

THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 1, Number 7

February 1993



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Prop. Regs. Address Use of Partnerships to Avoid *General Utilities* Doctrine Repeal

by Robert W. Wood • Bancroft & McAlister

When the Tax Reform Act of 1986 was passed, with the repeal of *General Utilities* doctrine as its centerpiece, corporate tax planners immediately went to work looking for ways to do an end-run. The use of partnerships by corporations was one of the early fertile planning grounds, particularly with respect to acquisitions and dispositions. Consequently, the IRS tried to stop this particular field from

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to physically pay a dividend to lock-in affiliated/separate-return-year earnings as basis adjustments. The group may make a deemed-dividend election for wholly owned subsidiaries. If S has affiliated/separate-return-year earnings of \$400, the deemed dividend from those earnings would not reduce P's basis in S. However, P gets a basis increase on the deemed retribution.

Many taxpayers can avoid this problem with current action or advance planning. Before the first year in which the group elects to consolidate, S can pay a dividend to P from affiliated/separate-return-year earnings. P gets a 100% DRD without a negative basis adjustment. This technique emulates the deemed-dividend election. It is unclear whether P can subsequently retribute the distributed funds to S without the distribution being treated as transitory.

Example 6. The proposed regulations are in effect and the facts are the same as in Example 5, except that S distributes \$300 in 1994 and \$100 in 1995. The 1994 distribution is tax-free, since P gets a 100% DRD. At the end of 1994, P's basis in S is \$500. In its 1995 consolidated return investment adjustments, P increases its basis in S by \$100, but reduces it by the \$100 distribution. At the end of 1995, P's basis in S is \$500. By distributing affiliated/separate-return-year earnings before electing to file consolidated returns, P was able to emulate an investment adjustment system.

Consolidated groups making acquisitions must be wary of this rule when the target group is not filing consolidated returns. Once the acquisition is made, the target is immediately added to the acquirer's consolidated group. It is too late to use the above pre-consolidation technique to lock-in the target group's affiliated/separate-return-year earnings. However, if the acquirer can negotiate with the target, and cause its subsidiaries to distribute its earnings to the target before the acquisition, then lock-in may be obtained. Alternatively, if the acquirer can make the acquisition through an unconsolidated entity, it may be able to lock-in the target subsidiary's affiliated/separate-return-year earnings through the dividend technique after the acquisition, and file consolidated returns in later years. ■

growing, and in Notice 89-37, 1989-1 CB 679, announced that it would promulgate regulations designed to prevent the use of partnerships to circumvent the repeal of the *General Utilities* doctrine.

The Notice indicated that Section 311(b) would apply when a partner receives its own stock in a partnership distribution. Likewise, a partner would recognize gain under the Notice when a pre-distribution transaction or series of transactions had the economic effect of an exchange by the partner of appreciated property for its stock (a deemed redemption).

True to its promise, the Service has now published proposed regulations that should be of interest to virtually every corporate tax planner. The proposed rules apply when a partnership owns, acquires, or distributes the stock of a partner, providing deemed-redemption and distribution rules.

Deemed-Redemption Rule

Under the deemed redemption rule, a partner will recognize gain when, and to the extent that, any transaction or series of transactions has the economic effect of a partner exchanging its interest in appreciated property for an interest in its stock that is owned or acquired by the partnership. The economic effect of an exchange of property for stock may occur in any of the following circumstances:

- A partner contributes property to a partnership.
- A partnership acquires stock of a partner.
- A partnership makes disproportionate distributions.
- A partnership agreement is amended to provide different sharing ratios.

Example 1. In 1993, C, a corporation, and A, an individual, form Partnership CA as equal partners. C and A each contribute assets with a basis and value of \$100. In 1998, when C's partnership interest has a basis of \$100 and a value of \$200, CA purchases C stock at a cost of \$100.

The 1998 purchase of the C stock by CA has the economic effect of an exchange by C of a portion of its partnership interest for an interest in its stock