



This Month in M&A*

October 2009

This Month's Features

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- Notice 2009-78: Intention to issue regulations on expatriated entities and their surrogate foreign corporations
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- PLR 200938010: IRS ruled payment-in-kind notes not treated as stock for section 382 purposes

Did you know . . . ?

The IRS has issued guidance allowing an eligible entity to request relief for a late entity classification election within three years and 75 days of the requested effective date of the election.

Background

In general, a business entity that is not a "per se" corporation (an "eligible entity") may elect its classification for U.S. federal tax purposes. Reg. sec. 301.7701-3(b) provides a default classification for eligible entities that do not file an entity classification election. Thus, an entity classification election is necessary only when an eligible entity elects: (i) an initial classification other than its default classification; or (ii) to change its current classification. Such elections are made on Form 8832, *Entity Classification Election*, which must be filed with the applicable IRS service center.

The regulations provide that the effective date for the election specified on Form 8832 cannot be more than 75 days before, or more than 12 months after, the date on which the election is filed.

Pursuant to the regulations under section 9100, the IRS may issue a private letter ruling granting an extension of time for a taxpayer to file Form 8832 ("9100 relief") upon a showing that the taxpayer acted reasonably and in good faith and that the grant of relief would not prejudice the government.

Rev. Proc. 2002-59

In Rev. Proc. 2002-59, the IRS provided procedures to permit a late initial classification election provided that the election was effective as of the date the eligible entity was formed under local law and Form 8832 was filed by the due date for the first U.S. federal income tax return (*excluding* extensions) of the entity's desired classification for the year of the entity's formation.

To qualify for relief under Rev. Proc. 2002-59, a taxpayer had to provide a reasonable cause statement explaining the reason for the failure to timely file its initial entity classification election.

Rev. Proc. 2009-41

On September 3, 2009, the IRS issued Rev. Proc. 2009-41, which supersedes Rev. Proc. 2002-59. Rev. Proc. 2009-41 expands late entity classification relief to include both initial classification elections and changes in entity classification, and also extends the time for filing late entity classification elections to within three years and 75 days of the requested effective date of the eligible entity's classification.

Relief under Rev. Proc. 2009-41 is available for eligible entities with respect to which the *only* error was the failure to timely file the Form 8832. Thus, for an entity to qualify for relief under Rev. Proc. 2009-41, (1) all U.S. federal tax or information returns (including Forms 5471, 8865, and 8858, as applicable) that were required to be filed must have been timely filed consistently with the entity's requested classification for all the years the entity intended the request to be effective, and (2) no inconsistent U.S. federal tax or information returns may have been filed during any of the tax years.

Rev. Proc. 2009-41 provides relief for late elections of an entity's initial U.S. federal tax classification upon formation, late initial classification elections of a foreign entity's U.S. federal tax classification upon becoming "relevant" (as defined in Reg. sec 301.7701-3(d)(1)) (that is, the time at which the entity's classification affects the liability or U.S. information reporting of any person for U.S. federal income tax or information purposes), and late elections to change an existing entity's U.S. federal tax classification.

Similar to Rev. Proc. 2002-59, Rev. Proc. 2009-41 requires a reasonable cause statement, but unlike Rev. Proc. 2002-59, the new guidance requires the reasonable cause statement to be accompanied by a dated declaration under penalties of perjury signed by an individual who has personal knowledge of the facts regarding the election.

For entities that satisfy its requirements, Rev. Proc. 2009-41 is the *exclusive* means for obtaining relief for a late entity classification election and is in lieu of the 9100 relief procedure.

Rev. Proc. 2009-41 is effective September 28, 2009. It

applies to requests pending with the IRS under Rev. Proc. 2002-59 on September 28, 2009, and to requests received thereafter. Subject to transition rules, it also applies to all 9100 relief requests pending in the IRS on September 28, 2009, and to requests for relief received thereafter.

For 9100 relief ruling requests currently pending in the IRS, taxpayers may be able to obtain a refund of the user fee. *For additional information, please contact Craig Gerson, Kevin Curran, Jennifer Breen, or Brad Thompson.*

Treasury Regulations

Modification to the Intercompany Transaction Regulations (Reg. sec. 1.1502-13T) – On September 3, 2009, temporary and proposed regulations were issued to modify the election under which a consolidated group can avoid immediately taking into account certain deferred gains with respect to the stock of a member of the consolidated group.

In general, a deferred gain with respect to member ("Target") stock is taken into account if Target participates in a transaction that results in the elimination of its stock basis (e.g., a section 332 liquidation, certain reorganizations and spin-offs, etc). Reg. sec. 1.1502-13(f)(5)(ii), issued in 1995, provides elective relief if substantially all of Target's assets are reincorporated into a new corporation ("Newco") by its former shareholder ("B") within twelve months of the filing of the group's timely filed original return (including extensions) for the year in which Target's liquidation occurs, and the appropriate disclosures are attached to such return. The purpose of this safe harbor is to replicate the gain inherent in Target stock in the newly-issued Newco shares, treating the Newco stock as a successor asset.

On September 3, 2009, Reg. sec. 1.1502-13T (T.D. 9458) (the "Temporary Regulation"), was issued. The Temporary Regulation treats the integrated transaction as a cross-chain reorganization, notwithstanding the potential characterization of the transaction steps as an upstream reorganization. Thus, Target is deemed to transfer substantially all of its assets directly to Newco in exchange for Newco stock in a reorganization (but only if all of the other reorganization requirements are

met). Because the Newco stock is a successor asset under this fiction, the intercompany gain can continue to be deferred, provided that the election requirements (a written plan and the filing of a statement) are satisfied. *For additional information, please contact Tim Lohnes, Jayant Haksar, or Ben Willis.*

Controlled Group Regulations (Prop. Reg. sec. 1.1563-1) – The IRS has issued a proposed regulation providing that a corporation that satisfies the section 1563 controlled group rules for stock ownership is a member of such controlled group, regardless of whether such member is a component member pursuant to section 1563(b)(1). To illustrate, a new example was added to the regulations to show that a controlled group can consist solely of "excluded members" under section 1563(b)(2). This proposed regulation is intended to clarify the final controlled group regulations issued in May 2009 (see the June 2009 edition of This Month in M&A).

Observations: Some commentators have argued that a corporation that is an "excluded member" cannot be a controlled group member. In the preamble, the IRS noted its disagreement with such arguments. The proposed regulations are intended to clarify the IRS's position that the statute and legislative history are clear that an excluded member that is not a component member under section 1563(b) nevertheless is a member of the controlled group under section 1563(a). *For additional information, please contact James Prettyman or Brad Thompson.*

Revenue Procedures

Rev. Proc. 2009-41 – See "Did you know...?" for a discussion of this guidance regarding relief for a late entity classification election.

Private Letter Rulings

PLR 200936022 – In connection with a D/355 transaction, a wholly-owned subsidiary of Distributing made a distribution of property to Distributing and subsequently merged, pursuant to state law, into Controlled. The IRS ruled that the pre-merger distribution qualified as "boot" taxable under section 356 and not a distribution taxable under section 301. Previously, in a similar transaction, the IRS ruled that a

pre-reorganization distribution is taxable under section 301.

Observations: Recent IRS rulings characterizing pre-reorganization distributions have highlighted uncertainty in this area. See PLR 200610007 (a pre-merger distribution by a target corporation was taxable under section 301). Previously, however, the IRS has ruled an asset distribution made in conjunction with a reorganization sourced from Target constitutes "boot" in a reorganization. See Rev. Rul. 71-364. Traditionally, the IRS has focused on the interdependency of the distribution and the reorganization in determining the correct characterization. Other relevant factors in determining the characterization of a distribution in conjunction with a reorganization include the source of the distribution and the form of the transaction. *For additional information, please contact Henry Miyares or Benjamin Willis.*

PLR 200937005 – In a multistep transaction, Oldco formed a holding company ("Holdco"), which in turn formed a subsidiary that merged into Oldco with Oldco surviving. Subsequently, but on the same day as the merger, Oldco converted under state law from a corporation to an LLC followed by a subsequent conversion to a corporation on the same day. The IRS ruled the merger followed by the initial conversion qualified as a tax-free reorganization within the meaning of section 368(a)(1)(F), even though Oldco converted back to a corporation on the same day. The IRS ruled the subsequent conversion of Oldco to a corporation qualified as a transfer under section 351.

Observations: The ruling illustrates that the IRS respects multiple conversions effectuated on the same day. Furthermore, the ruling highlights the additional timing flexibility afforded by state law conversions as opposed to check-the-box elections. Transactions that are deemed to occur as a result of check-the-box elections are deemed to occur at the end of the day preceding the effective date of a check-the-box election. However, with regard to state law conversions, taxpayers apparently may choose the exact timing of the conversion. *For additional information, please contact Jayant Haksar or Colin Zelmer.*

PLR 200938010 – Taxpayer's payment-in-kind notes ("PIK Notes"), did not offer rights to dividends, vote, or liquidation proceeds, and were held by a consortium of lenders, none of which had control or influence over management of Taxpayer. Taxpayer represented that at the time the PIK Notes were issued, financial projections indicated that all principal and interest payments could be made when due.

The IRS ruled that the PIK Notes will not be treated as stock for section 382 purposes provided that: (i) Taxpayer is not actively involved in placing the PIK Notes; (ii) no person becomes the owner of more than 50 percent of the PIK Notes; and (iii) there is no material change in the terms of the PIK Notes.

Observations: Under a similar fact pattern in PLR 9441036, the IRS ruled that a debt instrument would not be treated as stock, in part, because the taxpayer represented that financial projections at the time the debt instrument was issued indicated that the taxpayer could fund all principal and interest payments on the debt.

Section 382(k)(6)(B) permits Treasury to issue regulations that "treat stock as not stock," and to treat certain non-stock interests as "stock." Under temporary regulations, a non-stock interest generally will be treated as stock if, inter alia, such interest offers a potential for significant participation in the corporation's growth. The scope of this rule is unclear, however, since most non-stock interests referred to in section 382(k)(6)(B) are addressed under the section 382 option rules and are excluded by the regulations. PLRs 9441036 and 200938010 provide useful guidance to loss corporations that have debt instruments outstanding. *For additional information, please contact Rich McManus or Brad Thompson.*

Other Guidance

Announcement 2009-69 - The IRS has announced revisions to Rev. Proc. 2007-65, regarding wind energy production partnerships. Rev. Proc. 2007-65 establishes a safe harbor under which the IRS will respect partnership allocations of section 45 wind energy production credits under section 704(b).

Rev. Proc. 2007-65 provided conditions for taxpayers to meet in order to ensure that allocations under section 704(b) resulting in the claiming of the wind energy credit under section 45 would be respected. Taxpayers who failed to meet these conditions were not able to request a private letter ruling from the IRS. Under the revenue procedure as initially published, the wind energy production partnership was required to satisfy each of six conditions. First, the developer must hold at least a one percent interest in each material item of partnership income, gain, loss, deduction, and credit at all times. Second, each investor must at all times hold an interest in each material item of partnership income and gain equal to five percent of the investor's percentage interest in partnership income and gain for the taxable year for which the investor's percentage share of income and gain will be the largest. Third, the investor must make a minimum unconditional investment in the partnership that is not protected against risk of loss. Fourth, no person can guarantee or otherwise insure the investor's right to the section 45 credit, and the developer cannot lend funds or guarantee debt of the investor used to acquire the investor's interest in the partnership. Fifth, the section 45 credit must be allocated in accordance with the general rules of section 704(b) governing the allocation of credits.

Finally, the revenue procedure, as originally released, prohibited the developer, the investors, or related parties, from holding a contractual right to purchase wind farm property at a price less than its fair market value determined at the time of exercise of the contractual right to purchase. The revised revenue procedure now allows for contractual rights to purchase wind farm property at a price less than the fair market value at the time of exercise, if the purchase price is determined prior to the exercise at a price the parties reasonably believe will not be less than the fair market value at the time of the exercise.

In addition, the revisions remove all references that the IRS will "closely scrutinize" wind energy production partnerships, but adds that failure to satisfy any requirement of the revenue procedure would not be governed by the safe harbor. The announcement also clarifies the treatment for taxpayers subject to section 469, and that tax returns claiming wind energy

production tax credits are subject to examination by the IRS.

Observations: The revisions to Rev. Proc. 2007-65 should provide greater flexibility for taxpayers to structure wind energy production partnerships and meet the safe harbor requirements. Prior to Announcement 2009-69, wind energy production partnerships were unable to determine if an existing contractual right to purchase wind farm property at a fixed price violated the safe harbor requirements, because wind farm property is subject to variations in fair market value. The updated revenue procedure allows partners to enter into contractual arrangements to purchase without testing such contractual rights against future values as long as the parties reasonably believe at the time the price is determined, based upon all facts and circumstances, the purchase price will not be less than the fair market value of the wind farm property at the time the right may be exercised. *For additional information, please contact Bob Crnkovich or Scott Dillow.*

Notice 2009-78 announced the IRS and Treasury's intention to issue regulations under section 7874, related to expatriated entities and their surrogate foreign corporations, that would expand the scope of section 7874(a)(2)(B) and be effective for transactions completed on or after September 17, 2009.

In general, there are three conditions that must be met for a foreign corporation to be treated as a "surrogate foreign corporation" under section 7874; the "substantially all condition," the "ownership condition," and the "insubstantial business activities condition". With respect to the "ownership condition," Notice 2008-78 provides that such condition is met if, after a foreign corporation's acquisition of substantially all the properties held by a domestic corporation, at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of owning the domestic corporation's stock. Similar provisions apply if a foreign corporation acquires substantially all the properties constituting a trade or business of a domestic partnership.

The notice indicates that the IRS has become aware of transactions intended to avoid the application of section

7874. Such transactions may involve a transfer of cash or certain other assets by investors to the foreign acquiring corporation, thereby reducing the former shareholders' ownership in the foreign corporation for purposes of the ownership condition.

The IRS intends to issue regulations that would disregard, for purposes of the ownership condition, stock of the foreign corporation issued in exchange for "nonqualified property" in a transaction related to the acquisition described in section 7874(a)(2)(B)(i), without regard to whether such stock is publicly traded on the date of issuance or otherwise. Subject to certain exceptions, the term "nonqualified property" generally will mean: (1) cash or cash equivalents, (2) marketable securities as defined in section 453(f)(2), and (3) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874. The IRS intends that the regulations will identify stock that would not be taken into account even though it may not otherwise be considered "sold in a public offering" and, thus, potentially disregarded under section 7874(c)(2)(B), as well as stock that must be taken into account, even though it may otherwise be considered to be "sold in a public offering."

Observations: In June, the IRS issued temporary regulations that appear to provide less certainty for taxpayers regarding the application of the broad-reaching rules of section 7874. (See section 7874 Regulations from "This Month in M&A," July 2009, for a thorough discussion of T.D. 9453, issued on June 10, 2009, and all three conditions needed to satisfy the surrogate foreign corporation test). Notice 2009-78 continues the IRS's trend to expand the scope of section 7874 to address transactions that are deemed to be inconsistent with its purpose. Note that while stock issued by a member of the expanded affiliated group (within the meaning of section 7874(c)(1)) generally does not constitute "marketable securities" under the notice, such stock may nonetheless constitute "nonqualified property" if a principal purpose for its issuance is the avoidance of section 7874. *For additional information, please contact Matthew Chen, Eileen Scott, or Ben Willis.*

PwC M&A Publications

This Month's WNTS Editors

Tim Lohnes, Partner (202) 414-1686
Bob Crnkovich, Principal (202) 414-4333
Jay Haksar, Director (202) 414-4477
Robert Black, Manager (202) 414-1870
Brad Thompson, Manager (703) 918-4557
Scott Dillow, Manager (202) 346-5040
Ben Willis, Senior Associate (202) 346-5210
Colin Zelmer, Senior Associate (202) 346-5227

This Month's WNTS Contributors

Craig Gerson, Partner (202) 414-1883
Henry Miyares, Partner (202) 312-7595
James Prettyman, Partner (202) 414-1754
Rich McManus, Managing Director (202) 414-1447
Jennifer Breen, Director (202) 312-7584
Matthew Chen, Director (202) 414-1415
Kevin Curran, Director (202) 312-7730
Eileen Scott, Director (202) 414-1017

