
  • Cf. Notice 98-5: proposed to deny foreign tax credits to transactions that were not entered into for profit and to deduct foreign taxes as an expense in that analysis; withdrawn by Notice 2004-19.
  • Contra Compaq and IES, which applied ES doctrine to pre-foreign tax profits.
    – Theory is that US taxes are not counted, and so neither should foreign taxes that are creditable.
The Two Prong Test --
The Subjective Component

- The taxpayer must have a substantial purpose (apart from Federal income tax effects) for entering into such transaction. See section 7701(o)(1)(B).
  - What was original purpose of this prong in the caselaw? (likely to protect transactions such as incorporation that could not logically be related to profit motive?) Has this purpose been lost?
  - Do courts treat the subjective prong as equal to the objective prong?
  - JCT viewed this as the “dominant issue” and an “absolute requirement.” JCT 9/09
- The taxpayer can rely on the substantial net profit standard to satisfy the subjective prong as well as the objective prong. See section 7701(o)(2)(A).
  - Can the two prongs be collapsed into a single prong? See Coltec Industries Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006); Consolidated Edison Co. v. United States, 90 Fed. Cl. 228 (2009).
  - Note that, as with the objective prong, the satisfaction of the substantial net profit standard technically does not ensure that the subjective prong is satisfied.
    - Is anything else needed to be shown?
  - If there is no substantial non-tax purpose for the transaction, but the transactions results in a substantial profit, is the subjective prong satisfied?
- Who is the taxpayer tested for subjective intent?
  - For example, a partner in a partnership should be the taxpayer. What if the activities or motive in question relate to the other partner or the partnership?
The Two Prong Test --
The Subjective Component

• What does “substantial” mean?
  • Compare Reg. section 1.701-2(a)(1), the partnership anti-abuse rule, requires a transaction be entered into for a substantial business purpose;
  • Cf. Reg. section 1.355-2(b)(1), which in effect requires a substantial business purpose for a spin-off: a “substantial part” business purpose is thought not to require either a primary or more than 50% purpose; 1/3 purpose seems sufficient.
  • Cf. Reg. section 1.355-2(b)(2), as to non Federal tax benefits.

• Financial accounting benefits derived from Federal income tax savings and state tax benefits that are related to the Federal tax benefits will not be accepted.
  – Accounting benefit concern derived from Enron usage of accounting profits attributable to additions to deferred tax asset account for future expected acquisition of depreciable property, for example.

• Closer to core business the better?
  – Compare Consolidated Edison Co. v. United States, 90 Fed. Cl. 228 (2009) (LIGO case won where property leased was used in same business Con Ed was in); Shell Petroleum, Inc. v. United States, 2008-2 USTC ¶ 50,422 (S.D. Tex 2008) (property sold was business property)
  – But section 7701(o) says nothing about usual course of business transactions.
  • Query: does not fact that Congress chose to make the test a profits test, and to allow it to satisfy both prongs indicate that Congress understands all businesses and investors intend to make money any way they can, and so there should be no “regular course of business” test? Cf. section 162.
ES Doctrine
Individual Exception

• The statute carves out transactions of individuals unless “entered into in connection with a trade or business or an activity engaged in for the production of income.”
  – As a technical matter, section 7701(o)(5)(B) only excludes “personal transactions” from the two prong test set forth in section 7701(o)(1).
  – Thus, the ES doctrine, as codified, technically can still apply to these transactions. What is the effect?

• The exception presumably would not cover transactions where there is an expectation of gross income (as in section 212)
  – Thus, section 212, the section 183 hobby loss rule, and ES doctrine can all apply to activity expected to produce gross income
  – Note that section 183 is much easier for taxpayer to prove out of than ES doctrine (need not even have reasonable expectation of profit)

• Does the exception cover transactions designed to reduce taxes?
  – Charitable contribution planning
  – Estate planning
Economic Substance – Strict Liability Penalty
Section 6662(b)(6) (20% accuracy-related penalty)

Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.

Section 6662(i) -- INCREASE IN PENALTY IN CASE OF NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTION

(1) IN GENERAL.—In the case of any portion of an underpayment which is attributable to one or more nondisclosed noneconomic substance transactions, subsection (a) shall be applied with respect to such portion by substituting ‘40 percent’ for ‘20 percent’.

(2) NONDISCLOSED NONECONOMIC SUBSTANCE TRANSACTIONS.—For purposes of this subsection, the term ‘nondisclosed noneconomic substance transaction’ means any portion of a transaction described in subsection (b)(6) with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return.

(3) SPECIAL RULE FOR AMENDED RETURNS.—In no event shall any amendment or supplement to a return of tax be taken into account for purposes of this subsection if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted by the Secretary regarding the examination of the return or such other date as is specified by the Secretary.
ES Codification -- Penalties

Section 6664(c)(2):

Paragraph (1) [reasonable cause exception for underpayments] shall not apply to any portion of an underpayment which is attributable to one or more transactions described in section 6662(b)(6).

Section 6664(d):

(2) EXCEPTION.—Paragraph (1) [reasonable cause exception for reportable transaction understatements] shall not apply to any portion of a reportable transaction understatement which is attributable to one or more transactions described in section 6662(b)(6)

Section 6676(c) (erroneous claim for refund penalty):

(c) NONECONOMIC SUBSTANCE TRANSACTIONS TREATED AS LACKING REASONABLE BASIS.—For purposes of this section, any excessive amount which is attributable to any transaction described in section 6662(b)(6) shall not be treated as having a reasonable basis.

Section 6662A(e)(2) (coordination of section 6662A penalty with 40% nondisclosed noneconomic substance transaction penalty)

This section [section 6662A] shall not apply to any portion of an understatement on which a penalty is imposed under section 6662 if the rate of the penalty is determined under subsections (h) or (i) of section 6662.
ES Codification -- Penalties

- The 20% penalty for noneconomic substance transaction applies to any underpayment attributable to the disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law.
  - What is “any similar rule of law”? Not defined in the statute.
  - See JCX-18-10, fn 359: “It is intended that the penalty would apply to a transaction the tax benefits of which are disallowed as a result of the application of the similar factors and analysis that is required under the provision for an economic substance analysis, even if a different term is used to describe the doctrine.”
  - Prior JCT reports did not contain this clarification.
  - Based on JCT report, a “similar rule of law” must mean the disallowance of tax benefits through application of the ES doctrine but not in name (e.g., where the court referred to the ES doctrine incorrectly (perhaps “sham transaction doctrine” or “business purpose doctrine”).
  - The phrase “similar rule of law” should not mean “sham transaction doctrine” or even lack of “economic substance,” when those terms actually refer to fact finding (for example, the business was not actually operated in the corporation), or if they refer to interpreting a requirement into the statute (“business purpose doctrine”) as in case of Gregory v. Helvering.
  - Beware of tendency of IRS to view all fact finding methods (step transaction doctrine, etc.) and interpretive methods as “similar rule of law.”
ES Codification -- Penalties

• 20% Strict Liability Penalty
  – An opinion from an outside tax advisor does not provide protection.

• Calculation of the Penalty
  – The strict liability penalty applies to the underpayment attributable to a disallowance of claimed tax benefits by reason of a transaction lacking economic substance.
    • What is the connection between the assessment and disallowance required? “But for” standard?
  – Prior versions of ES contained penalties based on understatement (i.e., under section 6662A).
  – The section 6662A penalty may apply to a non-ES transaction if it is a listed transaction or reportable transaction with significant purpose of tax avoidance or evasion. See section 6662A(b)(2).
    • The section 6662 penalty normally only applies to the excess of the substantive understatement over the reportable transaction understatement. See section 6662A(e)(1).
    • If the transaction is not disclosed and the 40% strict liability penalty applies, then the section 6662A penalty will not apply to that portion of the understatement. See section 6662A(e)(2)(B).
ES Codification -- Penalties

• Coordination with the fraud penalty
  – The strict liability penalty does not replace the fraud penalty (a 75% penalty on the underpayment). See section 6663.
  – The ES penalty will not apply to the extent the fraud penalty applies. See section 6662(b) (flush language)

• Coordination with the gross valuation misstatement penalty
  – Does the section 6662(h) gross valuation misstatement penalty apply in economic substance cases?

• Amended returns
  – Coordination with section 6676
    • The 20% strict liability penalty applies equally if the taxpayer claims benefits on an amended return.
    • Compare treatment of “tax shelters” – reasonable basis to avoid penalty on amended return but MLTN to reduce understatement under section 6662.
  – Cannot disclose a transaction to reduce the strict liability penalty to 20% after first contact.
    • Limitation applies even if examination has not raised the issue of ES.
  – What happens if a taxpayer files an amended return after first contact to claim no tax benefits?
ES Codification -- Penalties

• **40% penalty**
  – Reduced to 20% if taxpayer makes adequate disclosure on return or in statement attached to return.
  – This is same language as used in section 6664(d)(2)(A) with respect to reportable transactions.
  
  • Under section 6664(d)(2)(A), the relevant facts affecting the tax treatment of the item must be adequately disclosed in accordance with the regulations prescribed under section 6011.
  
  • The section 6011 regulations provide a form for disclosure of (a) the expected tax treatment and all potential tax benefits, (b) any tax result protection, and (c) describe the transaction in sufficient detail for the IRS to be able to understand the structure and identify the parties.

• **IRS assertion of the strict liability penalty**
  – Can the IRS assert the ES doctrine and not assert the strict liability penalty?
  
  • If so, can the IRS then assert the substantial understatement penalty?
  
  – Can the IRS abate the penalty proportionately to the abatement of the tax? No indication in the bill.
  
  – What is the last point at which IRS can assert the strict liability penalty? Does it inevitably follow assertion of the ES doctrine and not have to be separately assessed?
Economic Substance – LMSB Directive on Imposition of Penalty
LMSB Directive

- LMSB directive on penalty imposition
  - On September 14, 2010, the IRS Large and Mid Size Business Division issued a directive on the imposition of a penalty on a transaction lacking economic substance.
  - According to the directive, “[t]o ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.”
Economic Substance – Practice and Procedure
When Does the Doctrine Apply -- Practice and Procedure

- Does the IRS have to assert the doctrine?
  - The statute only states that the ES doctrine will apply when relevant.
  - Can a court apply the ES doctrine if the IRS does not raise the issue?
    - “If economic substance as such is not explicitly stated as one of the grounds for disallowance of tax benefits, the application of the companion penalty provisions may be in doubt.” JCS 9/09 at p. 47.
    - Will a court be likely to independently raise the ES doctrine given the strict liability penalty?
- What is the proper time to raise the doctrine?
  - Can the doctrine be raised for the first time in litigation? In appeals?
  - Is RAR expected to be the proper place for assertion of ES doctrine?
  - What legal consequences hinge on timely assertion?
    - Applicability vel non – will the doctrine apply?
      - The burden of proof shifts to IRS in Tax Court if the doctrine is raised after the petition is filed. See Tax Court Rule 142(a).
      - The ES doctrine or any similar rule of law must be asserted in order to apply the 40% penalty (even though a 20% penalty may be applied for a substantial understatement apart from a non-ES transaction).
When Does the Doctrine Apply -- Practice and Procedure

- How will the IRS administer the ES doctrine
  - What role will LMSB / Chief Counsel have in determinations as to whether tax benefits are (i) consistent with Congressional plan or purpose, (ii) respected under longstanding practice, or (iii) permitted under specified safe-harbors?
    - Should IRS exam make these decisions? Must these decisions be confirmed with LMSB / Chief Counsel?
    - Will LMSB / Chief Counsel provide guidelines to IRS exam?
  - Will taxpayers be able to obtain advance certainty on transactions?
    - There will be a strict liability penalty that cannot be avoided by obtaining opinions from counsel.
When Does the Doctrine Apply -- Practice and Procedure

- IRS guidance on ES doctrine
  - Definition of critical terms (e.g., substantial profit, calculation of pre-tax profit, substantial purpose)
  - Clarification of the scope of the ES doctrine –
    - Confirmation that deductions and other benefits treated as credits cited in JCT report
    - Expansion of the four “safe harbors” listed in the JCT report
    - List of general criteria that will not cause the ES doctrine to apply
    - Reliance on anti-abuse rules
      - Should the doctrine be applied when anti-abuse applies and ES doctrine not traditionally at issue?
When Does the Doctrine Apply -- Practice and Procedure

- How will the IRS audit transactions in practice under the ES doctrine?
  - Assert the doctrine any time the two prong test is viewed as failed
  - Assert the doctrine any time it is relevant

- Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed
  - Example: IRS auditor concludes transaction (a) resulted in favorable tax reporting; (b) did not have business purpose; (c) was not expected to make much money.
    - Isn’t that likely to be the end of the auditor’s analysis?
    - Isn’t the “relevance” issue likely to be skipped or assumed?
    - Once the deficiency is set up, what realistic opportunity will taxpayer have to prove satisfaction of law as written and prove facts as occurred, or to contest ES doctrine relevance short of court?
    - JCS 9/09 and 2007 S. Rep. say flunking 2 prong test not dispositive, but isn’t it likely to work out that way in practice?
When Does the Doctrine Apply -- Practice and Procedure

• Default Possibility # 1 -- Assert the doctrine any time the two prong test is viewed as failed (con’t)
  – In fact, courts do not necessarily determine that the taxpayer’s facts satisfy the law as written before applying the ES doctrine, nor do they spend much time analyzing the relevance of the ES doctrine.
  • *Country Pine Finance LLC v. Commissioner*, T.C. Memo. 2009-251 (CARDS case; analysis portion of opinion only involved application of ES doctrine, citing *Am. Elec. Power*)
  • Two recent BLISS cases analyze and decide only ES doctrine: *Palm Canyon*, T.C. Memo. 2009-228; *New Phoenix Sunrise Corp.*, 132 T.C. No. 9 (2009).

• Default Possibility # 2 -- Assert the doctrine any time it is relevant
  – Assuming the IRS agent will not tend to assert the ES doctrine unless the agent perceives a tax motivated transaction (which is not hard to perceive), is it likely as a practical matter that the dispute may be over once the “relevance” issue is resolved by the agent/LMSB?
    – IRS Chief Counsel cannot advise agent on the factual analysis specifically.
    – Chief Counsel, or LMSB, or agent, or Appeals determination of relevance will be determinative absent litigation?
  • Isn’t the threshold decision made by the agent to assert the ES doctrine likely to go unchanged absent litigation?
When Does the Doctrine Apply -- Practice and Procedure

• **Venue**
  – Does the choice of circuit matter?
    • The mechanics of the test have been standardized – e.g., conjunctive test.
    • Will judicial application of the codified statute lead to differences between circuits?
      – Will some courts be more reluctant to apply the doctrine given the strict liability penalties?
    • Different circuits treat economic substance as issue of fact or issue of law, which impacts the scope of appeal. See *Sala v. United States*, 613 F.3d 1249 (10th Cir. 2010) (question of law; citing contrary circuits).
  – Will taxpayers choose Tax Court to avoid paying heavy penalties first?
    • Note that, if not raising separate grounds to challenge the penalty, prepayment of the penalty may not be required. See *Shore v. United States*, 9 F.3d 1524 (Fed. Cir. 1993).
    • What grounds are there to challenge the penalty?
When Does the Doctrine Apply -- Practice and Procedure

**Burden of Proof**

- As to the “consistent with” purposes of the Code, this is a legal issue, not a factual issue.
- The IRS is asserting a rule contrary to statute and regulations and so should have some sort of burden to justify that.
- Will *Chevron* deference play a role in the application of the ES doctrine?
- Even if taxpayer has normal burden of proof as to the two prong test if ES doctrine is asserted, the taxpayer should not be tasked with any burden to counter the IRS’s assertion of the generally applicability of the ES doctrine, but rather the court should carry out its duty to determine the true meaning of the law.
Economic Substance Doctrine – Summary
The economic substance doctrine is the conflation of statutory interpretation and common law fact finding into a court-made rule of law that, regardless of whether a taxpayer meets all the requirements of the Code and all facts are developed applying relevant common law doctrines, the taxpayer will not prevail if the taxpayer cannot satisfy the subjective and objective standards applied by the courts

The codified ES doctrine requires that the ES doctrine be relevant

The legislative history identifies two exceptions to the application of the ES doctrine --
- Whether the benefits claimed are consistent with a Congressional purpose or plan
- Whether the transaction has been respected under longstanding judicial and administrative practice, based on meaningful economic alternatives based on comparative tax advantages
  - A safe-harbor may be available

Will the IRS adopt other approaches to determine when the ES doctrine is relevant
- Adopt a similar approach as under 355(e) regulations – general safe-harbor, specific safe-harbors, factors indicating plan / non-plan
  - What characteristics can be used –
    - Reliance on significantly detailed statute or regulations (e.g., consolidated return regs)
    - Anti-abuse rules that are relevant but satisfied (e.g., Treas. Reg. § 1.701-2; section 269)
    - Involving an area that has been well considered (e.g., election for taxable treatment)
    - Electivity permitted under the law (e.g., a section 332 liquidation, COBE regulations).

Early guidance from the IRS
- The IRS must issue early guidance to provide some certainty for taxpayers entering into transactions post-codification – Rev. Rul., Rev. Proc., Announcement
- The IRS will continue to issue private letter rulings on substantive issues in transactions
  - What level of confidence will these rulings provide for taxpayers on the risk of ES doctrine?
Recent Economic Substance Cases
**Facts:** Coltec, a publicly traded company with numerous subsidiaries, sold the stock of one of its businesses in 1996 and recognized a gain of approximately $240.9 million. Garlock, a subsidiary of Coltec, and its own subsidiary had both previously manufactured or distributed asbestos products and faced substantial asbestos-related litigation claims. Coltec caused another one of its subsidiaries, Garrison, to issue common stock and Class A stock to Coltec in exchange for approximately $14 million. In a separate transaction, Garrison issued common stock to Garlock that represented approximately a 6.6% interest in Garrison and assumed all liabilities incurred in connection with asbestos related claims against Garlock, as well as the managerial responsibility for handling such claims. In return, Garlock transferred the stock of its subsidiary, certain relevant records to the asbestos-related claims, and a promissory note (from one of its other subsidiaries) in the amount of $375 million. Garlock then sold its recently acquired Garrison stock to unrelated banks for $500,000. As a condition of sale, Coltec agreed to indemnify the banks against any veil-piercing claims for asbestos liabilities. On its 1996 tax return, Coltec’s consolidated group claimed a $378.7 million capital loss on the sale of Garrison stock, which equaled the difference between Garlock’s basis in the stock ($379.2 million) and the sale proceeds ($500,000).
• The Court of Federal Claims entered a decision after trial in favor of Coltec, upholding the capital loss claimed by Coltec from the contingent liability transaction at issue in this tax refund litigation. See *Coltec Industries, Inc. v. United States*, 63 Fed. Cl. 716 (2004).

• The Court of Federal Claims relied on the District Court analysis in *Black & Decker* (discussed below) to hold that the operation of the applicable code sections justified a capital loss.
  
  – The contribution of assets in exchange for stock and the assumption of the liabilities qualified as a nontaxable exchange under section 351.

  – Under section 358, the transferor received a basis in the stock equal to the basis of the assets contributed. Ordinarily, when a transferee in a section 351 exchange assumes liabilities of the transferor, the transferor’s basis in the transferee’s stock is reduced by the amount of the liabilities. However, under sections 358(d)(2) and 357(c)(3), if the satisfaction of the liabilities would have given rise to a deduction to the transferor, the assumption of such liabilities does not reduce basis. Because satisfaction of the liabilities assumed by the transferee would have given rise to a deduction to the transferors (had the liabilities not been transferred), the basis of the stock is not reduced by the liabilities assumed under section 358(d)(2). After the transfer, payment of the liabilities would give rise to a deduction by the transferee. See Rev. Rul. 95-74, 1995-2 C.B. 36 (1995). The government argued that section 357(c)(3) requires that payment of the liabilities would give rise to a deduction by the *transferor*. The court held that this interpretation was incorrect.

  – In addition, the court held that section 357(b) did not require basis to be reduced because there was a bona fide business purpose for the assumption of the liabilities.
Coltec Decision – Court of Federal Claims

• The Court of Federal Claims rejected the government’s argument that the capital loss should nonetheless be disallowed under the economic substance doctrine.

• The court refused to apply the economic substance doctrine to the transaction because the transaction satisfied the statutory requirements of the Code. The court stated: “[I]t is Congress, not the court, that should determine how the federal tax laws should be used to promote economic welfare…. Where the taxpayer has satisfied all statutory requirements established by Congress, as Coltec did in this case, the use of the ‘economic substance’ doctrine to trump ‘mere compliance with the Code’ would violate the separation of powers.”
Coltec on Appeal – Federal Circuit

- The Federal Circuit (Judges Bryson, Gajarsa and Dyk) reversed the opinion of the Court of Federal Claims and held that the taxpayer was not entitled to a capital loss because the assumption of the contingent liabilities in exchange for the note lacked economic substance. See *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

- The Federal Circuit upheld the technical analysis of the Court of Federal Claims in favor of the taxpayer.

- The court concluded that section 357(c)(3) applies because payment of the liability would give rise to a deduction. The court stated that the government’s interpretation that the liabilities must be transferred with the underlying business was plainly inconsistent with the statute.

- The court concluded that if a liability was excluded by section 357(c)(3), then section 357(b)(1) was not relevant. The court reasoned that the exception in section 358(d)(2) for liabilities excluded under section 357(c)(3) does not contain any reference to section 357(b), nor does section 357(b) contain any reference to the basis provisions in section 358.
Coltec on Appeal – Federal Circuit

• However, the Federal Circuit reversed the Court of Federal Claims decision with respect to economic substance and held that the transfer of liabilities in exchange for the note should be disregarded.

• The Federal Circuit identified five (5) principles of economic substance.
  – The law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality;
  – It is the taxpayer that has the burden of proving economic substance;
  – The economic substance of a transaction must be viewed objectively rather than subjectively;
  – The transaction to be analyzed is the one that gave rise to the alleged tax benefit;
  – Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.
Coltec on Appeal – Federal Circuit

• In applying the economic substance test, the Federal Circuit focused solely on the transaction giving Coltec the high stock basis (i.e., the assumption of the liabilities in exchange for the note) and concluded that Coltec had not demonstrated any business purpose for that transaction.

• The court rejected Coltec’s claim that it would strengthen its position against potential veil-piercing claims, since it only affected relations among Coltec and its own subsidiaries and had no effect on third parties.
Coltec Certiorari Petition

• Coltec filed a petition requesting certiorari with the Supreme Court.

• One of the two questions presented for review in the cert petition relates to the disjunctive vs. conjunctive nature of the economic substance test and the current circuit split.
  – The cert petition stated the question as follows: "Where a taxpayer made a good-faith business judgment that the transaction served its economic interests, and would have executed the transaction regardless of tax benefits, did the court of appeals (in acknowledged conflict with the rule of other circuits) properly deny the favorable tax treatment afforded by the Internal Revenue Code to the transaction based solely on the court’s "objective" conclusion that a narrow part of the transaction lacked economic benefits for the taxpayer?"

• The other question presented for review in the cert petition relates to the standard of review in economic substance cases.
  – The cert petition stated the question as follows: "In determining that a transaction may be disregarded for tax purposes, should a federal court of appeals review the trial court’s findings that the transaction had economic substance de novo (as three courts of appeals have held), or for clear error (as five courts of appeals have held)?"

• Dow Chemical Co. filed a cert petition on October 4, 2006 that presented similar questions.

• On February 16, 2007, the Supreme Court denied certiorari in Coltec and Dow Chemical.
**Heinz Transaction**

**Facts:** Between August 11, 1994, and November 15, 1994, H.J. Heinz Credit Company (“HCC”), a subsidiary of the H.J. Heinz Company (“Heinz”), purchased 3.5 million shares of Heinz common stock in the public market for $130 million. In January of 1995, HCC transferred 3.325 million of the 3.5 million shares to Heinz in exchange for a zero coupon convertible note issued by Heinz. In May of 1995, HCC sold the remaining 175,000 shares to AT&T Investment Management Corp. (“AT&T”), an unrelated party, for a discounted rate of $39.80 per share, or $6,966,120, in cash. As a result of this sale, HCC claimed a capital loss and carried this loss back to 1994, 1993, and 1992. The IRS disallowed Heinz’s claimed capital loss arguing, among other things, that the transaction lacked economic substance and a business purpose. Heinz paid the tax and filed a $42.6 million refund action with the Court of Federal Claims.
Heinz – Court of Federal Claims


- All parties agreed that HCC had a basis of $124 million in the 3.325 million shares that were transferred to Heinz.

- Heinz asserted that the redemption qualified as a redemption under section 317(b), that the redemption should be taxed as a dividend, and that HCC’s basis in the redeemed stock should be added to its basis in the 175,000 shares which it retained. Accordingly, Heinz claimed that, when HCC sold its remaining 175,000 shares, it should recognize a large capital loss. Heinz then claimed it was entitled to carry back HCC’s capital loss to reduce the consolidated group’s taxes in 1994, 1993 and 1992.

- The IRS asserted that the Heinz acquisition was not a redemption because: (i) Heinz did not exchange property for the stock within the meaning of section 317(b); (ii) the transaction lacked economic substance and had no bona fide business purpose other than to produce tax benefits; and (iii) under the “step transaction doctrine,” HCC’s purchase and exchange of the stock for the note should be viewed as a direct purchase of the stock by Heinz.
Heinz – Court of Federal Claims

• The Court of Federal Claims dismissed the IRS’s first argument that no redemption occurred, but held that the acquisition and redemption of Heinz shares lacked economic substance and that the step transaction doctrine applied.

• The court followed the economic substance analysis set forth Coltec in addressing the IRS’s second argument, quoting the following language from Coltec – “the transaction to be analyzed is the one that gave rise to the alleged tax benefit.”

• Accordingly, the court stated that transaction in question is the purchase of Heinz shares from the public and the subsequent redemption. The court did not analyze the entire transaction (including the disposition) when applying the economic substance doctrine.

• The court in Heinz held that the acquisition and subsequent redemption of Heinz shares lacked economic substance.
Heinz – Court of Federal Claims

• The Court of Federal Claims was not persuaded by the taxpayer’s assertion that HCC acquired the Heinz stock for non-tax, business purposes: as an investment and to add “substance” to HCC’s operations for state tax purposes.

• In the eyes of the court, the taxpayer’s claim of an investment purpose was undercut by the factual record, as evidenced by the following factors. First, the convertible notes were contemplated and, in fact, were in the process of being drafted well before HCC purchased the Heinz stock. Second, because the acquired stock was not registered, HCC purchased the stock at full price in the market and sold the Heinz stock at a deep discount. Third, the purpose of the stock purchase program – the funding of stock option programs – could not be achieved so long as HCC held the Heinz stock.

• The court also found the factual record to be inconsistent with the taxpayer’s second claim of business purpose, which was to bolster the taxpayer’s tax return position that HCC should be respected as a Delaware holding company. The court cited three factors in support of its position. First, the record did not suggest that the taxpayer was motivated by this non-tax purpose. Second, internal communications indicated that any tax return exposure could not be limited at the time of the stock acquisition or on a going forward basis. Third, the record indicated that, at the time of the stock acquisition, Heinz was considering eliminating HCC’s lending operations, which raised the very issue that the taxpayer sought to mitigate through the stock acquisition.

• The taxpayer has appealed to the Court of Appeals for the Federal Circuit.
**Jade Trading – Son-of-Boss Transaction**

**Facts:** In March 1999, three taxpayers sold their cable business and realized an aggregate $40.2 million capital gain. Each of the three taxpayers created a single-member LLC on September 17, 1999. On September 23, 1999, Jade Trading LLC was formed by Sentinel Advisors, LLC (“Sentinel”) and a foreign financial institution. [Sentinel pitched the transaction to BDO Seidman, which marketed the transaction.] On September 29, 1999, each of the three LLCs purchased offsetting currency options for net premium paid of $150,000 to AIG. For each LLC, the options purchased and sold had a premium of $15 million and $14.85 million, respectively. On October 6, 1999, the LLCs contributed their spread options and $75,000 cash to Jade Trading LLC (“Jade”), in exchange for membership interests. About 60 days after the contribution, the three LLCs exited Jade with each receiving euros and Xerox stock (with a market value of approximately $125,000) in exchange for their interests.
Jade Trading – Taxpayer’s Position

• Each taxpayer claimed that the LLCs’ basis in the interest in Jade was increased by the value of the option purchased ($15 million), but not decreased by the value of the options sold ($14.85 million). Accordingly, each taxpayer claimed a large capital loss upon exiting the partnership (approximately $14.9 million).

• The primary Code sections at issue in Jade Trading were section 752(b) and section 722.
  – Section 752(b) provides that a decrease in a partner’s liabilities by reason of a partnership’s assumption of those liabilities will be treated as a distribution of money to the partner by the partnership (with the effect of reducing the partner’s basis).
  – Under section 722, a partner’s basis acquired by a contribution of property, including money, is equal to the amount of money and basis of such property contributed.

• The taxpayers relied principally on Helmer v. Commissioner, T.C. Memo. 1975-60, which provided that a contingent obligation (such as an option) was not a liability for purposes of section 752.

• At the time of the transaction, the principle set forth in Helmer was good law.
  – The IRS subsequently issued temporary regulations on June 24, 2003, which would have treated the sold option as a liability for purposes of section 752. See Treas. Reg. § 1.752-6T.
  – The temporary regulations had retroactive effect to October 18, 1999 (the LLCs contributed the spread options on October 6, 1999).
  – The Preamble to the temporary regulations explicitly states that the regulations do not follow Helmer.
**Jade Trading – Court of Federal Claims**

- The Court of Federal Claims held that the transaction creating the basis increase lacked economic substance. See *Jade Trading, LLC v. United States*, 80 Fed. Cl. 11 (2007).
- The court found that basis increase claimed by each LLC satisfied the technical provisions of the Code.
- The court then analyzed the transaction under the economic substance doctrine.
  - The court stated that *Coltec* unequivocally reaffirmed the vitality of the economic substance doctrine in the Federal Circuit.
  - The court found that –
    1. The transaction lacked economic reality because (i) the losses claimed were not tied to any economic loss (i.e., the LLCs did not incur a $15 million loss) and (ii) the use of the partnership structure had no real economic purpose.
    2. The taxpayer had the burden of proving that the transaction had economic substance.
    3. The objective reality of the transaction was the relevant criterion rather than any subjective intent of the taxpayer.
    4. The transaction to be analyzed was the spread transaction that gave rise to the inflated basis (rather than any hypothetical transactions that could have occurred and/or any other trades).
      - The court found that there was no objective profit potential, because the maximum profit potential on the spread ($140,000) was exceeded by the high fees ($934,100).
      - The court also noted that transaction was marketed as a tax avoidance mechanism.
      - The court also noted that the options had to be viewed together rather than as two distinct legal entitlements because of the economic realities of the transaction.
    5. The transaction did not alter the economic interests of independent third parties (i.e., the other partners in Jade).
  - The court held that the transaction lacked economic substance on the basis of the above conclusions, which the court viewed as relevant based upon its interpretation of *Coltec*. 
Jade Trading - Court of Appeals for the Federal Circuit

• The U.S. Court of Appeals for the Federal Circuit affirmed the Court of Federal Claim’s finding that the contributions to the spread transactions to the Jade partnership lacked economic substance and should be disregarded for tax purposes. See Jade Trading, LLC v. United States, 598 F.3d 1372 (Fed. Cir. 2010).

• The court relied on the principles established in Coltec Indus., Inc. v. United States, 454 F.3d 1340 (Fed. Cir. 2006) for purposes of conducting its economic substance analysis.
  – The court agreed with the determinations made by the Court of Federal Claims, noting that the loss generated was “purely fictional,” the formation of the Jade partnership had no economic purpose, the spread transaction was virtually guaranteed to be unprofitable, and the transaction was developed as a tax avoidance scheme and not an investment strategy.
  – The court also rejected the argument that the contribution of the spread transactions to the Jade partnership had economic substance because the spread strategy options were separate assets with separate documentation that were owned by unrelated parties.
  – The court agreed with the finding by the Court of Federal Claims that the transactions could not be separated because they were totally dependent on one another from an economic and pragmatic standpoint.
**Sala v. United States**

- The District Court of Colorado recently held in favor of a taxpayer that entered into a transaction similar to the transaction described in *Jade Trading*. See *Sala v. United States*, 552 F. Supp. 2d 1167 (D.C. Co. 2008).

- The IRS has referred to the *Sala* decision as an “anomaly” in the government’s continued litigation of “Son-of-Boss” transactions.

- **Relevant Facts**
  - The taxpayer in *Sala* realized $60 million of income in 2000 in connection with the exercise of stock options.
  - In 2000, the taxpayer invested approximately $9 million in a foreign currency investment program (the “Deerhurst Program”).
  - In connection with the “Deerhurst Program,” the investment manager acquired long and short options on foreign currencies for a net cost of approximately $730,000.
  - On November 8, 2000, the taxpayer formed an S corporation as its sole shareholder (“Solid”). On November 28, 2000, the taxpayer transferred the long and short options and approximately $8 million of cash to Solid. On the same date, Solid transferred the options and cash to a general partnership (“Deerhurst GP”).
  - Deerhurst GP liquidated prior to December 31, 2000. In the liquidation, Solid received approximately $8 million in cash and two foreign currency contracts.
  - Solid subsequently sold the foreign currency contracts prior to December 31, 2000.
  - Solid reinvested the liquidation proceeds into Deerhurst LLC for a minimum of five years.
Sala v. United States

• Taxpayer Position

– Solid claimed a basis in Deerhurst GP equal to the value of the cash plus the long options, or approximately $69 million. See Helmer v. Commissioner, T.C. Memo 1975-60.

– Solid claimed a basis in the two foreign currency contracts received in liquidation of Deerhurst GP equal to its partnership basis (~ $69 million) less the cash received in liquidation (~ $8 million), or approximately $61 million.

– Upon the sale of the two foreign currency contracts, Solid claimed a loss equal to approximately $60 million.

– The taxpayer claimed the $60 million loss on its original 2000 tax return, but filed a subsequent amended return that did not claim the $60 million loss and paid tax, interest, and penalties of over $26 million in connection with the amended return. The taxpayer subsequently filed a second amended return that claimed the $60 million loss. The taxpayer sued in District Court to claim a tax refund on the basis of the second amended return.

• The Deerhurst Program

– The District Court found the facts of the Deerhurst Program particularly persuasive.

– In the program, investors place a minimum of $500,000 in an account for an initial trial period. The account was managed by Deerhurst Management Company, Inc., which was owned and operated by a well-known foreign currency trader.

– Investors that were interested in remaining in the Deerhurst Program were then required to place additional funds into the program equal to at least 15% of the expected tax loss (for the taxpayer, 15% of ~ $60 million, or ~ $9 million).

– If the account was profitable after the liquidation in late 2000, investors had to reinvest their liquidation proceeds in Deerhurst LLC for a minimum of five years or be subject to a withdrawal penalty.
The District Court made the following rulings with respect to the Deerhurst Program:

1. The transactions entered into in connection with the Deerhurst Program satisfied the sham transaction / economic substance standard --
   - The court refused to focus its inquiry on the “Son-of-Boss” aspect of the Deerhurst Program and considered the entire investment program.
   - The court found that taxpayer had a potential (albeit small) of obtaining an economic return in excess of the $60 million loss and that the taxpayer entered into the transaction for profit.
   - The court found that the transaction had a good faith business purpose other than tax avoidance, concluding that –
     - The taxpayer’s stated purpose of creating Solid to reduce liability exposure was a valid purpose;
     - The creation of Deerhurst GP had the valid purpose of investing in currency options and its liquidation had the valid purpose of “easier accounting and redistribution of the partnership assets”;
     - The investment “test period” in the Deerhurst Program had a valid purpose since it permitted taxpayers to gauge their interest in the program at little cost;
     - The fact that “digital options” were not purchased (that would not have created the large tax loss) was immaterial; and
     - The Deerhurst Program, as a whole, had a legitimate business purpose – a good faith and reasonable belief in profitability beyond mere tax benefits.
   - Compare *Klamath Strategic Inv. Fund, LLC v. United States*, 568 F.3d 537 (5th Cir. 2009) (held that the transaction did not have economic substance; court applied a conjunctive economic substance test)
Sala v. United States – District Court Decision

2. The tax loss was permitted under the Code and applicable regulations --
   – The basis obtained in Solid and Deerhurst GP was equal to the value of long options and contributed cash and was not decreased by liabilities associated with the short options.
   – The at-risk rules of section 465 and the loss limitation rule of section 1366(d) did not apply.
   – Each of the 24 options contributed to Solid and Deerhurst GP were separate financial instruments. Accordingly, offsetting options were not offset against each other for purposes of determining the “net” value of property contributed to Solid and Deerhurst GP.
   – The two foreign currency contracts received by Solid upon liquidation of Deerhurst GP constituted “property” within the meaning of section 732. As a result, Solid obtained a basis in such property equal to Solid’s basis in the partnership reduced by any money distributed.


4. The taxpayer filed a valid qualified amended return, and the IRS was not entitled to offset excess interest payments made by the taxpayer with an accuracy-related penalty.
Sala v. United States – Tenth Circuit Decision

• On appeal, the Tenth Circuit Court of Appeals reversed the district court’s decision. See Sala v. United States, 613 F.3d 1249 (10th Cir. 2010).
• The Court focused its economic substance analysis on Deerhurst GP, unlike the district court, which had reviewed the entire Deerhurst Program as a single transaction.
  – According to the Court, the Deerhurst GP phase could not be legitimized merely because it was on the “periphery of some legitimate transactions,” as a “loss-generating transaction must stand or fall on its own merit.”
• In setting out the applicable standard for its economic substance analysis, the Court noted that transactions lacking an appreciable effect aside from tax benefits will not be respected for tax purposes, that a transaction having some profit potential does not necessarily require the finding that a transaction has economic substance, and that tax benefits must be linked to actual losses.
• The Court determined that Sala’s participation in Deerhurst GP lacked economic substance, relying on the following findings:
  – The claimed loss generated by the program was structured from the outset to be a complete fiction and was designed primarily to create a reportable tax loss with little actual economic risk.
  – Deerhurst GP was designed to exist for only a short time, as its liquidation before the end of 2000 was pre-determined in order to generate a tax loss to offset Sala’s income.
  – The expected tax benefit of around $24 million dwarfed the potential gain from Sala’s participation in Deerhurst GP (projected to earn profits of $550,000 over the course of one year), making the economic realities of the transaction insignificant in relation to the tax benefits.
  – The court disregarded the business explanations for the various components of the Deerhurst GP stage, stating that any anticipated economic benefit from the brief participation in Deerhurst GP was negligible in comparison to the asserted tax benefit.
  – The district court’s finding that Sala entered into the Deerhurst Program primarily for profit did not alter the Court’s conclusion. The Court stated that the presence of an individual’s profit objective did not require it to recognize a transaction lacking economic substance. The Court also discounted the district court’s findings on this issue, as they were based on the Deerhurst Program as a whole.
**Countryside – Facts of Transaction**

**Facts:** W and C are individual partners in a partnership ("Countryside"). W possessed a 70% interest and C possessed a 25% interest in Countryside. Two other partners held the remaining interests. On or about September 18, 2000, W, acting as president of two separate corporations, formed two separate LLCs ("CLPP" and "MP"). On October 27, 2000, each of the corporations contributed cash to obtain a 1% interest in the LLCs. Countryside borrowed $8.5 million from a third-party bank. On October 30, 2000, Countryside contributed the cash to CLPP in exchange for a 99% interest and CLPP contributed the borrowed funds to MP for a 99% interest. On or about that day, MP borrowed an additional $3.4 million from the third-party bank. On or about October 31, 2000, MP used the borrowed proceeds to acquire four privately issued notes (the "AIG Notes") in the aggregate principal amount of $11.9 million. On December 26, 2000, Countryside distributed its 99-percent interest in CLPP to W and C in complete liquidation of their respective partnership interests. As a result of the distribution, both W and C were relieved of their share of Countryside’s liabilities, although each retained a share of MP’s liabilities. In April 2001, Countryside sold real property and used the sale proceeds to repay the $8.5 million obligation to the third-party bank. In 2003, the AIG Notes were redeemed from MP by AIG. In 2004, MP repaid the $3.4 million loan.
Countryside – Tax Issues

- The IRS issued a notice of final partnership administrative adjustment (the FPAA) on October 8, 2004. The FPAA contained the following adjustments –
  - The distribution in liquidation of W and C’s interest in Countryside constituted a taxable event resulting in a large capital gain,
  - A denial of Countrywide’s election to receive a basis step-up under section 734(b)(1)(B) for the property remaining after the liquidating distribution (including the real property sold in 2001), and
  - A basis reduction in the AIG Notes held by MP.
- W filed a partial motion for summary judgment in the Tax Court to resolve the first of the above issues raised by the IRS in the FPAA.
- The IRS argued that Countryside’s distribution of its 99% interest in CLPP constituted a distribution of marketable securities for purposes of section 731(a)(1) or, alternatively, it should be treated as such under the economic substance doctrine.
  - Section 731(a) provides that a partner does not recognize gain on a partnership distribution, except to the extent that money distributed (including “marketable securities”) exceeds the partner’s adjusted basis in the partnership.
  - If the distribution was treated as a distribution of money, then W and C would recognize substantial gain because both would have a low basis in their interests in Countryside (in part, because the relief of Countryside liabilities assumed by W and C would be treated as a distribution under section 752 that would reduce W and C’s outside basis).
  - Note that W and C claimed that the $3.4 million borrowing by MP increased their outside basis and thus offset potential gain on the liquidating distribution.
- The Tax Court decided this issue in favor of the taxpayer. See Countryside Limited Partners v. Commissioner, T.C. Memo. 2008-3.
Countryside – Economic Substance

• The Tax Court rejected that IRS argument that the distribution of the 99% interest in CLPP constituted a distribution of marketable securities under section 731(a)(1).

• The Tax Court also rejected the IRS argument that the economic substance doctrine should apply to treat the distribution as a distribution of money for purposes of section 731(a)(1).

• The crux of the IRS position was that W and C effectively permanently deferred the recognition of gain on their share of the sale proceeds Countryside received in the 2001 sale of real property.

• The IRS unsuccessfully argued that Countryside had no potential for profit in the transaction because of interest and transaction costs and, thus, the transaction lacked a business purpose and should be recast under the economic substance doctrine.
  – The Tax Court rejected this IRS argument because it focused on Countryside’s pre-tax profit rather than the partners, W and C, who were the focus of the motion before the court.
  – At most, the Tax Court stated that this argument could support a challenge to any interest deductions claimed by Countryside with respect to the $8.5 million loan.

• The Tax Court concluded that the means of the transaction (i.e., the liquidation of W and C’s interest in Countryside) were designed to avoid recognition of gain, but that these means also served “a genuine, nontax, business purpose” – to convert W and C’s investments in Countryside into a 10-year promissory note.

• The Tax Court observed that these two forms of investment were economically distinct and therefore, in form and substance, the transaction constituted a redemption of W and C’s interest for non-marketable securities.

• The Tax Court clearly viewed the tax benefits of the transaction as being incidental to the legitimate business purpose of the transaction. Accordingly, the Tax Court found no harm in structuring the transaction in a manner to minimize the tax burden of W and C.
Countryside – Effect of Continued Litigation?

- The Tax Court only resolved the issue addressed by the partial motion for summary judgment.

- The Tax Court did not resolve the remaining issues raised by the FPAA, and it is uncertain whether W, C, Countryside or MP will retain any tax benefits claimed in connection with the transaction if and when the remaining issues are addressed.

- A footnote in the decision suggests that the Tax Court believes that the tax benefits claimed may not be warranted.

- Footnote 29 states that, given the totality of the circumstances, including (i) the formation of CLPP and MP and (ii) the section 754 elections made by Countryside and CLPP (but not by MP), there may be grounds to invoke the partnership anti-abuse rule of Treas. Reg. § 1.701-2 and/or the economic substance doctrine in order to determine –
  - Whether Countryside should obtain a basis step-up in the retained assets and/or
  - Disregard CLPP and MP as sham entities, and/or
  - Require a basis step-down in the AIG Notes held by MP.

- The remaining issues have been consolidated before the Tax Court judge.
Countryside and Valero – Section 7525

• On June 8, 2009, the Tax Court in Countryside denied an IRS motion to compel the production of “meeting minutes” and handwritten notes that memorialized conversations between the partnership (Countryside) and its outside tax advisor in respect of the transaction.

  – The documents were generally protected under section 7525.
  – However, the IRS argued that the section 7525 privilege did not apply because the underlying advice constituted “written communication” in connection with the “promotion” of a “tax shelter.” See section 7525(b).
  – The Tax Court held that the IRS did not meet its burden in establishing the elements of the “tax shelter” exception since (i) the handwritten notes, which were not communicated with anyone, did not constitute a “written communication” for purposes of section 7525(b) and (ii) the minutes were not prepared in connection with the “promotion” of a tax shelter for purposes of section 7525(b) since the tax advisor provided advice as part of a long-standing and ongoing relationship with the partnership. See Countryside v. Commissioner, 132 T.C. 347 (2009).

• In Valero Energy Corp. v. United States, 569 F.3d 626 (7th Cir. 2009), the 7th Circuit also recently addressed the tax shelter exception to the section 7525 privilege.

  – In Valero, the taxpayer raised the section 7525 privilege in respect of a summons issued to Arthur Andersen in connection with a transaction recommended to the taxpayer by Ernst & Young and reviewed by and supplemented by the taxpayer’s long-time advisors at Arthur Andersen.
  – The recommended transaction was specific to the taxpayer, and was neither “prepackaged” nor marketed to other taxpayers.
  – The 7th Circuit refused to limit the tax shelter exception in section 7525(b) to only “actively marketed tax shelters or prepackaged products” and upheld the District Court decision in favor of the government.
  – Thus, the 7th Circuit’s interpretation would extend the tax shelter exception to instances where a taxpayer receives specific advice (rather than marketed or “one-size-fits-all” advice) in connection with a transaction that qualifies as a tax shelter (i.e., there is a significant purpose of tax avoidance or evasion).
**Shell Petroleum – Facts of Transaction**

- **Facts: Step 1 – Formation of Shell Frontier.** In August 1992, three lower-tier subsidiaries of Shell Petroleum transferred assets to newly formed Shell Frontier in exchange for voting common stock and nonvoting preferred stock. The assets consisted of producing and nonproducing properties. In addition, unrelated investors purchased 1100 shares of auction-rate preferred stock in exchange for $110 million. The auction-rate preferred stock entitled the unrelated investors to 25.88% of the vote in Shell Frontier. One of the three lower-tier Shell Petroleum subsidiaries, Shell Western, also transferred additional assets to Shell Frontier in exchange for 900 shares of auction-rate preferred stock. The assets transferred by Shell Western consisted of non-producing Colorado oil shale properties and offshore oil leases in California and Alaska. Shell Western had an aggregate basis in these assets of $679,335,936. (Continued on next slide.)
Shell Petroleum - Facts of Transaction

- Facts: Step 2 – Sale of stock. In December 1992, Shell Western sold 540 shares of Shell Frontier stock to unrelated investors for $54 million. Shell Frontier was not a member of the Shell consolidated group for tax purposes because more 20% of the voting power in Shell Frontier was owned by outside investors. Accordingly, this transaction caused the Shell Group to recognize a capital loss of approximately $354 million and created a consolidated net operating loss of approximately $320 million. The carryback of a portion of this net operating loss to 1990 resulted in a refund of approximately $19 million. In addition, a portion of the NOL was carried back to 1989 and 1991 and a portion was carried forward to years after 1992.
Shell Petroleum - IRS Challenge

- The IRS challenged the capital loss claimed by the Shell Group as a result of Shell Western’s sale of auction rate preferred stock in Shell Frontier to the unrelated investors.

- The IRS argued that the auction rate preferred stock was not issued in exchange for property under section 351 because the nonproducing real estate properties did not earn income and therefore were without value.

- In addition, the IRS argued that the transaction should be disregarded because it lacked economic substance. In making this argument, the IRS relied heavily on the Federal Circuit’s decision in Coltec.

- Note that this transaction would not result in a capital loss today because of section 362(e)(2). Section 362(e)(2) requires taxpayers that transfer built-in loss property in a section 351 exchange to take a fair market basis in such property. Section 362(e)(2), however, was not enacted at the time of the transactions in Shell Petroleum.
Shell Petroleum – District Court Decision

- The United States District Court for the Southern District of Texas rejected the IRS argument and upheld the taxpayer’s capital loss. See Shell Petroleum Inc. v. United States, 2008-2 USTC ¶ 50,422 (S.D. Tex. 2008).

- The court determined that the transfer of property to Shell Frontier qualified as a tax-free section 351 transaction and therefore Shell Western obtained a basis in the stock received in the exchange equal to its basis in the transferred assets.
  - The court determined that the nonproducing real estate properties transferred to Shell Frontier had value, even though they weren’t earning income, and therefore such properties were “property” under section 351.

- The court rejected the government’s economic substance argument.
  - The court noted that different courts apply different versions of the economic substance test and that some require both objective economic substance and business purpose and others require only one or the other. The court did not identify which standard it was applying, but determined that the transaction had both economic substance and business purpose. The court concluded that the transaction allowed Shell to monetize certain assets and also established a better management structure by containing the assets at issue within a single subsidiary. The court acknowledged that the structure of the transaction was motivated in part by the tax consequences and that the use of Shell Frontier was proposed by Shell’s tax department. However, the court determined that the overall transaction was not proposed by the tax department, but rather by Shell business people. Further the court determined that the overall transaction had a legitimate business purpose and economic substance.

- The court criticized and declined to follow the step-by-step approach to economic substance analysis applied in Coltec:
  “Moreover, the Court has found no Fifth circuit cases, and the parties have cited none, similarly dissecting, or “slicing and dicing” as it was referred to in oral arguments, an integrated transaction solely because the Government aggressively chooses to challenge only an isolated component of the overall transaction.”

- The government has appealed to the Fifth Circuit Court of Appeals.
**Klamath Strategic Investment Fund v. United States – Facts**

On January 20, 2000, St. Croix LLC (“St. Croix”) and Rogue Ventures LLC (“Rogue”) were formed as single-member Delaware LLCs. Individuals Patterson and Nix each contributed $1.5M to St. Croix and Rogue, respectively. On March 29, 2000, St. Croix and Rogue each borrowed $41.7M from National Westminster Bank plc (“NatWest”) for seven years at a fixed interest rate. St. Croix and Rogue opted to pay an increased interest rate (17.97%) on their loans in return for NatWest paying St. Croix and Rogue premiums of $25M each. On April 6, 2000, St. Croix and Rogue each invested $68.2M to Klamath and Kinabalu, respectively, in exchange for a 90% partnership interest. Klamath and Kinabalu used these funds to purchase very low risk contracts on U.S. dollars and Euros and short 60- to 90-day term forward contract trades in foreign currencies. The investments involved three stages – I, II, and II – with the risk increasing with each stage.

This example shows the facts for Patterson, St. Croix and Klamath; the facts are the same for Nix, Rogue, and Kinabalu.
**Klamath Strategic Investment Fund v. United States – District Court Decision**

**Taxpayer’s Position**


– Patterson and Nix calculated their basis in the partnership as the $66.7M plus $1.5M, minus the liability assumption of $41.7M and, thus, were able to deduct over $25M from their taxable income.

**Government’s Position**

– The IRS disagreed with the basis calculation and stated that under Section 752, the partners should have treated the entire $66.7M as a liability.

– Alternatively, the IRS argued that the transactions were shams or lacked economic substance and should be disregarded for tax purposes.

**District Court**

– The Partnership filed suit against the Government under section 6226 for readjustment of partnership items. The Partnerships moved for partial summary judgment, and the Government cross-moved for summary judgment on the issue of whether the partners’ tax bases were properly calculated; specifically whether the loan premiums constituted liabilities under section 752 of the Code.

– The district court granted the Partnership’s motion and denied the Government’s, holding that the loan premiums were not liabilities under section 752 and therefore the partners’ bases were properly calculated.

– However, following a bench trial the district court held that the loan transactions must nonetheless be disregarded for Federal tax purposes because they lacked economic substance.

– The Government appealed the district court’s partial summary judgment in favor of the Partnerships, arguing that the “loan premiums” constitute liabilities under section 752.
Klamath Strategic Investment Fund v. United States – Fifth Circuit Decision

Fifth Circuit

- The Fifth Circuit applied the majority view of the economic substance doctrine – that a lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance (i.e., the conjunctive test).
- The court went on to explain that the Supreme Court in *Frank Lyon* set up a multi-factor test for when a transaction must be honored as legitimate for tax purposes. These factors include
  - Whether the transaction has economic substance compelled by business or regulatory realities,
  - Whether the transaction is imbued with tax-independent considerations, and
  - Whether the transaction is not shaped totally by tax avoidance features.
- The Fifth Circuit found that the evidence supported the district court’s conclusion that the loan transactions lacked economic substance.
  - Numerous bank documents stated that despite the purported seven-year term, the loans would only be outstanding for about 70 days.
  - NatWest’s profit in the loan transaction was calculated based on a 72-day period.
  - In the event that the investors wanted to remain with the plan beyond 72 days, NatWest would force them out.
  - The Partnerships contend that the loan funds were critical to the high-risk foreign currency transactions; however, the structure of the plan shows that these high-risk transactions could not occur until Stage III, which was never intended to be reached.
- The Fifth Circuit noted that various courts have held that when applying the economic substance doctrine, the proper focus is on the particular transaction that gives rise to the tax benefit, not collateral transactions that do not produce tax benefits.
  - In this case, the transactions that provided the tax benefits at issue were the loans from NatWest. Therefore, the court found that the proper focus is on whether the loan transactions presented a reasonable possibility of profit.
  - The Fifth Circuit found that the evidence clearly shows that Presidio and NatWest designed the loan transactions and the investment strategy so that no reasonable possibility of profit existed and so that the funding amount would create massive tax benefits but would never actually be at risk.
- The Fifth Circuit also held that the Government lacked standing to appeal the district court’s partial summary judgment ruling that Section 752 operates to eliminate the claimed tax benefits arising from the Partnerships’ participation in the loan transactions.
Facts: Schering-Plough Corporation (“SP”) owned all of the stock of Schering Corporation (“SC”), which owned all of the stock of Schering Plough-International (“SPI”). SP, SC, and SPI were U.S. corporations.

SPI owned a majority of the voting stock of Schering-Plough Ltd. (“SPL”), which owned a majority share in Scherico, Ltd. (“SL”). SPL and SL were Swiss corporations.

SP entered into 20-year interest rate swaps with ABN, a Dutch investment bank, in 1991 and 1992. The swap agreements obligated SP to make payments to ABN based on LIBOR and for ABN to make payments to SP based on the federal funds rate for the 1991 swap and on a 30-day commercial paper rate (plus .05%) for the 1992 swap.

The swap agreements permitted SP to assign its right to receive payments under the swaps (the “receipt leg” of the swap). Upon an assignment, SP’s payment to ABN and ABN’s payment to the assignee could not be offset against each other.

SP assigned substantially all of its rights to receive interest payments to SPL and SL in exchange for lump-sum payments totaling $690.4 million.
Schering-Plough Corp. v. United States

- **Taxpayer Position**
  - SP relied on Notice 89-21 to treat the swap and assignment transaction as a sale of the receipt leg of the swap to its foreign subsidiaries (SPL and SL) for a non-periodic payment that could be accrued over the life of the swap.
  - The IRS issued Notice 89-21 to provide guidance on the treatment of lump-sum payments received in connection with certain notional principal contracts in advance of issuing final regulations.
    - Notice 89-21 required that a lump-sum payment be recognized over the life of a swap in order to clearly reflect income.
    - Notice 89-21 stated that regulations would provide the precise manner in which a taxpayer must account for a lump-sum payment over the life of a swap and that similar rules would apply to the assignment of a “receipt leg” of a swap transaction in exchange for a lump-sum payment.
    - Notice 89-21 permitted taxpayers to use a reasonable method of allocation over the life of a swap prior to the effective date of the regulations.
    - Notice 89-21 cautioned that no inference should be drawn as to the treatment of “transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans.”
  - The IRS issued final regulations in 1993 that reversed the basic conclusion of Notice 89-21 and provided that an assignment of the “receipt leg” of a swap for an up-front payment (when the other leg remained substantially unperformed) could be treated as a loan. See Treas. Reg. 1.446-3(h)(4) and (5), ex. 4.

- **IRS position**
  - The IRS argued that the swap and assignment transaction should be treated as a loan from the foreign subsidiaries to SP, which would trigger a deemed dividend under section 956.
Schering-Plough Corp. v. United States

Court Decision

The District Court found in favor of the government on four separate grounds that, in the court’s view, would be sufficient to deny the taxpayer’s claim for tax-deferred treatment under Notice 89-21. See Schering-Plough Corp. v. United States, 651 F. Supp. 2d 219 (D.C. N.J. 2009).

1. Substance Over Form

   - The court noted that the integrated transaction had the effect of a loan in which SP borrowed an amount from its foreign subsidiaries in exchange for principal and interest payments that were routed through ABN.
   - The court discounted SP’s arguments (i) that there was an absence of customary loan documentation, (ii) that SP did not directly owe an amount to the foreign subsidiaries (even if ABN failed to fulfill its obligations), and (iii) that the amount of interest paid by SP to ABN would not equal the amount received by its foreign subsidiaries because of the different interest rate bases used under the swap.
   - The court determined that SP’s efforts to structure the transactions as sales failed to overcome the parties’ contemporaneous intent and the objective indicia of a loan.
     - The court stated that the foreign subsidiaries received the “economic equivalent” of interest and noted that SP “consistently, materially, and timely made repayments” to its foreign subsidiaries.
     - The court found that SP officials considered the transaction to be a loan.
     - The court observed that SP did not use customary loan documentation for intercompany loans.
   - The court also concluded that ABN was a mere conduit for the transactions which, according to the court, further supported its holding that the transactions were, in substance, loans.
     - ABN faced no material risk since it entered into “mirror swaps” to eliminate interest rate risk (but not the credit risk of SP).
     - The court found that ABN did not have a bona fide participatory role in the transactions, operating merely as a pass-through that routed SP’s repayments to the Swiss subsidiaries.
Schering-Plough Corp. v. United States

- Court Decision (con't)
  2. Step Transaction

- The court also applied the step transaction doctrine as part of its substance over form analysis to treat the swap and assignment transaction as a loan.

- In applying the “end-result test,” the court determined that the steps of the swap and assignment transaction could be collapsed because they all functioned to achieve the underlying goal of repatriating funds from the foreign subsidiaries (SPL and SL).
  - In the court’s view, the evidence established that the swaps and subsequent assignments were pre-arranged and indispensable parts of a “broader initiative” of repatriating earnings from the foreign subsidiaries.

- The court also concluded the steps of the swap-and-assign transactions to be interdependent under the “interdependence test.”
  - The court found that the goal of the interlocking transactions was to repatriate foreign-earned funds, and the interest rate swaps would have been pointless had SP not subsequently entered into the assignments with its subsidiaries.

- The court rejected SP’s argument that, in applying the step transaction doctrine, the IRS created the fictitious steps that (i) the foreign subsidiaries loaned funds to SP, (ii) SP entered into an interest rate swap for less than the full notional amount with ABN, and (iii) SP satisfied its obligation under the imaginary loans by directing ABN to make future payments under the swap to its foreign subsidiaries.

- The court also rejected SP’s argument that the step transaction doctrine should not apply because the IRS failed to identify any meaningless or unnecessary steps.
Schering-Plough Corp. v. United States

• Court Decision (con’t)

3. Economic Substance
• The court concluded that the swap and assignment transaction failed the economic substance doctrine and, thus, SP was not entitled to tax-deferred treatment.
• The court followed 3rd Circuit precedent, ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), which treats the "objective" and "subjective" elements of the doctrine as relevant factors (rather than applying a rigid conjunctive or disjunctive standard).
• The court rejected the taxpayer’s position that the repatriation proceeds represented "profit" from the transaction. The court also noted that any interest rate risk due to the swaps was hedged and that SP incurred significant costs in executing the transaction. In sum, the court found that there was little, if any, possibility of a pre-tax profit.
• The court concluded that both the swap and assignment lacked a business motive.
  – SP contended that it entered into both swaps for cash management and financial reporting objectives, the 1991 swap for hedging purposes, and the 1992 swap for a yield enhancement function. The court rejected each of these non-tax motivations.
  – Notably, the court avoided the difficult legal determination of whether the court must examine the whole transaction or, as the government argued, just the component part that gave rise to the tax benefit (here, the assignment step of the transaction).

4. Subpart F Principles
• The court determined that permitting the repatriation of $690 million in offshore earnings without at least a portion of those earnings being captured under subpart F would contradict Congressional intent.
• The court noted that Notice 89-21 did not supplant, qualify, or displace subpart F, nor was the notice intended to permit U.S. shareholders of controlled foreign corporations to repatriate offshore revenues without incurring an immediate tax.
• In the court’s view, the notice only dealt with the timing of income recognition.

• Third Circuit Decision
  – On appeal, the Court of Appeals for the Third Circuit upheld the District Court’s decision. See Merck & Co., Inc. v. United States, Docket No. 10-2775 (3d Cir. 2011).
  – The Third Circuit held that the District Court correctly found that the transactions were in substance loans, not sales.
  – Because the Third Circuit upheld the District Court’s characterization of the transactions as loans, it did not address the District Court’s alternative conclusion that the transactions lacked economic substance.
**Facts:** ConEd, a U.S.-based utility, entered into a leveraged lease with EZH, a Dutch utility, on December 15, 1997. The lease property was an undivided 47.7% interest in a gas fired cogeneration power plant located in the Netherlands (the “RoCa3 Facility”). Under the “Headlease,” ERZ leased the interest in the RoCa3 Facility to CEL Trust, a trust formed by a subsidiary of ConEd, for a period of 43.2 years. CEL Trust leased the interest back to EZH under the “Sublease” for a period of 20.1 years. CEL Trust was required under the Headlease to make an upfront rental payment ($120.1m), which was financed by an equity commitment of $39.3 million and a nonrecourse loan ($80.8m) from a third-party bank (“HBU”), and a deferred rent payment ($831.5m) due at the end of the Headlease term. Pursuant to the Sublease, EZH was required to make periodic rent payments, exclusive of certain payments, directly to HBU in satisfaction of CEL Trust’s obligations under the non-recourse loan. At the end of the Sublease term, three options could be exercised: (1) EZH could exercise the Sublease Purchase Option for the price of $215.4 million, (2) CEL Trust could exercise the Sublease Renewal Option to extend the lease term for approximately 16.5 years, or (3) CEL Trust could exercise the Retention Option pursuant to which EZH would return its interest in the RoCa3 Facility to CEL Trust.

The parties entered into defeasance arrangements to finance their obligations under the LILO arrangement. EZH established a defeasance account with the upfront payment attributable to the nonrecourse financing ($80.8m) to fund the “debt portion” of the periodic rental payments under the Sublease. EZH also established a defeasance account with a portion of the upfront payment attributable to the equity commitment ($31.2m) to fund the “equity portion” of the periodic rental payments and the equity portion of the Sublease Purchase Option, if exercised by EZH. ConEd received a pledge of the equity and debt defeasance investments and re-pledged the debt defeasance to the nonrecourse lender, HBU, to secure its obligations under the nonrecourse note. For simplicity, the precise mechanics of the defeasance arrangements are not shown in the above diagram.

CED, as a subsidiary of ConEd, claimed deductions in 1997 for the prepaid rent transferred to EZH and for the interest attributable to the nonrecourse financing.
ConEd v. United States – Court of Federal Claims

• Spoliation Claim
  – The government alleged that, at the time of the change to a new email system in late 2000, ConEd had a duty to preserve evidence relevant to the LILO arrangement because it anticipated litigation starting in 1997.
    • The government’s argument was based on the fact that Con Ed claimed work product protection for three memoranda drafted in 1997 that evaluated the tax consequences of the LILO arrangement.
    • In the alternative, the government argued that ConEd anticipated litigation in 1999 when Rev. Rul. 99-14 was issued.
    • The government sought an inference in its favor regarding open factual issues as to ConEd’s intent and understanding of the LILO arrangement.
  – The Court of Federal Claims ruled in favor of ConEd.
    • The court already had concluded that the memoranda at issue were not work product.
    • The court also held that Rev. Rul. 99-14 by itself was not sufficient to give rise to an anticipation of litigation.
    • Accordingly, the court held that ConEd did not have a duty to preserve documents at the time of the email conversion.
ConEd v. United States – Court of Federal Claims

- **Substance Over Form**
  - The government argued that the taxpayer did not qualify as the “true owner” of the leasehold interest in the RoCa3 Facility such that it possessed the “benefits and burdens” of ownership.
  - The Court of Federal Claims rejected the government’s argument.
  - The court found that there was some risk of loss and some opportunity for profit.
  - The court acknowledged that, if EZH does not, or is not certain to, exercise the Sublease Purchase Option, then ConEd would likely satisfy the benefits and burdens standard due to the risk incurred during the retention period.
  - The court referred extensively to the record (using both taxpayer and government experts) and, on the totality of the factual circumstances, concluded that the purchase option was not compelled to be exercised.
    - From an economic perspective, the court relied on expert testimony that confirmed that the cost of exercising the purchase option would exceed the remaining value in the RoCa3 Facility interest at the end of the Sublease term.
    - In addition, the court found persuasive the fact that numerous conditions that may affect the decision to make the election could change over time (e.g., discount rates, inflation, market changes, technological evolution, state of Dutch utility industry) and, thus, it was unlikely that an election was “virtually certain” at the time of the transaction.
    - The court discounted government expert testimony (used in multiple LILO litigation cases) to the effect that the option would be exercised, in part, because it failed to address the specific facts at issue in the case.
  - The court relied on ConEd expert testimony regarding the various risks that may arise upon an early termination of the LILO arrangement.
**ConEd v. United States – Court of Federal Claims**

- **Substance Over Form (continued)**
  - The Court of Federal Claims rejected the government’s argument that only a future interest was acquired because EZH held possession of the property during the Sublease period.
    - The court noted that possession is transferred in almost all true leases, including the lease in *Frank Lyon*.
  - The Court of Federal Claims also concluded that the nonrecourse debt was valid.
    - The court noted that all leveraged leases involve nonrecourse debt, that the nonrecourse loan permitted ConEd to acquire property, and that ConEd’s property rights had substantial value such that ConEd would not walk away from the property and default on the loan.
    - The court rejected the government’s circular funds argument and found that the defeasance arrangements, which only reduced risk, did not disqualify the debt as valid debt.

- **Economic Substance**
  - The Court of Federal Claims viewed the *Coltec* decision as consistent with past economic substance decisions that, in the aggregate, set forth the “general approach” to reviewing economic substance rather than “formulaic prescriptions" for determining which elements will result in a finding of economic substance.
  - The court stated that the *Coltec* decision reduced the relative weight afforded to subjective business motivations when applying the economic substance standard, although the court considered non-tax business purposes to remain relevant, if not necessary, for the economic substance analysis.
  - The court articulated the standard in the opinion’s conclusion as follows –
    “*Coltec* expands on the guidance in *Frank Lyon*, offering a methodology to analyze economic substance by reviewing whether the taxpayer’s sole motivation was tax avoidance, which party bears the burden of proof and, if the evidence does not demonstrate that the taxpayer’s sole motive was tax avoidance, a requirement for objective evidence of economic substance in the transaction at issue.”
ConEd v. United States – Court of Federal Claims

- Economic Substance (continued)
  - Subjective Factors
    - The Court of Federal Claims lists numerous non-tax business reasons for entering into the LILO arrangement based on testimony offered by ConEd, including (i) the ability to pursue new opportunities and alternatives in the deregulated market, (ii) the expectation of making a pre-tax profit, (iii) ConEd's entry into Western European energy markets, (iv) potential to benefit from the residual value of the RoCa3 Facility, and (v) technical benefits from operating a high tech plant in its own field of expertise.
  - Objective Factors
    - The Court of Federal Claims states that a “significant consideration” in the economic substance analysis is whether there is a reasonable opportunity for profit at the time of the transaction.
    - The court concludes that Con Ed had a reasonable opportunity for profit under each of the possible scenarios at the end of the Sublease (i.e., purchase option, renewal, retention).
      - The court noted that other decisions have accepted relatively low percentage of pretax profit (e.g., 3% or more) for leasing transactions.
      - In determining the profit percentage, the court did not accept the government’s position that a discount rate must be used.
- In sum, in applying the substance over form doctrine and the economic substance standard, the court reiterated that it was applying the judicial standards to unique set of facts and cited extensively to the record in this regard. On the basis of the totality of factual evidence, the court distinguished recent court decisions (BB&T, Altria, Fifth Third) involving LILO arrangements that were decided in favor of the government.
**Wells Fargo v. United States – Court of Federal Claims**

- In a subsequent decision, the Court of Federal Claims distinguished *ConEd* in *Wells Fargo v. United States*, 91 Fed. Cl. 35 (2010), holding that a similar SILO ("sale in/lease out") transaction failed a substance-over-form analysis and lacked economic substance.
- The court described *ConEd* as a “distinctly unique case” that was “easily distinguishable” from Wells Fargo’s SILO transactions.
- The court noted that, in *ConEd*, it repeatedly emphasized the fact-dependent basis for its holding.
  - The court went so far as to list a series of quotations from its earlier *ConEd* opinion in which it stressed the uniqueness of the facts presented and the intended limited application of its holding.
- Accordingly, analyzing economic substance with respect to the specific SILO transactions at issue, the court determined that Wells Fargo’s transactions were more similar to the SILO/LILO transactions disregarded in *AWG Leasing Trust v. United States*, 592 F. Supp. 2d 953 (N.D. Ohio 2008), and *BB&T Corp. v. United States*, 2007-1 USTC ¶ 50,130 (M.D.N.C. 2007), aff’d 523 F.3d 461 (4th Cir. 2008).
  - Thus, the court denied Wells Fargo’s refund claim for the tax deductions stemming from its SILO transactions.
  - The Federal Circuit upheld the decision of the Court of Federal Claims based solely on the substance-over-form doctrine.
**Southgate Master Fund v. United States**

**Facts:** China Cinda, an entity owned and operated by the Chinese government (“Cinda”), paid face value (approx. $1.1 billion) for certain nonperforming loans (“NPLs”) held by the state-owned Chinese Construction Bank (the “CCB”). On July 31, 2002, Cinda contributed these NPLs to Eastgate, a Delaware limited liability company, in exchange for 100% of the interests in Eastgate. On or about July 31, 2002, Eastgate contributed the NPLs to Southgate, a Delaware limited liability company, in exchange for a 99% membership interest. The remaining 1% membership interest was acquired for $100,000 cash and a note by Montgomery Capital Advisers, a Delaware limited liability company formed to pursue investment opportunities in China (“MCA”). D. Andrew Beal (“Beal”) formed Martel Associates, LLC, a Delaware limited liability company (“Martel”), which purchased 90% of Eastgate’s interests in Southgate for approximately $19.4 million on August 30, 2002. After the acquisition, Martel owned an 89.1% interest in Southgate, and Eastgate and MCA owned a 9.9% interest and a 1% interest, respectively.
Southgate Master Fund v. United States

Facts (continued): Southgate adopted a strategy to monetize the NPLs by selling a portion of low-quality NPLs to third parties and collecting on the remaining high-quality NPLs. Southgate planned to sell 20% to 25% of the NPLs in 2002, which would trigger a substantial amount of built-in losses to shelter Beal’s personal income in 2002. In late 2002, Beal and Martel entered in a sale-repurchase transaction (a “repo” transaction) and a restructuring of Beal’s interest in Martel (collectively, the “Repo/Restructuring”) in order to increase Beal’s outside basis in Southgate so that he could recognize the built-in losses that would be allocable to Beal (approx. $265 million).

The repo transaction consisted of the following steps: (i) Beal contributed Ginnie Mae securities (“GNMA” securities) with a basis and value of approximately $180.5 million to Martel, (ii) Martel entered into a repo transaction with UBS in exchange for $162 million and an agreement to repurchase identical GNMA from UBS, and (iii) Martel distributed the $162 million to Beal and Beal guaranteed Martel’s obligation to repurchase.

In the restructuring, (i) Martel distributed its interest in Southgate to Beal and (ii) Beal contributed his interest in Martel to Southgate. Beal became the sole manager of Martel under amended operating agreements and, in such capacity, held sole discretion inter alia to direct the purchase and sale of securities by Martel and the use of all proceeds from the repo transaction. After the restructuring, Beal’s percentage interest in Southgate increased to approximately 93.3% while Eastgate’s percentage interest decreased to 5%.
Southgate Master Fund v. United States

• Taxpayer’s position
  – Allocation of Southgate Losses
    • Southgate incurred approximately $294.8 million in losses in 2002, of which approximately $292.8 million were built-in losses (within the meaning of section 704(c)) and $2.0 million were post-contribution losses.
    • Beal was allocated 90% of both the built-in losses and post-contribution losses in 2002 (approx. $265 million) pursuant to section 704(c) and Treas. Reg. § 1.704-3(a)(7) (as those provisions were in effect in 2002).
  – Beal’s Outside Basis in Southgate
    • Beal’s acquired a cost basis in Southgate upon acquisition from Eastgate (increased prior to the Repo/Restructuring by a payment of a placement fee on behalf of Southgate and a loan to Southgate).
    • Beal’s contribution of the GNMA’s to Southgate increased his outside basis in Southgate by his basis in the GNMA’s, or $180 million.
    • The $162 million in repo liabilities assumed by Southgate in connection with the restructuring (through its ownership of Martel), and Beal’s guarantee of such liabilities, resulted in offsetting basis adjustments.
    • Beal’s basis in Southgate was approximately $210.5 million as of December 31, 2002, and he reported an ordinary deduction of approximately $216.3 million arising from his interest in Southgate.

• IRS position
  – The IRS argued that judicial doctrines (economic substance, sham partnership, and substance over form) prevented Beal’s outside basis increase from the Repo/Restructuring.
  – The IRS also raised three separate so-called “basis killer” arguments that would require a step-down in the basis of the NPLs contributed to Southgate and, thus, deny all of built-in losses claimed by the partnership and allocated to Beal:
    • The IRS argued that Cinda was a dealer in securities and therefore Cinda would be required to mark-to-market the NPLs transferred to Southgate.
    • The IRS argued that section 482 should apply to reallocate income from the purchase of the NPLs by Cinda from the CCB at face value.
    • The IRS argued that NPLs were worthless at the time they were acquired by Cinda.
Southgate Master Fund v. United States

- **Court Decision**
  - The district court held that the judicial doctrines of economic substance, sham partnership, and substance over form applied to deny Beal the increase in basis from the Repo/Restructuring. See *Southgate Master Fund v. United States*, 651 F. Supp. 2d 596 (N.D. Tex. 2009).
  - **Economic Substance**
    - The district court stated that the transaction as a whole must be divided for purposes of the economic substance analysis: (i) the partnership between Cinda, MCA, and Beal in the Southgate acquisition of the NPLs and (ii) the Repo/Restructuring that increased Beal’s basis in Southgate.
    - The district court held that Southgate itself had economic substance on the basis that the formation was not shaped solely by tax-avoidance features. In that regard, the district court found that there was a potential for profit (even though the venture turned out unprofitable) and noted that section 704(c), as it existed prior to 2004, arguably encouraged these types of transactions.
    - The district court held that the basis-increasing steps undertaken by Beal lacked economic substance. The court found that Southgate did not have a reasonable possibility for profit from the transaction (even though Southgate did in the original NPL transaction), in part, because Beal controlled the income streams from the GNMAIs and had sole discretion to award gains or losses to the partnership. Furthermore, in the court’s opinion, the taxpayer also did not establish a valid business purpose other than the tax benefits obtained by Beal.
  - **Sham Partnership**
    - The district court held that the Repo/Restructuring resulted in a sham partnership thereby denying Beal any resulting basis increase. Note that the district court did not disregard the partnership for all purposes.
    - The district court found, as described above, that there was no substantive non-tax business reason for structuring the Repo/Restructuring.
  - **Substance Over Form**
    - The district court also applied the substance over form doctrine to deny Beal the basis increase resulting from the Repo/Restructuring.
    - The district court appears to conclude that the Beal should be treated as entering into the repo transactions directly, thereby disregarding the use of Martel in the transaction.
Southgate Master Fund v. United States

• Court Decision (con’t)
  – Basis-Killer Arguments
    • Dealer status of Cinda
      – The district court rejected the government’s argument that Cinda should be treated as a dealer in securities required to mark-to-market the NPLs contributed to Southgate.
      – The district court noted that Cinda commonly entered into debt-to-equity swaps and other non-sale transactions in which it collected for its own account in the years preceding the transaction.
    • Section 482 adjustment
      – The district court rejected the government’s argument that section 482 should apply to adjust the consideration paid by Cinda to acquire the NPLs from the CCB.
      – The district court concluded that section 482 could not apply to the sale between Cinda and the CCB because the adjustments contemplated by section 482 must be made to entities having a U.S. tax liability.
      – The district court also questioned whether Cinda and CCB could be viewed as related parties for purposes of section 482.
    • Worthlessness of NPLs
      – The district court rejected the government’s argument that the NPLs were worthless when acquired by Cinda and therefore Southgate could not recognize a taxable loss on their disposition.
      – The district court cited evidence that the NPLs were sold for consideration.
      – The district court did not impose accuracy-related penalties asserted by the government, finding that Beal acted in good faith and with reasonable cause.
Facts: In 2001, several individual taxpayers sold stock in the Burnham Insurance Group (“BIG”) to HUB International (“HUB”) (referred to as the “Members”), recognizing gain on the exchange of BIG stock for HUB stock and cash.

In the CARDS transaction entered into in 2001, Fairlop Trading, LLC (“Fairlop”), an entity formed by two U.K. residents, borrowed €16.6 million from Zurich Bank. Fairlop used the loan proceeds to purchase two promissory notes from Zurich Bank to collateralize the loan: one for €13.6 million and another for €2.9 million. Fairlop later exchanged the €2.9 million note for a new note of €1.9 million and €1.0. [Note that this exchange not shown in diagram above.]

The Members formed Country Pine Finance, LLC (“Country Pine”) to participate in the CARDS transaction. The Members purchased the €1.9 million note and €1.0 from Fairlop in exchange for an agreement to become jointly and severally liable for the entire €16.6 loan from Zurich Bank to Fairlop. The Members then contributed the €1.9 million note and €1.0 to Country Pine. In exchange, Country Pine guaranteed the loan to Fairlop. The Members and Country Pine pledged the contributed property as collateral for the loan.

Country Pine and Zurich Bank entered into a currency swap pursuant to which Country Pine exchanged the €1.9 million note and €1.0 for $2.6 million in cash. Country Pine claimed a $11,952,871 loss on the exchange (allocated between a short-term capital loss on the note and an ordinary loss on the euro) since it claimed a basis in the exchanged property equal to the full amount of the joint and several liability assumed by the Members -- €16.6 million or $14.6 million.

The amounts exchanged served as the notional amounts under the swap. The swap required Zurich Bank to pay interest on €2.9 million received from Country Pine (that equaled Country Pine’s payments to Zurich Bank on the assumed loan) and Country Pine to pay interest on the $2.6 million received from Zurich Bank (that Country Pine used to obtain a promissory note from Zurich Bank, which was pledged back to Zurich Bank as collateral).
Country Pine Finance, LLC v. Commissioner

- IRS argued that the claimed losses should be denied because (i) the CARDS transaction lacked economic substance, (ii) substance-over-form principles should apply to disallow the loss, and (iii) neither Country Pine nor the Members could claim deductions under section 165, 465, or 988.

- The Tax Court held that the transaction did not have economic substance under either the standard applied in the 6th Circuit (no rigid test) or D.C. Circuit (disjunctive test), and denied the claims for losses in the CARDS transaction. See Country Pine Finance, LLC v. Commissioner, T.C. Memo. 2009-251.
  - The Tax Court did not address other arguments in the T.C. Memo. opinion raised by the government.

- The taxpayer argued that the CARDS transaction had economic substance and was entered into to permit Country Pine to finance real estate investments on the members’ behalf.
  - Taxpayer argues that Country Pine and the Members were jointly and severally liable for the entire € 16.6 million, and that Fairlop, the Members and Country Pine were at risk for the loan proceeds.
  - Taxpayer also argues that there was profit potential since real estate could have been substituted for collateral on the loans.

- The IRS argued that transaction had no economic substance and no practical effect other than creating tax losses.
Country Pine Finance, LLC v. Commissioner

- The Tax Court held that the tax losses must be denied under both an objective and a subjective analysis.

  **Objective Analysis**
  - Tax Court concluded that the transaction did not have a profit potential.
    - None of the loan proceeds ever left Zurich Bank’s control as loans acquired promissory notes that were pledged as collateral.
    - Expert testimony established that the transaction had a negative net present value and rate of return – fees of $700,000 paid in order to borrow €2.9 million for 1 year, the funds from which purchased investments that could never earn a profit (e.g., promissory notes from Zurich Bank).
  - Tax Court concluded that the transaction should not be analyzed as if real estate were substituted as collateral.
    - Country Pine could only earn a profit if it could substitute collateral and earn a return in excess of the cost of the initial loans.
    - However, the court found that Zurich Bank would not have permitted the substitution without imposing more onerous terms to account for its increased risk and that the Members knew prior to the transaction that real estate could not be substituted as collateral without a “haircut.”
    - The Tax Court further held that any substitution would be viewed as a separate transaction so that the currency exchange creating the tax loss would still have no pre-tax profit, citing Coltec.

  **Subjective Analysis**
  - Tax Court held that the Members did not have a nontax business purpose for entering into the CARDS transaction.
  - Tax Court noted that the Members knew that real estate could not be substituted prior to the transaction, the petitioner testified that the decision to enter into the transaction was to take advantage of tax benefits, and that Members repeatedly testified that they did not read any of the relevant documents or otherwise engage in due diligence.
Fidelity International v. United States

• The District Court of Massachusetts recently held that certain Son-of-BOSS type transactions should be disregarded because they lacked economic substance. See Fidelity Int’l Currency Advisor A Fund LLC v. United States, 2010-1 USTC ¶ 50,418 (D.C. Mass. 2010).

Relevant Facts:
• Taxpayers owned approximately 25 million shares of EMC stock. In 2000, taxpayers’ basis in the stock was extremely small in comparison to the stock’s trading price, and the sale of any portion of the stock would have resulted in substantial capital gains. Taxpayers also owned options to purchase an additional 8 million shares of EMC stock at very low strike prices. The exercise of the options would generate significant amounts of ordinary income.
• To avoid the large tax liabilities that would result from a stock sale or exercise of the stock options, taxpayers invested in son-of-BOSS style tax shelters promoted by KPMG.
• The first transaction involved the contribution of offsetting options (in large notional amounts) and EMC stock to Fidelity High Tech Advisor A Fund, LLC, which was taxed as a partnership.
  – Taxpayers treated the purchased option as an asset, but the sold option was not treated as a liability. Thus, the taxpayers contributed assets to the partnership entity but not liabilities, creating an inflated basis in their membership interest of more than $163 million. In 2002, the taxpayers sold all of the stock in Fidelity High Tech and claimed a significant capital loss.
• Taxpayers used a second transaction, the Financial Derivatives Investment Strategy (“FDIS”), a variation of the scheme discussed above, to shelter ordinary income resulting from the exercise of their EMC stock options.
  – The FDIS transaction, executed through Fidelity International Currency Advisor A Fund, LLC, generated paper losses for taxpayers by assigning any offsetting "gains" offshore to one of two Irish confederates of the tax promoters (neither of whom filed U.S. tax returns).
  – The Fidelity International transaction resulted in the creation of artificial losses of $158.6 million in 2001, which the taxpayers used to offset the ordinary income of $162.9 million from the option exercise on their income tax return that year.
Taxpayer’s Economic Substance Arguments:
• Taxpayers had a business purpose for the transactions.
  – The Fidelity High Tech transaction was to serve as a hedge against a downward movement in the price of EMC stock.
  – The Fidelity International transaction was to serve as a hedge against fluctuating interest rates and foreign currency exchange rates.
• The transactions possessed objective substance.
  – Both transactions were reasonably designed and implemented to serve a hedging function, and there was a reasonable possibility that the taxpayers could profit on the transactions.

Court’s Decision:
• Economic Substance Analysis:
  – The court stated that the First Circuit appears to have adopted a version of the economic substance doctrine that looks to both the subjective and objective features of the transactions, without applying a rigid two-part test (citing Dewees v. Commissioner, 870 F.2d 21 (1st Cir. 1989)).
  – Taxpayers relied on several other First Circuit opinions, including Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956), for the proposition that a transaction that is not fictitious should be upheld, without regard to the subjective intent of the taxpayer.
  – The court, however, stated that the Dewees opinion effectively overruled Granite Trust (as well the other cases cited by taxpayers), “at least as to the broad contours of the economic substance doctrine.”
    • The court stated that Dewees is in accordance with the view shared by most circuits, that a court may take into account both objective and subjective factors in assessing whether a particular transaction had economic substance.
    • Accordingly, to the extent the cases cited by taxpayers may be read to support the proposition that a taxpayer’s subjective intent is irrelevant, that proposition cannot survive the holding or the reasoning of Dewees.
  – The court concluded that, in making an economic substance determination, it considers both the objective features of the transactions and the subjective intent of the participants, including the overall features of the tax shelter scheme and the intentions of the promoters.
    • The court noted, however, that it was not necessary to decide whether the objective or subjective factors, standing alone, would be sufficient to support a finding of a lack of economic substance in this case, as the transactions at issue were without economic substance under either an objective or subjective analysis.
Fidelity International v. United States – District Court Decision

Overview of Court Analysis:
• From a subjective standpoint, the transactions had no business purpose of any kind. The taxpayers did not enter into the transactions for profit or to provide a hedge or other protection against economic risk, but to shelter capital gains and ordinary income from taxation.
• The transactions also had no economic substance from an objective standpoint.

Relevant Findings for Particular Transactions:
• Fidelity High Tech
  – The transaction served no reasonable hedging function
    • Option trades were not a rational economic hedge
    • Various components of the transaction served no hedging function
  – There was no reasonable possibility of profit
    • Transaction costs and fees were extremely high
    • Expected return on the transaction was negative
    • Net present value of the options was negative
    • One-option payout was not a real possibility
    • Options were not profitable
• Fidelity International
  – The transaction served no reasonable hedging function
    • Interest rate and currency option transactions were not rational economic hedges
    • Various components of the transaction served no hedging function
  – There was no reasonable possibility of profit
    • Capital structure was not rational
    • Costs and fees for the transaction were extremely high
    • Expected rate of return for the transaction was negative
    • One-option payout was not a real possibility
    • Transaction was intended to be profitless
Canal Corp. v. Commissioner

Facts: W, a wholly-owned subsidiary of C, proposed to transfer its assets and most of its liabilities to a newly-formed LLC in which W and GP, an unrelated corporation, would have ownership interests. In 1999, GP transferred assets valued at $376.4 million to the LLC in exchange for a 95-percent LLC interest. W contributed $775 million in assets to the LLC in exchange for a 5-percent LLC interest. On the same day it received the contributions from W and GP, the LLC borrowed $755.2 million from Bank of America and immediately transferred the loan proceeds to W as a special cash distribution. GP guaranteed payment of the Bank of America loan, and W agreed to indemnify GP for any principal payments made pursuant to its guaranty. W used a portion of the cash distribution it received to make a loan to C. W's only assets after the transaction were its LLC interest, a note from C, and a corporate jet. The LLC thereafter borrowed funds from a financial subsidiary of GP to retire the bank loan.

In 2001, GP entered into a separate transaction that required it to divest its entire interest in the LLC. W subsequently sold its LLC interest to GP, and GP then sold the entire interest in the LLC to an unrelated party. C reported gain from the sale on its consolidated income tax return for 2001. The IRS determined that the joint venture transaction was a disguised sale that resulted in capital gain includible in C's consolidated income for 1999. The IRS also asserted a substantial understatement penalty under section 6662(a).
Canal Corp. v. Commissioner

• The Tax Court found that the facts and circumstances evidenced a disguised sale, and held that W sold its business assets to GP in 1999, the year it contributed the assets to the LLC, not the year it sold its LLC interest. See Canal Corp. v. Commissioner, 135 T.C. 199 (2010).

• Under Treas. Reg. 1.707-3(c)(1), W’s transfer of assets to the LLC and simultaneous cash distribution were presumed to effect a sale unless the facts and circumstances clearly established otherwise.

• The taxpayer asserted that the LLC’s special distribution of cash to W was not part of a disguised sale, but was a debt-financed transfer of consideration (an exception to the disguised sale rules).
  – The regulations except certain debt-financed distributions in determining whether a partner received money or other consideration for disguised sale purposes. See Treas. Reg. § 1.707-5. A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner’s applicable share of the partnership liability.

• The taxpayer further asserted that the transaction should not be recast as a sale because the anti-abuse rule under Treas. Reg. § 1.752-2(j) did not disregard W’s agreement to indemnify GP, which, according to the taxpayer, imposed on W the economic risk of loss for the LLC debt.
  – Under the anti-abuse rule, a partner’s obligation to make a payment may be disregarded if (i) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s risk of loss or to create a facade of the partner’s bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. See Treas. Reg. § 1.752-2(j)(1), (3).

• The IRS argued that the taxpayer structured the transaction to defer capital gain, contending that W did not bear any economic risk of loss when it entered the joint venture agreement because the anti-abuse rule under Treas. Reg. § 1.752-2(j) disregards W’s obligation to indemnify GP. Thus, according to the IRS, the transaction should be treated as a disguised sale.

Tax Court’s Disguised Sale Analysis

• Addressing the taxpayer’s argument that the distribution was not part of a disguised sale because it was a debt-financed transfer of consideration, the court examined whether W had any allocable share of the LLC’s liability to finance the distribution. To make this determination, the court focused on whether W bore any economic risk under its agreement to indemnify GP.
Canal Corp. v. Commissioner

Disguised Sale Analysis (continued)

• The court found that the taxpayer crafted the indemnity agreement to limit any potential liability to W’s assets.
  – GP did not require the indemnity, and the indemnity agreement did not require W to maintain a certain net
    worth.
  – W was chosen as the indemnitor because it would cause the economic risk of loss to be borne only by W’s
    assets rather than C’s.
  – Contractual provisions reduced the likelihood of GP invoking the indemnity against W.
• The court also noted that, regardless of how remote the possibility was that W would have to pay anything under
  the indemnity agreement, W lacked sufficient assets to cover the maximum exposure on the indemnity.
  – In particular, the court noted that C could remove W’s main asset, the intercompany note, from W’s books at
    any time.
• The court concluded that W’s agreement to indemnify GP’s guaranty lacked economic substance and afforded no
  real protection to GP.

Section 6662(a) Penalty

• The taxpayer claimed that it reasonably relied in good faith on tax advice from PwC, including legal analysis
  detailed in a “should” level PwC opinion, and that no penalty should be imposed.
• The court, however, determined that PwC based its advice on unreasonable assumptions, noting the following:
  – The draft opinion submitted into evidence was disorganized and incomplete.
  – The opinion was filled with questionable conclusions and unreasonable assumptions. The opinion assumed
    the indemnity would be effective and that W would hold assets sufficient to avoid the anti-abuse rule, failing
    to consider whether the indemnity lacked substance.
  – The rendering of a “should” level opinion was unreasonable given the dubious legal reasoning provided in
    the opinion.
  – It was unreasonable for the taxpayer to have relied on an analysis based on erroneous legal assumptions.
• The court also found that the taxpayer did not act with reasonable cause or in good faith in relying on PwC’s
  advice, finding that any advice received was tainted by an inherent conflict of interest because a member of the
  PwC team helped plan the transaction.
  – The court also noted that the opinion was issued for an exorbitant fixed fee of $800,000, which was
    contingent on the closing of the transaction.
FLEXTRONICS AMERICA, LLC v. COMMISSIONER

**Facts:** C-MAC Industries, a Canadian corporation and the parent company of all C-MAC entities (the “C-MAC group”), owned C-MAC Interconnect, a Canadian company, and C-MAC Holdings, a U.S. subsidiary. In 1998, C-MAC Industries agreed to acquire a manufacturing facility from Nortel, an unrelated party who was one of the largest purchasers of the C-MAC group’s products. Before closing, C-MAC Interconnect acquired the facility’s inventory from Nortel for $12.1 million. C-MAC Interconnect and Nortel also executed a bailment agreement, which provided that the inventory was to be kept and maintained by Nortel at the facility pending the closing, but also provided that C-MAC Interconnect and its affiliates had the authority to pledge and encumber the inventory and transfer rights to, title to, and interest in the inventory. The acquisition was financed through loans totaling $51.6 million from a bank to various C-MAC entities, with the acquired inventory pledged by C-MAC Interconnect as security. Following its purchase of the inventory, C-MAC Interconnect sold a portion of the inventory to C-MAC Quartz, another member of the C-MAC group that operated a facility in the United Kingdom, which transferred the purchased inventory to another facility maintained by Nortel. Subsequently, C-MAC Interconnect transferred the inventory to C-MAC Holdings in exchange for 10,107 shares of C-MAC Holdings stock and a $9.5 million promissory note. Concurrently, C-MAC Industries transferred $4 million to C-MAC Holdings in exchange for 17,124 shares of C-MAC Holdings stock.
**FLEXTRONICS AMERICA, LLC v. COMMISSIONER**

**Facts (cont’d):** C-MAC Holdings transferred the inventory and $2.3 million to C-MAC Network Systems, a newly-formed U.S. subsidiary, in exchange for 10,107 shares of C-MAC Network System’s stock and a $9.5 million promissory note. Another entity within the C-MAC group then loaned $42.2 million to C-MAC Network Systems, which purchased the remaining noninventory facility assets from Nortel. On its 1998 federal income tax return, Taxpayer claimed a $37.3 million loss on the disposal of the inventory. This amount was based on a $39.8 million increase in the inventory’s basis under sections 357(c) and 362(a)(1). Under section 357(c), in a section 351 exchange, if the sum of the liabilities assumed by a transferee and the amount of the liabilities to which transferred property is subject exceeds the adjusted basis of the transferred property, the excess is recognized as gain to the transferor. Under section 362(a)(1), the basis of property transferred to the transferee in the section 351 transaction is equal to the basis of the transferred assets in the hands of the transferor, increased by the gain recognized by the transferor on the transfer.
Flextronics America, LLC v. Commissioner

- Although the IRS agreed that the inventory transactions involving C-MAC Holdings and C-MAC Network Systems met the literal requirements of section 351, the IRS contended that the inventory transactions should be disregarded because they fell outside the statutory purpose of section 351, lacked section 351 business purpose, lacked economic substance, and were subject to disallowance under the step transaction doctrine.

- The Tax Court, however, held that the inventory transactions were valid transactions, and rejected each of the IRS’s contentions, stating that it was “not inclined to stretch inapplicable judicial doctrines to corral a transaction that escaped before Congress closed the barn door.” See Flextronics America, LLC v. Commissioner, T.C. Memo. 2010-245.

  - In 1999, Congress amended section 357(c) and added sections 357(d) and 362(d), which effectively provide that the bump-up in basis could not exceed the fair market value of the transferred property.

- Scope of Section 351

  - The IRS, citing Wolf v. Commissioner, 357 F.2d 483, and Gregory v. Helvering, 293 U.S. 465 (1935), asserted that the section 351 inventory transactions fell outside the statutory purpose of section 351 because the purpose of that section is the deferral of gain or loss recognition, not total avoidance.

    - The IRS focused on the fact that C-MAC Network Systems received the tax benefit of the loss, while C-MAC Interconnect was not subject to U.S. tax and did not incur a corresponding gain.

    - The Tax Court distinguished the case law relied on by the IRS, noting that, although the creation and use of entities and transactions that lack substance falls outside the purpose of section 351, the inventory transactions at issue were valid substantive transactions.

- Business Purpose

  - The IRS contended that the inventory transactions lacked a business purpose as required under section 351.

  - The Tax Court, while noting that the existence of a business purpose requirement under section 351 was unclear, found that there was a business purpose for the inventory transactions, which provided for part of the capitalization of C-MAC Network Systems and enabled the acquired facility to be operated as a separate subsidiary of C-MAC Industries’ U.S. consolidated group.

  - The Court disregarded the role of the tax advisors who encouraged the use of the planning technique, noting that such advice did not nullify the Taxpayer’s business purpose.
Flextronics America, LLC v. Commissioner

• Economic Substance
  – The Tax Court rejected the IRS’s argument that the inventory transactions should be disregarded for lack of economic substance, holding that the inventory transactions had economic substance and were legally valid transactions that did what they purported to do.
    • According to the Court, C-MAC Interconnect purchased the inventory from Nortel, sold part of the inventory to C-MAC Quartz (which needed the inventory for its business), pledged the inventory as security for the bank loans needed to purchase the facility, and transferred the remaining inventory to C-MAC Holdings. C-MAC Holdings capitalized C-MAC Network Systems by contributing the inventory and other assets, which was legally transferred and subject to a valid lien.
    – The Court rejected the IRS’s argument that C-MAC Interconnect’s purchase of the inventory was in substance an advance deposit on the inventory acquired at closing, and that C-MAC Interconnect had no right to possession or control of, nor did it benefit from, the inventory until after closing.
      • According to the Court, upon the purchase of the inventory the C-MAC group had the right to pledge and encumber the inventory and transfer rights to, title to, and interest in the inventory. The C-MAC group also benefitted from the inventory purchase, as C-MAC Interconnect sold some of the inventory and made it available for use in its other operations.
      • The Court rejected the IRS’s argument that C-MAC Interconnect’s sale of the inventory to C-MAC Quartz was contrived or invalid.
      • The Court thus concluded that the advance inventory purchase had economic substance.

• Step Transaction Doctrine
  – The IRS argued that C-MAC Interconnect and C-MAC Holdings were mere conduits for C-MAC Network’s purchase of the inventory and that the transfers were without economic effect because neither conducted any business with the inventory and their ownership of the inventory was transitory.
  – The Tax Court, however, found that C-MAC Interconnect and C-MAC Holdings were bona fide entities that used the inventory in their businesses.
    • C-MAC Interconnect sold part of the inventory to C-MAC Quartz for use in C-MAC Quartz’s business, and C-MAC Holdings used the inventory to capitalize C-MAC Network Systems.
    • The inventory transactions also allowed the C-MAC group to create a separate U.S. subsidiary to operate the acquired facility and for that subsidiary to obtain the capital it needed.
  – The Tax Court thus concluded that the step transaction doctrine was inapplicable.
**Facts:** Ronald and Helen Sundrup (the “Sundrups”), had operated a trucking business as a sole proprietorship since 1967. In 2000, the Sundrups formed three separate entities – Sundrup Transfer, Inc. (“Transfer”), Sundrup Leasing, LLC (“Leasing”), and Sundrup Consulting, Inc. (“Consulting”). The Sundrups were the sole owners of the entities and the only members of their boards. Transfer operated as a trucking business and engaged in the same types of business activities previously conducted by the Sundrups in their sole proprietorship. The Sundrups transferred to Leasing certain assets that had been used in the trucking business, which Leasing leased to Transfer for use in Transfer’s trucking business. Consulting executed separate, but substantially similar, “management consulting agreements” with both Transfer and Leasing. Under these agreements, Consulting agreed to consult with Transfer and Leasing on matters related to the management and operation of their businesses. Transfer and Leasing made monthly payments to Consulting under the management consulting agreements. The Sundrups and Consulting also entered into a real estate contract whereby the Sundrups agreed to sell their residence to Consulting. The Sundrups, however, did not execute a deed in favor of Consulting with respect to their residence, and the Sundrups continued to live in their residence. Consulting paid to the Sundrups certain amounts described as interest and principal. Consulting also paid virtually all expenses relating to the Sundrups’ residence, in addition to other personal expenses. The IRS issued notices of deficiency to the Sundrups, Transfer, and Consulting that disallowed various deductions arising from the transactions between the parties. The IRS also determined that the Sundrups, Transfer, and Consulting were liable for accuracy-related penalties under section 6662.
Parties’ Arguments

• The IRS argued that the transactions between (i) Transfer and Consulting, and (ii) Leasing and Consulting, in which Consulting purported to provide services to each of these companies, should not be respected for tax purposes. The IRS also argued that the transaction between the Sundrups and Consulting, under which Consulting purported to agree to buy the Sundrups’ residence, should not be respected for tax purposes.
  – According to the IRS, there was no non-tax business purpose for any of the transactions, and each of the transactions was without economic substance and a sham.
  – The IRS contended that Transfer and Leasing’s payments to Consulting enabled the Sundrups to live a tax-free lifestyle through Consulting’s payment of their personal living expenses, and that such payments were not deductible.
  – The IRS also argued that the Sundrups’ sale of their residence was part of a scheme to deduct their personal living expenses.

• The petitioners contended that the transactions should be respected for tax purposes, arguing that Transfer, Leasing, and Consulting were created primarily for corporate protection in the form of premises liability, and that the companies were not part of a scheme to deduct the taxpayer’s personal expenses.

Tax Court Holding

• The Tax Court agreed with the IRS and held that the transactions lacked economic substance. Sundrup v. Commissioner, T.C. Memo. 2010-249.
  – The court stated that it was unwilling to rely on the respective testimonies of Mr. and Mrs. Sundrup (the only witnesses at trial) as to why they incorporated Consulting.
  – According to the court, the only intended purpose of the respective transactions was the tax-avoidance objective of having Consulting pay the Sundrups’ personal living expenses with the funds that Transfer and Leasing paid to Consulting and for which Transfer and Leasing claimed tax deductions.
  – Thus, the court found the transactions were entered into only for tax-avoidance reasons and did not have economic substance.

• Accordingly, the court concluded that the transactions should not be respected for tax purposes.
  – As a result, (i) Transfer was not entitled to deduct its payments to Consulting, (ii) Leasing was not entitled to deduct its payments to Consulting, and (iii) the Sundrups did not have interest income from the purported interest payments received from Consulting.

• The court also upheld the section 6662 accuracy-related penalties asserted against the Sundrups, Transfer, and Consulting, rejecting the petitioners’ claim that they had reasonable cause and acted in good faith in taking their tax return positions.
  – The court repeated its conclusion that the transactions at issue should not be respected for tax purposes.
  – The court found that, based on the evidence in the record, the Sundrups, Transfer, and Consulting were negligent and disregarded rules or regulations, or otherwise did not do what a reasonable person would do, with respect to the items that resulted in their respective underpayments.
  – The court further held that there was not reasonable cause for, and that the Sundrups, Transfer, and Consulting did not do what a reasonable person would do, with respect to any portion of their underpayments of tax.
**Historic Boardwalk Hall, LLC v. Commissioner**

**Facts:** The New Jersey Sports and Exposition Authority ("NJSEA"), a State instrumentality, and PB Historic Renovations, LLC ("PB") formed Historic Boardwalk Hall, LLC ("Boardwalk"), which was treated as a partnership for federal tax purposes, to invest in the historic rehabilitation of East Hall, a convention center in Atlantic City, New Jersey. PB had a 99.9-percent ownership interest in Boardwalk, and NJSEA had the remaining .01-percent interest. Because it was a historic structure, the rehabilitation of East Hall had the potential to earn historic rehabilitation credits under section 47. The formation of Boardwalk was intended to allow PB, a private party, to earn these historic rehabilitation credits from the rehabilitation of the government-owned East Hall. PB lent funds to Boardwalk and made capital contributions totaling $18 million. PB was entitled to a preferred return equal to 3 percent of its adjusted capital contribution. The transaction documents also included various purchase options in favor of NJSEA and put options in favor of PB. East Hall underwent significant rehabilitation during the years at issue, and Boardwalk claimed qualified rehabilitation expenditures. Boardwalk allocated these expenditures to PB, and PB claimed historic rehabilitation tax credits under section 47. The IRS issued an FPAA in which it determined that (i) Boardwalk was created for the express purpose of improperly passing along tax benefits to PB and was a sham, (ii) that PB's interest in Boardwalk was not a bona fide partnership interest because it had no meaningful stake in the success or failure of Boardwalk, (iii) that East Hall was not sold to Boardwalk because the benefits and burdens of ownership did not pass to Boardwalk, and (iv) that Boardwalk should be disregarded under Treas. Reg. § 1.701-2(b). The IRS also imposed an accuracy-related penalty under section 6662.
Historic Boardwalk Hall, LLC v. Commissioner

Economic Substance

- The Tax Court held that Boardwalk was not a sham and did not lack economic substance. Historic Boardwalk Hall, LLC v. Commissioner, 136 T.C. No. 1 (2011).
- The Tax Court applied the economic substance doctrine as interpreted by the Third Circuit, which requires a court to “analyze two aspects of a transaction to determine if it has economic substance: its objective economic substance and the subjective motivation behind it.”
  - The court further noted that these aspects do not constitute prongs of a rigid two-step analysis, but are related factors that inform the analysis of whether a transaction had sufficient substance apart from tax consequences.
  - Under this test, a transaction that affects a taxpayer’s net economic position, legal relations, or non-tax business interests will not be disregarded merely because it was motivated by tax considerations.
- IRS Arguments:
  - The IRS argued that Boardwalk was a sham because it lacked objective economic substance.
    - According to the IRS, NJSEA and PB negotiated and executed a transaction in anticipation of a limited number of possible outcomes, none of which would appreciably affect PB’s economic position aside from a reduction of its tax liabilities.
    - The IRS also argued that, even though PB was entitled to a 3-percent return on the transaction, such return was less than PB could have earned had it invested in other financial instruments.
  - The IRS also argued that Boardwalk served no subjective business purpose because it was intended solely to facilitate NJSEA’s sale of rehabilitation tax credits to PB.
  - The IRS’s arguments relied significantly on the conclusion that the rehabilitation credits were to be ignored in evaluating economic substance.
    - In support of this position, the IRS cited Friendship Dairies, Inc. v. Commissioner, 90 T.C. 1054 (1988), for the proposition that investment tax credits are never to be taken into account in determining the economic substance of a transaction.
- Petitioner’s Arguments:
  - Petitioner argued that the economic substance doctrine was inapplicable because Congress intended section 47 to spur investment in historic rehabilitation projects that would otherwise not be economically feasible.
  - Relying on Sacks v. Commissioner, 69 F.3d 982 (9th Cir. 1995), petitioner also argued that the rehabilitation tax credits should be taken into account in determining whether the transaction had economic substance and provided a net economic benefit to PB.
**Historic Boardwalk Hall, LLC v. Commissioner**

**Economic Substance (cont’d)**

- The Tax Court determined that PB did not invest in the Boardwalk transaction solely to earn rehabilitation tax credits.
  - The court stated that, taking into account both PB’s 3-percent return and the expected tax credits, the transactions, when viewed as a whole, had economic substance.
  - The court also found that PB, NJSEA, and Boardwalk had a legitimate business purpose, to allow PB to invest in the rehabilitation of East Hall.
- The court rejected the IRS’s argument that the structure of the transactions prevented the transactions from affecting NJSEA and PB’s economic positions.
- The court pointed to the legislative history of section 47, which the court found indicated that section 47 was intended to encourage taxpayers to participate in what would otherwise be an unprofitable activity.
  - The court noted that, without the rehabilitation credit, PB would not have invested in the rehabilitation of East Hall, because it could not have earned a sufficient net economic benefit on its investment.
  - The court found that Congress intended the credit to address this very issue.
- The court rejected the IRS’s attempt to read the Tax Court’s holding in *Friendship Dairies* as establishing that the investment tax credit is never taken into account in considering the economic substance of a transaction.
  - The court stated that *Friendship Dairies* did not make such a broad holding.
  - The court also found that *Friendship Dairies* was distinguishable on its facts because the transaction at issue had no chance of profitability.

**Other Holdings**

- The Tax Court also held that (i) Boardwalk was a valid partnership, (ii) NJSEA transferred the benefits and burdens of ownership of East Hall to Boardwalk, and (iii) the IRS’s attempt to recast the transaction under Treas. Reg. § 1.701-1(b) was inappropriate.
- The court also found that the section 6662 accuracy-related penalty asserted by the IRS was inapplicable.
Economic Substance – Transaction Planning
Sale to Recognize Loss

- May a taxpayer sell stock solely to recognize a loss under the Federal Circuit’s analysis in Coltec? No profit, no business purpose. Presumably not contrary to intent of Congress? How do you know that?
- The Supreme Court in Cottage Savings allowed a taxpayer to exchange mortgage securities for other mortgage securities and recognize a loss. The transaction was done solely for tax purposes and was disregarded for regulatory purposes.
Accelerating a Built-In Gain

Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2, and they file a consolidated return. In Year 1, S1 sells an asset to S2 for cash, resulting in a deferred intercompany capital gain. In Year 3, the P group has a capital loss that it would like to use, so S2 contributes the asset to a newly formed LLC owned by S1 and S2.

Result: Because the asset is no longer owned by a member of the P consolidated group, the deferred capital gain should be triggered, which P wants in order to utilize other losses.

Analysis: No business purposes, no profit potential from contribution. Contrary to intent of Congress?
**Facts:** FP, a foreign corporation, owns 100% of the stock of P, which owns all of the stock of S, which owns all of the stock of X. P, S, and X file a consolidated return. In order to deconsolidate X, S contributes the stock of X to an LLC formed by S and FP.

**Result:** Because X is no longer an includible corporation, it should not be a member of P’s consolidated group.

**Analysis:** No business purpose and no profit potential.
**Facts:** P, a domestic corporation, owns 100% of the stock of S1, S2, and X, and they file a consolidated return. In order to deconsolidate X, P contributes 50% of the X stock to each of S1 and S2, and S1 and S2 contribute the X stock to a newly formed LLC.

**Result:** Because X is no longer an includible corporation, it should not be a member of P’s consolidated group. No business purpose and no profit potential.
Avoiding Loss Disallowance Rules

Facts: P, a domestic corporation, owns 100% of the stock of S1 and S2. The P group wants to purchase the stock of X from Z, but X has built-in gain assets that could trigger the application of the loss disallowance rules if the P group later disposes of the stock of X. To avoid the potential application of the loss disallowance rules, S1 and S2 form LLC, and LLC acquires the stock of X.

Result: Because X is not an includible corporation, it should not be a member of P’s consolidated group. The use of the LLC had no business purpose and no profit potential.
Facts: P, a domestic corporation, owns all of the stock of S, which is a domestic subsidiary, and FS, which is a foreign subsidiary. P has a $100 basis in its S stock. The value of its S stock is $10. If P liquidates S, the loss in the S stock will not be realized. P therefore sells 25% of the S stock to FS and, after a period of time, S liquidates into P.

Result: P should recognize the loss on the remaining 75% of stock in S. There was no business purpose or non-tax profit potential for the division of ownership.
Section 332 Liquidation

**Facts:** P, a domestic corporation, owns 75% of the stock of S, which is a domestic subsidiary, and 100% of FS, which is a foreign subsidiary. P has a $10 basis in its S stock. The value of its S stock is $100. If P liquidates S, the gain in the S stock will be realized. P therefore purchases 25% of the S stock from FS *before a decision to liquidate is made*, and, after a period of time, S liquidates into P.

**Result:** P should not recognize the gain on the liquidation under section 332. Business purpose and non-tax profit potential?
Check-and-Sell Transaction

Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, P causes CFC1 to check-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, P causes CFC1 sells all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

Issue: Under the rationale of *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004), the income generated from the sale does not constitute Subpart F income. Was there a business purpose or profit potential from checking the box?


**Check-the-box Election to Claim Worthless Security Deduction**

**Facts:** X makes an election to change the classification of Y, a foreign corporation, to a disregarded entity for federal tax purposes. Immediately before the effective date of the election, the fair market value of Y’s assets does not exceed the sum of its liabilities.

**Analysis:** Under Rev. Rul. 2003-125, 2003-2 C.B. 1243, X is allowed to claim a worthless security deduction under section 165(g)(3) because the fair market value of Y’s assets do not exceed the entity's liabilities (i.e., on the deemed liquidation of Y, X receives no payment on its stock).

**Question:** Is this result affected by the ES doctrine if there was no business purpose for the check-the-box election?
Checking and Unchecking

- USCO decides to start doing business in Country A
- USCO already owns CFC Holdco
- CFC Holdco contributes cash into Newco, organized in Country A and makes a check the box election to treat Newco as a disregarded entity
Use of a blocker to avoid UBTI

X owns an operating business that requires additional funds to expand

Tax-Exempt Investor ("TE") is interested in making an investment in the X business
  - Income produced by the X business would be UBTI to TE

X and TE form a partnership, with X contributing its business and TE contributing cash

TE forms a corporation ("Blocker") to acquire and hold its investment in the partnership in order to avoid exposure to UBTI
Section 269(b) states deductions, credits, or other allowances may be disallowed, but only if the liquidation occurs within 2 years after a QSP.

Does Coltec and other recent caselaw replace section 269(b), or mean that a liquidation 2 years and a day after a QSP can result in such a disallowance?
In *Commissioner v. Court Holding*, the Supreme Court held that a liquidation of a corporation followed by a sale of the corporation’s assets resulted in tax to the corporation because “a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title.” However, five years later, in *United States v. Cumberland Public Service Co.*, the Court held that a liquidation followed by a sale did not result in tax to the corporation. The Court stated, “The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.”

In both *Court Holding* and *Cumberland* the sole purpose of the liquidation was to reduce tax; why did Cumberland win? Did the S. Ct. not understand the ES doctrine?
A corporation transfers stock of a subsidiary to a newly formed subsidiary ("Newco") for its stock and sells that stock to the public to "bust" the section 351 transaction and to be eligible to make the section 338(h)(10) election for Newco.

Was there a business purpose or profit potential for the step of busting the 351?
Section 351 Transaction with Built-in Loss Asset

- A corporation transfers an asset with a built-in loss to its subsidiary in exchange for subsidiary stock. Does S hold the transferred asset with a carryover basis and/or does P obtain the S stock with an exchanged basis?
- Is duplicating a loss through a corporation inherently subject to ES doctrine, despite enactment of section 362(e)(2)?
• What if, as is likely the case, certain steps are undertaken solely to come within the reorganization provisions in section 368? For example, assume that substantially all of a target corporation’s assets are acquired by another corporation solely in exchange for voting stock. If that corporation liquidates following the asset transaction to come within the terms of a “C” reorganization, is the liquidation step subject to risk because it occurred solely for tax reasons?
‘D’ Reorganizations – Cash – Rev. Rul. 70-240

Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D), according to Rev. Rul. 70-240.

Analysis: Assume the business purpose was to extract cash from Y tax free (under section 356, the boot was limited to the gain in the X stock, which here was zero). There was no other business purpose or economic change of ownership.
**All-Cash ‘D’ Reorganizations – Consolidation**

**Facts:** P owns all of the stock of X and Y. X owns the stock of T. P, X, Y, and T are members of a consolidated group. T transfers its assets to Y in exchange for cash and immediately thereafter liquidates into X.

**Result:** In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to T in exchange for T’s assets; (ii) T is treated as distributing the Y stock to X in a liquidation; and (iii) Y is treated as redeeming its stock from X for cash. See Treas. Reg. § 1.1502-13(f) and (f)(7), ex. 3.

The final D regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to a “nominal share” issued by Y. See Treas. Reg. § 1.368-2(l). An ELA will give rise to a deferred gain when the nominal share is treated as distributed from X to P in order to reflect actual stock ownership.

P may be able to avoid this result by having Y actually issue a single share of stock to T or by contributing a share of Y stock to X.

**Question:** Does the issuance of the one share have business purpose or economic substance?
**Facts:** P owns all of the stock of CFC1 and CFC 2. CFC 1 and CFC 2 are foreign corporations. CFC 1 transfers its assets to CFC 2 in exchange for cash and immediately thereafter liquidates into P.

**Result:** This transaction should be treated as a valid “D” reorganization. See Treas. Reg. § 1.368-2(l); but see *Schering-Plough v. Corp. v. United States*, F. Supp. 2d 219 (D.C. N.J. 2009), aff’d, *Merck & Co., Inc. v. United States*, Docket No. 10-2775 (3d Cir. 2011) (implying that efforts to repatriate foreign income without income inclusion will be rejected under the ES doctrine).
Section 304 Cross-Border Transaction

**Facts:** P, a domestic corporation, owns all of the stock of F1 and F2, both of which are foreign corporations. F2 has excess foreign tax credits. P sells F1 stock to F2 in exchange for cash in a transaction the sole purpose of which is to pull foreign tax credits out of F2.

**Result:** Section 304 applies to the transaction so that earnings are repatriated and foreign tax credits are pulled out of F2.

**Question:** Is this result questionable under the ES doctrine because there was no business purpose or profit potential?
Roll-up Transaction

- Assume that a parent corporation converts several LLCs or partnerships into a corporation in a roll-up transaction. Is this transaction subject to review if the roll-up was done in part to combine income and loss?
- Proposals indicate may be within “safe harbor”?
Other Recent Legislative Developments
American Recovery and Reinvestment Act of 2009

- On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”), Pub. L. 111-5. The Recovery Act was designed to stimulate economic recovery, and included about $290 billion in tax incentives.

- The Recovery Act included the following business tax provisions:
  - Amendment to section 382 to prevent the loss limitation rules from applying to certain ownership changes occurring by reason of EESA restructuring plans (targeting GM).
  - Amendment to section 108 to allow the deferral of certain COD income and subsequent taxable inclusion over a 5-year period.
  - Amendment to section 172 to permit to allow three-, four-, or five-year carrybacks of net operating losses (“NOLs”) for small businesses.
  - Repeal of Notice 2008-83, which interpreted section 382 as allowing acquiring banks to claim built-in losses from acquired banks.
  - Extension of enhanced small business expensing.
  - Extension of bonus depreciation.
  - Incentives to hire unemployed veterans and disconnected youth.
  - Increase in New Markets tax credit.

- The Recovery Act also included various individual income tax provisions and renewable energy tax provisions.
Addition of Section 382(n)

• Section 1262 of the Recovery Act added subsection (n) to Section 382.
• Section 382(n) prevents the application of section 382 to an ownership change that:
  – Occurs under a restructuring plan required under a loan agreement or a commitment for a line of credit entered into with the United States under the EESA, and
  – Is intended to result in a rationalization of the costs, capitalization, and capacity with regard to the manufacturing workforce of, and suppliers to, the taxpayer and its subsidiaries.
• Section 382(n) does not apply to subsequent ownership changes, unless that change is also described by this provision.
• Section 382(n) does not apply if, immediately after the change, any person, (other than a voluntary employees’ beneficiary association) owns stock of the loss corporation possessing at least 50% of vote or value.
  – Related persons, as defined by section 267(b) or 707(b), and groups of persons acting in concert, are treated as a single person.
• This rule is effective for ownership changes after February 17, 2009.
• General Motors, who was forced to restructure as a part of an agreement for a federal loan, appears to be the only taxpayer affected by the amendment to section 382(n).
Repeal of Notice 2008-83

• Section 1261 of the Recovery Act revokes Notice 2008-83.
  – The IRS issued Notice 2008-83 on September 30, 2008, regarding the built-in loss rules of
    section 382(h) for loans or bad debts following the acquisition of a bank.
  – Section 382 limited the ability of loss corporation to recognize losses attributable to built-in
    loss assets or deductions attributable to periods prior to an ownership change.
  – Notice 2008-83 provided that any deduction properly allowed after an ownership change to a
    bank with respect to losses on loans or bad debts shall not be treated as attributable to
    periods prior to an ownership change.

• Section 1261(a) of the Recovery Act sets forth the following findings:
  – The Secretary of the Treasury was not delegated authority under Section 382(m) to provide
    exemptions or special rules that are restricted to particular industries or classes of taxpayers,
    and it is doubtful that the IRS has legal authority to prescribe such a notice.
  – Notice 2008-83 was inconsistent with the congressional intent of Section 382(m).

• Recovery Act Section 1261(b) states that Notice 2008-83 remains effective for ownership changes
  occurring on or before January 16, 2009, but has no force or effect for ownership changes after
  that date.
  – Exception: The notice remains effective for ownership changes after January 16, 2009 if the
    change is (i) pursuant to a written binding contract entered into on or before January 16,
    2009, or (ii) pursuant to a written agreement entered into on or before January 16, 2009 and
    the agreement was described on or before January 16, 2009 in a public announcement or in
    a filing with the SEC required by reason of such ownership change.
Section 108(i)

- Section 1231 of the Recovery Act added subsection (i) to section 108.
- In general, a taxpayer may elect under section 108(i) to include COD income from the reacquisition of an “applicable debt instrument” in gross income ratably over a 5-year period (rather than including the entire COD income in the year of the reacquisition).
  - The five-year period for recognition of COD income begins with the fifth tax year following the tax year in which the reacquisition occurs if the reacquisition occurs in 2009.
- An election under section 108(i) precludes the taxpayer from excluding the COD income under section 108(a) (with a potential reduction of attributes under section 108(b)) for the year of reacquisition as well as any subsequent year.
- The section 108(i) election is irrevocable.
- Section 108(i)(2) defers deductions related to OID in debt-to-debt exchanges (including exchanges resulting from significant modifications) to match the deferral of income when a debtor makes a section 108(i) election.
Amendment of Section 172: Small Business NOL

• Section 1211 of the Recovery Act amended section 172 to allow eligible businesses to elect a 3, 4, or 5-year carryback period for a “2008 NOL” instead of the general two-year carryback.
  – A business is eligible if it is a “small business.”
  – A “2008 NOL” refers to a NOL for a tax year ending in 2008 or, upon an election by a taxpayer, for a tax year beginning in 2008.

• A "small business" generally refers to a corporation or a partnership (or a sole proprietorship if it were a corporation) whose average annual gross receipts for a three-tax-year period are $15 million or less.

• This law is effective for NOLs arising in tax years ending after December 31, 2007. Transitional rules are provided for tax years ending before February 17, 2009.
Worker, Homeownership, and Business Assistance Act of 2009

• On November 6, 2009, President Obama signed the Worker, Homeownership, and Business Assistance Act of 2009 (the “Assistance Act of 2009”).

• The Assistance Act of 2009 contained several tax provisions, including --
  – Extension and modification of the first-time homebuyer credit,
  – Expansion of eligibility for and NOLs subject to temporary 5-year operating loss carryback provision added by the Recovery Act,
  – Delay of the implementation of worldwide interest allocation,
  – Modification of penalty for failure to file partnership or S corporation returns,
  – Expansion of electronic filing by return preparers,
  – Exclusion from gross income of qualified military base realignment and closure fringe, and
  – Adjustment of the amount of estimated corporate income tax due in 2014.
Worker, Homeownership, and Business Assistance Act of 2009

- The Assistance Act of 2009 extended the election to increase the carryback period to a 3, 4, or 5-year carryback period to 2009 NOLs (i.e., operating losses from taxable years ending after December 31, 2007, and beginning before January 1, 2010, are now covered).
  - The election is available to all taxpayers rather than only eligible small businesses.
    - A separate change under section 810 was made to permit life insurance companies to carryback 2008 or 2009 operating losses for 4 or 5 taxable years.
    - The amount of a NOL carried back to the 5th taxable year is limited to 50% of taxable income for that year, with the excess NOLs carried forward.
      - The limitation will not affect eligible small businesses that made elections under the Recovery Act.
    - A taxpayer must make the election by the extended due date for filing the return for the taxpayer’s last taxable year beginning in 2009, and in such manner as may be prescribed by the Secretary.
    - An election will be irrevocable.
- The IRS issued Rev. Proc. 2009-52 on November 20, 2009, to provide guidance under the temporary NOL carryback provision. On June 23, 2010, the IRS and Treasury issued temporary regulations on the implementation of the temporary NOL carryback provision within a consolidated group. The IRS later issued Notice 2010-58 on August 20, 2010, which provides further guidance on the temporary NOL carryback provision in a Q&A format.
Administrative Developments and Caselaw
Schedule UTP
Schedule UTP

Background
• In Announcement 2010-9 (issued January 16, 2010), the IRS introduced a proposed reporting requirement on certain business taxpayers to provide information about uncertain tax positions affecting their federal income tax liability.
  – In Announcement 2010-17 (issued March 5, 2010), the IRS extended the comment period for the proposal and stated that it planned to require the filing of the new schedule for returns relating to calendar year 2010 and for fiscal years that begin in 2010.
  – In Announcement 2010-30 (issued April 19, 2010), the IRS announced the release of the draft schedule (“Schedule UTP”) and instructions, comments on which were due by June 1, 2010.
• On September 9, 2010, the IRS and Treasury issued proposed regulations authorizing the IRS to require certain corporations (as set out in forms, publications or instructions, or other guidance) to provide information concerning uncertain tax positions concurrent with the filing of a return.
  – The proposed regulations appear to have been in response to criticisms that the IRS and Treasury lack the authority to require taxpayers to file Schedule UTP.
  – On December 15, 2010, final regulations were published without any substantive changes.
• On September 24, 2010, the IRS released the final Schedule UTP and its instructions.
  – Changes from the draft Schedule UTP and instructions are detailed in the contemporaneously issued Announcement 2010-75.
  – The IRS also released a directive to the field to provide guidance on the implementation of Schedule UTP, as well as a separate announcement (Announcement 2010-76) regarding modifications to the policy of restraint.
Schedule UTP

Final Schedule UTP – Significant Changes from Draft Schedule

• Five-year phase-in of the reporting requirement based on a corporation’s asset size.
• No reporting of the rationale and nature of uncertainty in the concise description of the position.
• No reporting of a maximum tax adjustment.
• No reporting of tax positions for which no reserve was created due to a widely-understood administrative practice.
**Schedule UTP**

**Schedule UTP Filing Requirement**

- In general, for 2010 tax years, Schedule UTP requires a corporation with assets equal to or exceeding $100 million to report its U.S. federal income tax positions for which the corporation or a related party has (i) recorded a reserve in an audited financial statement or (ii) not recorded a reserve because the corporation expects to litigate the position.
  - Corporations are required to file a 2010 Schedule UTP with income tax returns for the calendar year 2010 and fiscal years that begin in 2010 and end in 2011. A corporation is not required to file a Schedule UTP for a short tax year that ends in 2010.
  - Corporations are not required to report a tax position taken in a tax year beginning before January 1, 2010, even if a reserve is recorded with respect to that tax position in audited financial statements issued in 2010 or later.
- The final Schedule UTP and instructions require only corporations filing a Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC to file a 2010 Schedule UTP. The IRS will consider whether to extend all or a portion of Schedule UTP reporting to other taxpayers for 2011 or later tax years, such as pass-through entities and tax exempt entities.
- The IRS has implemented a five-year phase-in of Schedule UTP for corporations with assets under $100 million.
  - The total asset threshold will be reduced to $50 million starting with 2012 tax years and to $10 million starting with 2014 tax years.
- The final instructions do not exclude taxpayers in the Compliance Assurance Program (CAP) from the Schedule UTP filing requirement.
  - The IRS indicated that it will be expanding CAP and making it permanent, and that it will address Schedule UTP compliance in upcoming CAP permanence guidance.
Schedule UTP

Reporting of Uncertain Tax Positions on Schedule UTP

• A corporation or a related party records a reserve for a U.S. federal income tax position when a reserve for income tax, interest, or penalties with respect to that position is recorded in audited financial statements of the corporation or a related party.
  – A tax position is taken in a tax return if it would result in an adjustment to a line item on that tax return (or would be included in a section 481(a) adjustment) if the position is not sustained.
  – Audited financial statements mean financial statements on which an independent auditor has expressed an opinion under GAAP, IFRS, or another country-specific accounting standard, including a modified version of any of the above. Compiled or reviewed financial statements are not audited financial statements.
  – The initial recording of a reserve triggers reporting of a tax position taken on a return. Subsequent reserve increases or decreases, however, do not.
• A corporation must report on Schedule UTP a tax position for which no reserve was recorded based on an expectation to litigate.
  – This occurs if the corporation or a related party determines the probability of settling with the IRS to be less than 50 percent and, under applicable accounting standards, no reserve was recorded because the corporation intends to litigate the position and has determined that it is more likely than not to prevail on the merits in the litigation.
• Schedule UTP and its instructions define a related party broadly to include any entity that is related to the corporation under sections 267(b), 318(a), or 707(b), or any entity that is included in a consolidated audited financial statement in which the corporation is also included.
  – The final schedule contains a box that must be checked if the corporation is unable to obtain information from related parties sufficient to determine whether a tax position must be disclosed.
• Schedule UTP generally requires the reporting of current year and prior year uncertain tax positions.
  – The portion of Schedule UTP relating to prior year uncertain tax positions will be used in tax years after 2010 to report tax positions taken by the corporation in a prior tax year that have not been reported on a prior year’s tax return.
  – A corporation is generally not required to report a tax position it has taken in a prior year if the corporation reported that tax position on a Schedule UTP filed with a prior year tax return. However, an exception applies if there is a transaction that results in tax positions taken in more than one tax return.
Schedule UTP

Information Required in Schedule UTP

• A corporation must provide a concise description of each uncertain tax position, including a description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. According to the IRS, this description should, in most cases, not exceed a few sentences.
  – The final Schedule UTP instructions expressly provide that a concise description should not include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position.
  – The instructions contain several examples of what constitutes an acceptable concise description.

• A corporation must rank by size each uncertain tax position (including transfer pricing and other valuation positions) reported on Schedule UTP.
  – The size of each tax position is determined on an annual basis and is the amount of U.S. federal income tax reserve recorded for that position. The size of a tax position, however, is not required to be reported on Schedule UTP.
    • If a reserve is recorded for multiple tax positions, then a reasonable allocation of that reserve among the tax positions to which it relates must be made in determining the size of each tax position.
    • For an affiliated group filing a consolidated return, the determination of the size of a tax position taken on such return is determined at the affiliated group level for all members of the affiliated group.
    • In ranking its uncertain tax positions, a corporation must specify whether a tax position is a transfer pricing position.
  – A corporation must also indicate on the Schedule UTP if an uncertain tax position is a “major tax position.”
    • An uncertain tax position is a major tax position if the reserve exceeds 10 percent of the aggregate amount of the reserves for all of the tax positions reported on the Schedule UTP.
  – The final instructions provide that no size needs to be determined for uncertain tax positions based on an expectation to litigate, which can be assigned any rank. Further, such positions are disregarded for purposes of the major tax position calculation.

• Other information that must be provided on the Schedule UTP with respect to an uncertain tax position includes: (i) the primary IRC sections relating to the tax position, (ii) whether a tax position creates temporary or permanent (or both) differences, and (iii) if the tax position relates to a position of a pass-through entity, such entity’s EIN.
Schedule UTP

Coordination with Other Reporting Requirements

- The final Schedule UTP instructions state that the IRS will treat a complete and accurate disclosure of a tax position on a Schedule UTP as if the corporation filed a Form 8275, Disclosure Statement (or Form 8275-R, Regulation Disclosure Statement), with respect to the tax position.

- Consistent with Notice 2010-62, in the case of a transaction that is not a reportable transaction, the IRS will treat a complete and accurate disclosure on Schedule UTP as satisfying the disclosure requirements of section 6662(i) (relating to the strict liability penalty under the codified economic substance doctrine).

- The IRS is continuing to study other ways to reduce duplicate reporting, and is considering whether complete and accurate disclosure on Schedule UTP would also, in appropriate circumstances, provide the information necessary to satisfy the reportable transaction disclosure requirements.

Penalties

- The final Schedule UTP instructions do not provide specific guidance regarding penalties.

- According to the IRS, it intends to review compliance on how Schedule UTP is completed by corporations and to take appropriate enforcement action, including the possibility of opening an examination or making another type of taxpayer contact, in those instances in which there appears to be a failure to complete Schedule UTP or a failure to report whether the corporation is required to complete the schedule.
Schedule UTP

LB&I Directive on Implementation of Schedule UTP

- Concurrent with the release of the final Schedule UTP, the IRS issued a directive for all Large Business and International Division (LB&I) personnel setting forth the planned treatment of Schedule UTP.
- The directive outlines the various uses for the information reported on Schedule UTP and indicates that initial processing of Schedule UTP information will be centralized to ensure appropriate review to identify trends and areas requiring further guidance to address uncertainty in the law.
- The directive also stresses that “[a]lthough the Schedule UTP is intended to expedite the return selection and issue identification process, it does not serve as a substitute for other examination tools or for the independent judgment of the examiner, and it should not be used to shortcut other parts of the audit process or the careful and considered examination of issues and an objective application of the law to the facts.”
- The IRS plans to institute training specific to the handling of Schedule UTP.
Schedule UTP

Announcement 2010-76 – Modification to IRS Policy of Restraint

• In connection with the release of the final Schedule UTP, the IRS announced that it is expanding its policy of restraint, and that it will forgo seeking particular documents that relate to uncertain tax positions and the workpapers that document the completion of Schedule UTP.
  – According to the IRS, these changes are designed to reassure taxpayers that the IRS is only seeking issue identification, and not legal analysis or risk assessments, in order to further IRS objectives for increased efficiency, certainty, and consistency.
• Significant changes in the modified policy of restraint include:
  – Disclosing issues on Schedule UTP does not otherwise affect the protections afforded under the policy of restraint.
  – Drafts of issue descriptions and information regarding qualification or ranking of issues are protected under the policy.
  – The IRS generally will not seek documents that would otherwise be privileged, even though the taxpayer has disclosed the documents to a financial auditor as part of an audit of the taxpayer’s financial statements.
Schedule UTP

Frequently Asked Questions

- On March 23, 2011, the IRS released FAQs that provide guidance on issues raised by taxpayers about Schedule UTP.
- The FAQs clarify the following with respect to reporting on Schedule UTP:
  - For a corporation subject to FIN 48, if the position is “highly certain” within the meaning of FIN 48, a tax position is considered “sufficiently certain so that no reserve was required,” and therefore does not need to be reported on Schedule UTP.
  - If the corporation reconsiders whether a reserve is required for a tax position and eliminates the reserve in an interim audited financial statement issued before the tax position is taken in a return, the corporation does not need to report the tax position to which the reserve relates on Schedule UTP.
  - The use of an NOL or credit carryover in a post-2009 return is a tax position that should not be reported if the portion of the NOL or the credit carryforward that is used includes a tax position taken in a pre-2010 return for which a reserve has been recorded.
    - This does not affect the requirement to report a tax position claimed on a post-2009 return for which a reserve has been recorded that is included in an NOL or credit carryover for potential use in a later year.
    - The FAQs indicate that additional guidance will be provided regarding reporting requirements for the use of NOLs and credit carryovers.
  - The size of a tax position is the amount of the reserve recorded for that position. If an amount of interest or penalties relating to a tax position is not separately identified in the books and records as associated with that position, then that amount of interest and penalties is not included in the size of a tax position used to rank that position.
- With respect to the policy of restraint, the FAQs provide:
  - The changes to the policy of restraint in Announcement 2010-76 apply to documents requested by Appeals.
  - In general, in document requests by IRS counsel after the filing of a Tax Court petition, IRS counsel will not issue discovery requests for documents or information that the IRS would not seek under its policy of restraint.
  - The changes announced in Announcement 2010-76 apply to any request for documents outstanding on or made after September 24, 2010, in any open examination.
United States v. Textron
United States v. Textron

District Court

- The IRS requested Textron’s tax accrual workpapers.
  - Attorneys prepared the workpapers, which were kept confidential, although content had been shared with accounting firm (E&Y).
  - Content of tax accrual workpapers:
    - List of issues (uncertain tax positions)
    - List of “hazards of litigation” conclusions, expressed as percentage chance of losing each issue in court
    - List of monetary value of each issue and reserve
- The District Court denied the IRS’ petition to enforce the summons, reaching the following conclusions:
  - Privilege:
    - Tax accrual workpapers were initially protected by attorney-client privilege and section 7525 tax practitioner-client privilege.
    - However, the privileges were waived when the workpapers were disclosed to Textron’s independent auditors.
  - Work Product
    - Tax accrual workpapers were protected by work product because they would not have been prepared “but for” the fact that Textron anticipated the possibility of litigation with the IRS.
    - Work product protection was not waived because disclosure to independent auditors did not substantially increase the opportunity for potential adversaries (i.e., the IRS) to obtain the information.
United States v. Textron

Initial Appeals Court Decision

- The First Circuit initially upheld the decision of the District Court.
- In the initial hearing, the First Circuit considered three issues: (1) whether the work-product doctrine protects Textron's workpapers; (2) whether any such work-product protection was waived through disclosure to E&Y; and (3) whether the District Court erred in not considering the IRS's request for E&Y's workpapers.
- The First Circuit concluded that the "ordinary course of business" exception to the work product doctrine could not be applied to require disclosure of all documents prepared with some business purpose in mind. Accordingly, the First Circuit found that dual purpose documents prepared by Textron may be protected under the work product doctrine.
- Although affirming the holding of the District Court regarding work product protection, the First Circuit remanded the case to the District Court to resolve factual issues relating to the discoverability of certain workpapers prepared by Textron's attest auditors. This group of workpapers was distinct from the workpapers prepared by Textron's inhouse attorneys.
  - The workpapers at issue were prepared and retained by the attest auditors. The First Circuit observed that Arthur Young “suggests such documents are not protected and Textron has not argued otherwise.”
  - As described by the First Circuit, the issue with respect to discoverability was whether Textron was considered to have possession, custody, or control of these documents, even though the documents were retained by the attest auditors. This was the issue because the summons in question was issued to Textron, not the attest auditors. The First Circuit stated that Textron may be considered to have possession, custody, or control if it has a right to access or obtain the documents from the attest auditors. The First Circuit remanded the case to the District Court to resolve this question.
United States v. Textron

Appeals Court Rehearing En Banc
• The First Circuit vacated its initial decision and reheard the appeal en banc.
  • The en banc court, divided 3-2, held that the workpapers were not protected by the work product doctrine because they were not prepared “in anticipation of litigation.”
    – According to the majority, “the work product privilege is aimed at protecting work done for litigation, not in preparing financial statements. Textron’s workpapers were prepared to support financial filings and gain auditor approval; the compulsion of the securities laws and auditing requirements assure that they will be carefully prepared, in their present form, even though not protected; and IRS access serves the legitimate, and important, function of detecting and disallowing abusive tax shelters.”
  • The dissent criticized the majority for abandoning, but not overruling, the First Circuit’s adoption of the “because of” test in Maine v. United States.
  • According to the dissent, “the majority purports to follow Maine, but really conducts a new analysis of the history of the work-product doctrine and concludes that documents must be ‘prepared for any litigation or trial.’” The dissent argued that the “prepared for” rule was contrary to the broader “because of” rule and inconsistent with the policy of the work product doctrine.

Petition for Certiorari Denied:
• On May 24, 2010, the U.S. Supreme Court denied a petition for certiorari to reconsider the First Circuit's ruling.
United States v. Deloitte
**United States v. Deloitte – District Court**

**District Court Decision**

- The IRS requested three documents from Deloitte, the independent auditor for Dow Chemical, who was involved in ongoing litigation concerning the tax treatment of two partnerships owned by it and two of its wholly owned subsidiaries.
  - The first document was a draft memorandum prepared by Deloitte summarizing a meeting between Dow Chemical’s employees, Dow Chemical’s outside counsel, and Deloitte about the possibility of litigation over one of the partnerships, and the necessity of accounting for this possibility in an ongoing audit. The meeting took place after Dow Chemical informed Deloitte about the likelihood of litigation regarding the partnership transaction.
  - The second document was a memorandum and flow chart prepared by two Dow Chemical employees (an accountant and in-house attorney).
  - The third document was a tax opinion prepared by Dow Chemical’s outside counsel.
  - The court concluded that the Deloitte memorandum was work product because it was “prepared because of the prospect of litigation with the IRS over the tax treatment of [the partnership].”
    - The court further concluded that, although the document was created by Deloitte, it was Dow Chemical’s work product because its contents recorded the thoughts of Dow Chemical’s counsel regarding the prospect of litigation.
  - The court also rejected the government’s contention that Dow Chemical had waived work-product protection for the three documents.
- The government appealed the district court’s ruling, and Dow Chemical intervened to assert work-product protection.
United States v. Deloitte – Court of Appeals

• On appeal, the U.S. Court of Appeals for the District of Columbia Circuit vacated the District Court’s holding in part and remanded for further proceedings. United States v. Deloitte, LLP, 610 F.3d 129 (D.C. Cir. 2010).

Deloitte Memorandum

• The government contended that the Deloitte memorandum was not attorney work product because (i) it was created by Deloitte, not Dow Chemical or its representative, and (ii) it was generated as part of the routine audit process, not in anticipation of litigation.
• The court found that Deloitte’s preparation of the memorandum did not exclude the possibility that it contained Dow Chemical’s work product.
  – According to the court, the question was not who created the document or how they were related to the party asserting work-product protection, but whether the document itself contained work product (i.e., the thoughts and opinions of counsel developed in anticipation of litigation).
• In addressing the government’s second argument, the court noted that it applied the “because of” test for determining whether a document was prepared “in anticipation of litigation.”
  – The court rejected the government’s argument that the document’s function should be examined separately from its contents in determining its status as work product.
  – The court also rejected the government’s argument that when a document is created as part of an independent audit, its sole function is to facilitate that audit, which means it is not prepared in anticipation of litigation.
• The court disregarded the government’s reliance on United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), finding that El Paso was decided under the more demanding “primary motivating purpose test,” and that under the more lenient “because of” test, material generated in anticipation of litigation may also be used for ordinary business purposes without losing its protected status.
• As part of its argument, the government relied on the First Circuit’s holding in Textron. The court, however, found Textron to be distinguishable because it turned on the First Circuit’s examination of the particular documents at issue and, while it determined those documents were not work product, it did not exclude the possibility that other documents prepared during the audit process might warrant work-product protection. The court also noted that the dissent in Textron made a strong argument that the First Circuit in that case applied a more exacting standard by examining whether the documents were “prepared for use in possible litigation.”
Deloitte Memorandum (cont’d)
• Ultimately, the court concluded that, although the Deloitte memorandum may have been protected work product, the district court did not have a sufficient evidentiary foundation for its holding that the memorandum was purely work product.
  – The court thus remanded this question to the district court to assess whether the document was entirely work product or whether a partial or redacted version of the document could have been disclosed.

Dow Chemical Documents
• With respect to the two documents prepared by Dow Chemical and its outside counsel, the government acknowledged that the documents were work product, but argued that Dow Chemical waived work-product protection by disclosing them to Deloitte, who, according to the government, was a potential adversary and a conduit to other adversaries.
• The court rejected both government arguments and concluded that Dow Chemical had not waived work-product protection.
  – The court found that Deloitte could not be considered a potential adversary with respect to the Dow Chemical documents. According to the court, Deloitte could not be Dow Chemical’s adversary in the sort of litigation the Dow Chemical documents addressed, as such documents were prepared in anticipation of a dispute with the IRS and would not likely be relevant in any dispute Dow Chemical might have with Deloitte.
  – The court also concluded that Deloitte was not a conduit to Dow Chemical’s adversaries. Because Deloitte was not an adversary, the court found that Dow Chemical’s disclosure was not a selective disclosure. Dow Chemical also had a reasonable expectation of confidentiality because Deloitte, as an independent auditor, had an obligation to refrain from disclosing confidential client information.
Tax-Free Acquisitions
What Is This Transaction?

• S transfers substantially all of its assets to Newco in exchange for Newco stock.
• S merges into P. S transfers its remaining assets and Newco stock to P.
• What is this transaction?
  – Downstream section 368(a)(1)(D) reorganization with section 361/356 asset distribution to P?
  – Section 368(a)(1)(F) reorganization with section 301 asset distribution to P? (What if S transfers all of its assets to Newco before the merger)?
  – Section 351 asset transfer to Newco followed by section 368(a)(1)(A) merger? See PLRs 201026010 and 200733002.
• What is P’s basis in the Newco stock?
• Where do S’s attributes end up?
Treas. Reg. § 1.368-2(k)(1)

- 2007 version: “Except as otherwise provided in this section, a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) **shall not be disqualified** by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.”

- 2009 version: “A transaction otherwise qualifying as a reorganization under section 368(a) **shall not be disqualified or recharacterized** as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of § 1.368-1(d) are satisfied and the transfer(s) are described in either paragraph (k)(1)(i) or (k)(1)(ii) of this section.”
Step Transaction Issues
**Facts:** The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an “A” reorganization. See King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-1 C.B. 1297 (May 11, 2001).
**Rev. Rul. 2001-46 - Situation 1**

**Facts:** P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

**Step vs. No Step:** If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. If step transaction principles applied, the transaction should be treated as a single statutory merger of T into P under section 368(a)(1)(A). See *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). If so, P would acquire the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

**Result:** On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T. In 2006, the Service finalized the regulations issued in 2003.
The IRS issued final regulations on July 3, 2006, which adopted the substance of temporary regulations issued in 2003.

The final regulations provide that “a section 338(h)(10) election may be made for T where P’s acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . ” Treas. Reg. § 1.338(h)(10)-1(c)(2).

– This rule applies regardless of whether, under the step transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under section 368(a). Id.

– If a section 338(h)(10) election is made under these facts, P’s acquisition of T stock will be treated as a qualified stock purchase (a “QSP”) for all federal tax purposes and will not be treated as a reorganization under section 368(a). See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 12 & 13.

– However, if taxpayers do not make a section 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under section 368(a). See id. at Ex. 11.

In issuing the final regulations, the IRS rejected a recommendation that the final regulations allow section 338(g) elections, as well as section 338(h)(10) elections, to turn off the step transaction doctrine, because extending the election as such would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a reorganization under section 368(a).

The IRS stated in the Preamble to the final regulations that it would continue to study whether the corporate purchaser requirement of -3(b) should be amended (e.g., an individual cannot make a QSP, although an individual can form a corporation to satisfy the QSP requirement if that corporation is treated as purchasing the target stock, which it may not be if that corporation liquidates following the stock purchase).

The final regulations are effective for stock acquisitions occurring on or after July 5, 2006.
**Rev. Rul. 2001-46 - Situation 2**

**Facts**: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

**Result**: Step transaction principles apply to treat the transaction as a merger of T directly into P.
**King Enterprises Transaction - Variation**

**Facts:** Same facts as in *King Enterprises*, except P sells T’s assets to X a third party immediately after the merger of T into P.

**Questions:**

1. Does the Step-Transaction Doctrine apply?
2. What is the result of this transaction for federal income tax purposes?

**Variation:** P shareholders exchange 100% P stock for T stock, and T sells its assets immediately after the reorganization.
**King Enterprises Transaction – Variation**

**Facts:** T currently operates two businesses. T contributes all of its Business 2 assets to C, a newly formed wholly owned subsidiary. T distributes the stock of C to T shareholders in a spin-off. P acquires T from the T shareholders in exchange for P stock. Immediately thereafter, T is liquidated into P.

**Form:** The above steps in form constitute a section 355 transaction, a B reorganization, and a section 332 liquidation.

**Result:** Step transaction principles apply to treat P’s acquisition of T as if: (1) P acquired a portion of T’s assets (Business 1) and (2) T liquidated. See Rev. Rul. 67-274; *Elkhorn Coal*. Under Rev. Rul. 67-274, P’s acquisition of T is not a valid B reorganization. Because T liquidates into P, Rev. Rul. 67-274 combines the steps and treats the transaction as an acquisition by P of T’s Business 1 assets. In this transaction, the acquisition does not qualify as a C reorganization because *Elkhorn Coal* steps together the spin-off and the acquisition such that P cannot be said to acquire substantially all of T’s assets. Therefore, the transaction will be a taxable acquisition and not a tax-free reorganization.

**Issue:** Can P’s acquisition of T be treated as a qualified stock purchase followed by a section 332 liquidation? See Rev. Rul. 2001-46; Treas. Reg. § 1.338-3(c)(1)(i), (2); Treas. Reg. § 1.338(h)(10)-1(c)(2), (e).
**Facts:** A, an individual, owns all of the stock of T. T holds assets worth $150 and has $50 of liabilities. P, an unrelated corporation, has net assets worth $410. P forms X for the sole purpose of acquiring the stock of T in a reverse subsidiary merger. In the merger, P acquires all of the stock of T, and A exchanges the T stock for $10 in cash and P voting stock worth $90. Following the merger and as part of an integrated plan that included the merger, T completely liquidates into P. In the liquidation, T transfers all of its assets to P, and P assumes all of T’s liabilities.

**Result:** The merger does not constitute a tax-free reorganization because T’s liquidation does not fall within the safe harbor from the application of the step transaction doctrine (i.e., Treas. Reg. § 1.368-2k). When the merger and liquidation are integrated, the transaction fails the requirements of a tax-free reverse subsidiary merger set forth in section 368(a)(2)(E) because T does not hold substantially all of its properties and the properties of the merged corporation. Moreover, viewing the merger and the liquidation as integrated steps does not cause the transaction to be treated as a tax-free “A”, “C” or “D” reorganization or a section 351 exchange. For example, the transaction would not constitute a tax-free “C” reorganization because 40% of the consideration exchanged by P is not solely P voting stock (i.e., $50 assumption of liabilities and $10 cash). The deemed taxable exchange of T assets to P would not permit P to obtain a cost basis in the T assets because Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d) reject the step transaction approach in so far as a taxpayer may obtain a cost basis in assets acquired in a stock purchase in absence of a section 338 election.
**Step One:** MLCR sells MLCR Subsidiaries to MLC Subsidiaries in section 304 transactions.

**Step Two:** MLC forms MLCMH to hold the stock of MLCR.

**Step Three:** MLCR distributes the gross sale proceeds to MLCMH as a dividend.

**Step Four:** MLCMH sells MLCR to GATX/BCE, an unrelated third party.

MLC entered into a similar transaction using subsidiaries of MLCR in 1986.
**Merrill Lynch v. Commissioner**

**Position of Merrill Lynch:** Under the consolidated return regulations in effect during 1986, Merrill Lynch took the position that the cross-chain sales of MLCR Subsidiaries and the dividend to MLCMH should be treated as a deemed redemption under section 304 subject to dividend treatment under section 301. Merrill Lynch argued that the transaction did not qualify for sale or exchange treatment under section 302 due to the fact that MLC’s interest in MLCR was not terminated at the time of the cross-chain sale. Therefore, Merrill Lynch claimed that MLCMH was entitled to a step-up in its basis in its MLCR stock to the extent of the dividend and recognized a loss on its sale of MLCR stock to GATX/BCE.

**Decision of Tax Court:** The Tax Court ruled that the cross-chain sales, dividend, and sale of MLCR to GATX/BCE were steps in a plan to terminate MLC’s ownership of MLCR and the section 304 redemption was therefore subject to sale or exchange treatment because it represented a complete termination of MLC’s interest in MLCR under section 302(b)(3). The court concluded that the cross-chain sales and sale of MLCR to GATX/BCE represented a “firm and fixed” plan to terminate MLC’s interest in MLCR for purposes of determining whether the section 304 redemption should be treated as a sale or exchange or a dividend. See *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974). In reaching its decision, the Court focused on the fact that the complete plan to sell MLCR was presented to Merrill Lynch’s board of directors only three weeks after the cross-chain sales and while the sale was not finalized, it was sufficiently mature at that time that a tax reserve for the transaction was established.
Merrill Lynch v. Commissioner

Decision of Second Circuit: The Second Circuit affirmed the Tax Court decision finding that there was a “firm and fixed” plan to sell MLCR at the time of the cross-chain sale and, thus, the cross-chain sale qualified for sale or exchange treatment.

Additional Merrill Position: On appeal, Merrill Lynch took the position that for section 302 purposes, the stock ownership of the parent company, MLC, was to be considered rather than the stock ownership of MLCR. Because the issue of law was first raised on appeal, the Second Circuit remanded the issue back to the Tax Court.
Merrill Lynch v. Commissioner

Position of Merrill Lynch on Remand: Relying on section 304(a)(1), Merrill Lynch took the position that because section 318 gives MLC constructive ownership of the stock of the MCLR Subsidiaries both before and after cross-chain sales, through its continued ownership of the MLC Subsidiaries, the complete termination requirement of section 302(b)(3) was not met. Thus, Merrill Lynch properly treated the proceeds of the cross-chain sales as dividends.

Decision of Tax Court: The Tax Court held that the plain language of section 304 and its regulations do not support Merrill Lynch’s position. According to the court, section 304 requires that the person in control must actually receive property in exchange for the stock being sold cross-chain. As a result, the attribution rules of section 318 only apply to combine the ownership of more than one person to meet the control requirement of section 304(a)(1)(A), but not the requirement of section 304(a)(1)(B) that the controlling corporation receives property from a controlled corporation in exchange for controlled corporation stock. In addition, the court found that section 302 only applies to persons that transfer stock in exchange for property. See Treas. Reg. § 1.304-2(a).
PLR 200427011

**Facts:** P forms Newco with a minimal amount of capital. P executes a “firm commitment” underwriting agreement to sell Newco stock and convertible instruments in an IPO. P then contributes the shares of subsidiaries S1, S2, and S3 to Newco in exchange for all of the outstanding Newco common stock, Newco convertible instruments, and other non-stock consideration (e.g., short-term promissory notes or cash). Pursuant to the underwriting agreement, P sells 30% of the common stock to the public. P also represents that, although not legally obligated to do so, it fully intends to reduce its interest in Newco below 50% within two years of completing the sale of the 30% of the common stock to the public.

**Issue:** Can P and Newco make a section 338(h)(10) election with respect to the contributed subsidiaries? See PLR 200427011 (October 6, 2003); Merrill Lynch & Co., Inc. v. Commissioner.
Facts: Between August 11, 1994, and November 15, 1994, H.J. Heinz Credit Company (“HCC”), a subsidiary of the H.J. Heinz Company (“Heinz”), purchased 3.5 million shares of Heinz common stock in the public market for $130 million. In January of 1995, HCC transferred 3.325 million of the 3.5 million shares to Heinz in exchange for a zero coupon convertible note issued by Heinz. In May of 1995, HCC sold the remaining 175,000 shares to AT&T Investment Management Corp. (“AT&T”), an unrelated party, for a discounted rate of $39.80 per share, or $6,966,120, in cash. As a result of this sale, HCC claimed a capital loss and carried this loss back to 1994, 1993, and 1992. The IRS disallowed Heinz’s claimed capital loss arguing, among other things, that the transaction lacked economic substance and a business purpose. Heinz paid the tax and filed a $42.6 million refund action with the Court of Federal Claims.
Heinz – Court of Federal Claims


- All parties agreed that HCC had a basis of $124 million in the 3.325 million shares that were transferred to Heinz.

- Heinz asserted that the redemption qualified as a redemption under section 317(b), that the redemption should be taxed as a dividend, and that HCC’s basis in the redeemed stock should be added to its basis in the 175,000 shares which it retained. Accordingly, Heinz claimed that, when HCC sold its remaining 175,000 shares, it should recognize a large capital loss. Heinz then claimed it was entitled to carry back HCC’s capital loss to reduce the consolidated group’s taxes in 1994, 1993 and 1992.

- The IRS asserted that the Heinz acquisition was not a redemption because: (i) Heinz did not exchange property for the stock within the meaning of section 317(b); (ii) the transaction lacked economic substance and had no bona fide business purpose other than to produce tax benefits; and (iii) under the “step transaction doctrine,” HCC’s purchase and exchange of the stock for the note should be viewed as a direct purchase of the stock by Heinz.
Heinz – Court of Federal Claims

• The Court of Federal Claims dismissed the IRS’s first argument that no redemption occurred, but held that the acquisition and redemption of Heinz shares lacked economic substance and that the step transaction doctrine applied.

• The court followed the economic substance analysis set forth Coltec in addressing the IRS’s second argument, quoting the following language from Coltec – “the transaction to be analyzed is the one that gave rise to the alleged tax benefit.”

• Accordingly, the court stated that transaction in question is the purchase of Heinz shares from the public and the subsequent redemption. The court did not analyze the entire transaction (including the disposition) when applying the economic substance doctrine.

• The court in Heinz held that the acquisition and subsequent redemption of Heinz shares lacked economic substance.
Heinz – Court of Federal Claims

• The Court of Federal Claims was not persuaded by the taxpayer’s assertion that HCC acquired the Heinz stock for non-tax, business purposes: as an investment and to add “substance” to HCC’s operations for state tax purposes.

• In the eyes of the court, the taxpayer’s claim of an investment purpose was undercut by the factual record, as evidenced by the following factors. First, the convertible notes were contemplated and, in fact, were in the process of being drafted well before HCC purchased the Heinz stock. Second, because the acquired stock was not registered, HCC purchased the stock at full price in the market and sold the Heinz stock at a deep discount. Third, the purpose of the stock purchase program -- the funding of stock option programs – could not be achieved so long as HCC held the Heinz stock.

• The court also found the factual record to be inconsistent with the taxpayer’s second claim of business purpose, which was to bolster the taxpayer’s tax return position that HCC should be respected as a Delaware holding company. The court cited three factors in support of its position. First, the record did not suggest that the taxpayer was motivated by this non-tax purpose. Second, internal communications indicated that any tax return exposure could not be limited at the time of the stock acquisition or on a going forward basis. Third, the record indicated that, at the time of the stock acquisition, Heinz was considering eliminating HCC’s lending operations, which raised the very issue that the taxpayer sought to mitigate through the stock acquisition.

• The taxpayer has appealed to the Court of Appeals for the Federal Circuit.
**Facts:** Schering-Plough Corporation (“SP”) owned all of the stock of Schering Corporation (“SC”), which owned all of the stock of Schering Plough-International (“SPI”). SP, SC, and SPI were U.S. corporations.

SPI owned a majority of the voting stock of Schering-Plough Ltd. (“SPL”), which owned a majority share in Scherico, Ltd. (“SL”). SPL and SL were Swiss corporations.

SP entered into 20-year interest rate swaps with ABN, a Dutch investment bank, in 1991 and 1992. The swap agreements obligated SP to make payments to ABN based on LIBOR and for ABN to make payments to SP based on the federal funds rate for the 1991 swap and on a 30-day commercial paper rate (plus .05%) for the 1992 swap.

The swap agreements permitted SP to assign its right to receive payments under the swaps (the “receipt leg” of the swap). Upon an assignment, SP’s payment to ABN and ABN’s payment to the assignee could not be offset against each other.

SP assigned substantially all of its rights to receive interest payments to SPL and SL in exchange for lump-sum payments totaling $690.4 million.
Schering-Plough Corp. v. United States

- **Taxpayer Position**
  - SP relied on Notice 89-21 to treat the swap and assignment transaction as a sale of the receipt leg of the swap to its foreign subsidiaries (SPL and SL) for a non-periodic payment that could be accrued over the life of the swap.
  - The IRS issued Notice 89-21 to provide guidance on the treatment of lump-sum payments received in connection with certain notional principal contracts in advance of issuing final regulations.
    - Notice 89-21 required that a lump-sum payment be recognized over the life of a swap in order to clearly reflect income.
    - Notice 89-21 stated that regulations would provide the precise manner in which a taxpayer must account for a lump-sum payment over the life of a swap and that similar rules would apply to the assignment of a “receipt leg” of a swap transaction in exchange for a lump-sum payment.
    - Notice 89-21 permitted taxpayers to use a reasonable method of allocation over the life of a swap prior to the effective date of the regulations.
    - Notice 89-21 cautioned that no inference should be drawn as to the treatment of “transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans.”
  - The IRS issued final regulations in 1993 that reversed the basic conclusion of Notice 89-21 and provided that an assignment of the “receipt leg” of a swap for an up-front payment (when the other leg remained substantially unperformed) could be treated as a loan. See Treas. Reg. 1.446-3(h)(4) and (5), ex. 4.

- **IRS position**
  - The IRS argued that the swap and assignment transaction should be treated as a loan from the foreign subsidiaries to SP, which would trigger a deemed dividend under section 956.
Schering-Plough Corp. v. United States

**Court Decision**

- The District Court found in favor of the government on four separate grounds that, in the court’s view, would be sufficient to deny the taxpayer’s claim for tax-deferred treatment under Notice 89-21. See Schering-Plough Corp. v. United States, F. Supp. 2d 219 (D.C. N.J. 2009).

1. **Substance Over Form**
   - The court noted that the integrated transaction had the effect of a loan in which SP borrowed an amount from its foreign subsidiaries in exchange for principal and interest payments that were routed through ABN.
   - The court discounted SP’s arguments (i) that there was an absence of customary loan documentation, (ii) that SP did not directly owe an amount to the foreign subsidiaries (even if ABN failed to fulfill its obligations), and (iii) that the amount of interest paid by SP to ABN would not equal the amount received by its foreign subsidiaries because of the different interest rate bases used under the swap.
   - The court determined that SP’s efforts to structure the transactions as sales failed to overcome the parties’ contemporaneous intent and the objective indicia of a loan.
     - The court stated that the foreign subsidiaries received the “economic equivalent” of interest and noted that SP “consistently, materially, and timely made repayments” to its foreign subsidiaries.
     - The court found that SP officials considered the transaction to be a loan.
     - The court observed that SP did not use customary loan documentation for intercompany loans.
   - The court also concluded that ABN was a mere conduit for the transactions which, according to the court, further supported its holding that the transactions were, in substance, loans.
     - ABN faced no material risk since it entered into “mirror swaps” to eliminate interest rate risk (but not the credit risk of SP).
     - The court found that ABN did not have a bona fide participatory role in the transactions, operating merely as a pass-through that routed SP’s repayments to the Swiss subsidiaries.
Schering-Plough Corp. v. United States

- **Court Decision (con’t)**
  2. **Step Transaction**

- The court also applied the step transaction doctrine as part of its substance over form analysis to treat the swap and assignment transaction as a loan.

- In applying the “end-result test,” the court determined that the steps of the swap and assignment transaction could be collapsed because they all functioned to achieve the underlying goal of repatriating funds from the foreign subsidiaries (SPL and SL).
  - In the court’s view, the evidence established that the swaps and subsequent assignments were pre-arranged and indispensible parts of a “broader initiative” of repatriating earnings from the foreign subsidiaries.

- The court also concluded the steps of the swap-and-assign transactions to be interdependent under the “interdependence test.”
  - The court found that the goal of the interlocking transactions was to repatriate foreign-earned funds, and the interest rate swaps would have been pointless had SP not subsequently entered into the assignments with its subsidiaries.

- The court rejected SP’s argument that, in applying the step transaction doctrine, the IRS created the fictitious steps that (i) the foreign subsidiaries loaned funds to SP, (ii) SP entered into an interest rate swap for less than the full notional amount with ABN, and (iii) SP satisfied its obligation under the imaginary loans by directing ABN to make future payments under the swap to its foreign subsidiaries.

- The court also rejected SP’s argument that the step transaction doctrine should not apply because the IRS failed to identify any meaningless or unnecessary steps.
Schering-Plough Corp. v. United States

3. Economic Substance

- The court concluded that the swap and assignment transaction failed the economic substance doctrine and, thus, SP was not entitled to tax-deferred treatment.
- The court followed 3rd Circuit precedent, ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), which treats the "objective" and "subjective" elements of the doctrine as relevant factors (rather than applying a rigid conjunctive or disjunctive standard).
- The court rejected the taxpayer's position that the repatriation proceeds represented "profit" from the transaction. The court also noted that any interest rate risk due to the swaps was hedged and that SP incurred significant costs in executing the transaction. In sum, the court found that there was little, if any, possibility of a pre-tax profit.
- The court concluded that both the swap and assignment lacked a business motive.
  - SP contended that it entered into both swaps for cash management and financial reporting objectives, the 1991 swap for hedging purposes, and the 1992 swap for a yield enhancement function. The court rejected each of these non-tax motivations.
  - Notably, the court avoided the difficult legal determination of whether the court must examine the whole transaction or, as the government argued, just the component part that gave rise to the tax benefit (here, the assignment step of the transaction).

4. Subpart F Principles

- The court determined that permitting the repatriation of $690 million in offshore earnings without at least a portion of those earnings being captured under subpart F would contradict Congressional intent.
- The court noted that Notice 89-21 did not supplant, qualify, or displace subpart F, nor was the notice intended to permit U.S. shareholders of controlled foreign corporations to repatriate offshore revenues without incurring an immediate tax.
- In the court’s view, the notice only dealt with the timing of income recognition.

Third Circuit Decision

- On appeal, the Court of Appeals for the Third Circuit upheld the District Court’s decision. See Merck & Co., Inc. v. United States, Docket No. 10-2775 (3d Cir. 2011).
- The Third Circuit held that the District Court correctly found that the transactions were in substance loans, not sales.
- Because the Third Circuit upheld the District Court’s characterization of the transactions as loans, it did not address the District Court’s alternative conclusion that the transactions lacked economic substance.
Step Transaction &
Treas. Reg. § 1.1502-13(f)(5) – In General

• S’s intercompany gain from a transfer of stock of another member (T) to B generally is taken into account if B’s basis in the T stock is permanently eliminated in a section 332 liquidation or other nonrecognition transaction. Treas. Reg. § 1.1502-13(c)(6)(ii).

• The regulations provide elective relief to prevent S from taking into account its intercompany item on the T stock where B transfers the “old T” assets to a new member (“new T”). Treas. Reg. § 1.1502-13(f)(5)(ii).

• Reincorporation Transactions Prior to the -2(k) Regulations
  – A reincorporation of assets following a liquidation could qualify as a cross-chain reorganization.
  – Prior final regulations under -13(f)(5) provided for reorganization treatment even if the transfer is not otherwise pursuant to the same plan or arrangement as the liquidation. Former Treas. Reg. § 1.1502-13(f)(5)(ii)(B).
  – Accordingly, if the liquidation and reincorporation would qualify as a cross-chain reorganization, then an election under -13(f)(5) would avoid the triggering of intercompany gain and the new T stock would be treated as a “successor” asset to the old T stock.

• Reincorporation Transactions under the -2(k) Regulations
  – Treasury and the IRS issued the -2(k) regulations on October 27, 2007. The -2(k) regulations provide that an upstream reorganization followed by a contribution will not be recharacterized as a cross-chain reorganization.
  – The treatment of an upstream transaction followed by a reincorporation under the -2(k) regulations raised concerns that an election under Treas. Reg. § 1.1502-13(f)(5) would not preserve the basis in the stock of old T.
    • B’s basis in new T would be determined by reference to the basis of old T’s assets transferred to new T rather than B’s basis in the old T stock.

- On September 3, 2009, Treasury and the IRS issued temporary regulations to address the conflict between an election under Treas. Reg. § 1.1502-13(f)(5)(ii) and the application of the -2(k) regulations.

- The temporary regulations provide that, if section 332 would otherwise apply to old T’s liquidation, and B transfers substantially all of old T’s assets to new T, and if a direct transfer of substantially all of old T’s assets to new T would qualify as a reorganization, then the liquidation and transfer will be treated as a cross-chain reorganization for all federal income tax purposes.

- The temporary regulations are generally effective for transactions in which T’s liquidation into B occurs on or after October 25, 2007 (i.e., the effective date of the -2(k) regulations).

- The IRS requested comments as to whether an election should be available even when there has not been a previous intercompany transaction with respect to the old T stock.
Facts: S owns all the stock of Old T. S sells the stock of Old T to B at a gain. Old T subsequently liquidates into B in a section 332 liquidation. B then transfers the Old T assets into a newly formed entity, New T. P files an election under Temp. Treas. Reg. § 1.1502-13T(f)(5)(ii) to avoid taking S’s deferred gain into account on the liquidation of Old T.

Result: If a direct transfer of Old T assets from Old T to New T would qualify as a reorganization described under section 368(a), then the integrated transaction will be treated as such so that S’s intercompany gain will not be taken into account and B’s stock of New T will be treated as a “successor asset” to B’s stock of Old T. See Temp. Treas. Reg. § 1.1502-13T(f)(5)(ii)(B).

What is the result if the liquidation of Old T occurred prior to the effective date of the temporary regulations?
Facts: S owns all the stock of Old T. S sells the stock of Old T to B at a gain. Old T subsequently liquidates into B in a section 332 liquidation. B then transfers 50% of the Old T assets into a newly formed entity, New T.

Result: Can P file an election under Temp. Treas. Reg. § 1.1502-13T(f)(5) to treat the transaction as a cross-chain reorganization and avoid taking into account the deferred gain on the Old T stock?
Liquidation / Reincorporation: Rev. Rul. 69-617
**Rev. Rul. 69-617**

**Facts:** P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers all of the assets received from S to X.
**Rev. Rul. 69-617 (Variation)**

**Facts:** P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers 50% of the assets received from S to X. Although this transaction appears to raise “liquidation/reincorporation” issues, private letter rulings allow the partial drop of S’s assets to X following the Section 368(a)(1)(A) reorganization. See, e.g., PLR 9222059 (Jun. 13, 1991); PLR 9422057 (Mar. 11, 1994); PLR 8710067 (Dec. 10, 1986). These rulings rely on Rev. Rul. 69-617 and treat the transaction as a merger followed by a Section 368(a)(2)(C) drop of assets. At least one ruling would allow a double-drop of S’s assets following the reorganization. See PLR 9222059 (Jun. 13, 1991).
1. Liquidate  

2. Some of S’s Assets

Facts: P owns all of the stock of S and X. S liquidates, distributing all of its assets to P. P then transfers some of the assets received from S to X. Can this transaction be treated under the analysis of Rev. Rul. 69-617 as a C reorganization followed by a drop of assets under Section 368(a)(2)(C), given the new Bausch & Lomb regulations? See Treas. Reg. Section 1.368-2(d)(4). What if X were a newly formed corporation?
Facts: P owns all of the stock of S, X, Y, and Z. S merges into an LLC created by P, causing a deemed liquidation of S for tax purposes. LLC then transfers 1/3 of S’s historic assets to X, Y, and Z respectively. (P will be treated as transferring such assets to X, Y, and Z for tax purposes).
**Facts:** Y’s stock is owned by X (79 percent) and various other individual shareholders. A plan of reorganization is adopted under which Y transfers all of its assets, subject to its liabilities, to newly-formed Z in exchange for all of the stock of Z. Immediately thereafter, Y merges into X. Under the merger, Y’s individual shareholders exchange their Y stock for stock of X.

**Ruling:** The transaction is treated as though Y merged into X and thereafter X transferred the Y assets to Z. The transaction thus constitutes an upstream “A” reorganization under section 368(a)(1)(A), followed by a transfer under section 368(a)(2)(C). See Rev. Rul. 58-93, 1958-1 C.B. 188.
**Facts:** P owns all of the stock of T. T drops 50% of its assets into a newly formed corporation (“A”) and merges up and into P.

**Result:** Can this transaction be treated as a valid upstream ‘A’ reorganization? See PLRs 200733002 and 201026010.
**Facts:** P owns all of the stock of T. T drops 50% of its assets into each of two newly formed corporation ("A1" and "A2") and liquidates into P. The requirements of section 355 are not satisfied.

**Result:** What is this transaction? Can it be two section 351 exchanges followed by an upstream ‘C’ reorganization? What if the section 355 requirements are satisfied? What if the A1 transaction satisfies the section 355 requirements but not the A2 transaction? What if substantially all of T’s assets were transferred in one drop?
H owns domestic corporations S1-Corp1 and S2.

S1-Corp1 and S2 hold assets as a tenancy-in-common (TIC) and other assets.

S1-Corp1 is incorporated in both State X and State Y.

H wants S1-Corp1 to transfer its TIC assets to S2 in a tax-free manner and eliminate S1-Corp1’s State Y affiliation.

S1-Corp1 converts to State X S1-LLC, a disregarded entity.

S1-LLC transfers the TIC assets to S2 for no consideration.

S1-LLC converts to S1-Corp2, incorporated only in State X.
PLR 200952032
Liquidation-Reincorporation (cont’d)

After Transactions:

H

S1-Corp2 (State X)

Other Assets

S2

TIC Assets

Other Assets
IRS rules that conversion of S1-Corp1 to S1-LLC is a transfer of substantially all of S1-Corp1’s assets to H in deemed exchange for H stock, followed by deemed distribution of the H stock received by S1-Corp1 back to H in complete liquidation of S1-Corp.

- PLR does not state whether S1-Corp’s interest in the TIC Assets or its Other Assets constitutes “substantially all” of S1-Corp’s assets.

IRS rules that transfer of S1-Corp1’s former interest in TIC Assets is section 351/368(a)(2)(C) transfer by H to S2.

IRS rules that conversion of S1-LLC into S1-Corp2 is section 351/368(a)(2)(C) transfer of former S1-Corp1 Other Assets by H to S1-Corp2.


What if instead S1-Corp1 had converted to S1-LLC and transferred all its assets to a newco, without reincorporating? See section 368(a)(1)(F) (“however effected”); Treas. Reg. §1.368-2(k).
“D” Reorganizations
‘D’ Reorganizations – Stock

**Facts:** P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for stock. X then liquidates into P.

**Result:** This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D). A transfer by one corporation (X) of substantially all of its assets to another corporation (Y) qualifies as a reorganization described in section 368(a)(1)(D) if, immediately after the transfer, one or more of the transferor corporation’s shareholders (P) is in control of the acquiring corporation (Y), and if stock or securities of the acquiring corporation (Y) are distributed in a transaction which qualifies under section 354, 355, or 356. See Section 354(b)(1).
‘D’ Reorganizations – Cash – Rev. Rul. 70-240

Facts: P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

Result: This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D). In the transaction, X distributes substantially all of its assets to D and its shareholder (P) is in control of Y after the exchange. However, the requirement that stock or securities of the acquiring corporation (Y) be distributed is not technically satisfied. This requirement is treated as satisfied because a distribution of Y stock in this example would be a meaningless gesture. See Rev. Rul. 70-240; see also Rev. Rul. 2004-83.
‘D’ Reorganizations – Temporary Regulations


• On March 1, 2007, Treasury and the IRS amended the temporary regulations so that certain related party triangular reorganizations that qualify as tax-free triangular reorganizations under section 368 would not be treated as ‘D’ reorganizations with boot under the temporary regulations.

• The temporary regulations provided that a transaction may be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) even if there is no actual issuance of stock and/or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions.
  – In such cases, transferee will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor’s assets.
  – The nominal share of stock in the transferee will then be deemed distributed by the transferor to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee.
‘D’ Reorganizations – Final Regulations

• On December 17, 2009, Treasury and the IRS issued final regulations on the treatment of transactions as acquisitive ‘D’ reorganizations where no stock and/or securities of the transferee is issued and distributed in the transaction.
  – The final regulations also confirm the determination of basis in stock of the transferee and the treatment where the reorganization involves consolidated group members.

• The final regulations generally are effective for December 18, 2009 and apply the nominal share and deemed stock rule to transactions occurring on or after that date.

• Nominal Share and Deemed Stock Rule
  – The final regulations adopt the general approach set forth in the temporary regulations and deem the issuance of stock where no stock and/or securities is issued and distributed in the transaction, provided that the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee in identical proportions.
  – The final regulations clarify that the transferee will only be deemed to issue a nominal share if the transferor corporation receives full consideration in exchange for its assets.
  – In cases where no consideration is received, or the value of the consideration received is less than the fair market value of the transferor's assets, the transferee is treated as issuing stock with a value equal to the excess of the value of the assets over the value of the consideration received.
  – As under the temporary regulations, the final regulations provide that the nominal share or the deemed stock will be deemed to be distributed by the transferor corporation in satisfaction of the distribution requirement under section 354(b)(1)(B), and then further transferred through chains of ownership to reflect the actual ownership of the transferor and transferee.
‘D’ Reorganizations -- Final Regulations

• Nominal Share and Deemed Stock Rule (Continued)
  – The constructive ownership rules of section 318 apply with modification.
    • Section 318(a)(1) applies such that an individual and all members of his or her family described in section 318(a)(1) will be treated as one individual.
    • Section 318(a)(2) applies without regard to the 50-percent limitation in section 318(a)(2)(C).
  – De minimis variation in shareholder identity or proportionality of ownership is permitted.
    • The final regulations do not define what level of variation would be treated as de minimis, although an example does conclude that a 1% ownership in the stock of the transferee by an individual who owns no stock in the transferor is de minimis variation in identity and proportionality where the other three shareholders own 34%, 33%, and 33% of the stock of the transferor and each owns 33% of the stock of the transferee. See Treas. Reg. § 1.368-2(I)(3), ex. 4.
  – Section 1504(a)(4) stock is not taken into account.

• Triangular Reorganizations
  • The nominal share and deemed stock rule does not apply to triangular reorganizations (i.e., transaction otherwise described in Treas. Reg. § 1.358-6(b)(2) or section 368(a)(1)(G) by reason of section 368(a)(2)(D).
  – These rules of application were included in the temporary regulations.
‘D’ Reorganizations -- Final Regulations

- Basis Allocation Issues
  - The final regulations did not adopt comments that would treat the nominal share as having tax significance solely to satisfy the distribution requirement in section 354(b)(1)(B).
  - Instead, the final regulations treat the nominal share as qualifying property for purposes of basis allocation and future stock gain or loss recognition.
  - The final regulations clarify that, in case of a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred (as well as the nominal share), the shareholder or security holder may designate the share of stock of the transferee to which basis, if any, of the stock or securities surrendered will attach.
  - This is distinguished from current Treas. Reg. § 1.358-2(a)(2)(iii), which the preamble notes technically only applies to reorganizations in which no consideration is received or the value of the consideration received is less than the fair market value of the transferor's assets.
  - That regulation provides for a substituted basis in the stock deemed received followed by a deemed recapitalization for the shares actually held by the transferor immediately after the reorganization.
‘D’ Reorganizations -- Final Regulations

- Application of the Nominal Share and Deemed Stock Rule in Consolidation
  - The final regulations confirm that the nominal share will be given effect in connection with all-cash 'D' reorganizations involving consolidated return members.
  - Under the consolidated return regulations, an all-cash 'D' reorganization involving consolidated return members will result in a deemed issuance of stock by the transferee corporation followed by a redemption of the deemed stock for the consideration actually received in the exchange.
  - The final regulations confirm that, upon the deemed issuance and redemption, the remaining stock basis or excess loss account ("ELA") will shift to the nominal share.
  - Thus, gain or loss inherent in that basis or ELA may be triggered upon the deemed transfer of the nominal share through chains of ownership, subject to the intercompany transaction rules of Treas. Reg. § 1.1502-13.
‘D’ Reorganizations -- Direct Ownership

Facts:  P owns all of the stock of X and Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into P.

Result: The transaction will be treated as a ‘D’ reorganization because the distribution of Y stock would constitute a meaningless gesture. See Rev. Rul. 70-240. Note that the same result would be obtained if P transferred X stock to Y in exchange for cash and, immediately thereafter, X liquidated into Y. See Rev. Rul. 2004-83.

The result does not change under the final regulations because there is complete shareholder identity and proportionality of ownership in X and Y. See Treas. Reg. § 1.368-2(l)(2); Cf. Treas. Reg. § 1.368-2(l)(3), ex. 1.
‘D’ Reorganizations -- Indirect Ownership

**Facts:** P owns all of the stock of S and S1. S owns the stock of X and S1 owns the stock of Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into S.

**Result:** The transaction will be treated as a ‘D’ reorganization because there is complete shareholder identity and proportionality of ownership in X and Y under section 318 principles. See Treas. Reg. § 1.368-2(l)(3), ex. 3.

The nominal share of Y stock will be treated as going up to P and back down to S1.

In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to X in exchange for X’s assets; (ii) X is treated as distributing Y stock to S in a liquidation; and (iii) Y is treated as redeeming its stock from S for cash. See Treas. Reg. section 1.1502-13(f) and (f)(7), ex. 3.

The final regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to the nominal share. What happens when the nominal share is treated as distributed from S to P and then contributed to S1?
‘D’ Reorganizations -- Constructive Ownership

**Facts:** A and B are mother and son. A owns the stock of S which owns the stock of X. B owns the stock of Y. X transfers its assets to Y and immediately thereafter liquidates into S.

**Result:** Has there been a ‘D’ reorganization? Does S control Y after the transaction? Would a distribution of Y stock be a meaningless gesture?

The final regulations adopt the constructive ownership rules of section 318(a)(1) to treat A and B as the same person and, thus, there is complete shareholder identity and proportional ownership in X and Y. The transaction is treated as a valid “D” reorganization under the temporary regulations. See Treas. Reg. § 1.368-2(l)(3), ex. 2; See also PLR 9111055.
Facts: A and B own 50 percent of the stock of X. B and C own Newco, with B owning 90 percent and C owning 10 percent of the stock, respectively. X Corporation transfers its assets to Newco in exchange for two notes. Immediately thereafter, X liquidates, distributing one note to each A and B.

Result: PLR 200551018 assumes that the transaction does not qualify as a ‘D’ reorganization in holding that Newco is entitled to amortize the cost of goodwill acquired as a result of the purchase of X assets.

Under the final regulations, there is no shareholder identity and proportionality of ownership in X and Newco and, thus, this transaction does not qualify as a tax-free ‘D’ reorganization. See Treas. Reg. § 1.368-2(l)(3), ex. 6.
‘D’ Reorganizations -- PLR 200551018 Variation

**Facts:** A and B own 50 percent of the stock of X. B and C own Newco, with B owning 90 percent and C owning 10 percent of the stock, respectively. X Corporation transfers its assets to Newco in exchange for cash and one share of Newco stock. Immediately thereafter, X liquidates, distributing cash to A and cash and the one share of Newco stock to B.

**Result:** The transaction qualifies as a valid ‘D’ reorganization. The technical requirements of section 368(a)(1)(D) are satisfied through the transfer of the one share of Newco stock.
Final Regulations – Deemed Stock

Facts: P owns all of the stock of X and Y. X transfers all of its assets to Y and then liquidates.

Result: This transaction should qualify as a ‘D’ reorganization because Y is deemed to issue stock to X in exchange for the X assets and X is treated as distributing the deemed stock to P in the liquidation. As a technical matter, the temporary regulations treated Y as issuing a nominal share in exchange for the X assets even though prior guidance suggested that Y would be treated as issuing deemed shares equal in value to X assets received in the exchange. The final regulations clarify that Y will be treated as issuing deemed stock rather than a nominal share.
Final Regulations -- Triangular Reorganizations

**Facts:** P owns all of the stock of S and T. T transfers substantially all of its assets to S solely in exchange for P stock and T liquidates.

**Result:** This transaction satisfies the technical requirements of a ‘C’ reorganization and is not treated as a ‘D’ reorganization by reason of the nominal share and deemed stock rules. Prior to the March 2007 amendment to the temporary regulations, this transaction was treated as a valid ‘D’ reorganization under the temporary regulations, even though no stock of the acquiring corporation, S, is transferred in exchange for T’s assets. Because section 368(a)(2)(A) precludes the transaction from being treated as a ‘C’ reorganization if it also a ‘D’ reorganization, the temporary regulations would have treated the transfer of P stock as boot in a ‘D’ reorganization. The March 2007 amendment prevents this transaction from being treated as a ‘D’ reorganization under the temporary regulations. The final regulations retain this amendment. See Treas. Reg. 1.368-2(l)(2)(iv).
‘D’ Reorganizations – Stock Sale & Deemed Liquidation

**Facts:** P, T, and X are corporations. P owns all of the stock of T and X. P transfers the stock of T to X in exchange for cash. In connection with the transfer of stock, T elects to be treated as a disregarded entity for federal income tax purposes.

**Result:** This transaction qualifies as a tax-free ‘D’ reorganization under section 368(a)(1)(D). See Rev. Rul. 2004-83. T is treated as transferring its assets to X in exchange for X stock, which it distributes to P in a transaction described in section 356.
Check-and-Sell Transaction

**Facts:** P, T, and X are corporations. P owns all of the stock of T and X. T checks the box to be treated as disregarded entity and P sells T’s LLC interests to X.

**Result:** Is the transfer treated as an asset transfer or a stock transaction? See *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).
Facts: P, X, Y, T and Z are corporations. P owns all of the stock of X and Y, and X and Y own all of the interests in T and Z, respectively. T checks the box to be treated as a disregarded entity and X sells T's LLC interests to Z.

Result: Is the transfer treated as a liquidation followed by a sale? See *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004). What result if X sells only part of its LLC interests in T?
Cross-Chain Section 351 Exchange

Facts: P owns all of the stock of S1 and S2. P and S1 are members of a consolidated group. S2 files a separate return. S1 transfers assets to S2 but does not receive stock or other consideration in exchange. S1 continues its business activities after the transfer of property.

Result: To qualify as a section 351 exchange, S1 must transfer property to S2 in exchange for stock and be in control of S2 immediately after the exchange. S1 satisfies the control requirement because it is treated as owning the S2 stock held by P, a member of its consolidated group under the consolidated stock attribution rule of Treas. Reg. § 1.1502-34. However, it is unclear whether S1 can satisfy the exchange requirement because it does not receive S2 stock in the exchange. Consistent with the final regulations on “D” reorganizations, should S2 be deemed to issue stock to S1, with the S2 stock distributed up to P?
Boot-Within-Gain Limitation – Effect on E&P

Facts: P owns all of the stock of CFC1 and CFC2, which are foreign corporations. P's basis in its CFC1 stock is $100. CFC1 transfers its assets to CFC2 in exchange for $100 cash and immediately thereafter liquidates into P.

Result: This transaction should be treated as a valid 'D' reorganization. See Treas. Reg. § 1.368-2(l). P does not recognize any income under the boot-within-gain limitation rule in section 356 – P did not realize any gain in its CFC1 stock and, therefore, none of the $100 boot is taxable.

Issue: What is the amount of the reduction to the E&P of CFC1, if any, prior to carryover under section 381 to CFC2? See section 312(a), (d), (n)(7); Treas. Reg. § 1.312-11(c); Rev. Rul. 72-327, 1972-2 C.B. 197.
Recent Section 355 PLRs
Step 5: D2 offers to exchange its Class A stock in C for D2 stock owned by the D2 shareholders (“Exchange Offer” resulting in an “External Split-off” to the D2 shareholders).

Step 6: If the conditions to the Exchange Offer are met, then D2 will convert the Class B stock received in the Internal Spin-off to Class A stock (the “Unwind”) prior to consummation of the Exchange Offer/External Split-off.
The IRS ruled that “The Unwind will not cause the Internal Spin-off to fail to satisfy the control immediately before requirement of Section 355(a)(1)(A).”

The taxpayer represented that immediately after the Internal Spin-off, there would be “no legally binding obligation to change the capital structure or the Charter of Controlled” and “no legally binding obligation to proceed with the remainder of the Proposed Transaction.”

  • Compare to prior PLRs requiring no plan or intention. See PLRs 200731025, 200705016.

Consummation of the Exchange Offer/External Split-off was conditioned upon a minimum level of participation in the Exchange Offer.

  • The exchange ratio for the Exchange Offer was set at a level intended to encourage the D2 shareholders to tender their D2 stock.
Repayment of Distributing Debt in 355 Spin-off: PLR 201029007

1. D issues Debt to unrelated investors

2. D contributes assets to C in exchange for C stock and C Debt

3. D distributes C stock to D’s shareholders and exchanges C Debt for D Debt

- The IRS ruled that D will not recognize gain or loss on the transfer of C Debt under Section 361(c) (with certain exceptions).
- The taxpayer represented that D Debt exchanged for C Debt “will not exceed the daily average outstanding third party indebtedness of D for the 365 day period ending” at the close of the last business day before D’s Board directed management to pursue the distribution.
- Compare to prior rulings requiring D Debt to be “old and cold”. See PLRs 200716024, 200345050, 200137011.
PLR 201029007 (cont’d)

• The ruling provides that D Debt will be issued to investors at least 9 days prior to distribution. The ruling does not specify when D and the investors will agree to the exchange of C Debt for D Debt.
  • Compare to PLR 201032017:
    • The Investment Banks acquired D debt (either by direct issuance or on secondary markets) at least 12 days prior to date of exchange (assumed to be 14 days based on PLR 200802009).
    • An Exchange Agreement was entered into by the Investment Banks and D no sooner than 5 days after the Banks acquired the debt (assumed to be 5 days based on PLR 200802009).
    • It was anticipated that the Investment Banks would sell the C debt they received in the debt exchange.
North-South Transactions

P contributes ATB1 to D, and D spins C to P

- P contributes ATB1 (the active business to be relied on by D in subsequent spin-off) to D. D then distributes C to P. Are the contribution and distribution considered to be an exchange under “North-South” principles?
  - See PLR 201033007. The taxpayer represented: “There is no regulatory, legal, or economic compulsion or requirement that the Asset Contributions be made as a condition of the Internal Distribution. The fact that the value of Distributing 1 will decrease as a result of the Internal Distribution was not a consideration in the decision to contribute property to Distributing 1. The Internal Distribution is not contingent on there being contributed to Distributing 1 assets having a specified (or roughly specified) value.” See also PLRs 201034005, 201030005, 201007050. See generally, Treas. Reg. §1.301-1(l).

- What if D’s distribution to P was a split-off? Does it matter whether the shares redeemed include the D shares issued (or deemed issued) in the contribution by P?

- Other North-South rulings: 201014048 (F reorganization into Newco and subsequent redemption of some Newco shares in exchange for a Newco note, treated as separate); 201047016 (cash investment by significant D shareholder into D, followed by D’s distribution of C and cash to public shareholders in a split-off, not treated as purchase of D shares by significant D shareholder; transaction was respected as cash investment into D followed by split-off with boot).
Temporary Regulations Under Section 304
Temporary Regulations under Section 304

- On December 30, 2009, Treasury and the IRS issued temporary regulations to address the use of controlled corporations to avoid dividend treatment under section 304.
  - The amount of a property distribution under section 304 that is a dividend must be determined by reference first to the E&P of the acquiring corporation and then, if necessary, to the E&P of the issuing corporation.
- Treasury and the IRS issued temporary regulations in 1988 that provided that the District Director (now known as the Director of Field Operations) was permitted to consider a corporation (a “deemed acquiring corporation”) as having acquired the stock of the issuing corporation that is in fact acquired by the acquiring corporation, if the deemed acquiring corporation controls the acquiring corporation and if one of the principal purposes for creating, organizing, or funding the acquiring corporation (through capital contributions or debt) is to avoid the application of section 304 to the deemed acquiring corporation.
- The Preamble notes that Treasury and the IRS have “become aware of certain transactions” that are subject to section 304 but entered into with a principal purpose of avoiding the treatment of a corporation as the issuing corporation [rather than as the acquiring corporation].” (See example on next slide.)
- The new temporary regulations address this concern and make other changes from the existing temporary regulations.
  - The new temporary regulations maintain the anti-avoidance rule for deemed acquiring corporations.
  - The new temporary regulations add a new anti-avoidance rule for deemed issuing corporations: the acquiring corporation shall be treated as acquiring for property the stock of a corporation (“deemed issuing corporation”) that is controlled by the issuing corporation, if, in connection with the acquisition of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation.
  - The new temporary regulations make both anti-avoidance rules self-executing.
  - The new temporary regulations provide that the anti-avoidance rule may apply when the funding of the acquiring corporation is from an unrelated party.
- The new temporary regulations apply to acquisitions of stock occurring after December 28, 2009.
**Example -- Temporary Regulations under Section 304**

**Facts:** P, a domestic corporation, owns all of the stock of CFC1 and CFC2. CFC1 is organized in Country X and has a stock basis of $100 and substantial E&P. CFC is organized in Country Y and has zero E&P. P wishes to own all of its foreign corporations in a direct chain and to repatriate cash of CFC2. In order to avoid obtaining Country X approval for the acquisition of CFC1 by CFC2 and to avoid the dividend distribution from CFC2 to P, P forms CFC 3 in Country X and transfers the stock of CFC1 to CFC3 in exchange for CFC3 stock. P then transfers the stock of CFC3 to CFC2 in exchange for $100.

**Result:** CFC2 is treated as acquiring the stock of CFC1 (the deemed issuing corporation) from P for $100 for purposes of determining the amount of the $100 distribution constituting a dividend under section 304, because a principal purpose for the transfer of CFC1 stock to CFC3 is to avoid the application of section 304. Thus, P receives a $100 dividend from CFC2. See Preamble to Temp. Treas. Reg. § 1.304-4T; Temp. Treas. Reg. § 1.304-4T(c), Ex. 2.
Final Regulations on Apportionment of Tax Items Among Controlled Group Members
Final Regulations on Apportionment of Tax Items Among Controlled Group Members

  – Temporary regulations issued in 2006 (T.D. 9304) provided guidance to component members of controlled groups of corporations and consolidated groups filing life-nonlife returns on the apportionment of tax benefit items and related reporting requirements that are designed to eliminate barriers to electronic filing. See Prior Temp. Treas. Reg. § 1.1502-43T(d)(2); Prior Temp. Treas. Reg. § 1.1502-47T(s).
  – Temporary regulations issued in 2007 (T.D. 9369) provided guidance on calculating and apportioning the section 11(b)(1) additional tax under section 1561 for component members of a controlled group of corporations and consolidated groups filing life-nonlife federal income tax returns. See Prior Temp. Treas. Reg. §§ 1.1561-1 to -3.

• The final regulations generally adopt the temporary regulations issued in 2006 and 2007 without substantive change, but make several clarifying amendments, including –
  – The final regulations provide that only the positive taxable income or positive alternative minimum taxable income of the component members of a controlled group of corporations shall be combined for purposes of determining the amount of the additional tax imposed by section 11(b)(1) and the reduction in the alternative minimum tax exemption amount under section 55(d)(3).
  – The final regulations provide that a component member that has a short taxable year that does not include a December 31st date calculates its additional tax and alternative minimum tax liability on its own income.
  – The final regulations also clarify the rules under which an apportionment plan is terminated.

• The final regulations are generally effective as of December 21, 2009.
Notice 2008-111 – Intermediary Transaction Tax Shelter
Notice 2008-111—Overview

• The IRS issued Notice 2008-111 on December 1, 2008, to clarify those transactions that will be treated as the listed transaction referred to in Notice 2008-111 as an Intermediary Transaction Tax Shelter (an “Intermediary Transaction”).

• Notice 2008-111 clarifies Notice 2001-16, which first identified the Intermediary Transaction as a listed transaction.

  – Commentators criticized Notice 2008-20 because taxpayers and their tax advisors may not be in a position to determine whether the transaction constitutes an Intermediary Transaction.
  – Commentators also raised questions as to the scope of the four components of the Intermediary Transaction set forth in Notice 2008-20 (e.g., the meaning of “all or most”).
Notice 2008-111– Effective Date

- Notice 2008-111 is generally effective January 19, 2001, which is the effective date of Notice 2001-16.

- Notice 2008-111 imposes no requirements, however, with respect to any obligation under sections 6011, 6111, or 6112 due before December 1, 2008, not otherwise imposed by Notice 2001-16.

- Any disclosure filed pursuant to Notice 2008-20 will be treated as made pursuant to Notice 2001-16.
Notice 2001-16 – Intermediary Transaction

• As described in Notice 2001-16, the Intermediary Transaction generally involves a seller (“X”) who desires to sell the stock of a target corporation (“T”) to a buyer (“Y”).

• The buyer in the transaction desires to acquire the assets of T (rather than the T stock) from X.

• Pursuant to a plan, X transfers the T stock to an intermediary (“M”) followed by a transfer by T of its assets to Y.

• As a result of the transaction, Y obtains a cost basis in the T assets it receives.

• Notice 2001-16 identifies certain transactions as an Intermediary Tax Shelter, including the use of an intermediary (i) that is a member of a consolidated group that uses consolidated tax attributes to shelter the gain otherwise resulting from the sale of T assets or (ii) that is an entity not subject to tax.
Intermediary Tax Shelter Example – Consolidated Group

Facts: X owns all of the stock of T. T owns an asset with a value of $100 and a basis of zero (“Asset”). X sells all of its T stock to M for $100 in Year 1. M is a parent of a consolidated group that expects to have a significant loss in Year 1. T transfers Asset to Y for $100 in Year 1.
Notice 2008-111—Intermediary Transaction

- Notice 2008-111 provides that a transaction will be treated as an Intermediary Transaction with respect to a particular person only if—
  - that person engages in the transaction pursuant to a Plan,
  - the transaction contains the four objective components indicative of an Intermediary Transaction set forth in Notice 2008-111, and
  - no safe harbor exception applies.
Notice 2008-111– Plan Requirement

• A transaction will be treated as an Intermediary Transaction with respect to a particular person only if that person engages in the transaction pursuant to the Plan.

• The “Plan” is defined as the structuring of a transaction to cause the tax obligation for the taxable disposition of the T’s Built-in Gain Assets to arise, in connection with the disposition by shareholders of T (“X”) of all or a controlling interest in T’s stock, under circumstances where the person or persons primarily liable for any Federal income tax obligation with respect to the disposition of the Built-in Gain Assets will not pay that tax.

• This plan can be effectuated regardless of the order in which T’s stock or assets are disposed.
Notice 2008-111—Knowledge Requirement

- A person engages in the transaction pursuant to the Plan if the person knows or has reason to know the transaction is structured to effectuate the Plan.

- X will be deemed to satisfy the knowledge requirement if X is at least a 5% shareholder of T (by vote or value), or an officer or director of T, if any of the following knows or has reason to know the transaction is structured to effectuate the Plan:
  - Any officer or director of T.
  - Any of T’s advisors engaged by T to advise T or X with respect to the transaction.
  - Any advisor of that X engaged by that X to advise it with respect to the transaction.
  - Note that if T has more than five officers then the term “officer” is limited to the CEO of T (or an individual acting in such capacity) and the four highest compensated officers for the taxable year (other than the chief executive officer or an individual acting in such capacity).

- Notice 2008-20 did not contain a knowledge requirement.
Notice 2008-111– Knowledge Requirement

• A person can engage in the transaction pursuant to the Plan even if it does not understand the mechanics of how the tax liability purportedly might be offset or avoided, or the specific financial arrangements, or relationships of other parties or of T after the Stock Disposition.

• A person will not be treated as engaging in the transaction pursuant to the Plan merely because it has been offered attractive pricing terms by the opposite party to a transaction.

• Thus, a transaction may be an Intermediary Transaction with respect to X but not Y, or vice versa, and with respect to some but not all Xs and/or some but not all Ys, depending on whether they engage in the transaction pursuant to the Plan.
Notice 2008-111 – Four Components of an Intermediary Transaction

• **Component 1** – (Built-in Tax) -- A corporation ("T") directly or indirectly (e.g., through a pass-through entity or a member of a consolidated group of which T is a member) owns assets the sale of which would result in taxable gain (T’s Built-in Gain Assets) and, as of the Stock Disposition Date (as defined in component 2), T (or the consolidated group of which T is a member) has insufficient tax benefits to eliminate or offset such taxable gain (or the tax) in whole. The tax that would result from such sale is hereinafter referred to as T’s Built-in Tax.


  – Notice 2008-111 added the de minimis rule.

• **De Minimis Rule** -- For purposes of this component, T will not be considered to have any Built-in Tax if, on the Stock Disposition Date, such amount is less than five percent of the value of the T stock disposed of in the Stock Disposition (as defined in component two).
Notice 2008-111 – Four Components of an Intermediary Transaction

• **Component 2 – (Sale of Stock)** -- At least 80 percent of the T stock (by vote or value) is disposed of by T’s shareholder(s) (“X”), other than in liquidation of T, in one or more related transactions within a 12 month period (Stock Disposition). The first date on which at least 80 percent of the T stock (by vote or value) has been disposed of by X in a Stock Disposition is the Stock Disposition Date.

  – Notice 2008-111 raised the Stock Disposition threshold contained in Notice 2008-20 from 50 percent to 80 percent.
Notice 2008-111 – Four Components of an Intermediary Transaction

- **Component 3 – (Sale of Assets)** -- Either within 12 months before, simultaneously, or within 12 months after the Stock Disposition Date, at least 65 percent (by value) of T’s Built-in Gain Assets are disposed of (Sold T Assets) to one or more buyers (Y) in one or more transactions in which gain is recognized with respect to the Sold T Assets.

  - For purposes of this component, transactions in which T disposes of all or part of its assets to either another member of the controlled group of corporations (as defined in section 1563) of which T is a member, or a partnership in which members of such controlled group satisfy the requirements of §1.368-1(d)(4)(iii)(B), will be disregarded provided there is no plan to dispose of at least 65 percent (by value) of T’s Built-in Gain Assets to one or more persons that are not members of such controlled group, or to partnerships not described herein.

- Notice 2008-111 changed the requirement in Notice 2008-20 that “all or most” of T’s assets are disposed of to “at least 65 percent of (by value).”

- Notice 2008-111 also ignores dispositions to members of controlled groups; Notice 2008-20 would only ignore dispositions to members of consolidated groups.
Notice 2008-111 – Four Components of an Intermediary Transaction

• **Component 4 – (Offset of Built-in Tax)** At least half of T’s Built-in Tax that would otherwise result from the disposition of the Sold T Assets is purportedly offset or avoided or not paid.
  
  – Notice 2008-111 changed the requirement in Notice 2008-20 that “all or most” of T's Built-in Tax be offset to “at least half.”
Notice 2008-111—Safe Harbor Exceptions

• Notice 2008-20 included the following safe harbor exceptions: a transaction was not an Intermediary Transaction with respect to the following persons under the following circumstances:
  – Any X, if the only T stock it disposes of is traded on an established securities market and prior to the disposition X (including related persons described in section 267(b) or 707(b)) did not hold five percent (or more) by vote or value of any class of T stock disposed of by X.
  – Any Y, if the only Sold T Assets it acquires are either (i) securities (as defined in section 475(c)(2)) that are traded on an established securities market and represent a less-than-five-percent interest in that class of security, or (ii) assets that are not securities and do not include a trade or business as described in Treas. Reg. § 1.1060-1(b)(2).

• Notice 2008-111 incorporated those exceptions and added one additional exception:
  – Any X, T, or M, if, after the acquisition of the T stock, the acquiror of the T stock is the issuer of stock or securities that are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such an issuer.
In *Enbridge Energy Co. v. United States*, 553 F. Supp. 2d 716 (S.D. Texas 2008), the court determined an intermediary company to be a sham.

Enbridge Energy Co. v. United States

• The district court disregarded the involvement of K-Pipe as a mere conduit and treated the transaction as a purchase of the Bishop stock by Midcoast, followed by a liquidation of Bishop. The court treated the transaction as a stock sale and liquidation rather than a straight asset purchase because the court determined that it was clear from the facts that Langley would not consider a straight asset sale. Therefore, the court determined that in substance the transaction was a direct sale of stock in Bishop from Langley to Midcoast, followed by a 332 liquidation of Bishop. Thus, Midcoast did not receive a cost basis in Bishop’s assets.

• The court disregarded the intermediary company or “midco” as a conduit based on an analysis of the following factors:
  – Whether there was an agreement between the principals to do a transaction before the intermediary participated;
  – Whether the intermediary was an independent actor;
  – Whether the intermediary assumed any risk;
  – Whether the intermediary was brought into the transaction at the behest of the taxpayer; and
  – Whether there was a non tax-avoidance business purpose to the intermediary’s participation.

• Although there was no formal agreement between Bishop and Midcoast, the court found that the facts indicated that Midcoast’s tax advisors identified Fortrend as an intermediary and that there was no nontax business purpose for Fortrend’s participation. Moreover, the entity formed for the transaction, K-Pipe, was a mere shell and did not have any other business activities.
Enbridge Energy Co. v. United States


  – The Fifth Circuit concluded that the “uncontroverted evidence supports the district court's conclusion that this was a sham conduit transaction, and that Midcoast is not entitled to claim a stepped-up basis for the assets it purchased.”

  – The Fifth Circuit concluded that the evidence supports only the inference that K-Pipe was merely an intermediary without a bona fide role in the transaction: (i) K-Pipe was formed solely for the purpose of executing the transaction, (ii) the financing obtained by K-Pipe was secured by Midcoast's funds and, thus, was no different than a stock purchase, (iii) the financing was obtained through a foreign bank known to finance these transactions, and (iv) Langley and Midcoast were discussing the purchase prior to K-Pipe's involvement, that they met together -- along with PWC -- to discuss the deal, and that the sell/buy transactions occurred within 24 hours.

  – The Fifth Circuit discounted the three business purposes advanced by the taxpayer: (i) That Midcoast wanted to earn a profit because it did not explain why one would pay K-Pipe to be an intermediary, (ii) that Midcoast wanted to acquire and operate the Bishop pipeline assets at a price it was willing and could afford to pay because this is not a tax-independent business consideration, and (iii) that Midcoast lessened its liability exposure by not buying the stock of Bishop since this objective could have been achieved without use of the intermediary.
Rescission
• Foreign parent FP owns all the stock of domestic corporation C
• C has debt to FP through a credit facility (CF), Note 1 and Note 2
• FP cancels Note 1 and CF in exchange for shares of C stock (section 108(e)(8))
• FP and C rescind the transaction in same tax year.
• Following the rescission, FP will cancel a portion of Note 1 and/or Note 2 as a capital contribution to C (section 108(e)(6))
• Taxpayer represented:
  Neither [C] nor [FP] is or will be bound by any legal obligation regarding the Subsequent Debt Cancellation at or before the Effective Time of the Rescission
• Would the result be the same if, after rescission, Note 1 and CF are cancelled? See PLR 201008033
PLR 200915031

Facts
- FS2 and S4 own c and d shares, respectively, in FS3.
- FS2 contributed $g to FS3 in exchange for “h” FS3 shares.
- Based on the value of FS3 at the time of the $g contribution, FS2 should have received “i” FS3 shares instead of “h” FS3 shares (“h” less “i” equals the “Excess Shares”).
- The number of shares issued were based on certain legal requirements under local country law, foreign regulatory and stamp considerations.

Rescission
- FS3 will redeem the Excess Shares held by FS2 for no consideration (within the group’s taxable year).

Ruling
- FS3 will be treated as not having issued the Excess Shares.
Facts

• Taxpayer (P) is the parent of a consolidated group which initially includes S. As part of a section 355 splitoff, P transfers assets to S and subsequently distributes S to its sole shareholder, A, in redemption of y of the x shares of P stock held by A.
• The 355 split-off was initially undertaken to improve the “fit and focus” of business A and business B.
• Subsequent to the split-off, new management determined that the changed business environment reduced the benefits and increased the costs of separating the two businesses.

Ruling

• The distribution and redemption are disregarded.
• The shares of S held by P and the shares of P held by A at the effective time of distribution and redemption will be treated as continuing to be outstanding.
• S will be treated as having remained a wholly-owned subsidiary of P and a member of the consolidated group at all times during the taxable year.
Facts
- A purchases T convertible preferred stock, then T merges into A.
- Pursuant to the merger agreement, T’s preferred stock held by A was cancelled.
- A realized that the merger may create tax consequences that could jeopardize its ability to continue as an ongoing entity.
- A, T, and certain T shareholders filed a petition in court to rescind the merger and to reinstate T as a corporation.
- In conjunction with the rescission of the merger and the Court’s holding (described below), A purchased T’s common stock.

Court Holding
- T remained in existence.
- T common stockholders prior to the merger remained as the common stockholders after the rescission.
- A remained owner of the convertible preferred stock during the tax year.

Ruling
- T will be treated as not merging into A.
- T and A will be treated as two separate corporations at all times during the tax year.
- A will be treated as acquiring all of the T common stock.
Facts
• FS1 was engaged in Business 1 and FS2 and FS3 were engaged in Business 2.
• To combine Business 1 and Business 2, Y contributed all of its stock in FS1 to FS2 in exchange for FS2 stock.
• FS1, FS2, and FS3 were amalgamated into Amalco and FS1, FS2, and FS3 ceased to exist as entities separate from Amalco.
• Y rescinded its transfer and was treated as restored to its prior position (as the owner of New FS1, which contained all the assets and liabilities (other than assets disposed of by Amalco in the ordinary course of its business) formerly held by FS1.

Ruling
• Y will be treated as owning all the stock of FS1 at all times from the effective date of the amalgamation through the effective date of the rescission transaction.
• FS1 and Amalco will be treated as two separate corporations at all times during the tax year.

Note: FS2 and FS3 remain in Amalco.
Contingent Liabilities
Contingent Liabilities in Taxable Asset Acquisitions

• Unfortunately almost every deal involves contingent liabilities
  – Examples
    • Environmental liabilities
    • Tort liabilities
    • Warranty claims
    • Retiree medical expenses
  – Complex area with very few answers
  – Conflicting authority
• Issue arises when a buyer purchases assets of a business and after the acquisition the buyer pays or incurs a liability that is attributable to the acquired business
  – It is not clear whether that liability is a liability of the seller that is assumed by the buyer;
    OR
  – Whether it is simply a liability that arose after the acquisition and is properly treated as the buyer’s liability
Contingent Liabilities in Taxable Asset Acquisitions

• Whose liability is it?
  – Is it a seller liability assumed by the buyer?
  – Or a liability of the buyer arising after closing?

• If the buyer is not assuming a debt of the seller
  – Buyer should get a deduction on the payment of the liabilities. (Under normal rules of the all events test and economic performance. See section 461(b).
  – Ability to get a deduction is subject to the capitalization rules.

• If the liability is the seller’s liability assumed by the buyer, there are numerous issues
  – Income to the seller
  – Offsetting deduction to the seller
  – Basis to the Buyer

• Threshold question is when will contingent liability be treated as a seller liability assumed by the buyer and when will it be treated as the buyer’s liability
  – Each case decided on its own facts and circumstances
  – Cases and rulings provide some guidance on factors as to when a liability will be treated as assumed by the buyer
Contingent Liabilities: Assumed Obligation?

Factors

- Results from Buyer’s Operation
- Arises Out of Post-Acquisition Events
- Buyer Aware of Liability
- When Did Legal Liability Arise
- Reflection in Price
- Express Assumption by the Buyer
- Balance Sheet Reserve
Contingent Liabilities: Assumed Obligation?

• First factor – Results from Buyer’s Operation
  – Whether the liability relates to
    • Buyer’s operation of the business
    • Activity performed by the buyer
    • Events under the buyer’s control
    • Liability arising from buyers decision
  – Goal is to separate the occurrence of the liability from the seller and the acquisition (i.e., not a seller liability)
  – If it does not relate to the seller’s operation of the business, then the Buyer can deduct the payment
  – Holdcroft Transportation Co. v. Commissioner, 153 F.2d 323 (8th Cir. 1946)
    • Corporation acquires assets of partnership in exchange for stock and assumption of liabilities—including two tort claims filed against the partnership
    • Corporation pays on the claims and deducts the payments
      – Corporation argues it should be treated as stepping into the shoes of the partnership and therefore should be able to deduct the payments
      – Corporation also argues it should be able to deduct the payments because the claims were contingent
    • Court holds: (i) claims did not arise out of buyer’s business; (ii) rather, expenses related to the seller’s business; (iii) buyer cannot deduct costs relating to seller; (iv) fact that liability was liability was contingent did not matter; (v) buyer assumed the liability as part of the costs of the assets; (vi) section 381 – step into the shoes.
  – Other authorities
    • Albany Car Wheel v. Commissioner, 333 F.2d 653 (2nd Cir. 1964) – liability arose after acquisition due to buyer’s decision to close plant
    • Rev. Rul. 76-520 – buyer acquired a newspaper business
      – Costs of filling prepaid subscriptions was assumed liability because it relates to sellers operation
      – Costs incurred to sell newspapers at newsstand were deductible because they related to the buyer’s operation
    • TAM 9721002 – acquisition and severance pay
      – “[A]lthough severance payments here were coincidental with Buyer's acquisition of Target, the severance payments had their origin in Buyer's termination of Target employees. While the acquisition may have been the catalyst for the employees' receipt of the severance payments, the acquisition was not itself the basis for the payments. Accordingly, the severance payments need not be capitalized and added to the basis of the stock purchased.”
    • Illinois Tool Works v. Commissioner, 355 F.3d 997 (7th Cir. 2004)
      – Because the taxpayer knew of the pending patent infringement lawsuit, and agreed to pay that contingent liability in exchange for purchasing the company, the taxpayer was not entitled to currently deduct the judgment as a business expense.
Contingent Liabilities: Assumed Obligation?

- **Second factor – Arises Out of Post-acquisition Events**
  - A closely related factor is whether the liability arises out of post-acquisition events
  - For example, employee benefit cases
    - Where there is a contract in place at the time of the acquisition to pay death benefits when an employee dies
    - If employee dies after closing, then the liability should be a buyer liability
      - Even though contract in place, it’s contingent because you know he will die eventually
    - If employee has already died and seller is obligated to pay, the buyer assumes the obligation—No deduction.
  - *M. Buten & Sons, Inc. v. Commissioner*, 31 T.C.M. (CCH) 178 (1972)
    - Corporation agreed to assume liabilities of partnership in section 351 transaction, including death benefits to surviving widows
      - Court held no deduction for payments to widow of employee who died before the acquisition; Payments were deductible if employee died after the acquisition
  - *David R. Webb Company, Inc. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983)
    - Buyer assumed seller’s obligation to make pension payments to wife of previously deceased employee
    - Court no deduction to buyer
Contingent Liabilities: Assumed Obligation?

- **Third factor – Buyer Aware of Liability**
  - The third factor is whether the buyer was aware of the liability.
  - In *Pacific Transport v. Commissioner*, 29 T.C.M. 133 (1970), rev’d per curiam, 483 F.2d 209 (9th Cir. 1973), a parent corporation liquidated its subsidiary (section 334(b)(2) and took assets and assumed the liabilities of the subsidiary, including a lawsuit that was asserted against the subsidiary.
    - The parent corporation believed its risk exposure on the claim was remote.
    - The parent corporation’s risk assessment was wrong and it ultimately had to pay the claim.
    - Tax court held that a deduction should be allowed because the claim was speculative and remote.
    - Appeals court reversed and held that contingency was irrelevant. Because the buyer was aware of the liability, payment of the claim was a cost of acquiring the assets.
      - No exception to capitalization for bad bargains.
  - Therefore, if buyer is aware of the claim at the time of the acquisition, there is no deduction for payment of the claim.
  - On the other hand, if buyer is not aware of the claim, then the court might permit the buyer to deduct.
  - But see *Holdcroft Transportation v. Commissioner*. Court might not care whether the buyer knew of the liability and may instead look to when the liability arose. If the liability relates to the seller, then no deduction
Contingent Liabilities: Assumed Obligation?

- Fourth Factor: When did legal liability arise?
  - The fourth factor used by some courts to determine if a liability has been assumed is when the legal liability arose.
  - This factor can be used to explain the tort cases. Courts have stated that legal liability for a tort arises when the tort occurs.
    - Therefore using this factor would lead a court to conclude that a pre-closing cause of action is a liability of the seller. If the buyer pays the liability, there is no deduction.
    - *Holdcroft* and *Pacific Transport* support the notion that the contingent nature of the tort is not relevant
  - Compare this result to the contract cases where the liability represents a contractual claim, not a tort.
    - *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831 (1963), aff’d 333 F.2d 653 (2nd Cir. 1964)
      - There was a collective bargaining agreement that required payment of severance wages to employees upon a plant shutdown.
      - The purchase agreement called for an express assumption of the severance pay liabilities.
      - After the assets were transferred, the plant was shut down and severance payments were made by the buyer.
      - Court held that the liability did not arise until after the closing when the plant shut down. Therefore the liability arose on the buyer’s side.
        - Contract required payment upon certain contingent, future events. Liability arose when the event occurred.
        - Event was post-closing.
Contingent Liabilities: Assumed Obligation?

• **Fifth Factor: Liability Reflected in Price**
  – The next factor is whether the contingent liability is reflected in the price.
  – Courts look to see if the purchase price was reduced on account of the contingent liability.
  – If the purchase price was reduced, then the liability looks like an assumed liability.
  – This factor comes up often where
    • Purchase price based on balance sheet
    • Reserve on balance sheet (e.g., for employee medical benefits)
  – Allows IRS to argue that the liability was reflected in the price

• **Sixth Factor: Liability Expressly Assumed by the Buyer**
  – The sixth factor is whether the buyer expressly assumed the liability.
  – If the buyer expressly assumes a liability of the seller, courts generally conclude that the buyer is assuming the liability.
  – However, this factor alone is not fatal. In *Albany Car Wheel* the buyer expressly assumed a collective bargaining liability (severance pay in the event of a plant shutdown). However, the court said that the liability in fact was assumed.
Consequences of an Assumed Liability

To the Seller:

- Income Inclusion – When
  What Amount
- Installment Reporting
- Offsetting Deduction
- Imputed Interest Income

To the Buyer

- Capitalize Payment
- Deduct Payment
- Report Income
- Imputed Interest Expense
Consequences of an Assumed Liability: To the Seller

• First Issue: Income Inclusion
  – Seller is being relieved of a liability
  – Seller’s amount realized is increased
    • Not clear when amount realized increased and by how much
    • One approach is to value the liability at closing and increase the amount realized by that amount
    • Second approach is to increase seller’s amount realized only when the contingency becomes fixed and determinable (however that standard is defined). This is sometimes referred to as the “Wait and See” approach.

• Second Issue: Installment Reporting
  – If the “wait and see” approach is taken, then the issue arises as to whether the sale is converted to an installment sale because of the possible future payment when liability becomes fixed
    • Section 453 regulations (relating to installment sales) do not discuss assumption of contingent liabilities
    • However, if you treat the payment of the liability as a payment of the purchase price, then the sale literally falls within the definition of contingent payment installment sale.
Consequences of an Assumed Liability: To the Seller

- Third Issue: Does the Seller get an offsetting deduction against the amount realized resulting in no net income?
  - Most practitioners would conclude the seller should get a deduction under *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (1964) and *Commercial Security Bank v. Commissioner*, 77 T.C. 145 (1981).
  - In *Pierce*, the seller operated a newspaper business.
    - Seller received prepaid subscription fees
    - Seller initially set up a reserve and deferred the income under section 453
    - Court said that when seller sold the business the seller must accelerate the reserve into income
    - But, the court also gave the seller a deduction
      - Buyer paid cash for reserve
      - Seller turned around and paid buyer for assuming the liability to fill newspaper subscriptions
      - Thus income was offset with a deduction
  - In *Commercial Security Bank* there was a slightly different rationale.
    - Court said that liability assumed by the buyer reduced the cash received by the seller
    - Such reduction in cash received treated as if seller actually paid the liability
    - Seller gets a deduction to offset income
Consequences of an Assumed Liability: To the Seller

- Third Issue (continued): Does the Seller get an offsetting deduction against the amount realized resulting in no net income?
  - Problem arises because a seller can have all kinds of liabilities and the timing rules for deductions must be considered.
  - For example, if the all events test is satisfied but there is no economic performance, does the seller still get a deduction?
  - Section 461(h) regulations reserve treatment of contingent liabilities. See Treas. Reg. § 1.461-4(j).
  - Section 461 regulations do provide that in a sale of a business if the buyer “expressly assumes” a fixed liability then economic performance occurs as the liability is included in the seller’s amount realized.
  - Problem is that the regulation is too narrow because it requires an express assumption.
  - If the regulation test is failed, then the seller may have income without a matching deduction.
    - Presumably the deduction is deferred until the buyer makes payment
      » This is the wrong answer – in the acquisition context the seller should not be subject to economic performance.
      » Section 461(h) was intended to prevent premature accrual. If the seller has income recognition, then accrual is not premature.
      » If the seller doesn’t get a deduction at the time of the acquisition, then there is not a clear reflection of income.
      » Query whether Pierce and Commercial Security Bank apply if the requirements of section 461(h) are not met.
  - Similar problem arises where the liability is to make payment to nonqualifying deferred compensation plan
    - Section 404(a)(5) – employer gets deduction when employee has income
    - IRS position in TAM 8939002 is that deemed payment found in Commercial Security Bank, Pierce, etc. doesn’t support a deduction without income to the employee
Consequences of an Assumed Liability: To the Seller

• Fourth Issue: Whether Interest Imputed on Deemed Payment
  – This issue should only apply to the “wait and see” approach
    • Arguably there is no imputed interest because section 1274
does not apply to assumed debt. See section 1274(c)(4).
Consequences of an Assumed Liability: To the Buyer

• **First Approach: Capitalization**
  – Treat liability as cost of the assets.
  – Add to the assets’ basis when the liability becomes fixed.
  – Capitalization approach has the greatest support in the case law
    • See *Webb v. Commissioner*, 77 T.C. 1134 (1981), aff’d, 708 F.2d 1254 (7th Cir. 1983).
      – Unfunded pension liability assumed in asset acquisition
      – Payments treated as cost of acquired assets
    • See also *Holdcroft, Pacific Transport, M. Buten & Sons*.
      – Uncertain whether buyer can treat a portion of the payments as interest
Consequences of an Assumed Liability: To the Buyer

- **Second Approach: Deduction**
  - This method says that even if the liability is assumed by the buyer, the buyer should still get a deduction when the liability is fixed.
  - There is some support for this approach in the case law.
    - *Albany Car Wheel*, 333 F.2d 653 (2d Cir. 1964)
      - Agreement specifically said liability to pay severance pursuant to collective bargaining agreement in the event of a plant shutdown was assumed.
      - But court said that facts showed that the liability was not assumed and the buyer had made a decision that resulted in the liability to pay severance (i.e., shutting down the plant).
    - *United States v. Minneapolis and St. Louis Railway Co.*, 260 F.3d 663 (8th Cir. 1958)
      - Suggests deductibility method.
      - But case can also be read as saying nothing was assumed.
    - *F&D Rentals, Inc.*, 365 F.2d 64 (7th Cir. 1966)
      - Court said in dicta that taxpayer could deduct if payment had been made.
      - ABA and NYSBA support the deductibility approach.
Consequences of an Assumed Liability: To the Buyer

- **Third Approach: Income Approach**
  - The third approach is the income approach. This approach comes from the *Pierce* case.
    - Seller sold a newspaper
    - Court required seller to include reserve for prepaid subscriptions in income on sale
    - Court permitted seller an offsetting deduction
    - Court’s theory was to construe a deemed payment from seller to buyer in an amount equal to the reserve
  - The income approach has not received much support outside of the publication industry
    - Doesn’t make sense to say buyer has income on a purchase
Contingent Liabilities: Section 338(h)(10)

Result under the Section 338 Regulations

SELLER’S ADSP

\[ \text{ADSP} = G + L \]

- Regulations eliminate the “Fixed and Determinable” standard for determining the Liabilities of Old T.
- General principles of tax law apply in determining the timing and the amount of liabilities to be included in ADSP.
- ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP.

BUYER’S BASIS

- Use AGUB Formula
- Regulations eliminate the “Fixed and Determinable” standard.
- In order to be taken into account for AGUB, a liability must be a liability of T that is properly taken into account in basis under general principles of tax law.
Economic Bailout Developments / Section 382 Developments
Notices Affecting Section 382

- **Notice 2008-76**: Relief for Fannie Mae and Freddie Mac
- **Notice 2008-84**: Relief for corporations in which the government holds a greater than 50% interest
- **Notice 2008-78**: Capital contributions under Section 382(l)(1)
- **Notice 2008-83**: Relief for Banks (repealed)
- **Notice 2008-100**: Relief for financial institutions (superseded)
- **Notice 2009-14**: Amplify and expand Notice 2008-100 to apply to five EESA programs (superseded)
- **Notice 2009-38**: Amplify and expand Notice 2009-14 to apply to eight EESA programs
Notice 2008-76: Application of Section 382(m) to Housing Act Acquisitions

- The IRS issued Notice 2008-76 on September 8, 2008 to address acquisitions made pursuant to the Housing and Economic Recovery Act of 2008, which bailed out Fannie Mae and Freddie Mac.

- Notice 2008-76 suspends the ownership change testing rules of section 382 when the United States, or any agency or instrumentality of the United States acquires stock or an option to acquire stock in a loss corporation.

- The effect of Notice 2008-76 is to preserve the loss corporation’s losses going forward after the United States or affiliated instrumentality acquires stock in a loss corporation.

- The notice is effective on and after September 7, 2008.

- Fannie Mae and Freddie Mac have been given access to $400 billion.

- Fannie Mae announced that it lost $58.7 billion in 2008. Freddie Mac has not yet released its 2008 losses.

- Many project that Fannie Mae and Freddie Mac will never be fully privately owned again. One reason is that a condition of becoming independent is the repayment of all taxpayer invested dollars, plus interest.
Notice 2008-84: Acquisitions Not Described in Notice 2008-76

• The IRS issued Notice 2008-84 on September 26, 2008 to expand the number of corporations protected from an ownership change under of section 382 as a result of government action.

• Notice 2008-84 provides that regulations will be issued to suspend “testing dates” for periods in which the US directly or indirectly owns a more-than-50-percent interest.
  – Notice 2008-84 provides that the loss rules of section 382 become effective when the United States no longer owns a more-than-50-percent interest in the loss corporation.

• Notice 2008-84 is effective for any taxable year ending on or after September 26, 2008.

• Notice 2008-84 has been applied to the US interest in AIG.
Notice 2008-83: Application of Section 382(h) to Banks

- The IRS issued Notice 2008-83 on September 30, 2008 to suspend the built-in loss rules of Section 382(h) on loans or bad debts following the acquisition of a bank.

  - Section 382 limited the ability of loss corporation to recognize losses attributable to built-in loss assets or deductions attributable to periods prior to an ownership change.

- Notice 2008-83 provided that any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts shall not be treated as attributable to periods prior to an ownership change.

- Members of Congress, tax experts, various organizations, and the media questioned whether the Treasury Department had legal authority to change the application of the built-in loss rules without Congressional approval.
Repeal of Notice 2008-83

• Section 1261 of the Recovery Act revokes Notice 2008-83.

• Section 1261(a) of the Recovery Act sets forth the following findings:
  • The Secretary of the Treasury was not delegated authority under Section 382(m) to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers, and it is doubtful that the IRS has legal authority to prescribe such a notice.
  • Notice 2008-83 was inconsistent with the congressional intent of Section 382(m).

• Recovery Act Section 1261(b) states that Notice 2008-83 remains to be effective for ownership changes occurring on or before January 16, 2009, but has no force or effect for ownership changes after that date.
  
  – *Exception*: The notice remains to be effective for ownership changes after January 16, 2009 if the change is (i) pursuant to a written binding contract entered into on or before January 16, 2009, or (ii) pursuant to a written agreement entered into on or before January 16, 2009 and the agreement was described on or before January 16, 2009 in a public announcement or in a filing with the SEC required by reason of such ownership change.
Notice 2008-100: Section 382 and CPP Acquisitions

- The IRS issued Notice 2008-100 on October 14, 2008 to address the application of section 382 to loss corporations whose instruments are acquired by Treasury under the Capital Purchase Program (“CPP”) pursuant to the Emergency Economic Stabilization Act of 2008 (“EESA”).

- Notice 2008-100 generally provided that Treasury’s purchase of stock in a financial institution would not be considered an increase in Treasury’s ownership percentage of that financial institution. Treasury’s CPP purchases would not be considered to contribute to an ownership change under section 382.

- Notice 2009-14, issued January 30, 2009, amplified and superseded Notice 2008-100. It expanded Notice 2008-100’s scope from Treasury’s acquisitions of stock in failing banks through the CPP, to five EESA programs:
  - the Capital Purchase Program for publicly-traded issuers (Public CPP);
  - the Capital Purchase Program for private issuers (Private CPP);
  - the Capital Purchase Program for S corporations (S Corp CPP);
  - the Targeted Investment Program (TARP TIP); and
  - the Automotive Industry Financing Program (TARP Auto).
Notice 2009-38: Expansion of Notice 2008-100 to Other EESA Programs


• Notice 2009-38 maintains that Treasury’s investments in ailing institutions are not considered to contribute to an ownership change under section 382.

• Notice 2009-38 expands Notice 2008-100’s scope from the five EESA programs indicated in Notice 2009-14 to eight EESA programs (the “Programs”):
  – the Capital Purchase Program for publicly-traded issuers (Public CPP);
  – the Capital Purchase Program for private issuers (Private CPP);
  – the Capital Purchase Program for S corporations (S Corp CPP);
  – the Targeted Investment Program (TARP TIP);
  – the Automotive Industry Financing Program (TARP Auto);
  – the Systemically Significant Failing Institutions Program (SSFI);
  – the Asset Guarantee Program (AGP); and
  – the Capital Assistance Program for publicly-traded issuers (TARP CAP).
Notice 2009-38: Operating Rules

• Instruments (other than warrants) issued by Treasury pursuant to the Programs (except TARP CAP) are treated as debt, if so designated, and section 1504(a)(4) preferred stock, if so designated, whether owned by Treasury or subsequent holders.
  – No such instrument is treated as stock for purposes of section 382 while held by Treasury or by other holders, except that preferred stock will be treated as stock for purposes of section 382(e)(1).
  – The treatment of instruments issued to Treasury pursuant to TARP CAP is determined under general principles of federal tax law.

• Warrants issued under the Programs (except Private CPP and S Corp CPP) are treated as options, not stock, whether owned by Treasury or subsequent holders.
  – While held by Treasury, the warrant is not deemed exercised under Treas. Reg. §1.382-4(d)(2).
  – Warrants to purchase stock acquired by Treasury pursuant to the Private CPP is treated as an ownership interest in the underlying stock, which is treated as section 1504(a)(4) preferred stock.
  – Warrants acquired by Treasury pursuant to the S Corp CPP shall be treated as an ownership interest in the underlying indebtedness.
Notice 2009-38: Operating Rules

• Stock (other than 1504(a)(4) preferred stock) issued to Treasury pursuant to the Programs (either directly or upon the exercise of a warrant) does not increase Treasury’s ownership in the issuing corporation over its lowest percentage owned on any date before Treasury acquired such stock.
  – Stock acquired pursuant to the Programs is considered outstanding for purposes of determining the percentage of stock owned by other 5-percent shareholders on a testing date, until the stock is redeemed.

• On or after the date on which the issuing corporation redeems stock held by Treasury that was acquired pursuant to the Programs (either directly or upon the exercise of a warrant), the redeemed stock is treated as if it had never been outstanding for purposes of measuring shifts in ownership by any 5-percent shareholder.
Notice 2009-38: Operating Rules

- Any amount received by an issuer in exchange for instruments issued to Treasury under the Programs is treated as received, in its entirety, as consideration for such instruments.
  - Therefore, even if Treasury pays more for a failing institution's instrument than what the institution's debt is trading for, there is no capital contribution aspect to Treasury infusions.

- Section 382(l)(1) is not applicable with respect to capital contributions made by Treasury pursuant to the Programs.
  - Any capital contribution made by Treasury pursuant to the Programs is not considered to have been made as part of a plan a principal purpose of which was to avoid or increase any section 382 limitation.

- The operating rules, except for the rules regarding “instruments other than warrants” and warrants, apply to “Covered Instruments” as though such instruments were issued directly to Treasury under the Programs.
  - “Covered Instrument” is defined as a any instrument acquired by Treasury in exchange for an instrument that was issued to Treasury under the Programs, and any instrument acquired by Treasury in exchange for a Covered Instrument.
Notice 2010-2: Expansion of Notice 2009-38

• On December 11, 2009, the IRS issued Notice 2010-2 to expand the operating rules of Notice 2009-38 to cover sales of stock held by Treasury to the public.

• Notice 2010-2 amplifies and supersedes Notice 2009-38.

• Notice 2010-2 provides that if Treasury sells stock that was issued to it pursuant to the Programs and the sale creates a public group (a “New Public Group”), the New Public Group’s ownership in the issuing corporation shall not be considered to have increased solely as a result of such sale.
  – A New Public Group’s ownership will be treated as having increased to the extent it increases its ownership pursuant to other transactions (e.g., stock issuance, redemption).
  – The stock sold by Treasury will be treated as outstanding for purposes of determining the percentage of stock owned by other 5-percent shareholders.

• On December 21, 2009, Senator Bunning (R-Ky) introduced a bill that would repeal Notice 2010-2 and would prevent Treasury from issuing similar guidance that provides for an exemption or special rule under section 382 which is restricted to the disposition of instruments acquired by the Secretary unless authorized by Congress.
Section 382 and Capital Contributions
Capital Contributions Under Section 382(I)(1)

• The IRS issued Notice 2008-78 on September 26, 2008, which provides rules for determining whether a capital contribution is a part of a plan the principal purpose of which is to avoid or increase any limitation under section 382.

• Section 382(I)(1) is an anti-stuffing rule providing that – "any capital contribution received by any old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section may not be taken into account" for purposes of section 382.”

• The term “capital contribution” has been interpreted broadly as any direct or indirect infusion of capital into a loss corporation, including --
  – section 351 exchanges, and
  – taxable acquisitions of stock directly from loss corporation.

• Section 382(I)(1) prevents a taxpayer from obtaining an increase in the amount of the section 382 limitation by making last-minute capital contributions in order to inflate the value of the loss corporation.

• Section 382(I)(1) may also apply to a contribution of built-in gain property to avoid the built-in loss rules of section 382(h).
Capital Contributions Under Section 382(I)(1)

- Section 382(I)(2) provides that a capital contribution will be disregarded under section 382(I)(1) if made within a 2-year period ending on the change date, except as provided in regulations.

- The IRS has not yet issued regulations under section 382(I)(1).

- The legislative history of section 382(I)(1) provides that “the conferees intend that the regulations will generally except” the following capital contributions –
  - contributions received on the formation of a loss corporation (not accompanied by the incorporation of assets with a NUBIL),
  - contributions received before the first year from which there is an NOL or excess credit carryforward (or in which a NUBIL arose), and
  - contributions made to continue basic operations of the corporation's business (e.g., to meet the monthly payroll or fund other operating expenses of the loss corporation).

- The legislative history further provides that regulations may take into account (i) the existence of substantial nonbusiness assets on the change date, and (ii) distributions made to shareholders subsequent to capital contributions, as offsets to such contributions.

- The IRS concluded in PLRs that certain capital contributions will not trigger the anti-stuffing rule of section 382(I)(1) even though made within the 2-year period ending on an ownership change. See, e.g., PLR 200814004.
Notice 2008-78

• Notice 2008-78 provides that Treasury and the IRS will issue regulations under section 382(l) that are consistent with the rules set forth in the notice.

• Notice 2008-78 reverses the presumption set forth in section 382(l)(2).
  – Notice 2008-78 provides that the IRS will not consider a capital contribution to be part of a plan whose principal purpose is to avoid or increase a section 382 limitation simply because of the timing of the contribution.
  – Instead, all of the facts and circumstances will be considered by the IRS.

• Notice 2008-78 also provides a safe harbor provision exempting certain capital contributions from section 382(l)(1).

• Notice 2008-78 is effective immediately and may be applied to contributions that occur in any taxable year ending on or after September 26, 2008.
  – What effect does Notice 2008-78 have on prior taxable years?

• Note that Notice 2008-78 may apply to corporations affected by the current financial crisis that have sought significant capital infusions.
Notice 2008-78: Safe Harbors

• The IRS will not consider the following capital contributions to be part of a plan to avoid or increase any limitation under section 382:

Safe Harbor #1 –

• The contribution is made by a person who is neither a controlling shareholder nor a related party;

• no more than 20% of the total value of the loss corporation’s outstanding stock is issued in connection with the contribution;

• there was no arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and

• the ownership change occurs more than six months after the contribution.
Notice 2008-78: Safe Harbors

Safe Harbor # 2 –

• The contribution is made by a related party but no more than 10% of the total value of the loss corporation’s stock is issued in connection with the contribution, OR the contribution is made by a person other than a related party;

• there was no arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and

• the ownership change occurs more than one year after the contribution.
Notice 2008-78: Safe Harbors

Safe Harbor #3 -- The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Treas. Reg. § 1.355-7(d)(8) or (9), respectively.

Safe Harbor #4 -- The contribution is received on the formation of a loss corporation, or it is received before the first year from which there is a carryforward of a net operating loss, capital, excess credit, or excess foreign taxes.

• Note that the fact that a safe harbor does not apply to a capital contribution does not evidence that the contribution should be treated as part of a plan.
Additional Section 382 Guidance
Notice 2010-49: Small Shareholders

• Notice 2010-49 requests comments relating to possible modifications to the treatment of shareholders who are not 5-percent shareholders (“Small Shareholders”) for purposes of determining whether there is an ownership change.

• Under section 382, there is generally an ownership change if the ownership of one or more 5-percent shareholders has increased by more than 50 percentage points.
  – Under section 382(g)(4)(A), Small Shareholders are aggregated and treated as one 5-percent shareholder for purposes of applying this rule.
  – This rule is modified, however, by section 382(g)(4)(B) and section 382(g)(4)(C). Section 382(g)(4)(B) provides that the aggregation rule must be applied separately to Small Shareholders of parties to certain reorganizations and section 382(g)(4)(C) provides that, except as provided in regulations, similar segregation rules apply in determining whether there has been an owner shift involving a 5-percent shareholder and whether such shift results in an ownership change.

• The Notice describes two general approaches to the treatment of Small Shareholders that may be incorporated into modified regulations: (i) the Ownership Tracking Approach, and (ii) the Purposive Approach.

• Ownership Tracking Approach:
  – Under this approach, all changes in ownership are tracked without regard to the particular circumstances, so that it is generally of no significance whether the shareholders who increase their ownership are Small Shareholders or 5-percent shareholders.
  – Thus, any transaction that allows the corporation to track the increase in ownership interests held by Small Shareholders results in the segregation of Small Shareholders into a new public group, which is treated as a single 5-percent shareholder. The creation of the new, segregated public group results in an increase in ownership for that public group.
  – However, “public trading,” the purchase by one Small Shareholder of stock from another Small Shareholder, is not taken into account because it is unduly burdensome for a corporation to account for all such transactions.
Notice 2010-49: Small Shareholders

- **Purposive Approach:**
  - Under this approach, the rules would seek to identify more specifically the circumstances in which abuses are likely to arise.
  - The Purposive Approach reflects the view that it is unnecessary to take into account all readily-identifiable acquisitions of stock by Small Shareholders, because Small Shareholders are generally not in a position to acquire loss corporation stock in order to contribute income-producing assets or divert income-producing opportunities.
  - Special rules generally would provide for a lesser percentage change in ownership for acquisitions of stock by Small Shareholders.

- The current regulations primarily reflect the Ownership Tracking approach.
  - The notice requests comments concerning whether the regulations should follow the Ownership Tracking Approach, the Purposive Approach, or another approach.
Section 382(I)(3)(C): Fluctuations in Value
Section 382(l)(3)(C): Fluctuations in Value

- Section 382 limits NOL carryforwards and built-in losses when there has been an ownership change of more than 50% of the stock (by value) in a loss corporation over the testing period.

- Under section 382(g)(1), an ownership change occurs if the percentage (by value) of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50% over the lowest percentage ownership of such shareholders at any time during the testing period.
  - The determination of the percentage of stock owned by a person shall be made on the basis of the relative fair market value of the stock owned by such person to the total fair market value of the corporation's outstanding stock. See Treas. Reg. § 1.382-2(a)(3).

- Section 382(l)(3)(C) provides that in the absence of regulations stating otherwise, changes in the ownership of a corporation attributable solely to fluctuations in the relative value of the different classes of stock are not be taken into account in the ownership change calculation.
  - The temporary regulations reserve a paragraph under which changes in percentage ownership may be disregarded if they are attributable solely to fluctuations in value. See Temp. Reg. § 1.382-2T(l).
Section 382(l)(3)(C): Fluctuations in Value

- The IRS has articulated its position on how Section 382(l)(3)(C) should apply, as evidenced by recent PLRs. See PLR 200901003, PLR 200901001, PLR 200622011, PLR 200520011, PLR 200511008, and PLR 200411012.
  - In each of these PLRs, the IRS stated that the value of shares within a class of stock relative to all other stock outstanding would be considered to remain constant since the date the shareholder acquired the stock for purposes of the ownership change calculation.
  - In addition, the PLRs provide that the value of such shareholder’s stock relative to the value of all other stock of the corporation issued subsequent to such acquisition date shall also be considered to remain constant since that subsequent date.
Fluctuation in Value – Example 1

Facts: A and B form a corporation (“L Corp”) in Year 1. A contributes $80 in exchange for the C/S of L Corp and B contributes $20 in exchange for the P/S of L Corp. In Year 2, the value of L Corp decreases to $25. The value of the P/S remains at $20 and the value of the C/S decreases to $5.

Result: In testing B’s ownership of L Corp under section 382, the IRS position in the PLRs suggests that the value of B’s P/S relative to all other stock of L Corp (here, the C/S) shall be considered to remain constant since the date B acquired the P/S. The value of P/S relative to the value of the C/S was 25% ($20 / $80) at the date of acquisition. If this relative value remains constant, then B’s ownership percentage (20%) should be unchanged. The same analysis would apply to the A’s ownership so that A’s ownership percentage would be unchanged by reason of the fluctuation in value.
Fluctuation in Value – Example 2

Facts: A and B form a corporation ("L Corp") in Year 1. A contributes $80 in exchange for the C/S of L Corp and B contributes $20 in exchange for the P/S of L Corp. In Year 2, the value of L Corp decreases to $25. The value of the P/S remains at $20 and the value of the C/S decreases to $5. At the end of Year 2, A sells the C/S to C for $5.

Result: The IRS position in the PLRs suggests that, in testing for ownership, the relative value of a shareholder’s stock in L Corp to all other stock in L Corp shall remain constant since the acquisition of the stock. In applying the IRS approach, there would be no change in percentage ownership held by B (even though B’s ownership actually increased by 60% from acquisition to the date of the sale – from $20/$100 or 20% to $20/$25 or 80%). C’s ownership should be treated as increasing by 20%.

Variation: What if the value of L Corp dropped below $20 at the time A sold the C/S to C?
Fluctuation in Value – Example 3

Facts: A and B form a corporation (“L Corp”) in Year 1. A contributes $80 in exchange for the C/S of L Corp and B contributes $20 in exchange for the P/S of L Corp. In Year 2, the value of L Corp decreases to $25. The value of the P/S remains at $20 and the value of the C/S decreases to $5. At the end of Year 2, B sells the P/S to C for $5.

Result: C’s ownership should be treated as increasing by 80% and an ownership change should arise.

Variation: What if B sold only 50% of the P/S to C for $10? C’s ownership should be treated as increasing by 40%. B’s remaining P/S in L Corp represents an ownership interest of 40% also, which exceeds B’s ownership interest at acquisition in those shares by 30%. Has there been an ownership change? Under the IRS position in the PLRs, the remaining P/S held by B should be treated as holding their relative value against all other shares of L Corp so that B’s percentage ownership does not increase even though there has been a sale of the other P/S.
Facts: A and B form a corporation (“L Corp”) in Year 1. A contributes $80 in exchange for the C/S of L Corp and B contributes $20 in exchange for the P/S of L Corp. B sells the P/S to C for $20. Later in Year 1, the value of L Corp decreases to $25. The value of the P/S held remains at $20 and the value of the C/S decreases to $5. A then sells the C/S to D for $5.

Result: How is C’s ownership interest measured as of the date C and D own all of the stock of L Corp? Under the IRS position in the PLRs, C should have a 20% interest. If so, does D also have a 20% interest? If so, has there been an ownership change?

Variation: What if B acquired all of A’s stock in Year 2?
Fluctuation in Value – Example 5

Facts: A forms a corporation ("L Corp") in Year 1. A contributes $100 in exchange for the C/S of L Corp. In Year 2, A sells a 10% interest in L Corp to B for $10. In Year 3, L Corp issues additional C/S to the public ("Public") representing approximately 44% of the total value of L Corp for $85. Assume that B’s interest in L Corp is diluted as a result of the public offering to approximately 6%.

Result: Public’s percentage ownership has changed by approximately 44%. How much has B’s percentage ownership changed? B owned 10% of the value of L Corp immediately prior to the public offering. As a result of the public offering, B’s interest was diluted to approximately 6%. If the lower figure is used, then there would be no ownership change (as there would be a 50% change in ownership). Is the value change from 10% to approximately 6% a fluctuation in value ignored for purposes of section 382(l)(3)(C) such that there would be an ownership change? The IRS position in the PLR suggests that, for any testing date, B’s shares will retain their relative value against other shares held at acquisition (and still outstanding) as well as subsequently issued shares.
Notice 2010-50: Fluctuations in Stock Value

• Notice 2010-50 provides guidance regarding the effect of fluctuations in the value of one class of stock relative to another class of stock for purposes of measuring owner shifts of loss corporations that have more than one class of stock outstanding.

• Section 382(l)(3)(C) provides that, except as provided in regulations, any change in proportionate ownership of the stock of a loss corporation attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account.
  – The current regulations under section 382 do not provide any specific guidance on section 382(l)(3)(C).
  – The Notice states that the IRS and Treasury are aware that taxpayers employ a number of differing methodologies to interpret and apply section 382(l)(3)(C), including the Full Value Methodology and the Hold Constant Principle

• Full Value Methodology:
  – Under the Full Value Methodology, the determination of the percentage of stock owned by any person is made on the basis of the basis of the relative fair market value of the stock owned by such person compared to the total fair market value of the outstanding stock of the corporation.
  – Thus, changes in percentage ownership as a result of fluctuations in value are taken into account if a testing date occurs, regardless of whether a particular shareholder actively participates or is otherwise party to the transaction that causes the testing date to occur; essentially all shares are “marked to market” on each testing date.

• Hold Constant Principle:
  – Under the Hold Constant Principle, the value of a share, relative to the value of all other stock of the corporation, is established on the date that share is acquired by a particular shareholder.
  – On subsequent testing dates, the percentage interest represented by that share (the “tested share”) is then determined by factoring out fluctuations in the relative values of the loss corporation’s share classes that have occurred since the acquisition date of the tested share.
  – There are generally two alternative methodologies for implementing the Hold Constant Principle.
    • Under the first methodology, the hold constant percentage represented by a tested share is recalculated to factor out changes in its relative value since the share’s acquisition date.
    • Under the second methodology, the percentage interest represented by a tested share is tracked from the date of acquisition forward, adjusting for subsequent dispositions and for the subsequent issuance or redemption of other stock.
Notice 2010-50: Fluctuations in Stock Value

• The Notice states that, because of the complexity of the issues involved in measuring owner shifts of loss corporation stock where fluctuations in value are present, the IRS and Treasury have determined that it is appropriate to accept taxpayers’ reasonable attempts to measure increases in ownership where fluctuations in value are present.
  – The Notice thus states that the IRS will generally not challenge any reasonable application of either the Full Value Methodology or the Hold Constant Principle, provided that a single methodology is applied consistently.
  – The Notice also states that either of the two alternative methodologies for implementing the Hold Constant Principle are reasonable applications of that principle.
• The Notice states that taxpayers may rely on the guidance in the Notice until the IRS and Treasury issue additional guidance regarding fluctuation in value under section 382(l)(3)(C).
• In addition, the Notice requests comments on what it describes as the “threshold” question of whether interpreting the fluctuation in value rule in section 382(l)(3)(C) broadly to require rules for factoring out fluctuations in value, such as may be done through the methodologies that employ the Hold Constant Principle, is appropriate in light of the purposes of section 382.
Troubled Companies
Cancellation of Debt
and
Section 108
Overview
In General

• In general, the issuance of debt results in no federal income tax consequences to either the debtor or creditor, because the debtor’s receipt of cash or property that gives rise to the debt is offset by the debtor’s obligation to satisfy the debt.

• If the debtor’s obligation is cancelled, reduced, or otherwise modified, or the debt is exchanged for new debt or stock of the debtor in a transaction that does not qualify as a tax-free reorganization, there are tax consequences to both the debtor and the creditor.
  
  • The debtor will realize cancellation of debt (“COD”) income if the amount of consideration given by the debtor is less than the adjusted issue price of the debt. Section 61(a)(12); Treas. Reg. § 1.61-12(c)(2)(ii); U.S. v. Kirby Lumber Co., 284 U.S. 1 (1931).
In General

- Section 108(a) Exclusion – A debtor is not required to include COD in income if (i) the discharge occurs in a Title 11 case, or (ii) the debtor is insolvent.
- The price for the Section 108 exclusion is that the amounts excluded are applied to reduce the debtor’s tax attributes. Section 108(b).
  - The creditor may be entitled to deduction under Section 165 (for worthless securities) or Section 166 (for bad debts), or it may recognize gain or loss on the debt instrument if the amount of consideration received for the debt is greater or less than its adjusted basis in the debt. See section 1271(a); 1001.
Cancellation of Debt – Basic Example

Facts: D has assets worth $150 and is indebted to Bank in the amount of $200 and to its shareholder in the amount of $100. D’s tax attributes consist of a $50 NOL carryover and asset basis of $50. Consider the consequences of the following options:

• Bank cancels $150 of D’s debt.
• D transfers $100 in satisfaction of its $200 debt to Bank.
• D transfers property worth $100 with an adjusted basis of $50 in satisfaction of its $200 debt to Bank.
• D issues a new note with an adjusted issue price of $200 to Bank in exchange for the old one. Bank agrees to modify the terms of the existing debt by reducing the interest rate and extending the maturity date.
• D issues stock with a FMV of $20 in exchange for its $100 debt to its shareholder.
• Shareholder cancels the $100 debt by contributing it to the capital of D.
Debt Cancellation and Modification: Section 108(a)-(e)
Debt-for-Cash

- Cancellation or reduction of amount of debt
  - Debtor will have COD income equal to the amount of debt canceled. Section 61(a)(12).
  - Creditor may be entitled to a worthless security or bad debt deduction. Section 165, 166.
- Satisfaction of debt for less than full amount in cash
  - Debtor will have COD income equal to the adjusted issue price of the debt (generally its stated principal amount) less the amount of cash paid. Section 61(a)(12).
  - Creditor will recognize gain or loss equal to difference between the amount of cash received and its adjusted basis in the debt. Section 1001, 1271(a).
Debt-for-Property

• Satisfaction of debt for less than full amount in other property
  • Debtor’s tax consequences differ depending on whether the debt is recourse or nonrecourse.
    » Recourse Debt – Bifurcated treatment: (i) Gain or loss equal to difference between FMV of property and adjusted basis (section 1001; Rev. Rul. 70-271) (ii) COD income equal to debt less FMV of property (Treas. Reg. § 1.1001-2(a)(2); (c), Ex. 8; Rev. Rul. 90-16).
    » Nonrecourse Debt – Gain or loss equal to difference between principal amount of debt and adjusted basis of property. Treas. Reg. § 1.1001-2(a)(1); (c), Ex. 7; Commissioner v. Tufts, 461 U.S. 300 (1983).
  • Creditor will recognize gain or loss equal to the difference between the FMV of property received and its adjusted basis in the debt. Section 1271(a), 1001.
Debt-for-Debt

- Exchange of old debt for new debt with different terms
  - No tax effect if:
    » Old debt instrument contemplated or provided for the changes in the new debt instrument. See Rev. Rul. 57-535.
  - Debtor will have COD income equal to the difference between the adjusted issue price of the old debt and the adjusted issue price of the new debt. Section 108(e)(10).
  - Creditor will recognize gain or loss equal to the difference between the adjusted issue price of the new debt and its adjusted basis in the old debt. Section 108(e)(10); 1001, 1271(a).
  - If the issue price of the new debt is less than its stated redemption price at maturity, the excess will be original issue discount. Section 1273(a)(1).
Debt Modification

- Modification of debt
  - No tax effect if the modification is not significant or was contemplated or provided for in the original debt instrument. Treas. Reg. § 1.1001-3(b), (c)(1)(ii).
  - If the modification is significant, the debt is deemed exchanged for new debt, and the consequences are the same as an actual debt exchange. Treas. Reg. § 1.1001-3.
Debt-for-Stock

- Issuance of stock in exchange for the debt
  - Debtor will have COD income equal to the adjusted issue price of the debt less the FMV of the stock issued. Section 108(e)(8).
  - Creditor will recognize gain or loss equal to the difference between the FMV of the stock received and its adjusted basis in the debt. Section 108(e)(8); 1001, 1271(a).
Capital Contribution of Debt

- Capital contribution of debt to debtor corporation
  - Debtor will have COD income equal to the adjusted issue price of the debt less the shareholder’s basis in the debt. Section 108(e)(6).
  - Creditor should increase its basis in the stock of the debtor corporation by the adjusted issue price of the debt. See F.S.A. 001134 (Jan. 5, 1994).
  - Issuance of stock vs. capital contribution
Section 108(i)
Section 108(i)

- Section 1231 of the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”) added subsection (i) to section 108.
- A taxpayer may elect under section 108(i) to include COD income from the reacquisition of an “applicable debt instrument” in gross income ratably over a 5-year period (rather than including the entire COD income in the year of the reacquisition).
- The five-year period for recognition of COD income begins with the fifth tax year following the tax year in which the reacquisition occurs if the reacquisition occurs in 2009.
  - If the reacquisition occurs in 2010, the five-year period begins with the fourth tax year following the tax year in which the reacquisition occurs.
  - Thus, for calendar year taxpayers, the five years of inclusion would be 2014-2018 regardless of whether COD income is realized in 2009 or 2010 (assuming no short-period returns).
  - Section 108(i) does not apply to a reacquisition occurring after 2010.
- On August 17, 2009, the IRS issued Revenue Procedure 2009-37 to provide guidance on the application of section 108(i).
  - Revenue Procedure 2009-37 provides the exclusive procedures for taxpayers to make a section 108(i) election.
- On August 13, 2010, the IRS and Treasury issued two sets of Temporary and Proposed regulations under section 108(i). The first set provides guidance to C corporations regarding the acceleration of COD income and OID deductions and the calculation of earnings and profits as a result of an election under section 108(i). The second set provides guidance to partnerships and S corporations and their partners or shareholders regarding the deferral of COD income and OID deductions under section 108(i).
Section 108(i)

Section 163(e)(5)(F)

• Section 163(e)(5)(F) was added in connection with section 108(i) to prevent section 163(e)(5) from deferring or disallowing OID on applicable high yield discount obligations.

Interaction with Section 108(a)

• An election under section 108(i) precludes the taxpayer from excluding the COD income under section 108(a) (with a potential reduction of attributes under section 108(b)) for the year of reacquisition as well as any subsequent year.
  – Thus, for example, a taxpayer cannot exclude the COD income under section 108(a) after deferring recognition of the income until 2014.
Election to defer COD income

- A taxpayer makes an election to defer COD income under section 108(i) by including a statement to the taxpayer’s timely filed (including extensions) federal income tax return for the taxable year in which the reacquisition occurs.
  - Rev. Proc. 2009-37 provides the information to be included on the election statement.
  - The statute provides that the election is made on an instrument-by-instrument basis.
    • Rev. Proc. 2009-37 states that a taxpayer may treat two or more applicable debt instruments that are part of the same issue and reacquired during the same taxable year as one applicable debt instrument.
- The section 108(i) election is irrevocable.

- Partial elections
  - Rev. Proc. 2009-37 confirms that a taxpayer may make a partial election for any portion of COD income realized from the reacquisition of any applicable debt instrument.

- Protective elections

- Who makes the election?
  - The statute provides that the election is made by the entity for partnerships, S corporations, or other pass-through entities, rather than the partners, shareholders, or members.
  - Rev. Proc. 2009-37 confirms that the common parent of a consolidated group makes a section 108(i) election on behalf of all members of the group.
  - Rev. Proc. 2009-37 provides that a controlling shareholder of a CFC not otherwise required to file a tax return may make the election on behalf of the CFC.
Election to defer COD income

- **Annual Information Statements**
  - The statute granted the IRS authority to require reporting of the election for years subsequent to the election.
  - Rev. Proc. 2009-37 requires a taxpayer that makes a section 108(i) election to file an annual information statement with its federal tax return for each tax year following the election, until the first tax year in which all items deferred under section 108(i) have been recognized.
Definition of terms

Applicable Debt Instruments

• Section 108(i) applies to *reacquisitions* of “applicable debt instruments.”

• An “applicable debt instrument” is defined as any debt instrument that was issued by –
  – a C corporation, or
  – any other person in connection with the conduct of a trade or business by that person.

• A “debt instrument” is defined broadly to include –
  – a bond,
  – a debenture,
  – a note,
  – a certificate, or
  – any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a)(1).

• Consolidated return rule
  – Rev. Proc. 2009-37 provides that an applicable debt instrument includes only an intercompany obligation (as defined under Treas. Reg. § 1.1502-13(g)(2)(ii)) that becomes an intercompany obligation for which COD income is realized upon a deemed satisfaction under Treas. Reg. § 1.1502-13(g)(5) (an “inbound transaction”).
  – Thus, section 108(i) will not apply where COD income is realized in a deemed satisfaction of a debt instrument in an outbound or intragroup transaction.
Definition of terms

Reacquisition

• A “reacquisition” is defined as any acquisition of an applicable debt instrument by the debtor that issued the debt instrument, or is otherwise the obligor, or a person related to that debtor.
  – A “related person” is defined by reference to section 108(e)(4).

• An “acquisition” is defined to include --
  – a “debt for cash” exchange;
  – a “debt for debt” exchange (including an exchange resulting from a modification of a debt instrument);
  – a “debt for stock” exchange (including debt exchanged for a partnership interest);
  – the contribution of debt to capital; and
  – the complete forgiveness of the indebtedness by the holder of the debt instrument.

• The Conference Report provides that the enumerated acquisitions apply “without limitation.”

• Although the statute is ambiguous, Rev. Proc. 2009-37 clarifies that a debt for property exchange qualifies as an acquisition.
OID Deferral Rule -- Debt-for-Debt Exchanges

• Section 108(i)(2) defers deductions related to OID in debt-to-debt exchanges (including exchanges resulting from significant modifications) to match the deferral of income when a debtor makes a section 108(i) election.
  – OID may be at issue, for example, where existing debt is restructured to defer the payment of interest on the new debt or to increase the interest rate on the new debt instrument.
  – The related party rules of section 108(e)(4) apply (i.e., issuance of debt for related party debt covered by section 108(i)(2)).

• If the taxpayer elects to defer COD income under section 108(i), and the new debt instrument has OID, the issuer of the debt instrument cannot deduct the portion of the OID that:
  – Accrues before the first tax year in the 5-year period in which the COD income attributable to the reacquisition of the debt instrument is includible, and
  – Does not exceed the COD income from the debt instrument being reacquired.

• The aggregate amount of the deferred deductions can be deducted ratably over the 5-year period to match the inclusion of COD income under section 108(i).

• Note that deferral of OID income accruals on the new debt instrument is not permitted under section 108(i).
OID Deferral Rule -- Debt-for-Debt Exchanges

Deemed Debt-for-debt exchanges

- The OID deferral rule applies to deemed debt-for-debt exchanges where the issuer of a new debt instrument uses the proceeds directly or indirectly to reacquire an applicable debt instrument.
- The debt instrument that was issued is treated as issued for the debt instrument being reacquired.
- The OID deferral rule applies if the newly-issued debt instrument has OID.
  - If only a portion of the proceeds are used to reacquire an applicable debt instrument of the issuer, the OID deferral rule applies to the portion of any OID on the newly issued debt instrument that is equal to the portion of the proceeds from that instrument used to reacquire the outstanding instrument.

Interaction with Section 382

- Can the deferred OID deductions under section 108(i)(2) be subject to the section 382 limitation upon an ownership change?
- Can the deferred COD income be treated as RBIG under section 382?
Section 108(i) – Other rules

Acceleration of Deferred Items

• Any item of income or deduction deferred under section 108(i) must be taken into account at the time the taxpayer dies, liquidates, or sells substantially all of its assets (including in a Title 11 or similar case).
  – The deferred items will not be accelerated if the taxpayer reorganizes and emerges from the Title 11 case. See Conference Report, H.R. Report 111-16 (2009)

• The acceleration rule applies to the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-through entity by a partner, shareholder, or other person holding an ownership interest in the entity.

• The IRS has been granted authority to apply an acceleration rule “in circumstances where appropriate.”

Partnership Allocations

• In the case of a partnership, any deferred COD income is allocated to the partners immediately before the discharge in the manner those amounts would have been included in their distributive shares if the income or deduction were recognized at that time.

• Any decrease in a partner's share of partnership liabilities as a result of the discharge is not taken into account for purposes of section 752 partnership liability rules to the extent it would cause the partner to recognize gain under section 731.
  – Thus, the deemed distribution under section 752 is deferred for a partner to the extent it exceeds the partner's basis.

• Any decrease in partnership liabilities that is deferred under section 108(i) will be taken into account by the partner at the same time, and to the same extent, as the deferred income is recognized.
Section 108(i) – Temporary Regulations for C Corporations
Mandatory Acceleration Events for Deferred COD Income

• The temporary regulations generally provide that an electing corporation will accelerate all of its remaining deferred COD income only if the electing corporation:
  – (i) Engages in a transaction that impairs its ability to pay the tax liability associated with its deferred COD income (the net value acceleration rule),
  – (ii) Changes its tax status, or
  – (iii) Ceases its corporate existence in a transaction to which section 381(a) does not apply.

• Under section 108(i)(5)(D), the inclusion of a taxpayer’s remaining deferred COD income is accelerated in the case of the death of a taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including a Title 11 or similar case), the cessation of business by the taxpayer or similar circumstances.

• Although this statutory rule is susceptible to a broad interpretation, the preamble to the temporary regulations states that the rules provided in the temporary regulations reflect a narrower interpretation of the statutory acceleration events in an effort to focus more precisely on the underlying purpose of section 108(i)(5)(D).
  – Thus, the temporary regulations do not require acceleration in every instance enumerated in the statute, but provide for acceleration in a limited number of circumstances in which corporations have impaired their ability to pay their incipient tax liability.
Net Value Acceleration Rule

General Rule
• Under the net value acceleration rule, an electing corporation generally is required to accelerate its remaining deferred COD income if immediately after an impairment transaction, the gross value of the corporation’s assets is less than 110% of the sum of its total liabilities and the tax on the net amount of its deferred items (the “net value floor”).

Impairment Transaction
• An “impairment transaction” is any transaction, however effected, that impairs an electing corporation’s ability to pay the amount of federal income tax liability on its deferred COD income (e.g., distributions, redemptions, below market sales).
  – The following are not considered impairment transactions: (i) value-for-value sales or exchanges, (ii) investments and expenditures made in pursuance of good faith business judgment, (iii) mere declines in an asset’s market value, (iv) distributions and charitable contributions to the extent they are consistent with a corporation’s historical practice.

Restoration of Value
• An electing corporation can avoid the accelerated inclusion of its deferred COD income if value is restored to the corporation by the due date of the electing corporation’s tax return (including extensions).
  – The amount generally required to be restored is the lesser of (i) the amount of value that was removed (net of amounts previously restored) from the electing corporation in one or more impairment transactions, or (ii) the amount by which the electing corporation’s net value floor exceeds its gross asset value.
• The value that must be restored is determined at the time of the impairment transaction, and is determined on a net value basis.
Other Mandatory Acceleration Events

Changes in Tax Status
• An electing corporation must take into account its remaining deferred COD income immediately before a change in tax status, which includes a C corporation that becomes –
  – An S corporation,
  – A qualified subchapter S subsidiary,
  – A qualified RIC or REIT (or qualified REIT subsidiary, but only if the subsidiary was not a REIT immediately before it became a qualified REIT subsidiary),
  – A tax-exempt entity, or
  – An entity operating on a cooperative basis within the meaning of section 1361(b)(3).

Cessation of Existence
• An electing corporation must accelerate its remaining deferred COD income in the taxable year that the corporation ceases to exist.
• However, if the assets of the electing corporation are acquired in a transaction to which section 381(a) applies, the electing corporation’s deferred COD income is generally not accelerated.
  – In such a case, the acquiring corporation succeeds to the electing corporation’s remaining deferred COD income, and becomes subject to section 108(i).
• A section 381(a) transaction may, however, still constitute an impairment transaction.

Title 11 (or similar case)
• No special acceleration rules are provided for an electing corporation in a title 11 or similar case.
Example 1 – Net Value Acceleration Rule

Facts: On January 1, 2009, S reacquires its own note and realizes $400 of COD income. Pursuant to an election under section 108(i), S defers recognition of the entire $400 of COD income. On December 31, 2010, S makes a $25 distribution to P, its sole shareholder. Immediately after the distribution, S’s gross asset value is $100, S has no liabilities, and the federal income tax on S’s $400 of deferred COD income is $140 – making S’s net value floor $154 (110% x 140).

Under the temporary regulations, S’s distribution to P is an impairment transaction. Immediately following the distribution, S’s gross asset value of $100 is less than the net value floor of $154. Consequently, under the net value acceleration rule, S takes into account its $400 of deferred COD income immediately before the distribution. See Treas. Reg. § 1.108(i)-1T(c), Ex. 1.

Variation – Restoration of Value: P contributes assets with a value of $25 to S before the due date of S’s 2010 return. Because P restores $25 of value to S (the lesser of the value removed in the distribution and the excess of S’s net value floor over its gross asset value), S does not take into account its deferred COD income. See Treas. Reg. § 1.108(i)-1T(c), Ex. 1.
Example 2 – Cessation of Corporate Existence


Although S ceases its corporate existence as a result of the liquidation, S is not required to take into account its remaining deferred COD income because its assets are acquired in a transaction to which section 381(a) applies.

However, S’s distribution to P is an impairment transaction, and the net value acceleration rule is applied with respect to the assets, liabilities, and deferred items of P immediately following the distribution. If S’s deferred COD income is not taken into account under the net value acceleration rule, P succeeds to S’s remaining deferred COD income and to S’s reporting requirements. See Treas. Reg. § 1.108(i)-1T(c), Ex. 3.
Earnings and Profits

• In Rev. Proc. 2009-37, the IRS and Treasury announced its intention to issue regulations on the computation of earnings and profits ("E&P") with respect to income and deductions deferred under section 108(i).

• Consistent with this revenue procedure, the temporary regulations provide that deferred COD income generally increases E&P at the time of the COD event, not at the time that the COD is included in income.
  – According to the preamble to the temporary regulations, an electing corporation realizes economic income in the year of discharge, and, even though the electing corporation is not required to recognize income until later years, its dividend paying capacity is enhanced immediately, not during the inclusion period, or at the time the deferred COD income may be accelerated into income.

• Similarly, deferred OID deductions decrease E&P at the time the deduction would be allowable without regard to the deferral rules of section 108(i).

• The temporary regulations also provide certain exceptions to current year adjustments to earnings and profits.
  – In the case of RICs and REITs, deferred COD income increases E&P in the taxable year or years in which the deferred COD income is includible in gross income and not in the year that the deferred COD income is realized, and deferred OID deductions decrease E&P in the taxable year or years that the deferred OID deductions are deductible. The preamble to the temporary regulations provides that this rule is intended to ensure that a RIC or REIT has sufficient E&P to claim a dividends paid deduction in the taxable year that the deferred COD income is included in taxable income.
  – Additionally, for purposes of calculating alternative minimum taxable income, deferred items increase or decrease adjusted current earnings under section 56(g)(4) in the taxable year or years that the item is includible or deductible.
Deferred OID Deductions

Deemed Debt-for-Debt Exchanges

- For purposes of the OID deduction deferral rules of section 108(i)(2), the temporary regulations provide that, if the proceeds of any debt instrument are used directly or indirectly by the issuer or a person related to the issuer (within the meaning of section 108(i)(5)(A)) to reacquire an applicable debt instrument, the debt instrument is treated as issued for the applicable debt instrument being reacquired.
  - Thus, section 108(i)(2) may apply to a debt instrument issued by a corporation for cash in which some or all of the proceeds are used directly or indirectly by the corporation’s related subsidiary in the reacquisition of the subsidiary’s applicable debt instrument.
  - This rule is intended to prevent related parties from avoiding the rules for deferred OID deductions.

“Directly or Indirectly”

- Under the temporary regulations, whether the proceeds from an issuance of a debt instrument are used directly or indirectly by the issuer of the debt instrument or a person related to the issuer to reacquire an applicable debt instrument generally depends on all of the facts and circumstances surrounding the issuance and the reacquisition.
  - The proceeds of an issuance of a debt instrument will be treated as being used indirectly to reacquire an applicable debt instrument if:
    - (i) at the time of issuance, the issuer anticipated that an applicable debt instrument of the issuer or related person would be reacquired by the issuer, and the debt instrument would not have been issued if the issuer had not so anticipated such reacquisition,
    - (ii) at the time of issuance, the issuer or related person anticipated that an applicable debt instrument would be reacquired by a related person and the related person receives cash or property that it would not have received unless the reacquisition had been so anticipated, and
    - (iii) at the time of the reacquisition, the issuer or related person foresaw or reasonably should have foreseen that it would be required to issue a debt instrument, which it would not have otherwise been required to issue if the reacquisition had not occurred, in order to meet its future economic needs.
Deferred OID Deductions

Proportional Rule for Accruals of OID

- The temporary regulations provide that, if a portion of the proceeds of a debt instrument with OID are used directly or indirectly to reacquire an applicable debt instrument, then the amount of the issuer’s deferred OID deductions is generally equal to—
  - The product of the amount of OID that accrues in the taxable year under section 1272 or section 1275 (whichever is applicable), and a fraction—
    - the numerator of which is the portion of the total proceeds of the debt instrument used directly or indirectly to reacquire the applicable debt instrument, and
    - the denominator of which is the total proceeds of the debt instrument.
  - However, if the total amount of OID that accrues before the inclusion period is greater than the total amount of deferred COD income under section 108(i), then the OID deductions are disallowed in the order in which the OID is accrued, subject to the total amount of deferred COD income.

Acceleration Events for Deferred OID Deductions

- The temporary regulations provide that all or a portion of a C corporation issuer’s deferred OID deductions with respect to a debt instrument are taken into account to the extent that an electing entity or its owners include all or a portion of the deferred COD income to which the C corporation issuer’s deferred OID deductions relate.
  - A C corporation issuer also takes into account all of its remaining deferred OID deductions if the issuer (i) changes its tax status, or (ii) ceases to exist in a transaction to which section 381(a) does not apply, taking into account the application of Treas. Reg. 1.1502-34.
Effective Dates

- The rules provided in the temporary regulations relating to deferred COD income and the calculation of E&P apply to reacquisitions of applicable debt instruments in tax years ending after December 31, 2008.
  - The rules regarding deferred OID deductions generally apply to debt instruments issued after December 31, 2008.

- The rules relating to the acceleration of deferred COD income and deferred OID deductions apply prospectively to acceleration events occurring on or after August 13, 2010.
  - These rules may be applied to acceleration events occurring prior to this date by taking a return position consistent with these provisions.
  - In the case of a consolidated group, this option is available only if the acceleration rules are applied to all acceleration events with respect to all members of the group.

- To the extent an electing corporation or C corporation issuer does not apply these acceleration rules to acceleration events occurring prior to August 13, 2010, then all deferred items are subject to the rules of section 108(i)(5)(D)(i).
Section 108(i) – Consolidation
Section 108(i) – Temporary Regulations
Section 108(i) Temporary Regulations

Elective Acceleration for Electing Members of a Consolidated Group

• The temporary regulations provide an elective provision under which an electing member of a consolidated group (other than the common parent) may at any time accelerate in full (and not in part) the inclusion of its remaining deferred COD income with respect to all applicable debt instruments.

Net Value Acceleration Rule

• With respect to consolidated groups, the determination of whether an electing corporation that is a member of a consolidated group has engaged in an impairment transaction is made on a group-wide basis.
  – Thus, an electing member is treated as engaging in an impairment transaction if any member’s transaction impairs the group’s ability to pay the tax liability associated with the group’s deferred COD income.
  – Consequently, intercompany transactions are not impairment transactions.
  – Similarly, the net value acceleration rule is applied by reference to the group asset value of all members (excluding stock of members), the liabilities of all members, and the tax on all members’ deferred items.
Section 108(i) Temporary Regulations

Net Value Acceleration Rule—Departing Member

• Special rules are provided when an electing member that previously engaged in an impairment transaction on a separate entity basis leaves a consolidated group.

• If the electing member ceases to be a member of a consolidated group, the cessation is treated as an impairment transaction and the net value acceleration rule is applied to the departing member on a separate entity basis immediately after it ceases to be a member (taking into account the impairment transaction(s) that occurred on a separate entity basis).
  – If the departing member’s gross asset value is less than the net value floor, the departing member’s remaining deferred COD income must generally be taken into account immediately before it ceases to be a member.
  – If the departing member’s COD income is not accelerated, the departing member is subject to the reporting requirements of section 108(i) on a separate entity basis.

• In the case of an electing member that becomes a member of another consolidated group, the cessation is treated as an impairment transaction and the net value acceleration rule is applied by reference to the assets, liabilities, and deferred items of the members of the acquiring group immediately after the transaction.
  – If the gross asset value of the acquiring group is less than its net value floor, the departing member’s remaining deferred COD income is taken into account immediately before the departing member ceases to be a member of the former group.
  – If accelerated inclusion is not required, the common parent of the acquiring group succeeds to the reporting requirements of section 108(i) with respect to the departing member.
Section 108(i) Temporary Regulations

Application of Treas. Reg. § 1.1502-13(g)(5)

• Consistent with Rev. Proc. 2009-37, the temporary regulations provide that, in the case of an intercompany obligation (as defined in Treas. Reg. § 1.1502-13(g)(2)(ii)), the term applicable debt instrument includes only a debt instrument for which COD income is realized upon the debt instrument’s deemed satisfaction under Treas. Reg. § 1.1502-13(g)(5) (i.e., transactions in which a non-intercompany obligation becomes an intercompany obligation).
  – Thus, the temporary regulations confirm that section 108(i) will not apply where COD income is realized in a deemed satisfaction of a debt instrument in an outbound or intragroup transaction.

• The preamble to the temporary regulations notes that the intercompany obligation rules of Treas. Reg. § 1.1502-13(g) generally operate to minimize the effect on consolidated taxable income of items of income, gain, deduction, or loss arising from intercompany debt, generally matching the amount, timing, and character of the creditor and debtor member’s items, and ensuring that future items similarly correspond.
  – However, for transactions in which a non-intercompany obligation becomes an intercompany obligation, the timing and attributes of the debtor and creditor member’s items from the deemed satisfaction are determined on a separate entity basis, making the elective deferral rules of section 108(i) potentially beneficial.
Section 108(i) – Consolidation

Issues in Consolidation

• Elections under section 108(i)

• Stock basis adjustments under Treas. Reg. § 1.1502-32

• Treatment of E&P

• Application of the matching rule and acceleration rule in Treas. Reg. § 1.1502-13

• Application of the deemed satisfaction / reissuance approach (the “DSR” approach) of Treas. Reg. § 1.1502-13(g)

• Application of section 108(i) to intercompany debt
Example 1 – Section 108(i) Election

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. B acquires the $100 note for $70 and realizes $30 COD income.

Election – Rev. Proc. 2009-37 confirms that P, as the parent of the consolidated group, can make a section 108(i) election on behalf of B.

E&P – Under Treas. Reg. § 1.108(i)-1T(d)(1), B’s E&P would be increased on the date of the COD event (irrespective of whether a section 108(i) election is made).

Basis Adjustment – When does P increase its basis in B stock to take into account the $30 COD income?
Example 2 – Deconsolidation of Debtor Member

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. B acquires the $100 note for $70 in Year 1 and realizes $30 COD income. A section 108(i) election is made in Year 1. In Year 2, P sells the stock of B to Y for cash, and B becomes a member of another consolidated group.

If B previously engaged in an impairment transaction on a separate entity basis, B’s departure from the consolidated group is treated as an impairment transaction, and the net value acceleration rule is applied using the assets, liabilities, and the tax on deferred items of the members of the acquiring group immediately after the transaction. See Treas. Reg. § 1.108(i)-1T(b)(2)(iii)(F)(2).

If the acquiring group’s gross asset value is below the net value floor, B’s remaining deferred COD income is taken into account immediately before it ceases to be a member of the former group (unless value is restored). If B’s COD income is not accelerated, the common parent of the acquiring group succeeds to the reporting requirements of section 108(i) with respect to B. See Treas. Reg. § 1.108(i)-1T(b)(2)(iii)(F)(2).
Example 3 – Deconsolidation of Debtor Member with Section 338(h)(10) Election

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. B acquires the $100 note for $70 in Year 1 and realizes $30 COD income. A section 108(i) election is made in Year 1. In Year 2, P sells the stock of B to Y for cash, and P and Y make a timely section 338(h)(10) election with respect to the sale.

Under section 338(h)(10) and the regulations thereunder, B is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities. This deemed value-for-value exchange is not an impairment transaction. See Treas. Reg. § 1.108(i)-1T(c), Ex. 3(iv).

After the deemed sale, B is treated as distributing all of its assets to P and ceasing its existence. B is not required to take into account its remaining deferred COD income because its assets are acquired in a transaction to which section 381(a) applies. P succeeds to B’s remaining deferred COD income and the reporting requirements under section 108(i). Further, the intercompany distribution from B to P is not an impairment transaction. See Treas. Reg. § 1.108(i)-1T(c), Ex. 3(iv).
Example 4 – Section 108(i)(2) – Basic Illustration

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. B and X modify the terms of the note (e.g., increase interest rate) at a time when the $100 B note has a $70 value. Assume that the debt modification constitutes a deemed exchange under Treas. Reg. § 1.1001-3. Assume further that the deemed exchange results in $30 COD income under section 108(e)(10) and that the new note has OID.

Section 108(i)(2) applies to defer any OID deductions if B makes an election to defer the COD income under section 108(i).
Example 5 – Section 108(i)(2) – Consolidated Issues

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. P issues a note to Y and contributes the proceeds to B, which B uses to acquire the $100 B note. At the time P issues the note, P anticipated that the loan proceeds would be used to reacquire the debt of B, and the debt instrument would not have been issued if P had not anticipated this reacquisition.

The proceeds from P’s issuance of its debt instrument are treated as being used indirectly to reacquire B’s debt instrument, and P’s OID deductions on its debt instrument are subject to deferral under section 108(i)(2)(A). See Treas. Reg. § 1.108(i)-3T(d), Ex. 1.

Variation 1 – B borrows $70 from P in exchange for a note, and uses the proceeds to acquire the $100 B note. Does section 108(i)(2) apply to defer any OID deductions on the intercompany note? See Treas. Reg. § 1.108(i)-3T(a) (if the proceeds of any debt instrument are used directly or indirectly to reacquire an applicable debt instrument, the debt instrument is treated as issued for the applicable debt instrument being reacquired). If so, can P defer OID income accruals under -13?

Variation 2 - P contributes $70 to B, which B uses to acquire the $100 B note. What is the result?
Example 6 – DSR Approach (Inbound with Debt)

Facts: P and B are members of a consolidated group. X holds an outstanding note issued by B with a $100 face amount. P acquires the $100 B note for $70.

DSR Approach -- The intercompany obligation rules of -13(g) apply because the $100 B note becomes an intercompany obligation. B is deemed to satisfy the $100 B note for $70 immediately after the note becomes an intercompany obligation and recognizes $30 COD income. P does not recognize an offsetting loss. B is then deemed to reissue a note to P with a face amount of $100 for $70 (that has $30 OID).

Deemed Satisfaction – B can make a section 108(i) election for the COD income recognized in the “reacquisition” of the $100 B note. In the case of an intercompany obligation, an applicable debt instrument includes a debt instrument for which COD income is realized upon the debt instrument’s deemed satisfaction under Treas. Reg. § 1.1502-13(g)(5). See Treas. Reg. § 1.108(i)-0T(a)(2). Note that there is no offsetting loss within the P Group (i.e., X incurs the loss).

Deemed Reissuance -- Do the section 108(i)(2) OID deferral rules apply to the deemed reissuance of debt?

Variation -- P issues a note to X in exchange for the $100 B note. The DSR approach applies. If the P note has OID, would section 108(i)(2) apply to both the deemed reissuance of B’s note and P’s note?
Example 7 – Intragroup Section 108(i)

Facts: P, S, and B are members of a consolidated group. S holds an outstanding note issued by B with a $100 face amount. B acquires the $100 note for $70 and realizes $30 COD income. S realizes a $30 loss on the exchange (recharacterized as ordinary under the -13 rules). Assume that the DSR approach does not apply because of the intercompany extinguishment exception in Treas. Reg. § 1.1502-13(g)(3)(i)(B)(5).

Rev. Proc. 2009-37 provides that P cannot make an election on behalf of B for COD income realized on B’s intercompany obligation. See also Treas. Reg. § 1.108(i)-0T(a)(2) (limiting the application of section 108(i) to intercompany obligations by providing that the term applicable debt instrument includes only a debt instrument for which COD income is realized upon the debt instrument’s deemed satisfaction under Treas. Reg. § 1.1502-13(g)(5)).

Can B make an election under section 108(a) to reduce attributes?

Variation – S sells the $100 B note to P for $70.
Insolvency and Liability Issues
Situation 1: Corporation P owns 100 percent of the stock of FS, an entity organized under the laws of Country X that operates a manufacturing business. FS is an “eligible entity” under Treas. Reg. § 301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation for federal tax purposes (under section 7701(a)(3)). On December 31, 2002, the stock of FS was not worthless. On July 1, 2003, P files a check-the-box election for FS, changing the classification of FS from a corporation to a disregarded entity for federal tax purposes effective as of that date. At the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of its liabilities. However, at that time, the fair market value of FS's assets, excluding intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities. After the change in entity classification election is effective, FS continues its manufacturing operations.

Situation 2: Same facts as in Situation 1, except that at the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.
Holding: When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under section 165(g) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that on the deemed liquidation of the entity the shareholder receives no payment on its stock.

Situation 1: Because the aggregate value of FS’s tangible and intangible assets ($1,050,000) exceeds FS’s liabilities ($1,000,000) immediately before the effective date of the P’s check-the-box election for FS, the stock of FS is not worthless on that date. Accordingly, because P receives at least partial payment on its FS stock in the deemed liquidation of FS. As a result, Section 332 applies to the deemed liquidation and no loss is allowable to P.

Situation 2: Because the aggregate value of FS’s tangible and intangible assets ($950,000) does not exceed FS’s liabilities ($1,000,000) immediately before the effective date of the P’s check-the-box election for FS, the stock of FS is worthless. Accordingly, Section 332 does not apply because P does not receive any payment on its FS stock in the deemed liquidation of FS. The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock and, therefore, P is allowed a worthless security deduction under section 165(g) for its 2003 tax year. Also, depending on the facts, FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under Sections 165 or 166.
Rev. Rul. 2003-125 clarifies that:

- Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholders receive payment for their stock. See *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

- A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities.

- The value of intangible assets, including goodwill and going concern, is included in determining the fair market value of the entity’s assets immediately before the deemed liquidation.

- Certain facts, such as (i) the continuation of the corporation's business after a liquidation without a substantial infusion of capital, and (ii) the revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation, may suggest that at the time of liquidation the fair market value of the liquidating entity's assets, including goodwill and going concern value, exceeded the sum of its liabilities.
Rev. Rul. 2003-125 clarifies that (cont.):

• Nevertheless, depending on the facts, the parent could claim a bad debt deduction and a worthless stock deduction where its wholly owned subsidiary owes a bona fide indebtedness to its parent corporation that exceeds the fair market value of its assets and the subsidiary transfers all of its assets to the parent in partial satisfaction of its indebtedness. This may be true even where the parent continues the business formerly conducted by the subsidiary. See Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying Rev. Rul. 59-296, 1959-2 C.B. 87.

• If a shareholder receives no payment for its stock in a liquidation of the corporation, neither Section 331 nor Section 332 applies to the liquidation.

• The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless.

• The liquidation is an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g).
Facts: S1 is a wholly owned subsidiary of P. S1 has liabilities (owed solely to P) that exceed the FMV of its assets, and is thus insolvent. S1 merges with and into P, transferring all of its assets to P in partial satisfaction of its liabilities. Previously, foreign and domestic subsidiaries of S1 either merged with and into, or were liquidated into, S1. Some of these subsidiaries held additional subsidiaries that either merged with and into, or were liquidated into, their immediate parent prior to that entity’s merger or liquidation into S1. S1 also owned, directly or indirectly, other domestic and foreign subsidiaries whose stock was previously sold outside P’s affiliated group. Intercompany distributions (as described in former Treas. Reg. § 1.1502-14) had been made by several of these subsidiaries to the subsidiaries that were subsequently merged or liquidated (directly or indirectly) into S1.

Ruling: The ruling concludes that P may claim a worthless stock deduction with respect to its S1 stock.

- For purposes of determining whether S1 meets the 90-percent active gross receipts test under section 165(g)(3)(B), S1 must take into account the historic gross receipts of each subsidiary corporation that was merged with and into, or was liquidated into, S1 (directly or indirectly). However, S1 must eliminate intercompany distributions received from any first-tier subsidiary, and each first-tier subsidiary must eliminate intercompany distributions received from a second-tier subsidiary.

- In computing S1’s gross receipts under section 165(g)(3)(B), S1 must treat as a dividend the full amount of any intercompany distributions made out of E&P, and received in a taxable year beginning prior to July 12, 1995, from a lower-tier subsidiary. The ruling does not attempt to examine whether such dividends are attributable to active or passive receipts of the subsidiaries.
Facts: P owns all of the member interests of S, an insolvent LLC treated as a corporation for federal income tax purposes. S owns directly or indirectly member interests of several other LLCs (treated as either corporations or disregarded entities for federal income tax purposes). P sells 100 percent of its member interests in S to Purchaser, an unrelated LLC that has elected to be treated as a corporation for federal income tax purposes, in exchange for cash and membership interests in Purchaser. Subsequently, a section 338(h)(10) election is made for the purchase. As a result of the election, S and each of the subsidiary corporations owned by S are deemed to be sold in a qualified stock purchase, and a section 338(h)(10) election is made for each of these entities.

Ruling: Provided the requirements of section 165(g) are satisfied, the ruling concludes that P may claim a worthless stock deduction under section 165(g)(3) on the deemed liquidation of S resulting from the section 338(h)(10) election with respect to the purchase.

- For purposes of determining whether S meets the 90-percent active gross receipts test under section 165(g)(3)(B), S’s gross receipts from passive sources is determined by looking at all of S’s gross receipts from intercompany transactions (as described in Treas. Reg. § 1.1502-13) and sourcing the gross receipts based on S’s counterparty’s gross receipts from passive sources (even if on its face the intercompany transaction appears not to be gross receipts from passive sources). Such amounts are treated as gross receipts from passive sources to the extent they are attributable to the intercompany transactions’ counterparty’s gross receipts from passive sources. The counterparty will include in its aggregate gross receipts all amounts it received in intercompany transactions, and such amounts will be treated as gross receipts from passive sources to the extent they are attributable to its counterparty’s gross receipts from passive sources (and so on, until the ultimate counterparty is reached).

- In computing S’s gross receipts under section 165(g)(3)(B), S also takes into account the historic gross receipts of the transferor corporations in the deemed section 332 liquidations. However, S will eliminate gross receipts from intercompany transactions with the transferor corporations to prevent duplication (as appropriate).
Liquidations and Upstream Mergers
In General

- **Section 332**
  - A liquidation is not taxable to a corporate shareholder if the corporate shareholder owns at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. Under section 337, the liquidating corporation does not recognize gain or loss.
  - If the requirements of Section 332 are not satisfied, a liquidation is generally taxable to the liquidating corporation and its shareholders under Sections 331 and 336.

- **Treas. Reg. §1.332-2(b)**
  - Section 332 applies only where the parent receives at least partial payment for its stock.
  - This requirement has been held to apply to section 331 liquidations as well. See *Braddock Land Co. v. Commissioner*, 75 T.C. 324 (1980); *Jordan v. Commissioner*, 11 T.C. 914 (1948).
  - Section 332 requires a distribution in cancellation or redemption of all of the stock of the liquidating company. Thus, a distribution that is sufficient to redeem only the company’s preferred stock is not a liquidation. See *Commissioner v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).
In General

- **Proposed No Net Value Regulations**
  - The proposed regulations retain the partial payment rule of the current regulations and provide new rules with respect to liquidations involving multiple classes of stock. Prop. Treas. Reg. §1.332-2(b).
  - If partial payment is not received for *every* class of stock but is received for at least one class, the proposed regulations look separately to each class of stock to determine the tax consequences.
  - With respect to those classes of stock for which no payment is received, the proposed regulations refer to Section 165(g) worthless stock deductions.
  - With respect to those classes of stock for which payment is received, the proposed regulations refer to Section 368(a)(1) regarding a potential reorganization or to Section 331 if the distribution does not qualify as a reorganization.

- The IRS also takes the position that an upstream merger cannot qualify as a tax-free A reorganization. Rev. Rul. 70-489. **But see** Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967) (noting that unlike the requirement for a liquidation that there be a payment in cancellation or redemption of stock, there is no such requirement for a statutory merger to qualify under section 368(a)(1)(A)).
Liquidations vs. Upstream Merger

**Facts:** P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $150. S adopts a plan of liquidation, and distributes all of its assets to P.

**Result:** The transaction does not qualify as a Section 332 liquidation under either current law or the proposed regulations. Instead, S should be treated as transferring its $100 of assets in satisfaction of its $150 debt to P, and P should be entitled to a worthless stock deduction of $100 and a bad debt deduction of $50.

Facts: P owns all of the common and preferred stock of S. The preferred stock has a liquidation preference of $200. S has assets worth $100 and no liabilities. S adopts a plan of liquidation, and distributes all of its assets to P.

Result: The transaction does not qualify as a section 332 liquidation under either current law or the proposed regulations, because P did not receive any payment on its common stock. See Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986); Prop. Treas. Reg. §1.332-2(b), (e), Ex. 2. Thus, P is entitled to a worthless stock deduction for its common stock under section 165(g). Under the proposed regulations, the transaction may qualify as a reorganization with respect to P’s preferred stock, since it received partial payment on that. If the transaction does not qualify as a reorganization, then P would recognize gain or loss on the preferred stock under section 331.
Deemed Liquidation

Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. S converts into a single-member LLC pursuant to state law.

Result: The conversion into a single-member LLC results in a deemed liquidation under Treas. Reg. §301.7701-3(g)(1)(iii). However, because S is insolvent, the deemed liquidation does not qualify as a section 332 liquidation under either current law or the proposed regulations. The deemed liquidation is considered an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g). Rev. Rul. 2003-125, 2003-52 I.R.B. 1 (reversing the result in F.S.A. 200226004 (Mar. 7, 2002)). Thus, P should be entitled to worthless stock and bad debt deductions, even though P continues the business formerly conducted by S. Id.; see also Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying Rev. Rul. 59-296, 1959-2 C.B. 87.
Revenue Ruling 68-602

Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. P cancels the $160 debt by contributing it to S’s capital. S then adopts a plan of liquidation, and distributes all of its assets to P.

Result: In Rev. Rul. 68-602, 1968-2 C.B. 135, the IRS ruled that the debt cancellation was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of S’s net operating loss carryover. Therefore, the IRS regarded the cancellation as transitory and disregarded it. Cf. Rev. Rul. 78-330, 1978-2 C.B. 147 (respecting debt cancellation immediately before a sideways merger because such cancellation had independent economic significance). As a result, the liquidation in this example does not qualify as a Section 332 liquidation, and the result is the same as in the prior two examples. The proposed regulations do not change this result.
Facts: P owns all of the stock of S. S has assets worth $150 and is indebted to P in the amount of $200 and to the bank in the amount of $100. P cancels the $200 debt by contributing it to S’s capital. S then adopts a plan of liquidation, repaying the bank debt in full and distributing the remaining assets (i.e., $50) to P.

Result: Absent the debt cancellation, 1/3 of S’s assets (i.e., $50) would have gone to the bank, and 2/3 (i.e., $100) would have gone to P. Arguably, in these circumstances, the debt cancellation has independent economic significance and Rev. Rul. 78-330, not Rev. Rul. 68-602, should apply. Query whether the cancellation has independent economic significance only to the extent of $150, the value of S’s assets available to repay its outstanding debt.
P is the common parent of a consolidated group. P owns all of the stock of S1. S1 owns x% (at least 80%) of the stock of S2. The public owns the remaining shares of S2. S2 owns all the stock of S3. S1 was the lender on an intercompany indebtedness with S3. Prior to the transaction, S3’s liabilities exceed the fair market value of its assets and S2's liabilities exceed the fair market value of its assets.

On Date 1, as a condition to a pending sale, S1 forgave a portion of the indebtedness it had with S3. Immediately after this cancellation, the net value of S3’s assets exceeded its liabilities and the net value of S2’s assets (including the stock of S3) exceed S2’s liabilities. On Date 2, S1 sold all of its stock in S2 to purchaser X, an unrelated third party. On Date 3, P and X make a section 338(h)(10) election with respect to the sale of the stock of S2 and the deemed sale of the stock of S3.

The National Office determined that the deemed liquidation of S2 pursuant to the section 338(h)(10) election would not qualify under section 332. The National Office determined that the cancellation of the indebtedness between S1 and S3 would be disregarded as in Rev. Rul. 68-602. Because the cancellation of indebtedness would be disregarded, S1 would not be treated as receiving any net value for its stock interest in S2 and therefore the liquidation would not qualify under section 332. The CCA stated that the fact that there may be economic significance in the cancellation of indebtedness does not alter the result. The CCA distinguished Rev. Rul. 78-330 because there was no liquidation in the transaction at issue in that ruling.
Creditor Continuity of Interest
On December 11, 2008, the IRS issued final regulations on creditor continuity of interest (“COI”) (TD 9434).

- These rules were originally proposed in connection with the no net value regulations on March 10, 2005.
- The final regulations are similar in substance to the earlier proposed regulations, but add minor modifications and clarifications.

The COI requirement requires that in substance a substantial value of the proprietary interests in the target corporation be preserved in the reorganization.

The final regulations provide when and to what extent creditors of a bankrupt or insolvent corporation will be treated as proprietors of the corporation for purposes of determining whether COI is preserved in a potential reorganization.

The final regulations apply to transactions occurring after December 12, 2008.

Treating Creditors’ Claims as Proprietary Interest

- The regulations treat a creditor’s claim against a target corporation as a proprietary interest if (i) the target is in a title 11 or similar case, or (ii) the target is insolvent immediately before the reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, then every claim of that class of creditors and every claim of all equal and junior classes of creditors is a proprietary interest in the target corporation. Treas. Reg. §1.368-1(e)(6)(i).

- Shareholders retain their proprietary interest in the target corporation notwithstanding that creditors are treated as having a proprietary interest. Treas. Reg. §1.368-1(e)(6)(iv).
Final Regulations on Creditor Continuity of Interest

• Measuring COI
  – **Senior Creditors** – The claims of the most senior class of creditors to receive a proprietary interest and all other equal creditors (together the “senior creditors”) represent, in part, a creditor claim and, in part, a proprietary interest. The portion of the claim treated as a proprietary interest is equal to --

  \[
  \text{FMV of creditor’s claim} \times \frac{\text{FMV of proprietary interests issued to senior creditors}}{\text{Total consideration paid to senior creditors}}
  \]

  Treas. Reg. §1.368-1(e)(6)(ii)(A)

  – **Junior Creditors** – The claims of the junior creditors are treated as a proprietary interest in full (i.e., the proprietary interest is equal to the FMV of the creditor’s claim). Treas. Reg. §1.368-1(e)(6)(ii)(B).

• The final COI regulations add a new rule which requires that where only one class of creditors receives stock, more than a de minimis amount of acquiring corporation stock must be exchanged for the creditors’ proprietary interest relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of COI. Treas. Reg. §1.368-1(e)(6)(ii)(A).

• The final COI regulations also add an example to demonstrate the bifurcation of senior claims when the creditors of that class receive disproportionate amounts of acquiring corporation stock and other property. Treas. Reg. §1.368-1(e)(8), Ex. 10(ii).
Creditor Continuity of Interest

**Facts:** T is in bankruptcy and has assets with a fair market value of $150 and liabilities of $200. T has three classes of creditors: senior secured with claims of $20, senior unsecured with claims of $30, and junior unsecured with claims of $150. Pursuant to the plan of reorganization, T transfers its assets to A in exchange for A stock worth $55 and $95 cash. T distributes $16 cash and $4 stock to the senior secured creditors; $24 cash and $6 stock to the senior unsecured creditors; and $55 cash and $45 stock to the junior unsecured creditors. T’s shareholders receive nothing.

**Result:** Under the prior law, the most senior class of creditors to receive stock was the senior secured and the most junior class to receive any consideration was the junior unsecured creditors, so all classes count toward COI. The COI requirement was likely not satisfied because only $55 out of the total $150 consideration, or 36.6%, consisted of A stock.

Applying the new regulations, the senior creditors together receive $40 cash and $10 in A stock. The value of their proprietary interest is $10 (i.e., $50 value of claims x ($10 stock received by senior creditors ÷ $50 total consideration). The value of the junior creditors’ claims is $100. The COI requirement is satisfied, because A is treated as acquiring $55 of the total $110 claims, or 50%, in exchange for stock. See Treas. Reg. §1.368-1(e)(8), Ex. 10(i).
Proposed Basis Allocation Regulations
Proposed Basis Allocation Regulations

• On January 16, 2009, Treasury and the IRS issued proposed regulations that provide 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 (the “Proposed Regulations”).
  – The Proposed Regulations apply the single model regardless of whether section 301 or section 302(a) applies directly or by reason of section 302(d), section 304, or section 356.

• The Proposed Regulations also provide a methodology for determining gain realized under section 356 and stock basis determined under section 358.

• The Proposed Regulations generally will apply to transactions that occur after the regulations are published as final regulations.
Distributions Under Section 301

• Section 301(c)(2) provides that “that portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.” [emphasis added.]

• The Proposed Regulations treat a section 301 distribution as received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made.

• The Preamble provides that the share-by-share approach is consistent with the fundamental notion that a share of stock is the basic unit of property that can be disposed of.
  – The approach in the Proposed Regulations follows the generally accepted treatment of section 301 distributions. See Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).

• Under the share-by-share approach, a distribution that is not a dividend can result in gain with respect to some shares within a class of stock while other shares have unrecovered basis.
Dividend Equivalent Redemptions

• The Proposed Regulations apply the basis recovery rules applicable to section 301 distributions to dividend equivalent redemptions and certain section 304 transactions.
  – Current law does not provide clear guidance on what share’s basis will be recovered in a dividend equivalent redemption.

• The Proposed Regulations provide that a dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the “redeemed class” held by the redeemed shareholder immediately before the redemption.

• This approach can result in gain with respect to some shares within a class even though other shares may have unrecovered basis.

• Less Than All Shares in a Class Redeemed
  – If less than all of the shares of a class of stock are redeemed, there is a hypothetical recapitalization in which the redeemed shareholder is deemed to exchange all of its shares in the class, including the redeemed shares, for the actual number of shares held after the redemption.
  – The Proposed Regulations clarify that the tracing rules in existing regulations under section 358 apply to this deemed recapitalization (e.g., basis remaining on the redeemed shares, if any, will shift to a portion of the remaining shares).
Dividend Equivalent Redemptions

• All Shares in a Class Redeemed
  – The Proposed Regulations preclude the shifting of basis if all shares of single class of stock held by a shareholder are redeemed in a dividend equivalent redemption.
  – Currently, Treas. Reg. § 1.302-2(c) permits the basis of the redeemed shares to shift in certain circumstances.
  – The Proposed Regulations preserve the tax consequences of unrecovered basis by treating the amount of unrecovered basis as a deferred loss that can be recognized when the conditions of sections 302(b)(1), (2), or (3) are satisfied or when all shares of the issuing corporation become worthless.
• If a redemption is treated as a sale or exchange, the Proposed Regulations clarify that a shareholder that owns stock with different bases can decide which shares to surrender.
  – This is consistent with current law. See Treas. Reg. § 1.1012-1(c).
Dividend Equivalent Reorganizations

• The Proposed Regulations provide for a different treatment for boot received in a reorganization depending on whether the reorganization exchange is the equivalent to a dividend.

• The overall reorganization exchange must be taken into account in determining whether a particular exchange is dividend equivalent. See, e.g., Commissioner v. Clark, 489 U.S. 726 (1989).

• The Proposed Regulations provide that a reorganization exchange involving an exchange of one class of stock for stock and the exchange of another class of stock for non-qualifying property must be considered as an overall exchange rather than as two separate exchanges.
Dividend Equivalent Reorganizations

- **Dividend equivalent transactions.** Dividend equivalent transactions will be treated similar to dividend equivalent redemptions under the Proposed Regulations.
  - The Proposed Regulations provide that shareholders cannot specify that boot is received with respect to particular shares within a class of stock.

  - **Solely Boot**
    - The Proposed Regulations provide that section 302(d) applies (rather than section 356(a)(2)) to the extent a dividend equivalent transaction involves the exchange of a class of stock solely for boot. Compare Rev. Rul. 74-515, where a transfer of preferred stock of a target for cash is treated as an exchange under section 356.
      - Note that the “boot within gain” limitation in section 356(a)(2) will not apply to a dividend equivalent reorganization to the extent section 302(d) applies.
    - A shareholder’s receipt solely of boot with respect to a class of stock in a reorganization exchange is treated as received pro rata, on a share-by-share basis, with respect to each share in the class. See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971).
    - As a result of this rule, an exchange can result in gain recognition with respect to some shares while other shares in the class have unrecovered basis.

  - **Boot and qualifying property**
    - If a shareholder receives both qualifying and nonqualifying property with respect to shares within a particular class, the nonqualifying property must be allocated proportionally among all of the surrendered shares within the class.
    - Current regulations under section 358 permit designations of qualifying and nonqualifying property to shares within the class.
      - A taxpayer may specify the terms of the exchange between the classes of stock surrendered if the shareholder receives more than one class of stock or surrenders one class of stock and securities, provided the designation is economically reasonable.
Dividend Equivalent Reorganizations

- Dividend equivalent transactions (continued).
  - The IRS and Treasury declined to reverse Johnson and allow gain to be determined in the aggregate with respect to a single class of stock.
  - The Preamble to the Proposed Regulations states that the IRS and Treasury believe such an aggregate approach would contradict the fundamental principle that a share is a discrete unit of property and also would compromise the principle that a reorganization is not an event that justifies stock basis averaging.
**Dividend Equivalent Reorganizations**

**Facts:** P owns all of the stock of Sub 1 and Sub 2. P has 2 different blocks of stock in Sub 1: Block 1 with a basis of $50 and a value of $150 and Block 2 with a basis of $150 and a value of $50. Neither Sub 1 nor Sub 2 has any E&P. Sub 1 transfers all of its assets to Sub 2 in exchange for $200, which Sub 1 distributes to P in a transaction that qualifies as a “D” reorganization.

**Result:** The transaction will be treated as a dividend equivalent reorganization under section 356(a)(2). Because there is no E&P, P recognizes gain on the exchange of Block 1 and Block 2 in an amount not to exceed $200. The Proposed Regulations reject an aggregate approach to determining the amount of “gain” that may be recognized under section 356(a)(2). The Proposed Regulations determine “gain” on a share-by-share basis. Therefore, P must recognize $100 on the exchange even though P has zero gain in all shares of Sub 1.

**Note** that section 302(d) should not apply to the dividend equivalent reorganization under the Proposed Regulations because Sub 2 is treated as issuing a nominal share to Sub 1, which Sub 1 transfers to P in exchange for P’s Sub 1 stock.
Non-Dividend Equivalent Reorganizations

- Non-dividend equivalent reorganizations.
  - The Proposed Regulations provide that section 302(a) applies to the extent shares are exchanged solely for boot.
    - Under current law, section 356(a)(1) applies so that gain but not loss may be recognized in the exchange. See Rev. Rul. 74-515.
    - Under section 302(a), gain and loss may be recognized in the exchange.
  - A shareholder that owns stock with different bases can decide which shares to exchange solely for boot (provided that the terms of the exchange are economically reasonable).
  - Note that section 356(a)(1) will still apply if shares are received for other shares.
Other Issues Related to Redemptions

- The Proposed Regulations do not affect the basis reduction rules of section 1059, such that a redeeming shareholder must first reduce basis under section 1059(e)(1)(A) and then the Proposed Regulations would apply to the shareholder.

- The Proposed Regulations clarify that the transferor in a section 304 transaction will receive common stock of the acquirer in a deemed redemption under section 304.

- The Proposed Regulations reserve with respect to issues relating to redeemed shareholders that are flow-through entities pending further study and comment.

- The Preamble to the Proposed Regulations provides that the IRS and Treasury continue to study issues raised when a redeemed shareholder with a deferred loss files a consolidated return.
Section 351 Exchanges

• **Current Regulations**
  – Current regulations under section 358 require tracing to determine basis in stock received in a section 351 exchange only if (i) such exchange also qualifies as a reorganization (e.g., there is a transfer of only stock) and (ii) no liabilities are assumed in the exchange.
  – For other section 351 exchanges, an aggregate approach applies to allocate basis in transferred assets to shares received in the exchange.

• **Proposed Regulations**
  – The Proposed Regulations retain the aggregate approach if only property is transferred in a section 351 exchange or if liabilities are assumed in the exchange.
  – The Proposed Regulations expand the scope of the tracing rules to section 351 exchanges involving a transfer of stock not otherwise qualifying as a reorganization.
    • An aggregate approach applies to other property transferred in the exchange.
Capital Contributions and Certain Section 351 Exchanges

• **Current Regulations**
  – Current regulations require a deemed issuance and recapitalization for section 351 exchanges that qualify as a reorganization where value of property received by the transferor was less than the value of the property transferred.
  – For other capital contributions and section 351 exchanges, the basis of transferred property appeared to be added to the basis of the existing stock held by the shareholder (i.e., the basis in the transferred property was not preserved).

• **Proposed Regulations**
  – The Proposed Regulations apply the deemed issuance and recapitalization approach to section 351 exchanges to preserve basis if insufficient shares, or no shares at all, are actually issued in the exchange.
  – The Proposed Regulations apply to capital contributions to which section 118 applies.
  – The Proposed Regulations treat a capital contribution in effect as a section 351 exchange in which stock is deemed received followed by a deemed recapitalization.
Example 1 – Section 351 Exchange

Facts: P owns all of the stock of Sub 1 and Sub 2. P contributes cash to Sub 1 in exchange for Sub 1 stock. The parties engage in one of two alternative transactions: (i) Sub 1 transfers all of its assets to Sub 2 in exchange for cash, which Sub 1 distributes to P in a transaction that qualifies as a ‘D’ reorganization, or (ii) Sub 2 acquires Sub 1 stock from P in exchange for cash in a transaction governed by section 304 (i.e., the transaction is treated as if P contributed the Sub 1 stock to Sub 2 in exchange for Sub 2 stock in a section 351 transaction, and Sub 2 redeemed that stock in exchange for the consideration used in the transaction).

Result—Current Regulations: In the ‘D’ reorganization under alternative 1, tracing is required to determine P’s basis in each separate block of its Sub 1 stock. In the section 304 transaction under alternative 2, the tracing rules do not apply, and the bases of P’s multiple blocks of Sub 1 stock appear to be blended and transferred to the stock issued by Sub 2. See Rev. Rul. 85-164, 1985-2 C.B. 117.

Change in Result—Proposed Regulations: Under alternative 2, the tracing rules would apply because such rules are expanded to apply to section 351 exchanges involving a transfer of stock not otherwise qualifying as a reorganization (assuming no liabilities are assumed in the exchange).
Example 2 – Capital Contribution

Facts: P owns all of the stock of Sub 1 and Sub 2. P contributes cash to Sub 1, but receives no stock or other property in exchange. The parties engage in one of two alternative transactions: (i) Sub 1 transfers all of its assets to Sub 2 in exchange for cash, which Sub 1 distributes to P in a transaction that qualifies as a ‘D’ reorganization, or (ii) Sub 2 acquires stock in Sub 1 from P in exchange for cash in a transaction governed by section 304 (i.e., the transaction is treated as if P contributed the Sub 1 stock to Sub 2 in exchange for Sub 2 stock in a section 351 transaction, and Sub 2 redeemed that stock in exchange for the consideration used in the transaction).

Result—Current Regulations: Under both alternatives, the cash is added to the basis of the existing Sub 1 stock held by P.

Change in Result—Proposed Regulations: In both alternatives, there would be a deemed issuance of Sub 1 stock and recapitalization of Sub 1, as the proposed regulations effectively treat P’s capital contribution as a section 351 exchange in which Sub 1 stock is deemed received followed by a deemed recapitalization. As in Example 1 above, the tracing rules would apply to both the subsequent ‘D’ reorganization and section 304 transaction in alternatives 1 and 2, respectively.