Acceptable Tax Planning After *Canal Corporation*?

By Henry K. Chen • Wood LLP

Over the last few years, tax professionals have often suffered a kind of push-me/pull-you effect. Companies, executives and clients want tax-efficient structures and lower effective tax rates. Yet from a public relations perspective, a deal can take on virtual pariah status.

Consider inversions, which became fashionable—and then the reverse—in quick succession. In the patriotism furor that unfolded, few tax planners felt comfortable relying on the old Learned Hand notion that tax planning was okay. Remember that hallowed line about there not being even a patriotic duty to pay more than your required taxes?

In an effort to keep practitioners abreast of developments and ahead of the curve, Practicing Law Institute hosted a three-day program in New York on tax strategies entitled "Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2014." Like a buffet of appetizers, it covered a smorgasbord of modern transactions. Strategies were shared for classic single-buyer acquisitions of assets or stock to multiparty joint ventures, cross-border mergers and complex acquisitions of public companies with global operations.

An underlying theme was how the various strategies evolved. Baseline transactions were presented followed by how government actions were taken to deter real or perceived abuses. When is a business purpose required? More broadly, what is acceptable tax planning?

Judicial Doctrines

A group of panelists, Jasper L. Cummings, Jr., Jeffrey H. Paravano, Armando Gomez and Bryan C. Skarlatos, offered interesting perspectives by identifying judicial doctrines typically used to attack transactions. One is the sham-transaction doctrine.

Another is statutory purpose cases. That is, a statute may not explicitly include a particular requirement, but the requirement could be read into the statute based on the statute's underlying purpose.

Re-characterization cases were also highlighted under the doctrine more classically called substance-over-form. Here, the IRS essentially argues that the legal terminology used to call something should be changed to something else. A classic example of this doctrine is debt-versus-equity.

Of course, the codified economic-substance doctrine was also discussed. The presenters openly acknowledged that it seemed impossible to define when this should apply. Notably, though, there are four pending appeals of foreign tax credit generator cases that raise economic-substance issues. The presenters challenged the IRS to definitively define when the economic-substance doctrine applies.

The message? Tax planning should avoid these judicial doctrines. Here are examples of recent transactions shared by presenters during the conference.

Baseline Stock Acquisition

A group of presenters from accounting, law and investment firms, David Schnabel, Eric Sloan and Lewis R. Steinberg, gave a scenario in which a private equity fund ("PE Fund") wants to acquire a corporation that operates two businesses ("Target"). A baseline structure was given where the PE Fund contributes cash to a newly formed buyer corporation ("Buyer"). The Buyer then purchases the Target's stock from its selling parent ("Selling Parent").

The Buyer typically prefers to instead purchase the Target's assets to get a basis step-up. But the Target and Selling Parent may not want an asset deal, which can depend on the Target's outside versus inside basis. Assuming a stock acquisition, can the Buyer nevertheless get a basis step-up?

Elections For Basis Step-Up

Two elections under Code Sec. 338 can achieve a basis step-up for the Buyer. Both elections should be considered acceptable tax planning. One election is under Code Sec. 338(g), which treats the purchase as an asset sale.

The Buyer can unilaterally make this election. Nonetheless, it can result in a prohibitive double tax on the Selling Parent. That is, a tax on the Target for the deemed asset sale, and a second tax on the Selling Parent on the actual stock sale. The Selling Parent prevents this election with provisions in the purchase agreement.

The other election is under Code Sec. 338(h)(10),which is a dual election by the Selling Parent and Buyer. If elected, the second tax on the Selling Parent is avoided. However, the election is not available if the Target is a foreign corporation.

Split the Baby

Assuming neither election is made, a common-sense solution could be for the Buyer and Selling Parent to split the acquisition. Instead of an all-or-nothing approach, the Buyer could purchase assets of one of the Target's businesses. Then, it could purchase the Target's stock to acquire the Target's second business.

Nevertheless, under Code Sec. 338(e), there is a consistency rule that operates to limit this form of tax planning. If the stock and asset acquisition occurs within a prescribed period, then a carryover basis can apply to the assets of both businesses.

Change the Form

To avoid the consistency rule and carryover basis, a recent strategy used in practice was for the PE Fund to form the Buyer as an LLC, not a corporation. Under Code Sec. 338(e), the consistency rule, and when it applies, assumes the Buyer is a corporation. [*See* Treasury Reg. §1.338-8(b)(1).]

This solution was seemingly blessed by the IRS in LTR 201213013. In this ruling, the proposed transaction was much more complex, but it involved a target with two groups of business assets. An LLC buyer acquired one group of assets directly and the remaining assets indirectly through the target's stock. The ruling concluded that the consistency rule under Code Sec. 338(e) did not apply.

However, the Treasury stopped this debatable loophole with final regulations effective May 15, 2013. Interestingly, the regulations are under Code Sec. 336, and they did not revise the regulations under Code Sec. 338. Instead, the IRS simply references the consistency rule in the Code Sec. 338 regulations and applies it to any buyer, not just a corporate buyer.

One cannot help but wonder if these legal gymnastics were even necessary. The statutory purpose doctrine presumably could have been used to attack this tax strategy. On the other hand, achieving a desired tax result based on the type of entity formed has been a constant practice in tax planning.

New Planning

Mr. Schnabel, Mr. Sloan and Mr. Steinberg offered a work-around strategy to characterize

the transfer of the Target's stock as a contribution, not a sale. The initial steps would remain the same. The PE Fund contributes cash to a newly formed Buyer LLC. The Buyer LLC then purchases the Target's assets of the first business.

Then, the Target distributes the proceeds to the Selling Parent. However, in the final step, the Selling Parent would transfer the Target's stock to the Buyer LLC in exchange of a five-percent interest in the Buyer plus cash (not just cash, like before). This can result in the Selling Parent and PE Fund being partners of the Buyer!

The resulting partnership presumably means that the transfer of the Target's stock to the Buyer is a contribution to form the partnership, not a sale. Since the consistency rules apply to sales, it should not apply here according to Revenue Ruling 99-95.

In Revenue Ruling 99-95, one party owned an LLC, and a third party transferred cash to the LLC. The LLC then had two owners, and the ruling held it became a partnership. The transfer was deemed to be a contribution and thus not taxable as a sale.

Interestingly, apart from the buyer's basis step-up, the effect of this new planning could be viewed as a "disguised sale." Indeed, after the final step in the new plan, the Selling Parent is left with cash. If the transfer of the Target's stock is not treated as a sale, then the Selling Parent effectively converted the Target's stock into cash, with a deferral of tax due to the contribution treatment.

Disguised Sales

Another group of PLI presenters, Stuart L. Rosow and Blake D. Rubin, discussed the nuances of disguised sales. A disguised sale is defined in Code Sec. 707(a)(2)(B) and must have two direct or indirect transfers. One transfer is from a partner to the partnership, and another is from the partnership to a partner.

A disguised sale is defined extremely broadly. The transfers are required to be treated as a sale or exchange of property if "when viewed together, are properly characterized as a sale or exchange of property." Moreover, there is a presumption that transfers within a two-year window are a disguised sale. [*See* Treasury Reg. §1.707-3(c)(1).]

Fortunately for taxpayers, there is an exception to this presumption for a debt-financed transfer under Treasury Reg. §1.707-5(b). If a recourse loan is used to finance a partner's transfer to the partnership, and the partner is deemed to bear the economic risk of the loan, then the two-year presumption should not apply.

Baseline Transaction

The disguised sale presentation provided various examples to demonstrate what is and is not a disguised sale. As with the evolution of the step-up basis strategies, a baseline transaction was given, involving Partner A and Partner B, who form a partnership.

Partner A contributes assets to the partnership, and Partner B contributes a note. The partnership then borrows additional cash from a third-party lender to operate. The loan is more than is needed to operate, so the partnership distributes a significant amount of the loan proceeds to Partner A. As a result, Partner A in effect converts the assets it contributed to the partnership into cash. Assuming Partner A bears the economic risk of the loan, there could be no gain recognition.

Canal Corporation

Famously, *Canal Corporation* [135 TC 199, Dec. 58,298 (2010)] provides some boundaries to this strategy. This case had the same basic fact pattern as the example above, but the taxpayer took steps in an attempt to allocate economic risk. In this case, one partner (*i.e.*, Partner B) guaranteed the loan, and the other partner (*i.e.*, Partner A) agreed to indemnify Partner B on the guarantee.

The Tax Court in *Canal Corporation* held the transaction to be a disguised sale. The indemnity agreement contained too many limits as to when Partner A actually could be required to make the payment. That is, the court applied substance-over-form principles and concluded that the indemnity was not real.

In fact, it wasn't even close according to the Tax Court, which listed multiple facts that the court found offensive. Looking at just the indemnity agreement, Partner A did not need to maintain a minimum level of net worth. Partner B also had to look first to the partnership's assets for payment before demanding indemnification from Partner A.

Even if Partner A somehow had to pay on the indemnity, it would receive a proportional increase in interest in the partnership. Outside of the indemnity agreement, the court also concluded that the entire plan was generated by Partner A and its advisors. Apparently, Partner B did not even request the indemnity.

Interestingly, the Tax Court found that the accuracy-related penalty under Code Sec. 6662(a) also applied even though Partner A received a "should" opinion from outside counsel for the transaction. In that part of the analysis, the court emphasized that the opinion was paid for with a fixed fee that was exceptionally high—$800,000. Moreover, payment was contingent on the transaction closing.

The Tax Court also was disturbed by the how the opinion was presented. The opinion used the phrase "it appears" repeatedly, was riddled with typos and was disorganized. These facts were not directly attributed to the disguised sale holding. Yet they presumably must not have helped the overall optics, nor the sense that this was really a tax-driven deal with little attention to reality, and not even nicely served!

In the wake of *Canal Corporation*, there is still considerable uncertainty when a disguised sale occurs. Recently, David van den Berg reported that the Treasury Department is finalizing regulations on disguised sales. [*See* "Official Says Treasury May Split Up Partnership Regs," 2014 TNT 203-4.] Stay tuned.

Conclusion

What is acceptable tax planning and what is not? Surely some things are above reproach. Using elections authorized by statute, such as the Code Sec. 338, clearly should be fair game.

Changing the form of an entity can also be acceptable. Yet another chilling read through the opinion in *Canal Corporation* may be a good idea, even if it isn't pleasant.

For additional information about the PLI conference, see *www.pli.edu* or call (800) 260-4754.

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