Corporate Tax Update

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Agenda

I. IRS/Treasury Guidance
II. Effect of TCJA on Corporate Provisions
III. Spinoffs
I. IRS/Treasury Guidance
Regulatory Guidance

• Executive Order 13771 (Jan. 30, 2017): for every new regulation issued, at least two prior regulations must be identified for elimination

• Executive Order 13789 (Apr. 21, 2017) and Notice 2017-38, 2017-30 I.R.B. 147 (July 7, 2017): review of significant 2016 regulations, including regulations under Section 385 (debt/equity), Section 367 (outbound transfers), Section 337(d) (transfers to RICs and REITs) and five other regulations

• October 2, 2017 “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens”

• The IRS has proposed to revoke the Reg. § 1.385-2 documentation rules and is reviewing the Reg. § 1.385-3 recharacterization rules (see the Appendix re Section 385)

• April 12, 2018 Memorandum of Agreement between Treasury and OMB re Review of Tax Regulations
Recent Regulatory Actions

• March 25, 2019 proposed regulations that would revise the Section 337(d) regulations about partnerships acquiring stock of a corporate partner.

• March 28, 2019 withdrawal of 2009 proposed regulations regarding stock basis recovery in Section 301, Section 302(d) and Section 304 transactions.

• April 1, 2019 withdrawal of 2011 proposed regulations regarding continuity of interest. See also Rev. Proc. 2018-12.
Recent Regulatory Actions (cont’d)

• April 17, 2019 second set of proposed regulations regarding opportunity zones.
• June 7, 2019 final regulations regarding gain recognized on transfers by C corporations to REITs following a spinoff.
• September 10, 2019 proposed regulations under Section 382 regarding built-in gains and losses.
Proposed Revisions to the “May Company” Regulations: 
Prop. Reg. § 1.337(d)-3
Proposed “May Company” Regulations

• Proposed regulations issued on March 25, 2019 would make certain refinements to the “May Company” regulations in Reg. § 1.337(d)-3 that were finalized in June 2018.
Corporate Partner and third party form a partnership. Corporate Partner contributes an asset with a value of $100x and a basis of $0 to partnership. Third party contributes stock of Corporate Partner (or cash used by the partnership to acquire stock of Corporate Partner).

At some future date, the partnership liquidates and Corporate Partner receives its own stock.

Treasury concern: Formation of the partnership is effectively a redemption by Corporate Partner of $100x of stock without recognition of any Section 311(b) gain in the contributed asset.

Reg. § 1.337(d)-3 generally provides for gain recognition by Corporate Partner upon formation of the partnership as if it directly redeemed its own stock using appreciated property.

The same rule applies if the partnership, instead of acquiring an equity interest in Corporate Partner, instead acquires an equity interest in “a corporation that controls the Corporate Partner” or “interests in any entity to the extent that the value of the interest is attributable to Stock of the Corporate Partner.”
Withdrawal of the 2009 Proposed Regulations Regarding Stock Basis Recovery
Highlights of 2009 Proposed Regulations

- The 2009 proposed regulations included the following concepts (among others):
  - Extended tracing of basis to:
    - Transfers of stock in all Section 351 transactions, except where liabilities of the shareholder are assumed (see Prop. Reg. §§ 1.358-2(f)(2), (g), and 1.1016-2(e)).
    - Capital contributions to which Section 118 applies and stockless Section 351 transactions by treating the transaction as resulting in a deemed issuance and recapitalization of shares in the same manner as for “stockless” reorganizations (see Prop. Reg. §§ 1.1016-2(e) and 1.358-2(g)(3)).
  - Provided that the portion of a distribution that is not a dividend is applied pro rata, on a share-by-share basis, to reduce the adjusted basis of each share of stock held by the shareholder within the class of stock upon which the distribution is made. Prop. Reg. § 1.301-2(a); see also Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).
  - Treated dividend equivalent redemptions as a pro rata distribution on all shares in the redeemed class followed by a deemed recapitalization of all shares in the redeemed class, including the redeemed shares, into the number of shares held by the holder after redemption. Prop. Reg. § 1.302-5(a)(1)-(2). This approach essentially preserved parity between Section 301 distributions and Section 302(d) redemptions. Where all of the shareholder’s shares in a class were redeemed in a dividend equivalent redemption, any unrecovered basis became a deferred loss. Prop. Reg. § 1.302-5(a)(3).
  - Provided that in a dividend equivalent Section 304 transaction, the transferor would be treated as receiving only shares of acquiring common stock in the deemed Section 351 transaction. Prop. Reg. § 1.304-2(a)(3).
Withdrawal of 2009 Proposed Regulations

• On March 28, 2019, the government withdrew the 2009 proposed regulations. The notice of withdrawal states:

  • “The chief concern raised by commenters was that the approach taken in the 2009 Proposed Regulations represented an unwarranted departure from current law as a result of which minor changes to an overall business transaction could cause meaningful changes to the tax consequences, thereby elevating the form of the transaction over its substance.”

  • The fact that minor changes to an overall business transaction could cause meaningful changes to the tax consequences is also present in many cases under current law and in part prompted the issuance of the 2009 proposed regulations.
Withdrawal of 2009 Proposed Regulations (cont’d)

• “After thoroughly considering the comments received, the Treasury Department and the IRS have determined that it is unlikely that the approach of the 2009 Proposed Regulations can be implemented in comprehensive final regulations without significant modifications.”
Statement Regarding Section 301 Distributions

“The Treasury Department and the IRS continue to believe that under current law, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise. See Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).”
Section 301

- Section 301(c)(1) provides: “That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.”

- Section 301(c)(2) provides: “That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.”
  - What is meant by “the stock” --- i.e., the aggregate basis of all shares of stock or using a share-by-share approach?

- Section 301(c)(3)(A) provides: “[T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.”
Basis Recovery in a Section 301 Distribution -
*Johnson v. United States*

- USP owns 100% of USS
- USS has $25 of E&P
- USP has 3 shares of USS stock (each with a FMV of $100)
  - Share 1 has a basis of $60
  - Share 2 has a basis of $30
  - Share 3 has a basis of $0
- USS distributes $100 to USP

See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971); Prop. Reg. § 1.301-2(a); but cf. Reg. § 1.1367-1(c)(3); Rev. Rul. 84-53.

**Consequences to USP under Johnson case:**
- The entire $100 is distributed pro rata against each share.
- The first $25 is a dividend; for the remaining $75:

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<th>Basis</th>
<th>Allocation</th>
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<th>$301(c)(3)</th>
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Statement Regarding Continuing Study

“The Treasury Department and the IRS are continuing to study the issues addressed in the 2009 Proposed Regulations, with a particular focus on issues surrounding sections 301(c)(2) and 304, and § 1.302-2(c) of the Income Tax Regulations.”
Statement Regarding Basis Shifts

• “The Treasury Department and the IRS also continue to believe that, under current law, with respect to redemptions governed by section 302(d), any unrecovered basis in the redeemed stock of a shareholder may be shifted to other stock only if such an adjustment is a proper adjustment within the meaning of § 1.302-2(c).”

• “Not all shifts of a redeemed shareholder’s unrecovered basis result in proper adjustments, and certain basis adjustments can lead to inappropriate results. See, e.g., Notice 2001-45, 2001-33 I.R.B. 129.”
Reg. § 1.302-2(c)

Reg. § 1.302-2(c) provides that, in the case of a redemption of stock which is treated as a distribution of a dividend “proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.”

Example 2 provides as follows:

**Facts:**
- In Year 0, H purchased all of the stock of Corp. X for $100 cash.
- In Year 1, H gave one-half of the stock to W, the stock having a value in excess of $50.
- In Year 6, all of the stock held by H is redeemed for $150 in a dividend equivalent redemption.

**Conclusion:**
- Immediately after the transaction, W holds the remaining stock of Corp. X with a basis of $100.

**Note:** For a similar basis shifting result in a consolidated return context, see PLR 9815050 (Jan. 9, 1998) and PLR 200810015 (Dec. 4, 2007)
Withdrawal of 2011 Proposed Regulations Regarding Continuity of Interest
Continuity of Interest
The Signing Date Rule (Reg. § 1.368-1(e)(2))
A Brief Chronology

• 8/10/04  First Proposed Version (REG-129706-04)
• 9/16/05  First Final Version (T.D. 9225)
• 3/20/07  Temp./Prop. Revision (T.D. 9316 / REG-146247-06)
• 3/17/10  Extended Reliance on 2007 Proposal (Notice 2010-25)
• 12/19/11  Current Final Regulations (T.D. 9565)
• 12/19/11  Further Proposed Revisions (REG-124627-11)
• 4/1/19  Withdrawal of 2011 Proposed Regulations
The Signing Date Rule:
Reg. § 1.368-1(e)(2)

• For continuity of interest purposes, the consideration to be received shall be valued as of the “pre-signing date” (the last business day before signing a binding contract) if the contract provides for “fixed consideration.”
The 2011 Proposed Regulations

• Floors and Ceilings:

“In response to comments, the IRS and the Treasury Department have reconsidered the scope of the signing date rule, and agree that its underlying principles support additional methods for determining whether COI is satisfied. For example, a contract to effect a potential reorganization may provide that the amount of an item of consideration will vary as the value of issuing corporation stock declines between the stock's Pre-Signing Date value and some lower value provided for in the contract (Floor Price), but will not vary below the Floor Price. If the closing date value is less than the Floor Price in such a case, the target shareholders have been subjected to the economic fortunes of owning the consideration received in the exchange in the same manner as if the contract had fixed the consideration based upon the contract's stated Floor Price. Accordingly, these proposed regulations generally provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock declines between the stock's Pre-Signing Date value and a Floor Price, and the closing date value is less than the Floor Price, COI is determined as if the consideration that would have been delivered at the Floor Price were issued and valued based upon the Floor Price. Applying the same principle, these proposed regulations provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock increases between the stock's signing date value and some higher value provided for in the contract (Ceiling Price), and the closing date value is greater than the Ceiling Price, COI is determined as if the consideration that would have been delivered at the Ceiling Price were issued and valued based upon the Ceiling Price.”
The 2011 Proposed Regulations (cont’d)

• Alternative Valuation Dates:

“In response to comments, these proposed regulations also permit, in lieu of the value of issuing corporation stock on the Closing Date, the use of an average value for issuing corporation stock in certain circumstances. The proposed regulations provide that an average value may be used if it is based upon issuing corporation stock values occurring after the signing date and before the Closing Date, and the binding contract utilizes the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. This rule also applies signing date rule principles because the average value fixes the number of shares and amount of other consideration. Accordingly, the target shareholders become subject to the fortunes of the issuer's stock across the range of dates being averaged.”

- Rev. Proc. 2018-12 provides safe harbor methods that taxpayers may use to value stock for continuity of interest purposes under the Signing Date Rule or the Closing Date Rule.
- “Exchange Traded Stock” can be valued over a series of days (a “Measuring Period”) under either the Signing Date Rule or the Closing Date Rule.
- The parties can choose the “Safe Harbor Valuation Method” and Measuring Period, but must do so in their contract and apply it consistently.
- The values can be averages of one of three daily prices: volume weighted average prices, average of high/low prices, or closing prices.
- A Measuring Period is between 5 and 35 consecutive trading days.
April 1, 2019 Withdrawal Notice

• “[The 2011 Proposed Regulations] identified situations, other than those covered by the Signing Date Rule, in which the value of Issuing Corporation stock could be determined based on a value other than its actual trading price on the Closing Date. In one of these situations, the 2011 Proposed Regulations would have allowed the parties to use an average of the trading prices of Issuing Corporation stock over a number of days, in lieu of its actual trading price on the Closing Date, for purposes of determining whether the COI requirement is satisfied.”

• “The Treasury Department and the IRS have determined that current law generally provides sufficient guidance to taxpayers with respect to the COI requirement. Therefore, the Treasury Department and the IRS have decided to withdraw the 2011 Proposed Regulations. However, after considering comments received on the 2011 Proposed Regulations, the IRS has concluded that, in certain circumstances, taxpayers should be able to rely on certain average stock valuation methods for purposes of measuring COI. Accordingly, the IRS issued a revenue procedure effective January 23, 2018, that provides the circumstances under which the IRS will not challenge a taxpayer's use of certain stock valuation methods to value certain Issuing Corporation stock for purposes of determining whether the COI requirement is satisfied. See Rev. Proc. 2018-12, I.R.B. 2018-6.”
April 1, 2019 Withdrawal Notice (cont’d)

• The withdrawal notice does not mention addressing floors, ceilings, collars or anything else regarding the Signing Date Rule in the future.

• Is this the end of guidance about the Signing Date Rule?
Final Regulations regarding REITs and Spinoffs: Reg. § 1.337(d)-7
REITs and Section 337(d)

• If a C corporation converts into a REIT or transfers property to a REIT, Reg. § 1.337(d)-7 imposes a corporate-level tax under the rules of Section 1374 if the REIT disposes of C corporation property within 5 years after the conversion transaction.

• This rule is intended to prevent avoidance of corporate-level tax by means of a conversion transaction.
REITs and Spinoffs

• Congress became concerned about spinoffs where the spinoff allows a corporation to separate REIT-qualifying assets from nonqualifying assets.
• In the PATH Act (December 2015), Congress enacted Sections 355(h) and 856(c)(8).
  • Section 355(h) provides that Section 355 does not apply if either the distributing corporation or the controlled corporation is a REIT.
  • Section 856(c)(8) provides that the distributing corporation and the controlled corporation (and their successors) are not eligible to make a REIT election for 10 years after the spinoff.
REITs and Spinoffs (cont’d)

• But what if, after a spinoff, either the distributing corporation or the controlled corporation merges into a REIT?

• Treasury and the IRS believed that applying Section 1374 treatment in this situation did not adequately implement General Utilities repeal and could circumvent the purposes of the PATH Act.

• Accordingly, in June 2016 Treasury and the IRS issued temporary regulations under Section 337(d) that impose a deemed sale (i.e., full taxability instead of Section 1374 treatment) if a distributing corporation (D) or controlled corporation (C) in a spinoff merges into a REIT within 10 years after the spinoff.
REITs and Spinoffs (cont’d)

• Unfortunately, the 2016 temporary regulations could result in the recognition of gain greatly in excess of amount that would have been recognized if D or C had directly engaged in a conversion transaction.
  • For example, if C merges into a REIT (X) within 10 years after the spinoff, the built-in gain in all of X’s assets was recognized under the temporary regulations.
  • Final regulations issued on June 7, 2019 adopt the deemed sale approach, but limit the amount of gain recognized on the deemed sale election to gain on property traceable to D or C in the spinoff.
  • Gain would be recognized on property owned by D or C immediately after the Section 355 distribution (and other property the basis of which is determined in whole or in part by reference to that property).
Proposed Regulations Under Section 382 Regarding Built-In Gains and Losses:

See Later Slides Regarding TCJA
II. Effect of TCJA on Corporate Provisions
TCJA Topics

A. Rate Structure Changes
B. Interest Limitations: Section 163(j)
C. Expensing: Section 168(k)
D. Net Operating Losses: Section 172 and Section 382
E. Cross-Border Provisions
Some Potential Effects of TCJA

• Effect of lower corporate tax rate
• Effect on choice of entity
• Effect of denial of net interest deductions
• Effect of expensing
• Effect of changes to net operating loss rules
• Effect of changes in taxation of international operations
• Effect on state and local tax treatment
• Importance of modeling
Some Potential Effects of TCJA (cont’d)

- Higher purchase price for transactions?
- More taxable acquisitions?
- Less leverage in acquisitions?
- Fewer spinoffs?
A. Rate Structure Changes
Rate Structure Changes

- C corporations: tax rate reduced from 35% to 21% (permanent)
  - Repeal of corporate AMT
  - DRD reset so actual rates are roughly the same as before
- International changes
  - Participation exemption under Section 245A
  - GILTI (Global Intangible Low-Taxed Income) under Section 951A
  - FDII (Foreign Derived Intangible Income) under Section 250
  - BEAT (Base Erosion and Anti-Abuse Tax) under Section 59A
- Individuals: modest rate compression
- Pass-throughs and sole proprietorships: Section 199A 20% deduction against certain qualifying income (through 2025)
Relative Rates for Businesses

• The C corporation double tax burden can be higher than the pass-through tax burden if corporate earnings are distributed currently to shareholders, but not if earnings are retained for the long term.

• Whether there is an advantage to converting to C corporation status depends on many variables.
Will Businesses Migrate into the C Corporation Regime?

- For many taxpayers, 21% is a beneficial tax rate if earnings are retained.
- Some benefits are available only to C corporations (e.g., the GILTI deduction).
- Need to remember the accumulated earnings tax, personal holding company tax, General Utilities repeal, and the possibility of future rate changes.
B. Interest Limitations: Section 163(j)
Net Interest Limitation

• The purpose of new Section 163(j) is to (1) prevent U.S. base erosion, and (2) address thin capitalization concerns.

• New Section 163(j) limits the interest deduction for the business interest of all taxpayers – not just C corporations – that are over a size threshold (Section 448(c) $25 million average gross receipts, aggregating related parties).

• The deductible business interest cannot exceed the sum of:
  • Business interest income,
  • 30 percent of adjusted taxable income, and
  • Floor plan financing interest.

• New Section 163(j) is effective for taxable years beginning after 2017. There is no grandfathering for old debt.
Net Interest Limitation (cont’d)

• Certain activities are excluded from Section 163(j), such as electing real property trades or businesses, electing farming businesses, and certain regulated utilities.

• Adjusted taxable income is taxable income without regard to:
  • Any item not properly allocable to a trade or business;
  • Any business interest or business interest income;
  • Any net operating loss deduction;
  • The Section 199A deduction; and
  • In the case of taxable years beginning before 2022, any deduction for depreciation, amortization or depletion.

• For taxable years beginning in 2022 and thereafter, adjusted taxable income takes into account depreciation, amortization and depletion, so the cap will be lower.
Net Interest Limitation (cont’d)

• There is an indefinite carryforward of disallowed business interest.
• There is no carryforward of excess Section 163(j) limitation.
• The interest limitation is applied at the partnership level.
Section 163(j) Proposed Regulations

• The IRS issued proposed regulations on November 26, 2018 that address new Section 163(j).

• The proposed regulations are proposed to be effective for taxable years after the regulations are finalized.

• Taxpayers may apply the rules of the proposed regulations to taxable years beginning after December 31, 2017, provided the rules are applied consistently.
Definition of Interest

• The proposed regulations have a broad definition of interest. See Prop. Reg. § 1.163(j)-1(b)(20).

• Interest includes an amount paid, received or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement that is treated as a debt instrument under Section 1275 and Reg. § 1.1275-1(d), or an amount that is treated as interest under other Code provisions.

• Interest includes, for example, original issue discount, acquisition discount, repurchase premium and deferred payments treated as interest under Section 483.
Definition of Interest (cont’d)

- In addition, interest includes certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis.
  - Interest includes, for example, loan commitment fees, debt issuance costs and guaranteed payments.
- An anti-avoidance rule treats as interest any expense or loss incurred by a taxpayer to secure the use of funds for a period of time if such expense or loss is predominantly incurred in consideration of the time value of money.
• Furthermore, there is a general anti-avoidance rule in Prop. Reg. § 1.163(j)-2(h) that authorizes the IRS to disregard or recharacterize any arrangement entered into with a principal purpose of avoiding the rules of Section 163(j).

• The broad definition of interest creates a category of items that are treated as interest for purposes of Section 163(j) but not for other purposes of the Code.
Some Rules for C Corporations

• All interest paid or accrued by a taxpayer that is a C corporation is treated as business interest expense.
  • A C corporation does not have investment interest expense within the meaning of Section 163(d).
  • Consequently, all of a C corporation’s interest expense is subject to limitation under Section 163(j), except to the extent it is allocable to an excepted trade or business.
• With regard to earnings and profits, the payment or accrual of business interest expense reduces E&P in the year of payment or accrual, regardless of Section 163(j).
Consolidated Group Computations

• Under the proposed regulations, new Section 163(j) applies at the consolidated group level.

• In general, a consolidated group has a single Section 163(j) limitation.
  • Members of an affiliated group that does not file a consolidated return are not aggregated for purposes of Section 163(j).
  • Partnerships wholly owned by members of a consolidated group are not aggregated.

• To compute a consolidated group’s adjusted taxable income, the relevant taxable income is the group’s consolidated taxable income, determined under Reg. § 1.1502-11 without regard to any carryforwards or disallowances under Section 163(j).
Intercompany Obligations and Items

• Intercompany obligations are disregarded for purposes of determining current-year business interest expense and business interest income and for purposes of calculating the consolidated group’s adjusted taxable income.

• Intercompany items and corresponding items under Reg. § 1.1502-13 are disregarded for purposes of calculating the group’s adjusted taxable income to the extent those items offset in amount.
Utilization of Member Business Interest Expense

The proposed regulations provide a multi-step process for determining how a member’s business interest expense may be utilized. This process determines which member’s interest expense is being utilized and is relevant for stock basis adjustments and allocation when a member leaves the consolidated group.

1. First, the consolidated group determines if its Section 163(j) limitation for the current year exceeds the members’ aggregate current-year business interest expense. If so, none of the current year business interest expense would be subject to disallowance.

2. If the members’ aggregate current year business interest expense exceeds the group’s Section 163(j) limitation for the current year, each member can deduct its current year business interest expense up to the amount of its business interest income.
Utilization of Member Business Interest Expense (cont’d)

3. If the group has any Section 163(j) limitation remaining after the application of Step 2, each member with remaining current year business interest expense can deduct its current year business interest expense pro rata.

4. If the group has any Section 163(j) limitation remaining after deducting current year interest expense, then carryforwards are permitted to be deducted in the order of the year in which they arose. For carryforwards from the same year, they are deducted on a pro rata basis.
SRLY Limitations

• The proposed regulations include rules somewhat similar to those in Reg. § 1.1502-21(c) regarding disallowed business interest expense carryforwards from SRLYs.

• Note, however, that there is no cumulative register as in Reg. § 1.1502-21. In other words, a taxpayer cannot carry forward unused Section 163(j) SRLY limitation from one year to the next.
SRLY Limitations (cont’d)

• Disallowed business interest expense carryforwards of a member arising in a SRLY that are included in the group’s business interest expense deduction may not exceed the group’s Section 163(j) limitation for that year, determined by reference to only the member’s items of income, gain, deduction and loss for that year.

• Deduction of SRLY carryforward interest expense is only available if the group has any remaining Section 163(j) limitation for the current year after the deduction of current year business interest expense, and only to the extent that the member’s Section 163(j) SRLY limitation for the current year exceeds the amount of the member’s business interest expense already deducted by the group.
SRLY Limitations (cont’d)

• SRLY limited disallowed business interest expense carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards.

• Section 382 applies to disallowed interest carryforwards.

• An overlap rule turns off the SRLY rules if Section 382 applies, similar to the overlap rule for net operating losses.
Investment Adjustments and Leaving the Group

• Regarding investment adjustments under Reg. § 1.1502-32, if a member has business interest expense that is disallowed under Section 163(j), the basis in the stock of the member is not reduced until the interest expense is later absorbed by the group.

• If a corporation ceases to be a member of the group during a consolidated return year, the amount of its business interest expense, including carryforwards from prior taxable years, that is neither deducted by the consolidated group, nor reduced under the attribute reduction rules in the unified loss rules of Reg. § 1.1502-36, are carried forward to the corporation’s first separate return year.

  • Prior to 2022, if a member of the group sells or disposes of stock of another group member, the group’s adjusted taxable income is reduced by the investment adjustments with respect to such stock that are attributable to depreciation, amortization or depletion deductions from 2018 through 2021.
Excepted Businesses

• The proposed regulations include rules for determining the amount of a taxpayer’s interest expense, interest income and other tax items properly allocable to excepted trades or businesses (e.g., electing real property trades or businesses, electing farming businesses, and certain regulated utilities) and non-excepted trades or businesses.

• The rules generally use asset basis to allocate interest expense and interest income, subject to various special rules (e.g., interest expense from qualifying nonrecourse indebtedness).
Excepted Businesses (cont’d)

• There are also rules regarding the application of the allocation rules to members of a consolidated group.
  • For this purpose, a consolidated group is treated as a single corporation, and the group, rather than any particular member, is treated as engaged in excepted or non-excepted trades or businesses.
  • After a consolidated group determines the percentage of the group’s interest expense that is allocable to an excepted trade or business and thus is not subject to limitation under Section 163(j), this exempt percentage is applied proportionally to each member of the group that has paid or accrued interest to a person other than a group member during the taxable year.
  • Consequently, in general, each member with interest paid or accrued to a lender that is not a group member will have the same percentage of interest allocable to excepted trades or businesses, regardless of whether any particular member actually engaged in the excepted trade or business.
C. Expensing: Section 168(k)
Expensing

• TCJA amended Section 168(k) to expand bonus depreciation from 50% to 100% (i.e., full expensing) for assets placed in service through 2022. Expensing is phased out 20% per year through 2026.
• Section 168(k) now includes used property.
• Section 168(k) still excludes most intangibles.
• TCJA increased Section 179 expensing limits and broadened categories.
• TCJA liberalized small business accounting methods.
• The Section 199 Domestic Production Activities deduction was repealed.
Issuance of Section 168(k) Regulations

• On August 8, 2018, Treasury and the IRS published proposed regulations regarding Section 168(k) as amended by TCJA.

• On September 24, 2019, Treasury and the IRS published final regulations and another set of proposed regulations.
Used Property Can Qualify

• Unlike previous versions of bonus depreciation, expensing is not limited to property the original use of which begins with the taxpayer.

• The previous limitation excluded asset acquisitions of a going business.

• This expansion to include used property provides additional benefits to taxable asset acquisitions of existing businesses.
Taxable Asset Acquisitions

In the corporate context, asset acquisitions include:

• Actual asset acquisitions
• Acquisitions of disregarded entities
• Cash forward mergers
• Stock acquisitions with a Section 338(h)(10) election
• Some transactions involving a Section 336(e) election
Situations for Taxable Asset Acquisitions

• Expect to see taxable asset acquisitions in the same contexts as before – where the targets are:
  • Subsidiaries or divisions of consolidated groups; or
  • S corporations.
• Expensing for the acquiror may affect the pricing of these transactions and, at the margins, the decision as to whether to sell stock or assets.
Election Out

• A taxpayer may elect out of expensing with respect to any class of property placed in service in that year.

• In an environment in which current year deductions (other than for interest) generally may be more useful than loss carryforwards, an election out may prove useful where expensing could otherwise create a loss carryforward.
What Kind of Property?

- The main category of qualified property is property depreciable under the Modified Accelerated Cost Recovery System (“MACRS”) having a recovery period of 20 years or less.
- The availability of expensing for “qualified improvement property” will have to be resolved, if at all, by Congress.
- Certain types of computer software, water utility property, film, TV or live theatrical productions, and plants (of the botanical variety) producing fruit and nuts, also qualify.
- There are two major types of exclusions:
  - Property mandatorily subject to the alternative depreciation system under Section 168(g) (e.g., foreign and tax-exempt use property); and
  - Businesses that get preferred treatment under the interest limitation of Section 163(j) (e.g., businesses excepted under Section 163(j)(7)(A) and property used in businesses that benefit from the floor-plan financing exception).
Qualifying Acquisitions

Either –

• The property’s original use must begin with the taxpayer, or

• The property’s acquisition by the taxpayer must meet these requirements:
  • The acquired property was not used by the taxpayer at any time prior to its acquisition; and
  • The acquisition of the property meets the requirements of Section 179(d)(2)(A), (B), and (C) and Section 179(d)(3).
Section 179 Requirements

• The property cannot –
  • have been acquired from a person whose relationship with the acquiror would result in the disallowance of losses under Section 267 or 707(b) (but in applying Section 267(b) and (c) for this purpose, an individual’s family includes only his spouse, ancestors and lineal descendants);
  • have been acquired by one component member of a controlled group from another component member of the same controlled group;
  • have a basis determined in whole or in part by reference to the basis in the hands of the person from whom acquired (or from a decedent under Section 1014); or
  • be exchanged basis property, to the extent of the exchanged basis.
• See also limitations in Section 168(i)(7) (regarding certain nonrecognition transactions and transactions between members of a consolidated group).
No Prior Use

• Under the final regulations, a taxpayer has used property if it had a previous depreciable interest in the property.
  • To determine if the taxpayer had a previous depreciable interest in the property, the taxpayer must look back to the five calendar years prior to the taxpayer’s current placed-in-service year of the property.
  • Prior use includes use by a predecessor.
• There are diligence issues for an acquiror to confirm that it or a predecessor had no previous depreciable interest in the property.
Partnerships

• The final regulations allow the adjustment to basis under Section 743(b) that comes from a transfer of a partnership interest to be treated as an acquisition of used property by the partner that can meet the tests for qualified property to the extent the partner has not owned an interest in that property before, is unrelated to the seller, and has a cost basis in the interest.

• The final regulations deny bonus depreciation for other basis adjustments under Subchapter K, including those under Section 734(b) and remedial allocations under Section 704(c).

• In the context of corporate acquisitions, one will mainly encounter Section 743(b) adjustments, which are eligible for bonus depreciation.

• For example, if old target has among its assets an interest in a partnership, and unrelated new target or acquiror buys or is deemed to buy the interest along with the other assets, the step-up, to the extent applicable to qualifying assets, is eligible for expensing.
Consolidated Returns

Under the September 2019 proposed regulations:

• A member of a consolidated group has previously used property if any current or previous member previously used it while a member of the group.

• A member has prior use if, in a series of related transactions, a member acquires property and a corporation that previously used it becomes a member of the acquiring group.

• This rule is illustrated by an example (ex. 30) in which a group acquires the stock of an unrelated target and also acquires an asset previously sold by the target to a party unrelated to both the target and the acquiring group. The facts recite that these two events are parts of a series of related transactions, but do not suggest what facts might make the two events related or unrelated.
Consolidated Returns (cont’d)

• Under the September 2019 proposed regulations, if there is an acquisition of property by one group member from another group member, and as part of the same series of related transactions the transferee members ceases to be a group member within 90 days after its acquisition of the property:
  • The transferor member is treated as disposing of, and the transferee member is treated as acquiring, the property on the day after the transferee member ceases to be a member of the group (the “Deconsolidation Date”) for all federal income tax purposes; and
  • The transferee member is treated as placing the property in service not earlier than one day after the Deconsolidation Date.
• This rule facilitates intercompany acquisitions incident to transactions in which the transferee member leaves the group.
• The regulations provide an example (ex. 28) of an intercompany sale of property between two members of a group followed, in a related transaction, by the sale of the stock of the transferee member to another unrelated consolidated group. The example applies the proposed rule to remove complicating factors such as Section 168(i)(7).
  • The example places the expensing deduction in the purchasing consolidated group.
Section 338(h)(10) and Section 336(e) Transactions

• In a Section 338(h)(10) transaction, a corporation purchases 80% or more of the stock of a target corporation and, per the election, old target is deemed to sell its assets to an unrelated new target.

• In a Section 336(e) transaction, a corporation disposes of 80% or more of the stock of the target corporation and, per the election, old target is deemed to sell its assets to an unrelated new target (except where Section 355(d) or (e) applies, see below).

• As an unrelated new corporation, new target cannot have used the property before.

• In a spinoff taxable to the distributing corporation under Section 355(d) or (e) in which a Section 336(e) election is made for the distributed corporation, the Section 336(e) regulations employ a “sale-to-self” model.
Section 338(h)(10) and Section 336(e) Transactions (cont’d)

• The September 2019 proposed regulations provide that if a member of a consolidated group (transferee member) acquires the stock of another member that holds depreciable property (target) in either a qualified stock purchase for which a Section 338 election is made or a qualified stock disposition for which a Section 336(e) election is made, and if the transferee member and the target cease to be members of the group within 90 days after the acquisition date as part of the same series of related transactions, then:
  • The acquisition date or disposition date is treated as the day after the Deconsolidation Date for all federal income tax purposes; and
  • New target is treated as placing the property in service not earlier than one day after the Deconsolidation Date.
• The expensing deduction is outside the selling consolidated group.
• Example 29 illustrates the rule for a Section 338 election.
• Under the September 2019 proposed regulations, in a Section 355 distribution taxable under Section 355(d) or (e), the distributed corporation is not a new target even if it is the subject of a Section 336(e) election, so expensing is not available.
State Taxes

• Not all states conform to bonus depreciation.
• States vary in the extent to which they adopt the results of federal tax consolidation.
D. Net Operating Losses: Section 172 and Section 382
Impact of TCJA on Net Operating Losses

• Carryforwards and carrybacks of NOLs arising in taxable years ending after December 31, 2017:
  • Indefinite carryforward and no carrybacks
  • Old rules apply to carryforwards and carrybacks of NOLs from tax years ending on or before December 31, 2017
  • A technical correction would change the effective date to taxable years beginning after December 31, 2017
• Use of NOLs arising in taxable years beginning after December 31, 2017:
  • Can only use these NOLs to offset up to 80% of taxable income
Impact of TCJA on Net Operating Losses (cont’d)

• There is a separate carryforward for interest that is disallowed by Section 163(j)
• Remember Section 382 limitations
• No changes to capital loss carryforward and carryback rules for corporations
  • Carryback 3 years and carryforward 5 years
  • Capital losses can only offset capital gains
NOL Ordering

• Section 172(a) provides that the NOL deduction for the taxable year is an amount equal to the lesser of:
  • The aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or
  • 80% of taxable income computed without regard to the deduction allowable under this section

• How do the rules apply where there are pre-2018 NOLs and post-2017 NOLs?
NOL Ordering (cont’d)

- Example:
  - Calendar year LossCo has $90 million in NOLs generated through 12/31/17 and incurs a $50 million NOL in 2018
  - LossCo has $100 million of taxable income in 2019
  - LossCo can offset $90 million of 2019 taxable income with pre-2018 NOLs
    - How much 2018 NOL can be used? Is the 80% limitation calculated with or without regard to the pre-2018 NOLs?
    - In other words, is the limitation (A) 80% of $100 million (allowing use of $10 million of 2018 NOLs) or (B) 80% of $10 million (allowing use of $8 million of 2018 NOLs)?
  - Notice 2018-67 (Section 9 notes the issue)
  - Joint Committee Bluebook (intent of Congress was approach B, but a technical correction may be necessary)
  - Chairman Brady’s Discussion Draft of Technical Corrections Bill would adopt approach B
Refundable AMT Credits

• Corporate AMT was repealed by TCJA.
• AMT credits are now refundable, in an amount equal to 50% (in years 2018-2020) and 100% (in 2021) of the excess of the credit over the credit otherwise allowed in such year.
• Are AMT credits previously limited by Section 383 still subject to Section 383 now that they are refundable?
  • The IRS position is that refundable AMT credits are not subject to Section 383 (see CCA 201126029).
Section 382 Overview

- To prevent trafficking in NOLs, Section 382 limits the ability of a corporation to offset income after an ownership change with NOLs generated before the ownership change.
- In general, an ownership change is a more than 50% shift in the equity ownership of a loss corporation over a 3-year period.
- Section 382 also applies to certain built-in losses and built-in gains accrued before an ownership change but recognized within the 5-year period after the ownership change.
- Besides Section 382, other limitations on the use of losses might apply.
Section 382 Built-In Gains and Losses

- Section 382(h) requires a corporation that undergoes an ownership change to determine whether it has a net unrealized built-in loss (NUBIL) or net unrealized built-in gain (NUBIG).

- If a corporation has a NUBIL, then built-in losses recognized (RBIL) during the 5-year period after the ownership change are subject to the Section 382 annual limitation.

- If a corporation has a NUBIG, then built-in gains recognized (RBIG) during the 5-year period after the ownership change increase the Section 382 limitation for that year.

- The policy underlying Section 382(h) is that the tax treatment of deductions and income attributable to the pre-change period should be the same whether the items are recognized before or after the ownership change.
Section 382 Built-In Gains and Losses (cont’d)

• A stand-alone corporation can have a NUBIL or NUBIG, but not both.

• If a threshold amount of NUBIL or NUBIG is not exceeded, then the NUBIL/NUBIG is zero.
  • The threshold amount is the lesser of 15% of the FMV of the loss corporation’s assets or $10 million.
Section 382 Built-In Gains and Losses (cont’d)

- Under Section 382(h)(6), RBIL can include deduction items that are taken into account in the 5-year period after an ownership change but are attributable to periods before the ownership change.

- RBIG can include income items that are taken into account in the 5-year period after an ownership change but are attributable to periods before the ownership change.
Notice 2003-65

• Notice 2003-65 provides safe harbors regarding the determination of NUBIL/NUBIG and the identification of RBIL/RBIG.

• Notice 2003-65 provides a safe-harbor approach for determining NUBIL/NUBIG: the 1374 approach.

• Notice 2003-65 provides two safe-harbor approaches for determining when items of deduction, loss, income and gain are treated as RBIL and RBIG: the 1374 approach and the 338 approach.

• These approaches have different results with respect to items of income and deductions.
Notice 2003-65 (cont’d)

• Under the 1374 approach, a loss corporation’s NUBIL or NUBIG generally equals the net amount of loss or gain that the loss corporation would have recognized if it had sold all of its assets for fair market value to a purchaser that assumes all of the loss corporation’s liabilities.

• The 1374 approach generally relies on the accrual method of accounting to identify RBIL and RBIG.

• The 338 approach determines the amount of NUBIL or NUBIG in the same manner as the 1374 approach.

• The 338 approach identifies RBIL and RBIG by comparing a loss corporation’s actual items of loss, deduction, income and gain with those items that would have resulted if a Section 338 election had been made with respect to a hypothetical purchase of the stock of the loss corporation on the date of the ownership change.

• Corporations with deduction items would generally prefer the 1374 approach, whereas corporations with income items would generally prefer the 338 approach.
Notice 2018-30

• The TCJA provides that new and used qualified property acquired and placed in service after September 27, 2017 may be eligible for expensing under Section 168(k).

• Notice 2018-30 requires that calculations of RBIG and RBIL under the 338 approach of Notice 2003-65 must use the prior law cost recovery system and not the 100% expensing approach of Section 168(k). A similar rule applies to the calculation of RBIL under the 1374 approach.

• Otherwise, in the IRS’s view, the calculation of RBIG and RBIL would be inappropriately distorted, in particular resulting in an increase in RBIG or a decrease in RBIL in the first year after an ownership change.
Proposed Regulations Under Section 382(h)

• On September 10, 2019, Treasury and the IRS issued proposed regulations regarding NUBIL/NUBIG and RBIL/RBIG.

• In general, the regulations would be effective for an ownership change occurring after the date the regulations are finalized.

• Upon finalization, the regulations would render obsolete the following guidance:
  • Notice 87-79 (re cancellation of indebtedness income);
  • Notice 90-27 (re installment sales);
  • Notice 2003-65; and
  • Notice 2018-30.
Proposed Regulations Under Section 382(h) (cont’d)

• The proposed regulations would eliminate the 338 approach of Notice 2003-65.
• The proposed regulations would make the 1374 approach mandatory for computing both NUBIL/NUBIG and RBIL/RBIG, with modifications for cancellation of indebtedness (COD) income and deductible contingent liabilities.
• In general under the 1374 approach, a deduction or loss allowed during the 5-year recognition period would be treated as RBIL if an accrual method taxpayer would have been allowed a deduction for the item against gross income before the change date.
• In general under the 1374 approach, an item of income or gain taken into account in the 5-year recognition period would be treated as RBIG if an accrual method taxpayer would have included the item in gross income before the change date.
Impact of the Proposed Regulations Regarding Wasting or Consumption of Built-In Gain Assets

- As indicated above, the 338 approach identifies items of RBIL and RBIG by comparing the loss corporation’s actual items of deduction, loss, income and gain with those items that would have resulted if a Section 338 election had been made with respect to a hypothetical purchase of the stock of the loss corporation on the date of the ownership change.

- The 338 approach assumes that, for any taxable year, an asset that had a built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset if an election under Section 338 had been made.

- The 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset had an election under Section 338 been made over the loss corporation’s actual cost recovery deduction.

- Thus, under the 338 approach, built-in gain assets may generate RBIG even if they are not disposed of during the recognition period, and RBIG is created regardless of the loss corporation’s gross income in any particular year.

- Elimination of the 338 approach would eliminate this RBIG.

- The proposed regulations would result in less RBIG.
Some of the Issues Raised by the Proposed Regulations

• Elimination of the 338 approach for wasting assets
• Differing treatment of COD income from nonrecourse debt versus recourse debt
• Treatment of deductible contingent liabilities
• Transition rules
• Would some of the rules encourage taxpayers to recognize income items before an ownership change because of the lack of neutrality between treatment of pre-change and post-change events?
E. Cross-Border Provisions
Cross-Border Changes: Outbound Investment

• Section 965 imposes a transition tax on the deferred earnings and profits of foreign subsidiaries. The rate is 15.5% for cash/8% for non-cash and can be paid in installments.

• Section 245A provides a 100% participation exemption for distributions of foreign earnings not taxed currently under Subpart F or Section 951A (the tax on global intangible low-taxed income, or GILTI).

• Section 951A imposes a current GILTI tax on certain “excess” foreign earnings, with a partial offsetting deduction under Section 250.

• The Section 367(a) exception for outbound transfers of businesses was repealed.

• The foreign tax credit baskets were revised.

• Section 250 provides a FDII deduction as an incentive to earn certain types of income in the United States rather than abroad.
GILTI

- Under the Section 951A GILTI tax, a U.S. shareholder of any controlled foreign corporation (CFC) must include in gross income its GILTI in a manner similar to inclusions of Subpart F income.
- GILTI means the excess of the shareholder’s “net tested CFC income” over the shareholder’s “net deemed tangible income return.”
- Very broadly, net tested CFC income is the aggregate of net income of the U.S. shareholder’s CFCs, determined with certain exceptions such as effectively connected income and Subpart F income.
- Very broadly, the net deemed tangible income return is 10% of the adjusted bases of the CFCs’ depreciable tangible property.
  - Note that, to decrease GILTI, there is an incentive to locate depreciable tangible property in CFCs.
- Section 250 generally allows a 50% deduction against GILTI, resulting in a 10.5% U.S. tax.
- Foreign tax credits for GILTI are in a separate basket under Section 904(d), and under Section 960(d) are allowed only to the extent of 80% of taxes attributable to GILTI.
Base Erosion and Anti-Abuse Tax (BEAT)

- The TCJA repealed the corporate alternative minimum tax, and provides for refunds of corporate AMT credits.
- However, the new BEAT operates like a corporate AMT.
- Under Section 59A, an “applicable taxpayer” is required to pay additional tax to the extent the BEAT calculation results in more tax than the regular tax liability.
- Very broadly, an applicable taxpayer is a corporation with gross receipts above a threshold and a percentage of base erosion payments above a threshold.
- Very broadly, the BEAT calculation is 10% of modified taxable income. Taxable income is modified to add back any deductible amount paid or accrued to a related foreign person.
- Foreign tax credits are treated as reducing regular tax liability and therefore the amount of BEAT liability is increased, having the effect of disallowing the foreign tax credits.
Foreign-Derived Intangible Income (FDII)

- The TCJA seeks to encourage activity in the United States rather than elsewhere.
- The TCJA includes a provision allowing a deduction that reduces the U.S. tax rate on foreign-derived income of a U.S. corporation - the deduction for Foreign-Derived Intangible Income (FDII).
- Very broadly, the computation of FDII starts with a U.S. corporation’s net income, determined with certain exceptions such as foreign branch income. The net income is reduced by 10% of the adjusted basis of the corporation’s depreciable tangible property. This difference is the “deemed intangible income.”
- FDII is the portion of the deemed intangible income that is derived from property sold to a foreign person for foreign use or services provided to any person, or with respect to property, not located in the United States.
- The deduction is 37.5% of FDII, in effect reducing the U.S. tax rate on the foreign income to 13.125%.
- Note that, to increase the FDII deduction, there is an incentive to locate depreciable tangible property outside the United States (similar to GILTI, where locating such property outside the United States decreases the GILTI tax).
Summary of Cross-Border Provisions

• Essentially the TCJA creates buckets of offshore income that are taxed in the United States at different rates and have differing foreign tax credit rules.

1. Certain income earned by foreign subsidiaries is exempt from U.S. tax when earned or repatriated.
   • For example, income of a CFC that is not subject to Subpart F or GILTI is exempt from U.S. tax when earned, and can be distributed to the U.S. parent tax-free under Section 245A. Foreign tax credits are not allowed with respect to this income.
2. Certain income earned by foreign subsidiaries is subject to current U.S. tax at reduced rates, which might be reduced by foreign tax credits to a limited extent.
   • This category includes GILTI income (taxed at a 10.5% U.S. rate) and Section 965 repatriation income (taxed at a 15.5% or 8% U.S. rate).
   • FDII earned by a U.S. corporation is taxed at a 13.125% rate.

3. Certain income earned by foreign subsidiaries is subject to immediate U.S. tax at the 21% rate, which might be reduced by foreign tax credits.
   • This category includes Subpart F income (other than income subject to the repatriation tax under Section 965) and also includes gain from the sale of stock in a foreign subsidiary that is not subject to Section 1248. (Section 1248 income is in Category #1.)
   • Income earned by a foreign branch of a U.S. corporation is subject to immediate U.S. tax at the 21% rate, which might be reduced by foreign tax credits. Similar to GILTI, branch income has its own separate foreign tax credit basket.
III. Spinoffs
Spinoff Topics

A. Rev. Proc. 2017-52: Section 355 Full PLR Program
B. October 13, 2017 IRS Statement
E. Active Trade or Business Without the Collection of Income
F. Proposed Regulations re Device and Active Trade or Business
Section 355

- D must own Section 368(c) control of C.
- Distributing (D) and Controlled (C) must each be engaged in a 5-year-old active trade or business (ATB). If either ATB was acquired within the last 5 years, it must have been acquired tax-free, or acquired from an affiliate of D or C.
- The spinoff must not be used principally as a device to distribute the E&P of D or C, such as by a post-spin sale of the stock of D or C.
- Generally, the distribution must be made predominantly to the historic shareholders of D. (No 50% purchases of D during the preceding 5 years (Section 355(d)). No 50% acquisitions of D or C as part of a plan involving the spin (Section 355(e)).
- Business purpose.
- Section 355(g). No cash rich splitoffs.
- Section 355(h). Generally no REIT spins.
A. Rev. Proc. 2017-52: Section 355 Full PLR Program
Full PLR Program

• On September 21, 2017, the IRS issued Rev. Proc. 2017-52, initiating a pilot program expanding the scope of private letter rulings available regarding the tax consequences of a distribution under Section 355 (including a Section 368(a)(1)(D)/Section 355 distribution).

• If the taxpayer submits proper documentation, description and analysis of legal issues, and numerous representations, then the taxpayer can receive a ruling regarding the tax consequences under Sections 312, 355, 357, 358, 361, 362(b), 362(e), 368(a)(1)(D), 368(b), 1032(a), 1223(1) and 1223(2).

• The pilot program was to expire on March 21, but an IRS statement on March 12 extended it permanently.

• Taxpayers can still obtain rulings only on significant issues as under prior ruling practice even if the transaction would qualify under the new pilot program.
B. October 13, 2017 IRS Statement
On October 13, 2017, the IRS released a statement addressing four topics.

Two of the topics dealt with issues under Section 355.

One Section 355 topic was drop/spin/liquidate transactions, which raises General Utilities issues.

A second Section 355 topic was where a distribution of stock, securities or other property is substantially delayed, discussed next.
October 13, 2017 IRS Statement Regarding Delayed Distributions

• Regarding delayed distributions, the IRS statement says: “If, in connection with a section 355 distribution, a distribution of stock, securities or other property to the distributing corporation’s shareholders or creditors is substantially delayed, IRS will continue to rule on whether the delayed distribution is tax-free under section 355 or section 361. However, rulings on such issues will not be based solely on the length of the delay. Instead, IRS will rule on this issue only based on substantial scrutiny of the facts and circumstances (including the circumstances of the delay) and full consideration of the legal issues and the effects of a ruling on federal tax administration.”
Regarding delayed distributions, the IRS statement continues:

“However, in determining whether a retention of stock or securities is in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, within the meaning of section 355(a)(1)(D)(ii), IRS will continue to follow the guidelines in Appendix B of Rev. Proc. 96-30, even though Rev. Proc. 2017-52 has superseded Rev. Proc. 96-30. Thus, IRS will continue to rule in accordance with prior practice as to the application of section 355 to the distribution of the stock, or stock and securities, that are not retained.”
C. Debt Issued in Anticipation of a Spinoff:  
2013 IRS No-Rule

• In Rev. Proc. 2013-3, the IRS included the following as an area under study with respect to which private letter rulings would not be issued until the IRS resolves the issue through publication of formal guidance:
  • “Whether either § 355 or § 361 applies to a distributing corporation’s distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution.”

• On May 9, 2017, the IRS issued Rev. Proc. 2017-38, which deletes the no-rule relating to transfers of stock or securities to creditors of Distributing.

• The IRS stated, “it has been determined that issuing private letter rulings or determination letters in this area would be in the interest of sound tax administration.”
• A taxpayer engaging in a Section 368(a)(1)(D)/Section 355 transaction (a “Divisive Reorganization”) may request rulings that no gain or loss will be recognized by Distributing (i) upon Controlled’s assumption of liability for an obligation of Distributing, and (ii) upon Distributing’s receipt of “§ 361 Consideration” and its distribution of the § 361 Consideration to a creditor in satisfaction of Distributing’s debt obligation.

• § 361 Consideration is the consideration received by Distributing from Controlled in exchange for property Distributing transfers to Controlled as part of the Divisive Reorganization.

• The § 361 Consideration can include money, securities or other debt obligations of which Controlled is the obligor, and other property.
Scope of Rev. Proc. 2018-53 (cont’d)

• The procedures in Rev. Proc. 2018-53 apply to a request for a Significant Issue Ruling or a Transactional Ruling under Rev. Proc. 2017-52, to the extent that a subject of the request is an assumption by Controlled of liability for “Distributing Debt” or the satisfaction of Distributing Debt with § 361 Consideration.

• For purposes of Rev. Proc. 2018-53, an obligation is Distributing Debt if (a) Distributing is the obligor, and (b) the obligation (i) is a non-contingent payment debt instrument and (ii) by its terms is payable only in money.
Scope of Rev. Proc. 2018-53 (cont’d)

• The IRS will continue to rule on transactions that are not otherwise covered by Rev. Proc. 2018-53 but are similar.

• These transactions include assumption or satisfaction of Distributing’s obligations that are not Distributing Debt (for example, contingent liabilities) and distributions of §361 Consideration to Distributing’s shareholders.

• However, Rev. Proc. 2018-53 does not describe procedures for requesting such rulings.

• In addition, a taxpayer may request rulings regarding assumption or satisfaction of some obligations that are, and of other obligations that are not, Distributing Debt.
Information to Submit

• In a request under Rev. Proc. 2018-53, the taxpayer should submit (in addition to the representations, information and analysis described in Rev. Proc. 2018-1 and Rev. Proc. 2017-52) information that describes:

  (1) The Distributing Debt that will be assumed or satisfied (including its terms and the date it was incurred);

  (2) The § 361 Consideration that will be distributed to creditors in satisfaction of the Distributing Debt; and

  (3) The transactions that will implement Controlled’s assumption of liability for Distributing Debt or Distributing’s receipt of § 361 Consideration and Distributing’s distribution of § 361 Consideration to creditors in satisfaction of Distributing Debt.
Information to Submit (cont’d)

• The taxpayer should also submit information and analysis to establish that:

  (1) Any assumption of Distributing Debt by Controlled will be consideration received by Distributing in the Divisive Reorganization; and

  (2) Any Distribution of § 361 Consideration by Distributing to its creditors in satisfaction of Distributing Debt will be in connection with the plan of reorganization.
Contingencies

• If, at the time of the first distribution of Controlled Stock to Distributing shareholders, the assumption or satisfaction of Distributing Debt is subject to any contingency, the taxpayer should:

  (1) Describe each contingency and any alternative transactions; and

  (2) Establish that there are one or more substantial business reasons for the plan not being fixed and determined at that time.
Representations, Information and Analysis

• The taxpayer should submit seven Standard Representations, described below.

• The taxpayer should set forth each applicable representation and requested additional information and analysis.

• If the taxpayer believes that any of the representations is not applicable, the taxpayer should explain its rationale for this belief.
Representations, Information and Analysis (cont’d)

• If the taxpayer is unable to submit an applicable representation in the form set forth, the taxpayer should submit:

  (1) An explanation for its inability to provide the Standard Representation; and

  (2) The rationale supporting the issuance of each relevant requested ruling in the absence of the Standard Representation.
Representations, Information and Analysis (cont’d)

• If appropriate, the taxpayer should submit:
  (1) A modified representation that addresses the same matter;
  (2) An explanation of the modification; and
  (3) The rationale supporting the issuance of each relevant requested ruling, taking into account the modified Standard Representation.
Standard Representations (1) and (2)

(1) Distributing as obligor in substance. *Distributing is in substance the obligor of each Distributing Debt that will be assumed or satisfied.*

(2) **Holder not a Related Person.** *No holder of Distributing Debt that will be assumed or satisfied is a person related to Distributing or Controlled within the meaning of Section 267(b) or Section 707(b)(1) ("Related Person").* If a holder is a Related Person, the taxpayer should establish that the § 361 Consideration received by the Related Person will be used to satisfy an obligation that is evidenced by a non-contingent debt instrument and is held by a person other than a Related Person.
Standard Representation (3)

(3) **Holder of Distributing Debt.** *The holder of Distributing Debt that will be assumed or satisfied will not hold the debt for the benefit of Distributing, Controlled, or any Related Person.*

A collateral benefit received by Distributing from an arrangement with an intermediary (for example, facilitation of exchanges of § 361 Consideration for Distributing Debt) will not be treated as the intermediary holding Distributing Debt for the benefit of Distributing, Controlled or a Related Person.
If an intermediary will acquire pre-existing Distributing Debt from any person, and such Distributing Debt will be satisfied with § 361 Consideration, the taxpayer should submit the following representation: [Name of intermediary] will not acquire Distributing Debt from Distributing, Controlled, or any Related Person. Neither Distributing, nor Controlled, nor any Related Person will participate in any profit gained by [name of intermediary] upon an exchange of § 361 Consideration; nor will any such profit be limited by agreement or other arrangement. The value of the § 361 Consideration received by [name of intermediary] in satisfaction of the Distributing Debt will not exceed the amount to which the holder is entitled under the terms of the Distributing Debt.
Standard Representation (4)

(4) Distributing Debt as historic debt. Distributing incurred the Distributing Debt that will be assumed or satisfied (a) before the request for any relevant ruling is submitted and (b) no later than 60 days before the earliest of the following dates: (i) the date of the first public announcement of the Divisive Reorganization or a similar transaction, (ii) the date of the entry by Distributing into a binding agreement to engage in the Divisive Reorganization or a similar transaction, and (iii) the date of approval of the Divisive Reorganization or a similar transaction by the board of directors of Distributing.
Standard Representation (4) (cont’d)

If Distributing incurred or will incur any of the Distributing Debt that will be assumed or satisfied at a later time, the taxpayer should establish that, based on all the facts and circumstances, the borrowing and the assumption or satisfaction of such Distributing Debt will result in an allocation of historic Distributing Debt between Distributing and Controlled or an exchange of historic Distributing Debt for Controlled stock. As one example, the taxpayer may establish that the proceeds of the more-recently incurred Distributing Debt were used to satisfy other Distributing Debt that was incurred no later than the time described in the representation on the previous slide (cf. Rev. Rul. 79-258 re Section 357(b)). As another example, the taxpayer may establish that the proceeds of the Distributing Debt assumed or satisfied were or will be used in Controlled’s business.
Standard Representation (5)

(5) **Historic average.** The total adjusted issue price of Distributing Debt that will be assumed or satisfied does not exceed the historic average of the total adjusted issue price of (a) Distributing Debt owed to persons other than Related Persons and (b) obligations that are evidenced by [non-contingent debt instruments] and are owed by other members of Distributing’s separate affiliated group ... to persons other than Related Persons.

The historic average of total adjusted issue price should be determined based on debt outstanding as of the close of the eight fiscal quarters that ended or will end immediately before the date of approval of the Divisive Reorganization by the board of directors of Distributing.
(6) Delayed satisfaction of Distributing Debt. There are one or more substantial business reasons for any delay in satisfying Distributing Debt with § 361 Consideration beyond 30 days after the date of the first distribution of Controlled stock to Distributing’s shareholders. All the Distributing Debt that will be satisfied with § 361 Consideration will be satisfied no later than 180 days after such distribution.
Standard Representation (6) (cont’d)

The taxpayer should submit information and analysis to establish the substantial business reasons for any delay in satisfying Distributing Debt after the 30-day period beginning on the date of the first distribution of Controlled stock to Distributing’s shareholders. If satisfaction of any Distributing Debt with § 361 Consideration will occur more than 180 days after the date of such first distribution, the taxpayer should submit information and analysis to establish that, based on all the facts and circumstances, the satisfaction will be in connection with the plan of reorganization.
Standard Representation (7)

(7) No replacement of Distributing Debt. The taxpayer will not replace any Distributing Debt that will be assumed or satisfied with previously committed borrowing, other than borrowing in the ordinary course of business pursuant to a revolving credit agreement or similar arrangement.

If Distributing is a prospective borrower under a revolving credit agreement or similar arrangement, the taxpayer should submit information and analysis to establish that the agreement or arrangement was not entered into, and amounts of borrowing provided for therein were not increased, in a transaction related to the Divisive Reorganization.
General Information and Analysis

• The taxpayer should also submit information and analysis to establish that, under general principles of tax law, the transactions (including any exchange facilitated by an intermediary) should not be recast, recharacterized, or otherwise treated as one or more transactions that would not qualify under the relevant provisions of the Code.
E. Active Trade or Business Without the Collection of Income
September 25, 2018 IRS Statement

- To qualify under Section 355, both Distributing and Controlled must have actively conducted a trade or business for five years before the spinoff (the “ATB requirement”). See Sections 355(a)(1)(C) and 355(b).

- Reg. § 1.355-3(b)(2)(ii) states that the group of activities constituting a trade or business “ordinarily must include the collection of income ...”

- On September 25, 2018, the IRS published an announcement stating that it is studying the ATB qualification of corporations that have not yet collected income.
Sept. 25, 2018 IRS Statement (cont’d)

• “The IRS has observed a significant rise in entrepreneurial ventures whose activities consist of research and development in lengthy phases. During these phases, the ventures often collect no income or negligible income but nonetheless incur significant financial expenditures and perform day-to-day operational and managerial functions that historically have evidenced an ‘active’ business. For instance, a venture in the pharmaceutical or technology field might engage in research to develop new products with the purpose of earning income in the future from sales or licenses. The venture might even forgo current income opportunities to obtain increased future income by developing products on its own. The nature and duration of the research phases [are] often dictated by regulatory agencies, which require complex review processes that can span multiple years and cost millions of dollars.”
Sept. 25, 2018 IRS Statement (cont’d)

• The IRS is considering guidance to address whether a business can qualify as an ATB if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected.

• The IRS wants to develop standards in this area that would streamline the process. According to Bob Wellen, Associate Chief Counsel (Corporate), the standards need to be predictable, repeatable, fair and reasonable.
Sept. 25, 2018 IRS Statement (cont’d)

- Per Bob Wellen, IRS Associate Chief Counsel (Corporate), guideposts being considered include:
  - Regular, continuing research and related activities by a significant number of full-time management and operational employees;
  - Regular, continuing expenses for research and related activities;
  - Significant progress toward developing an income-producing product;
  - Holding out that the business is available to enter into an income-producing arrangement;
  - An actual offer or specific expression of interest made or received by the business to enter into an income-producing arrangement; and
  - Similarly situated businesses have entered into income-producing arrangements with research that has progressed to a similar level as the taxpayer’s research.

- Pending completion of the study, the IRS will entertain PLR requests regarding the ATB qualification of corporations that have not collected income. Taxpayers are encouraged to request pre-submission conferences.

- On May 6, 2019, the IRS issued a request for more information about the ATB qualification of corporations that have not collected income.
Rev. Rul. 2019-9 and PLR 201920008

• In Rev. Rul. 2019-9, the IRS suspended two revenue rulings, Rev. Rul. 57-464 (a real estate activity) and Rev. Rul. 57-492 (an oil exploration and production operation), in which the IRS ruled that the ATB requirement was not satisfied.

• In Rev. Rul. 2019-9, the IRS stated that the ATB analysis underlying the holdings in the two revenue rulings focused, in significant part, on the lack of income generated by the activities under consideration. Consequently, these revenue rulings could be interpreted as requiring income generation for a business to qualify as an ATB.

• Accordingly, the IRS suspended the two revenue rulings pending the completion of the ATB study.

• In PLR 201920008, the IRS ruled that a spinoff qualified under Section 355 despite the fact that following the distribution Controlled might not generate revenue, although it would continue to seek to generate revenue.
F. Proposed Regulations re Device and Active Trade or Business
Background of Proposed Regulations

• In Rev. Proc. 2015-43 and Notice 2015-59, the IRS expressed concern that a spinoff involving a relatively small active trade or business and a large proportion of investment assets could present evidence of a device for the distribution of E&P, lack an adequate business purpose, or be used as a means of improperly circumventing General Utilities repeal.

• In Rev. Proc. 2015-43, the IRS announced two new no-ruling positions:
  • The IRS will ordinarily not issue a private letter ruling if the fair market value of the gross assets of the active trade or business on which Distributing or Controlled will rely is less than 5% of the total fair market value of the gross assets of such corporation; and
  • Because the area is under study, the IRS will not issue a private letter ruling in certain situations where Distributing or Controlled has a high percentage of investment assets, the fair market value of the active trade or business of the corporation is small compared to total assets, and the ratio of investment assets to total assets of Distributing or Controlled is substantially disproportionate to the ratio for the other corporation.
Overview of Proposed Regulations

- On July 14, 2016, the IRS issued proposed regulations under Section 355 that would modify the device and active trade or business rules. The proposed regulations would:
  - Modify the corporate business purpose nondevice factor in Reg. § 1.355-2(d)(3)(ii);
  - Modify the nature and use of the assets device factor in Reg. § 1.355-2(d)(2)(iv);
  - Introduce a per se device rule; and
  - Establish a 5% minimum threshold to satisfy the 5-year active trade or business requirement.
- The proposed regulations are proposed to be effective for transactions on or after the date the regulations are finalized.
Appendix
Section 385 Regulations

• Final and temporary related-party debt-equity regulations under Section 385 were issued on October 13, 2016.
• The regulations include rules (Reg. § 1.385-2) imposing documentation requirements for an instrument issued by a domestic corporation to a related corporation to be respected as debt.
  • The effective date of the documentation rules was delayed by Notice 2017-36 so now the rules apply to debt instruments issued on or after January 1, 2019.
• The regulations also include rules (Reg. § 1.385-3) recharacterizing as equity certain instruments issued by a domestic corporation to a related corporation in specified transactions.
  • The recharacterization rules are effective for debt instruments issued after April 4, 2016.
Overall Framework of the Recharacterization Rules in Reg. § 1.385-3

- Under Reg. § 1.385-3, subject to various exceptions, certain “covered debt instruments” issued by a covered member (a domestic corporation) to a member of the covered member’s “expanded group” will be treated as equity of the issuer, either at the time of issuance, or in a subsequent taxable year.
  - A covered debt instrument is a debt instrument issued after April 4, 2016, that is not a “qualified dealer debt instrument” or an “excluded statutory or regulatory debt instrument”, and that is issued by a covered member (a domestic corporation) that is not an “excepted regulated financial company” or a “regulated insurance company.”

- Issuances of debt instruments subject to recharacterization under the “general rule” include:
  - Distributions of debt instruments;
  - Debt instruments issued in exchange for expanded group stock; and
  - Debt issuances issued in exchange of property in an asset reorganization, to the extent a shareholder of the target corporation that is a member of the issuer’s expanded group receives the covered debt instrument.

- There is also a “funding rule”, described on the next slide, that recharacterizes a debt instrument as equity.

- The recharacterization rules affect the deductibility of interest payments and have withholding tax implications.
Funding Rule of Reg. § 1.385-3

- Subject to various exceptions (such as a “qualified short-term debt instrument”), a debt instrument is also recharacterized as stock to the extent that it is issued by a corporation (funded member) and treated as funding a distribution or acquisition.

- The distributions or acquisitions subject to the “funding rule” include (with exceptions for each category):
  - A distribution of cash or other property by the funded member to a member of its expanded group;
  - An acquisition of expanded group stock by the funded member from another member of the funded member’s expanded group in exchange for cash or other property; or
  - An acquisition of property by the funded member in an asset reorganization, to the extent that shareholders of the target corporation that is another member of the funded member’s expanded group receive boot in the reorganization.
Per Se Funding Rule

- The funding rules have a non-rebuttable presumption, under which a covered debt instrument is treated as stock if it is issued within three years before the date of the distribution or acquisition by the covered member or within three years after the date of the distribution or acquisition (i.e., a six-year period in total).

- This presumption is non-rebuttable. Motive is irrelevant (i.e., the debt is stock under this per se rule).
Rules Limited to Issuers that are Domestic Corporations

• The final regulations do not apply to debt issued by foreign issuers.
• The final regulations narrow the rules to focus primarily on cross-border earnings stripping.
Debt Between Affiliated U.S. Corporations

• Debt between members of a consolidated group is generally not subject to the rules.

• However, the rules do apply to debt between non-consolidated U.S. members of an expanded group, subject to exceptions.
Scope of Rules for Multinationals with a U.S. Parent

• Section 956 loans (a loan by a CFC to its U.S. parent)
• Trade payables owed by U.S group members to foreign affiliates
Scope of Rules for Multinationals with a Foreign Parent

• Long-term inbound lending
• Short-term funding/cash pooling for U.S. group members where a foreign group member is the lender
• Trade payables owed by U.S. group members to foreign affiliates
October 2, 2017 Report re Tax Regulatory Burdens

• On October 2, 2017, the Treasury Department issued a “Second Report to the President on Identifying and Reducing Tax Regulatory Burdens” pursuant to E.O. 12789.

• In that report, Treasury recommends that the Section 385 regulations be revoked in substantial part.

• The report recommends revoking the Section 385 documentation regulations as issued.

• The report recommends retaining the recharacterization rules, including the funding rule, until tax reform occurs.
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

• Regarding the documentation rules of Reg. § 1.385-2, the Report states that “Treasury and the IRS now agree with commenters that some requirements of the documentation regulations departed substantially from current practice and would have compelled corporations to build expensive new systems to satisfy the numerous tests required by the regulations.”

• “Treasury and the IRS are considering a proposal to revoke the documentation regulations as issued. Treasury and the IRS are actively considering the development of revised documentation rules that would be substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes.”

• In particular, consideration is being given to the requirement to document a reasonable expectation of ability to repay indebtedness.

• In addition, the treatment of ordinary trade payables will be reexamined.

• The new proposed rules would have a prospective effective date.
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

- Regarding the recharacterization rules of Reg. § 1.385-3, the Report states: “The distribution regulations address inversions and takeovers of U.S. corporations by limiting the ability of corporations to generate additional interest deductions without new investment in the United States. In recent years, earnings-stripping by foreign-parented multinational corporations, as well as corporate inversions whereby U.S. corporations become foreign corporations and engage in earnings stripping, frequently as a tax artifice, have put U.S. corporations at a competitive disadvantage compared to their foreign peers. Treasury is committed to the Administration’s goals of leveling the playing field for U.S. businesses, so that they may compete freely and fairly in the global economy, and implementing tax rules that reduce the distortion of capital and ownership decisions through earnings stripping and similar practices.”
• Regarding the recharacterization rules of Reg. § 1.385-3, the Report further states: “Commenters have criticized the complexity and breadth of the distribution rules. They have criticized in particular the funding rule .... Treasury understands that the distribution rules are a blunt instrument for accomplishing their tax policy objectives, and continues to consider how the distribution rules might be made more targeted and compliance with the regulations less onerous. At the same time, Treasury continues to believe firmly in maintaining safeguards against earnings-stripping and diminishing incentives for inversions and foreign takeovers.”
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

• Regarding the recharacterization rules of Reg. § 1.385-3, the Report continues: “Treasury has consistently affirmed that legislative changes can most effectively address the distortions and base erosion caused by excessive earnings stripping, as well as the general tax incentives for U.S. companies to engage in inversions. Treasury is actively working with Congress on fundamental tax reform that should prevent base erosion and fix the structural deficiencies in the current U.S. tax system. Tax reform is expected to obviate the need for the distribution regulations and make it possible for these regulations to be revoked.”
October 2, 2017 Report re Tax Regulatory Burdens (cont’d)

• Regarding the recharacterization rules of Reg. § 1.385-3, the Report concludes: “In the meantime, after careful consideration, Treasury believes that proposing to revoke the existing distribution regulations before enactment of fundamental tax reform, could make existing problems worse. If legislation does not entirely eliminate the need for the distribution regulations, Treasury will reassess the distribution rules and Treasury and the IRS may then propose more streamlined and targeted regulations.”

• Now that a major tax bill has been enacted addressing base erosion concerns, what is the status of the reconsideration of the Section 385 regulations?