Allegheny Tax Society

Federal Tax Update

December 16, 2013

pwc

Agenda

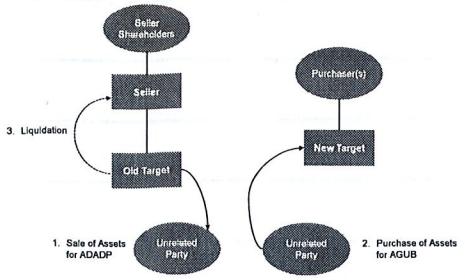
I. Federal tax update: Gregory Rosko and Daryl Sherred
   A. Final Section 336 regulations
   B. Granite Trust guidance
   C. ASC740 – Regulatory update
   D. ADVO decision – Section 199 benefits and burdens analysis

II. Q&A

Section 336(e) election overview

- On May 10, 2013, the IRS issued final regulations under section 336(e) that permit taxpayers to make an election to treat certain dispositions of a target corporation's stock as a sale of the underlying assets of the target corporation. The final regulations are effective on May 15, 2013.
- Expands the scope of elective deemed asset sale treatment to cover any taxable "disposition" or series of dispositions by a **domestic seller** of section 1504(a)(2) stock of a **domestic target**, if the stock disposed of, is to **non-related persons** within a 12 month period.
- Modeled on section 338(h)(10), except section 338(h)(10) looks to the purchase of Target stock, section 336(e) looks to its disposition.
- The election has the following consequences:
  - Seller recognizes no gain or loss on the disposition of Target stock.
  - Target is deemed to dispose of all of its assets.
  - Target attributes are generally transferred to Seller.

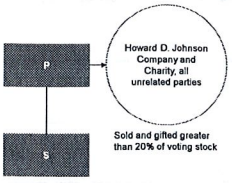
QSD mechanics – §336(e) election for sale "The basic model"



Section 338(h)(10) vs. Section 336(e)

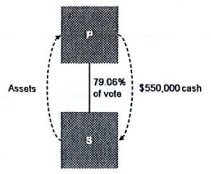
Section 338(h)(10)	Section 336(e)
Election jointly made by seller and buyer	Election jointly made by seller and target
Election w/in 8.5 months	Election on tax return(s)
Seller must be a member of a consolidated group or target must be an S corporation	Seller must be a corporation or S corporation shareholders
Buyer must be a corporation	Buyer need not be a corporation, and there can be several buyers
Requires a purchase of 80 percent	Requires any combination of sales, exchanges, and distributions totaling 80 percent
Distributions do not qualify	Distributions qualify
Not available for a disposition to related parties	Not available for a disposition to related parties
Not available if seller or target is foreign	Not available if seller or target is foreign

Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956)



- S was formed for the purpose of acquiring land and constructing a building
- The building substantially declined in value
- Bank regulators demanded a write down of S's stock
- P subsequently decided to liquidate S
- P did not want non-recognition treatment and decided to sell and gift some of its S stock
- The stock transfers reduced P's ownership interest in S below the 80% threshold

Granite Trust



- Once P's ownership was below 80%, S sold its assets to P in return for $550,000 in cash, after which S liquidated
- The Court held that the liquidation was a taxable event, relying heavily on a Senate Finance Committee report discussing the "elective features" of § 332
- Citing the Senate Finance Committee Report on the reenactment of § 332 as part of the 1954 Code, the Court stated, "...the 'elective features' of the subsection seems inescapably to reflect a legislative understanding...that taxpayers can, by taking appropriate steps, render the subsection applicable or inapplicable as they choose"

Section 267(f) final regulations
§ 1.267(f)-1

A. Apply to transactions that occur on or after April 16, 2012.

B. Address the appropriate time for taking into account deferred losses on the sale or exchange of property between members of a controlled group *even after the target is dissolved in a taxable liquidation.*

C. Focus on Granite Trust planning (see *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956)) – where a taxpayer intentionally structured a subsidiary liquidation to be taxable to allow a loss to be recognized.

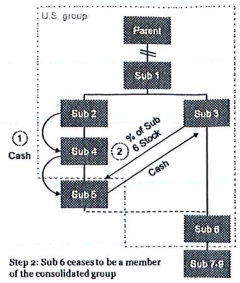
D. The preamble to the regulations considers a scenario where a corporation (the "selling member") wholly-owns a loss subsidiary (the "sold subsidiary"). Before liquidating the sold subsidiary, the selling member sells 30% of the sold subsidiary stock to another corporation within the same controlled (but not consolidated) group (the "buying member"). Issue: Under the current regulations the selling member's loss on the sale of sold subsidiary is deferred under section 267(f); however, there is uncertainty as to whether the deferred loss should be taken into account upon a subsequent taxable liquidation of sold subsidiary.

Section 267(f) final regulations *(continued)*
§ 1.267(f)-1

E. Deferred losses between members of a controlled group are taken into account on the occurrence of either of two events:

1. To the extent of any corresponding gain that the member acquiring the property recognizes with respect to the property; or
2. When the parties to the transaction cease to be in a controlled group relationship

PLR 201330004 – Steps 1 & 2



Step 2: Sub 6 ceases to be a member of the consolidated group

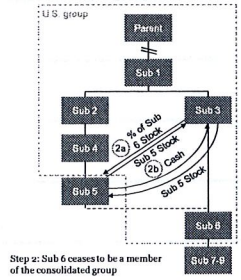
Transaction Steps:

1. Sub 2 contributes cash to Sub 4, which contributes the same amount of cash to Sub 5.
2. Sub 3 sells, at fair market value, a percentage (presumably 21%) of the common stock of Sub 6, which then ceases to be a member of the Parent Consolidated Group.

Treatment in the PLR:

- Section 304 applies to the sale of Sub 6 stock because Sub 3 was in control of Sub 5 and Sub 6 (after applying the section 318 attribution rules) and Sub 3 received property from Sub 5 in exchange for the Sub 6 shares.
- As a result, the transaction was characterized as a dividend-equivalent redemption under section 304(a)(1) after the application of section 302.

PLR 201330004 – Step 2 recast



Step 2: Sub 6 ceases to be a member of the consolidated group

Section 304(a)(1) Recast:

- 2a. Sub 3, in a qualifying section 351 exchange, transfers the stock of Sub 6 to Sub 5 in return for Sub 5 stock.
- 2b. Sub 5 redeems the stock it was treated as issuing in the section 351 exchange with the consideration it transferred in the stock sale.

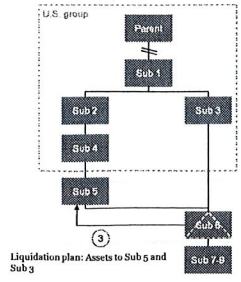
Result:

- As a result of being treated as a dividend-equivalent redemption the sale proceeds may be treated as dividend income.

Considerations:

- Presumably, a section 362(e)(2)(C) election was made on the deemed section 351 exchange, allowing Sub 5 to take a carryover basis and preserve the built-in loss in the Sub 6 stock.

PLR 201330004 – Step 3



Liquidation plan: Assets to Sub 5 and Sub 3

Transaction Step:

3. Sub 3 and Sub 5 will consider adopting a plan of liquidation whereby Sub 6 will liquidate and distribute its assets to both Sub 5 and Sub 3.

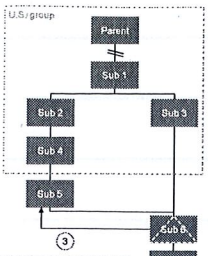
Treatment in the PLR:

- Taxable section 331 liquidation, resulting in Sub 3 and Sub 5 recognizing a loss with respect to their Sub 6 shares.

Considerations:

- Section 267(f) generally defers losses from the sale or exchange of property between members of the same controlled group, but does not apply to losses recognized as a result of a section 331 liquidation.
- Through the use of a section 304 sale (resulting in a deemed section 351 transfer) in conjunction with *Granite Trust* planning, the taxpayer avoided the application of section 267(f) to the Sub 6 stock that was sold and was able to recognize the loss on the section 331 liquidation.

PLR 201330004 – Step 3 (continued)

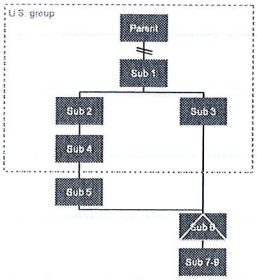


Liquidation plan: Assets to Sub 5 and Sub 3

Considerations:

- The question arises whether the Sub 6 liquidation resulted in a complete termination of Sub 3's interest in Sub 6 and whether the section 304 sale of the Sub 6 stock to Sub 5 should be treated as a sale or exchange transaction. *See Merrill Lynch.*
  - If there were a sale or exchange there would be a capital loss that would be deferred under section 267(f).
  - Presumably the IRS differentiated *Merrill Lynch* on the fact that the liquidation leaves the assets in the hands of Sub 3 and Sub 5 and not in the possession of an unrelated party.
- Note that there is no successor asset or section 381 attribute carryover as a result of the section 331 liquidation.

PLR 201330004 – Resulting structure



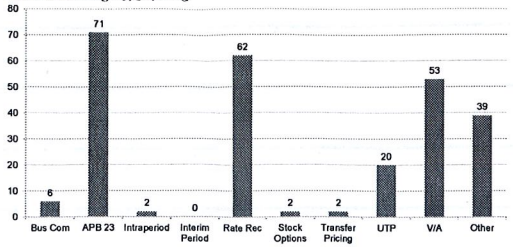
Related supplemental PLR

PLR 201334006

The IRS issued a supplemental PLR, PLR 201334006 as a result of changes to the transaction steps in the prior ruling. In the executed transaction, there was no section 304(a)(1) transfer because Sub 5 issued section 351(g) stock instead of cash for the shares of Sub 6. In light of the changes, only a portion of the loss inherent in the subsidiary's shares was allowed upon the liquidation. The remaining portion was deferred under section 267(f).

Regulatory environment

SEC comment letters issued from 1/1/2013 to 9/30/2013 and publicly released through 9/30/2013



Regulatory and investor focal points

Impairment assessment of deferred tax assets

1. **Please provide us with copies of your detailed forecast information and key assumptions you relied on in your 2012 tax valuation allowance determination.** To the extent you applied a sensitivity analysis to your assumptions, **please provide us with the details of your sensitivity analysis.** Given your significant Section 382 limitations and your history of losing built-in loss deductions, it may also be helpful to provide us with an analysis of the expected timing of your ability to use your deferred tax assets in light of any potential limitations.

Regulatory and investor focal points (continued)

Indefinite reinvestment of foreign earnings

We note you have disclosed that it is not practicable to determine the tax amounts that would be payable if the $557 million in undistributed foreign earnings were distributed to the U.S. parent. **Please explain why it is impracticable to determine the tax amounts in-light-of the fact that you have determined and recorded a deferred tax liability for the $395 million in undistributed foreign earnings not considered indefinitely reinvested.**

Regulatory and investor focal points (continued)

Uncertain tax positions

Reference is made to your disclosure regarding certain transactions you refer to as Lease In/Lease Out ("LILO") transactions. You disclose that in January 2013, the U.S. Court of Appeals for the Federal Circuit reversed an October 2009 trial court decision and disallowed tax deductions claimed by you relating to certain LILO transactions you entered into in 1997 and 1999, and that you expect to record an estimated charge of between $150 million and $170 million (after-tax) in the first quarter of 2013. Please provide all of the journal entries you anticipate recording in conjunction with this decision. **As this ruling appears to relate to events that occurred prior to the date of the financial statements and the information was available before the financial statements were issued, please explain to us in detail why you have not recorded this charge within the year ended December 31, 2012. Please also tell us what amounts, if any, you recorded as uncertain tax positions related to these transactions as of December 31, 2011 and 2012 and a detailed description of your assessment under ASC 740.**

Regulatory and investor focal points (continued)

Effective tax rate reconciliations

Please clarify to us how the proportion of income before provision for income taxes from international sources correlates to the amount of foreign tax rate differential included in the effective income tax rate reconciliation. As part of your response, **please provide us with a breakdown of income before provision for income taxes for each of your foreign subsidiaries, the statutory tax rate in each of these foreign jurisdictions, and the amount of income taxes you have provided for in each of these foreign jurisdictions.**

ADVO v. commissioner — Tax court addresses Section 199 benefits and burdens test in contract manufacturing context

Facts

- ADVO claimed a Section 199 deduction with respect to income derived from advertising material, referred to as shared mail packages, distributed through the US Postal Service to residential recipients. ADVO's shared mail packages consisted of individual printed wraps, inserts, and a detached address label combined into a single delivery mechanism. ADVO's graphics print department assisted its customers with the design of the advertisement graphics, which were supplied solely by ADVO or directly by customers.
- ADVO employed graphics print coordinators (GPCs) to interact with ADVO's contract printers and clients. After creation of an advertisement, the GPC transmitted PDF files containing the artwork for ADVO's products to its contract printers for printing. Once ADVO received the printed materials from the printers, ADVO used machinery to insert the printed materials into a wrap and prepare the materials for mailing.

ADVO v. commissioner — Tax court addresses Section 199 benefits and burdens test in contract manufacturing context (continued)

Issue

- Whether ADVO manufactured the advertising mailing packages or produced only intangible property used by printers to produce tangible personal property in the form of the advertising mail packages.

Conclusion

- The court said that the taxpayer that has the benefits and burdens of ownership (B&B) is the appropriate recipient of the Section 199 deduction. The court used a list of nine factors to determine whether ADVO had the B&B of the property during the manufacturing process. Based on its analysis, the court held that ADVO did not have the B&B of the printed materials while the advertising material was being printed.

Thank you

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