High Tech M&A Developments
Selected Topics

2016 High-Tech Tax Institute

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Bart Bassett
Morgan Lewis

Andrew Kim
Fenwick & West

Brandon Hayes
E&Y

Eileen Marshall
WSGR

AGENDA

- **High-Tech Spin-Offs**
- **Select Inversion Developments**
- **Developments for Integration Transactions**
- **Section 367 Issues**

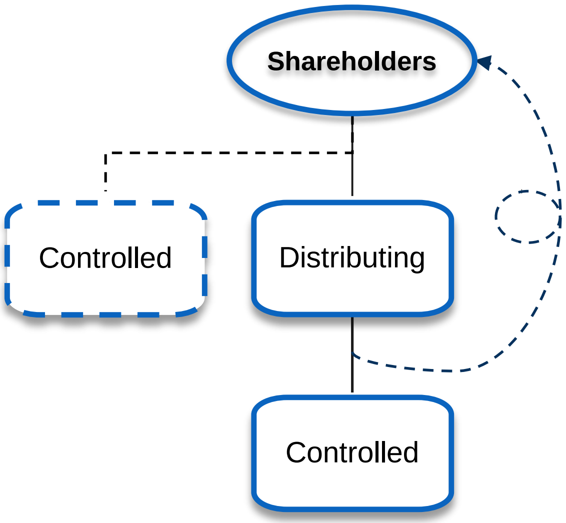
High-Tech Spin-Offs

AGENDA

Section 355 Spin-Off Transactions

- Overview
- Comparison to Section 301 Distributions
- Revenue Procedure 2016-40—Section 355 "Control Gathering" Guidance
- New Section 355 Active Trade or Business (ATB) Proposed Regs
- New Section 355 Device Test Proposed Regs
- Section 355(e) Safe Harbors
- [Monetization Strategies (See Appendix 1)]

SPIN-OFFS – OVERVIEW



Section 355 Distributions

- "Distributing" can make a tax-free distribution of "Controlled" shares if certain requirements are met:
  - Statutory Requirements
    - 80% control
      - High/low voting structures;
      - Control gathering
    - Distribution of control
    - ATB
      - Hot dog stand?
      - Expansion doctrine
    - Not a device for distribution of E&P
      - Non-business assets
  - Judicial Requirements
    - Business purpose
    - Continuity of business enterprise
    - Continuity of interest
- May be a pro-rata "spin-off" distribution or non-pro-rata "split-off" or "split-up" redemption

SPIN-OFFS – COMPARISON TO SECTION 301 DISTRIBUTIONS

	Section 301 Distribution	Section 355 Spin-Off
Income/Gain	• Corporate level deemed sale treatment under Section 311(b) • Apply Section 301(c)(1) – (c)(3) to determine shareholder tax treatment (dividend to extent of Distributing's E&P, reduction of Distributing's stock basis, excess capital gain) • For internal distributions within consolidated group-deferral triggered on external distribution	• Non-recognition treatment
Impact on Tax Attributes	• Gain on deemed sale of target shares ▪ Subpart F ▪ Section 1248 or Section 964(e) • Shareholders' tax basis in Controlled shares equal to fair market value of the shares	• Treas. Reg. Section 1.312-10 impact • Treas. Reg. Section 1.367(b)-5 analysis • Shareholders' tax basis in Controlled shares equal to a proportionate allocation of their tax basis in Distributing's shares
Elective?	• No, distributions that do not meet qualifications of Section 355 transactions are treated as Section 301 distributions	• No, Section 301 distributions that meet qualifications of Section 355 transactions are treated as Section 355 transactions

SPIN-OFFS – REVENUE PROCEDURE 2016-40
PRE-SPIN CONTROL GATHERING

- Confirms that pre-spin high vote/low vote recaps and other issuances by Controlled in which Distributing acquires 80% voting control of Controlled can pass muster.
- Two safe harbors under which IRS will not challenge recaps into control and subsequent unwinds:
  - No Change for 2 Years: Where no action is taken to effectuate unwind within 24 months of spin-off by Controlled's management, board or controlling shareholders, including adoption of any plan or policy; or
  - Unanticipated Transaction: Where Controlled engages in transaction (*e.g.,* merger with 3rd party) resulting in unwind of high vote/low vote structure and there was:
    - No agreement, understanding, arrangement or substantial negotiations *or discussions* concerning the transaction during 24-month period ending on date of spin-off; and
    - No more than 20% (by vote or value and applying attribution rules) of the 3rd party is owned by persons that own more than 20% of Controlled.

SPIN-OFFS – NEW PROPOSED REGULATIONS SECTION 355(B) 5-YEAR ATB TEST

- Current ATB statute and regs do not include requirement that value of ATB used to satisfy Section 355(b) must be significant in relation to total FMV of Distributing or Controlled.
- IRS had issued PLRs and GCMs that ATB test could be met regardless of absolute or relative size of ATB, although small active business is device factor.
- Liberal ruling policy perhaps became less necessary when legislative and regulatory changes (*e.g.,* separate affiliated group (SAG) rules) made it easier to satisfy ATB test.
- Several high profile transactions (*e.g.,* Yahoo/Alibaba) involving very small active business with no historical connection to business being spun off.
- Revenue Procedure 2015-43 (no-rules relating to relatively small ATB or large investment assets); Notice 2015-59.

SPIN-OFFS – NEW PROPOSED REGULATIONS SECTION 355(B) 5-YEAR ATB TEST (cont'd)

- Value of assets used by each of Distributing and Controlled to meet 5-year ATB test must be at least 5% of total assets.
- Each SAG is treated as one corporation.
- Pro rata look-through to assets of partnership if Distributing or Controlled is considered engaged in partnership's business by virtue of holding interest in partnership.
- Assets used in a business that is not an ATB (*e.g.,* because of 5-year requirement or taxable acquisition prohibition) are not ATB assets, even though they are business assets for purpose of non-device factors.
- Anti-abuse rule under which transactions with a principle purpose of affecting ATB asset percentage will not be given effect. Rule generally would not apply to non-transitory transactions other than with related parties.

SPIN-OFFS – CURRENT LAW
DEVICE TEST

- Spin-off cannot be used principally as a device to distribute earnings and profits of Distributing, Controlled or both.
- Failing the device test would cause the spin-off to be taxable to Distributing and its stockholders.
- Facts and circumstances test.
- Factors indicating a device:
  - Pro rata distribution.
  - Subsequent sale or exchange of Distributing or Controlled stock.
    - In connection with spin-off tax opinion or ruling, Distributing, Controlled and 5% stockholders of Distributing typically would be required to represent that there was no plan or intent to dispose of the Controlled stock.
  - Presence of significant amounts of cash and other liquid assets relative to business assets.
- Factors indicating not a device:
  - Publicly and widely held Distributing stock.
  - Strong business purpose for spinoff.

SPIN-OFFS – NEW PROPOSED REGULATIONS DEVICE TEST

- New regs provide objective standards for device test where Distributing or Controlled has substantial non-business assets.
- Ratio of business and non-business assets based on FMV.
  - Business assets include all active business assets, including working capital, regardless of whether business otherwise meets 5-year ATB test. Non-business assets are everything else.
  - Each SAG treated as one corporation. Pro rata look-through to assets of (i) partnership if Distributing or Controlled is considered engaged in partnership's business by virtue of holding interest in partnership, and (ii) $\geq$50% owned corporation outside SAG.
- Facts and circumstances test taking into account device and non-device factors.

SPIN-OFFS – NEW PROPOSED REGULATIONS DEVICE TEST (cont'd)

- Presence of non-business assets is evidence of device;
  Larger ratio → stronger evidence.
  - But ordinarily not considered evidence of device if non-business asset percentage of both Distributing and Controlled is <20%.
- Difference between non-business asset percentage of Distributing and Controlled is evidence of device;
  Larger difference → stronger evidence.
  - But ordinarily not considered evidence of device if difference is less than 10 percentage points, or distribution is not pro rata and difference is needed to equalize values received by distributees.
- Corporate business purpose (for spin-off, ownership of non-business assets and/or difference in non-business asset percentages) is evidence of non-device, which can outweigh evidence of device.
  - But if business purpose relates to separating business and non-business assets, then it must relate to exigency requiring investment or use of non-business assets in order to be evidence of non-device *(e.g.*, expiring lease, Distributing will use disproportionate non-business assets to buy building).

SPIN-OFFS – NEW PROPOSED REGULATIONS DEVICE TEST (cont'd)

- *Per se* test under which spin-off will be considered device if either Distributing or Controlled has non-business asset percentage of ≥66-2/3% and non-business asset percentages of Distributing and Controlled differ materially, based on sliding scale:
  - Non-business asset percentage of one entity is ≥66-2/3% but <80%, and of other entity is <30%;
  - Non-business asset percentage of one entity is ≥80% but <90%, and of other entity is <40%;
  - Non-business asset percentage of one entity is ≥90% but <80%, and of other entity is <50%.
- Anti-abuse rule under which transactions with a principle purpose of affecting non-business asset percentage will not be given effect. Rule generally would not apply to non-transitory transactions other than with related parties.

SPIN-OFFS – SECTION 355(e)
WHY SHOULD ACQUIRER WORRY?

- **Corporate Tax on Controlled Gain.** Distributing (but not its stockholders) is taxed under Section 355(e) if an otherwise tax-free spin-off is part of a plan for 3rd party to acquire 50% or more of the Distributing or Controlled.
  - Rebuttable statutory presumption that acquisition of 50% or more of voting power or economic value of Distributing or Controlled stock is part of a plan triggering Section 355(e) if it occurs within 2 years before or 2 years after the spin-off.
  - Types of transactions that may contribute to or result in a transfer of 50% or more for purposes of Section 355(e) include issuances of stock by Distributing or Controlled in public offerings or acquisition transactions, as well as acquisitions of Distributing or Controlled by 3rd parties. Issuances of options or stock to employees generally are not included in the 355(e) analysis.
  - Section 355(e) rules apply to certain successors and predecessors of Distributing and Controlled, such that under certain circumstances, acquisitions of stock of other corporations may be relevant to the 50% or more test.
- **Distributing's Legal Liability.** Typically allocated to Controlled by contract, however, if Controlled's actions create liability.
- **Acquirer Concerns.** Potential acquirers and strategic partners of Distributing or Controlled will tend to be conservative in analysis of whether proposed post-spin-off transaction could trigger Section 355(e) liability, since acquirer typically would inherit liability.

SECTION 355(e) – SAFE HARBORS FOR POST-DISTRIBUTION ACQUISITIONS

- **In General:** Safe harbors relax 2-year presumptions and may provide flexibility to enter into certain unplanned acquisition transactions. Key factors affecting applicability of safe harbors include the timing of negotiations and business purpose for spin-off.

- **"Super Safe Harbor":** Except in the case of a public offering, a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution.

  – Base case for Super Safe Harbor is where Distributing has had no contacts with the eventual acquirer regarding an acquisition for more than two years pre-spin.

  – Assumes substantial business purpose for spin-off unrelated to any potential acquisition.

  – Substantial negotiations involve discussion of significant economic terms by officers, directors, controlling shareholders or other persons with implicit or explicit permission to engage in such discussions.

  – Super safe harbor is not available for post-spinoff public offerings.

SECTION 355(e) – SAFE HARBORS FOR POST-DISTRIBUTION ACQUISITIONS (cont'd)

- **One-Year Safe Harbor:** A post-distribution acquisition will not be considered part of a plan if there was no agreement, understanding or arrangement regarding the acquisition or a similar acquisition at the time of the distribution, and there was no agreement, understanding, arrangement or substantial negotiations regarding the acquisition or a similar acquisition within one year after the distribution.
  - Pre-distribution negotiations without reaching an agreement , understanding or arrangement should not compromise the spin-off, provided that there are no negotiations for one year post-spin.
  - Distributing and Controlled generally could not re-engage with potential acquirers with which there were substantial negotiations pre-spin for one-year period post-spin.

SECTION 355(e) – SAFE HARBORS FOR POST-DISTRIBUTION ACQUISITIONS (cont'd)

- **<u>18-Month Safe Harbor</u>:** A post-distribution acquisition will not be considered part of a plan if:
  - spin-off was motivated in whole or substantial part by a business purpose other than to facilitate acquisition,
  - acquisition occurs more than six months after spin-off, and
  - there was no agreement, understanding, arrangement or substantial negotiations regarding the acquisition or a similar acquisition during the period beginning one year before and six months after the spin-off.

<u>Timing of Substantial Negotiations</u>	**<u>Safe Harbor for Post-Spin Transaction</u>**
Never	Immediately after spin-off
More than 2 years prior to spin-off	Immediately after spin-off
Between 1 and 2 years prior to spin-off	No [substantial] negotiations for 12 months prior to and 6 months after spin-off
Less than 1 year prior to spin-off	No [substantial] negotiations for 12 months after spin-off

SECTION 355(e) – SAFE HARBORS FOR POST-DISTRIBUTION ACQUISITIONS (cont'd)

- Other safe harbors protect acquisitions of stock of Distributing or Controlled before the spin-off is disclosed.
- Public trading of Distributing or Controlled stock by unrelated small stockholders generally is not taken into account for any of the safe harbors.
- Stock issued to service providers and small issuances to certain retirement plans generally is not taken into account for any of the safe harbors.

SPIN-OFFS – EXTRACTING VALUE

[SEE APPENDIX 1]

Select Inversion Developments

Highlights from TD 9761

- On April 4, 2016, Treasury and IRS issued proposed and temporary regulations under five separate Code sections
- These regulations target “inversion” transactions and certain post-inversion transactions that Treasury and the IRS generally view as contrary to the purpose of § 7874 and other specified provisions of the Code
- The Temporary § 7874 regulations implement provisions previously announced in Notice 2014-52 and Notice 2015-79, and also introduce new provisions
  - The text of the proposed regulations track the temporary regulations
- TD 9761 was released the same day Treasury and IRS released the proposed § 385 regulations

Highlights from TD 9761

- Two categories of rules introduced in TD 9761
- Category 1: temporary regulations under §§ 7874 and 367 that limit the ability of taxpayers to effectuate an inversion transaction, including:
  - New 36-month multiple acquisition rule
  - Disproportionate distribution rule
  - Passive foreign acquiring rule
  - Third-country limitation for acquisitions
- Category 2: temporary regulations under §§ 7874, 367, 304, 956 and 7701(l) addressing post-inversion transactions

Highlights from TD 9761

- Effective dates – the temporary regulations introduce three separate effective dates:
  - Regulations adopting provisions announced in Notice 2014-52 are effective as of the dates set forth therein (September 22, 2014)
  - Regulations adopting provisions announced in Notice 2015-79 are effective as of the dates set forth therein (November 19, 2015)
  - New provisions not previously announced are effective April 4, 2016

  *some exceptions

New Multiple Domestic Acquisition Rule

- Temp. Treas. Reg. § 1.7874-8T introduces a new multiple acquisition rule that has a 36-month look-back
  - The regulations exclude from the denominator of the § 7874 ownership fraction any stock of the foreign acquiring corporation issued in connection with other acquisitions of domestic corporations in the 36 months preceding the tested transaction
  - The new multiple acquisition rule of Temp. Treas. Reg. § 1.7874-8T is <u>not</u> dependent on a presence of a plan or intent linking the multiple domestic acquisitions
    - Contrast Treas. Reg. § 1.7874-2(e), which characterizes multiple domestic entity acquisitions that occur pursuant to a plan (or series of related transactions) as a single transaction for purposes of § 7874(a)(2)(B)

New Multiple Domestic Acquisition Rule

- Temp. Treas. Reg. § 1.7874-8T, cont.
  - Adjustments are also made for redemptions, share buy-backs, and other changes in capital structure
  - The temporary regulations also include a de minimis exception that applies if the prior domestic acquisition involved: (i) a § 7874 ownership fraction of less than 5% (vote and value); and (ii) the fair market value of the stock of the foreign acquiring corporation described in § 7874(a)(2)(B)(ii) did not exceed $50 million

Third Country Acquisition Rule

- Notice 2015-79 introduced a third country transaction rule, which may limit the ability to execute an inversion transaction via a newly created foreign parent corporation located in a country where the foreign acquiring corporation was not a tax resident prior to the acquisition
- Temp. Treas. Reg. § 1.7874-9T implements the third country rule
- When triggered, the stock of the foreign acquiring corporation issued to the foreign "target" shareholders in the combination is excluded from the denominator of the § 7874 ownership fraction
- The rule is limited to "covered foreign acquisitions," which is defined at Temp. Treas. Reg. § 1.7874-9T(d)(4) as a foreign acquisition in which, after the acquisition and all related transactions are complete, the foreign ownership percentage is at least 60%

Disregard of Stock Attributable to Passive Assets

- Notice 2014-15 introduced a rule that disqualifies stock of the foreign acquiring corporation from the denominator of the § 7874 ownership fraction where the foreign acquiring corporation holds predominately passive assets
- Temp. Treas. Reg. §1.7874-7T implements the passive asset rule
- General rule: If, on the completion date, more than 50% of the gross value of all foreign group property constitutes "foreign group nonqualified property," then a portion of the stock of the foreign acquiring corporation shall be excluded from the denominator of the § 7874 ownership fraction
- "Foreign group nonqualified property" generally targets cash, cash equivalents, marketable securities, certain related party debt obligations
  - Exceptions for property held in the active conduct of a banking or insurance business

Disregard of Non-Ordinary Course Distributions

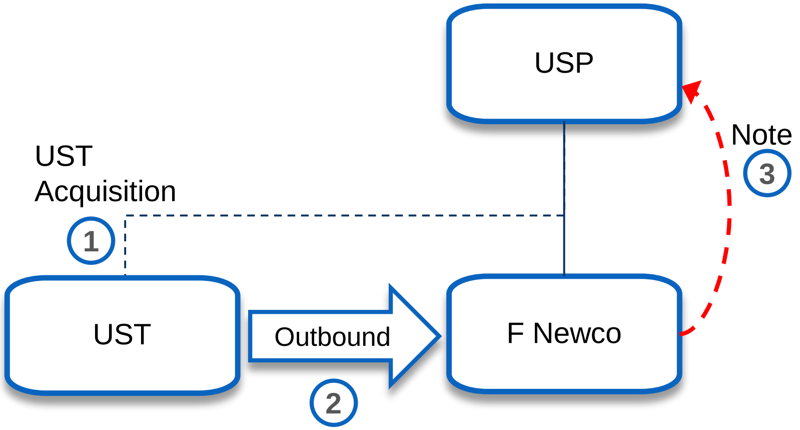
- Notice 2014-52 introduced rules governing the characterization of "non-ordinary course distributions" ("NOCDs") made by domestic entities prior to an acquisition.
  - Frequently referred to as "skinny down" transactions
- Temp. Treas. Reg. § 1.7874-10T retains the general rule introduced in Notice 2014-52: distributions made by a domestic entity in excess of 110% of the average annual distributions made during the 36-month period prior to the tested acquisition will be considered NOCDs, and such amounts shall be added back to the numerator and denominator of the § 7874 ownership fraction.

Developments for Integration Transactions

Final and Temporary Section 385 Regulations

- **Issued on October 13, 2016**
- **Applies to taxable years ending on or after January 19, 2017 with respect to debt instruments issued after April 4, 2016.**
- **The regulations reserve on debt issued by a foreign issuer**
  - Given that the regulations solely apply to indebtedness issued by US corporations, the impact on certain planning structures is limited.
- **Revised documentation timing rule**
  - Required documentation must be completed by issuer's filing of its tax return, replacing the 30- and 120-day proposed compliance periods.
- **Expanded group earnings reduction (f/k/a current E&P exception)**
  - The amount of a member's distributions and acquisitions is reduced to the extent of the member's E&P, computed as of the close of its taxable year, accumulated:
    - in taxable years ending after April 4, 2016; and
    - during the period that the member is a member of an expanded group with the same expanded group parent

Base Case – Outbound F and Note Distribution

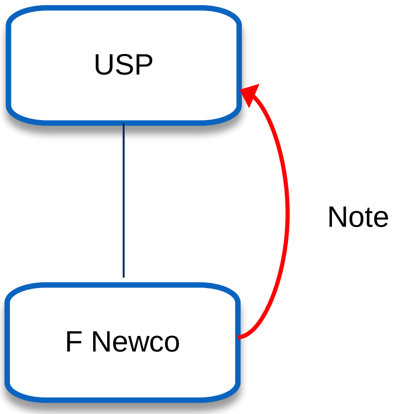


Steps

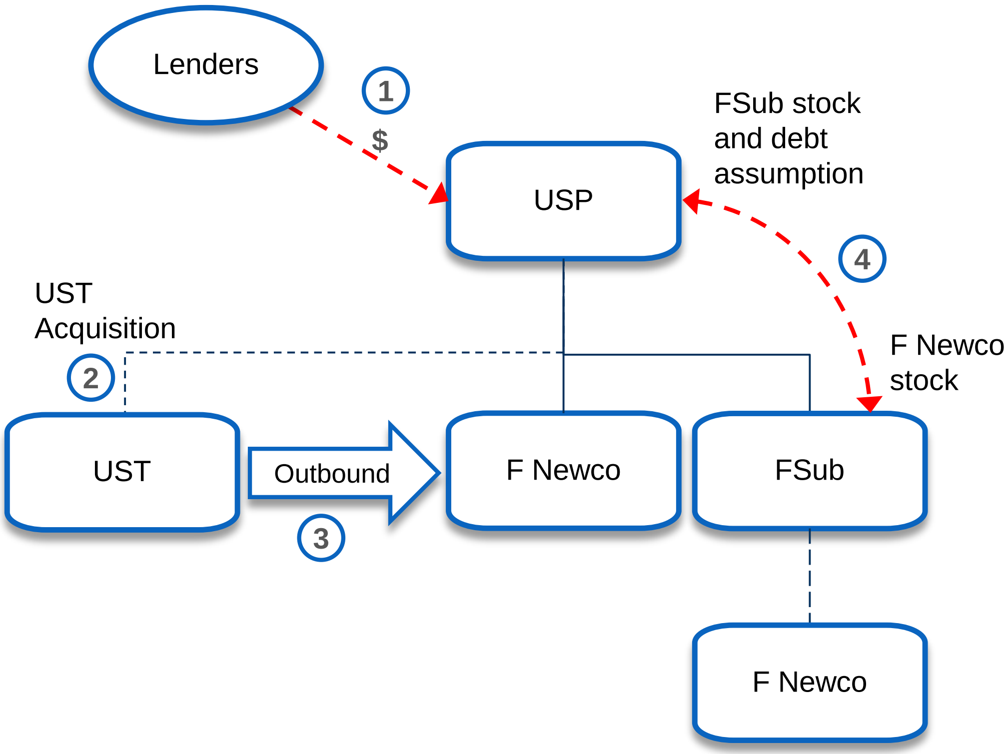
1. USP purchases all of the stock of UST.
2. After integrating the US tangible property with USP's operations, UST reincorporates as a foreign company ("F Newco") in a reorganization under §368(a)(1)(F).
3. F Newco distributes a note to USP.

Base Case – Outbound F and Note Distribution

Final Structure



Acquisition Indebtedness Exception

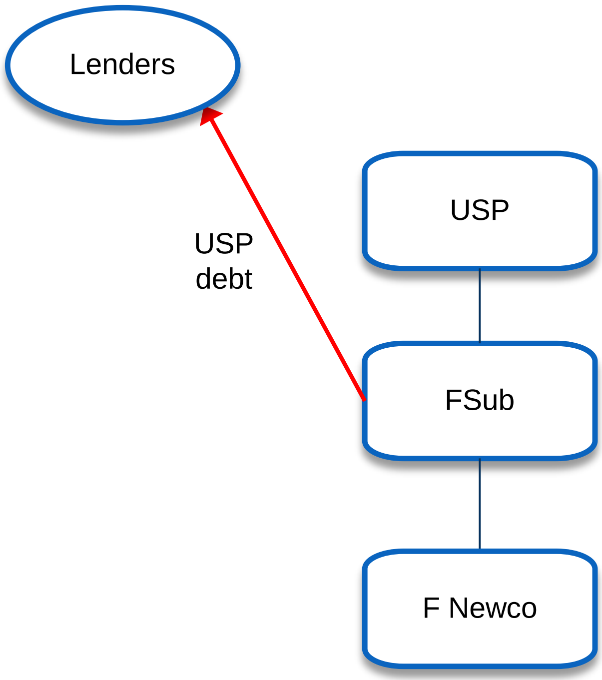


Steps

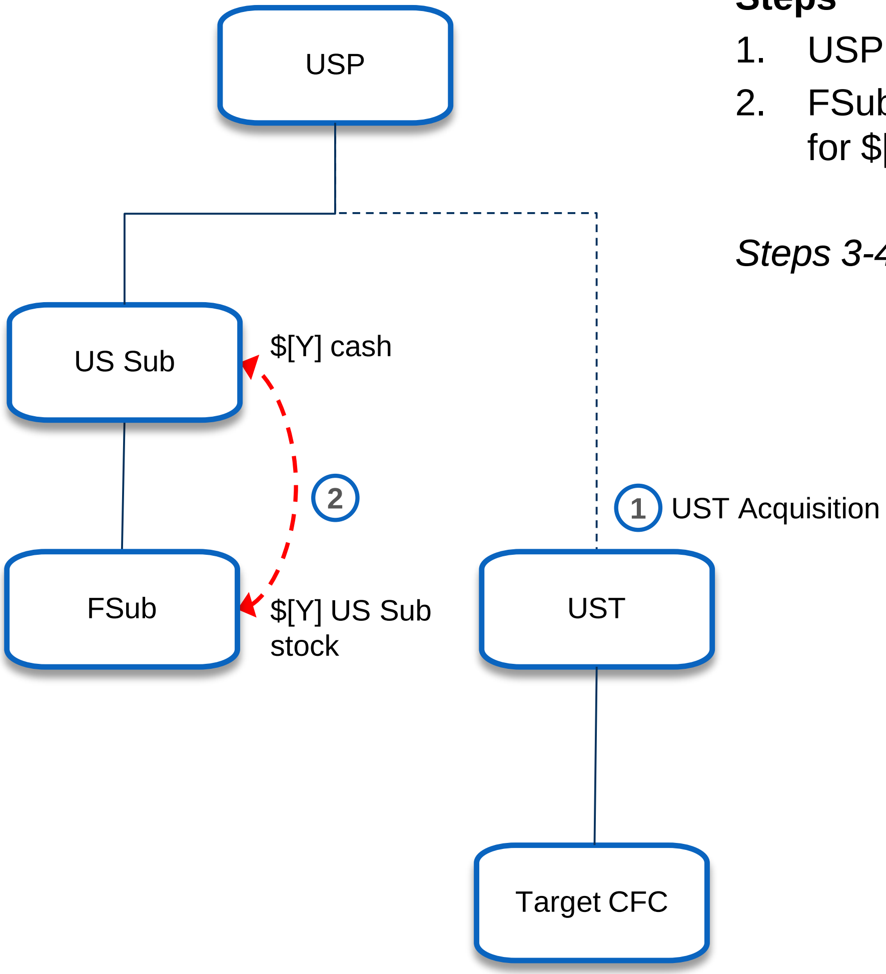
1. USP borrows from lenders to finance the acquisition of UST.
2. USP purchases all of the stock of UST for the cash loaned in Step 1.
3. After integrating the US tangible property with USP's operations, UST reincorporates as a foreign company ("F Newco") in a reorganization under §368(a)(1)(F).
4. USP transfers F Newco to FSub in exchange for FSub stock and FSub's assumption of USP's acquisition debt.

Acquisition Indebtedness Exception

Final Structure



Tri-B reorganization: PTI Variation

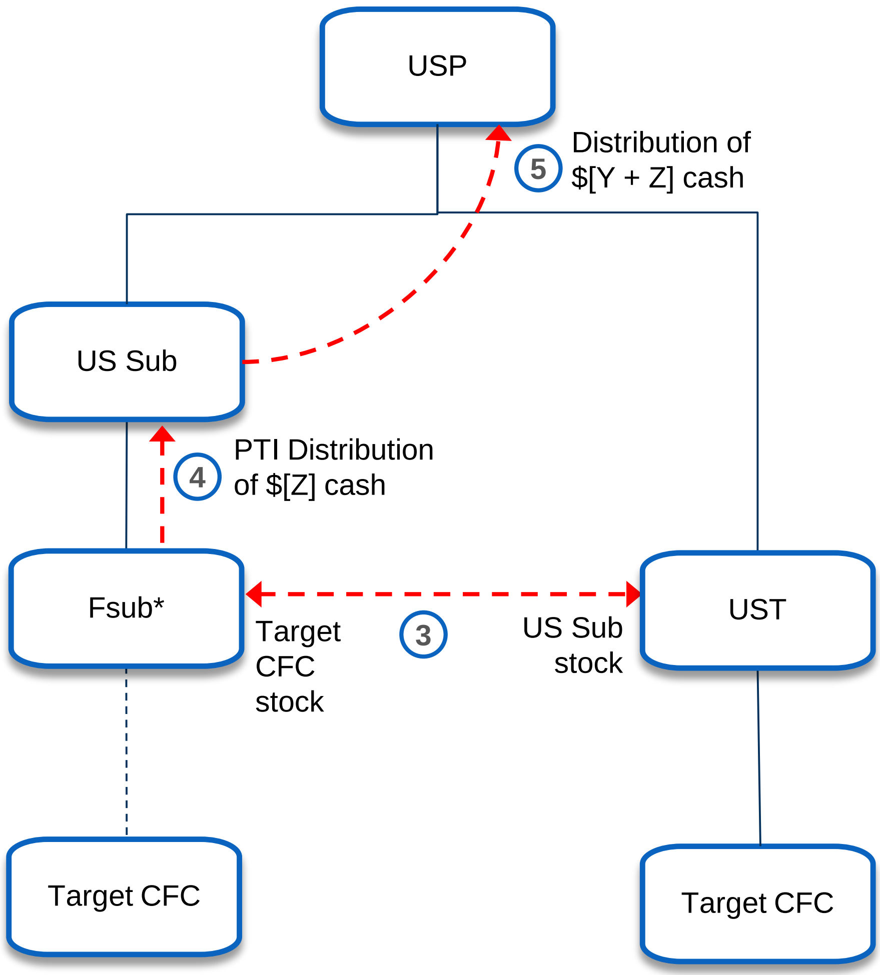


Steps

1. USP purchases all of the stock of UST.
2. FSub transfers $[Y] cash to US Sub in exchange for $[Y] US Sub stock.

Steps 3-4 on next slide

Tri-B reorganization: PTI Variation



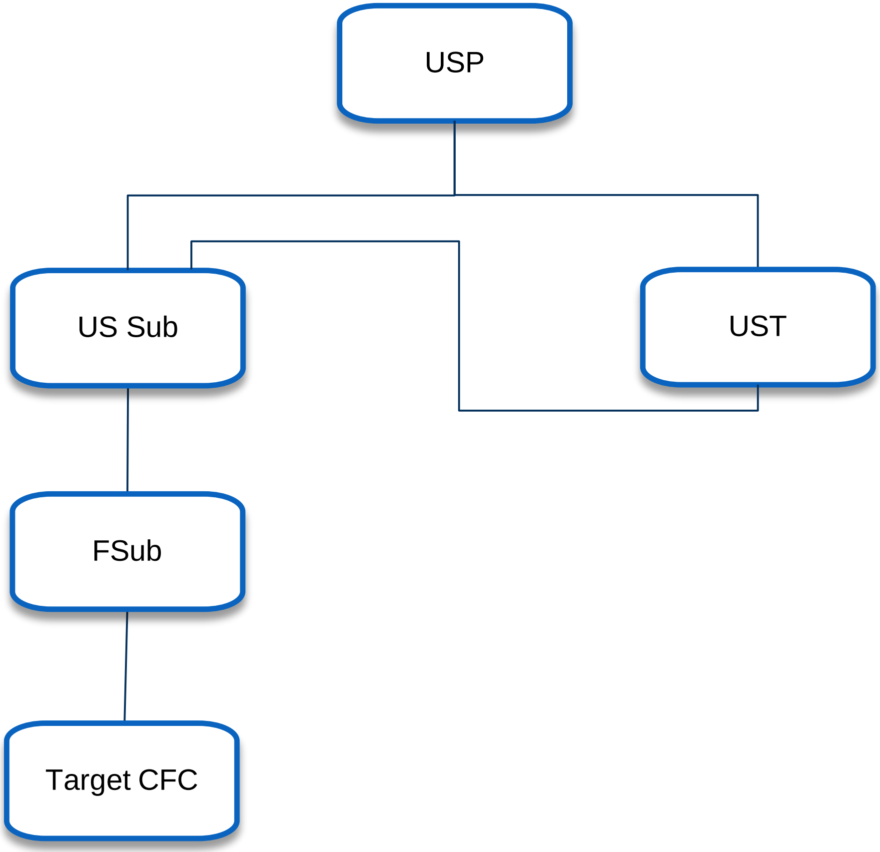
Steps

3. FSub acquires all of the outstanding Target CFC shares from UST for US Sub voting shares.
4. In a subsequent tax year, FSub makes a distribution of $[Z] of PTI generated to US Sub.*
5. US Sub makes a distribution of cash to USP consisting of $[Y] cash received in the “Tri-B” in Step 3 and $[Z] cash received in the PTI distribution in Step 4.

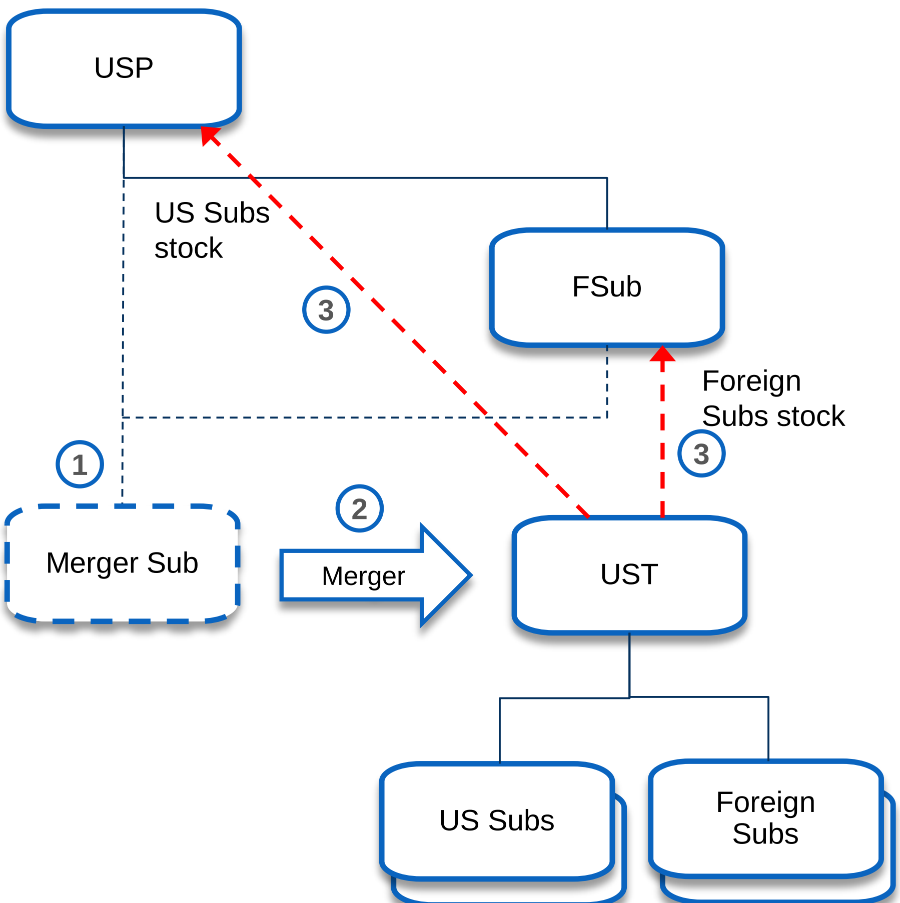
* Note: It is assumed that FSub has sufficient previously taxed income (“PTI”) to make the distribution.

Tri-B reorganization: PTI Variation

Final Structure



Statutory A Merger

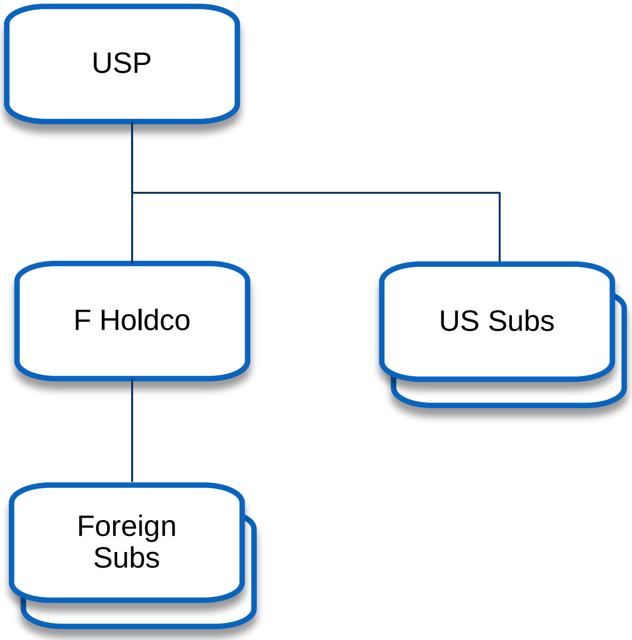


Steps

1. Merger Sub is formed. USP and FSub contribute $[X] and $[Y] to Merger Sub, respectively.
2. Merger Sub merges with and into UST with UST surviving. USP and FSub receive X% and Y% of the UST stock, respectively (but FSub cannot receive > 60% of the UST stock).
3. UST Merges with and into USP with USP surviving.
    1. USP receives the US Subs stock
    2. FSub receives the Foreign Subs stock

Statutory A Merger

Final Structure



Section 367 Issues

SECTION 367 ISSUES—367(d)

- Proposed regulations with a retroactive effective date eliminate the so-called foreign goodwill exception from the § 367(d) regulations.
- They also limit the § 367(a) active trade or business exception to certain tangible property and financial assets.

SECTION 367 ISSUES—367(d)

- **Temp. Treas. Reg. § 1.367(d)-1T(b) generally provides that § 367(d) applies to the transfer of any intangible property, but not to the transfer of foreign goodwill or going concern value (“foreign goodwill exception”).**
- **Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(i) generally defines “intangible property,” for purposes of § 367, as knowledge, rights, documents, and other intangible items within the meaning of § 936(h)(3)(B).**
- **Section 936(h)(3)(B) contains a specific list of items of intangibles. Goodwill and going concern value are not on the list.**
- **Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines “foreign goodwill or going concern value” as the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued.**

SECTION 367 ISSUES—367(d)

- In amending § 367 in 1984, Congress identified problems as arising when "transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible."
- The Senate Finance Committee stated that "The committee contemplates that ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business." The House report contains a similar statement. The Senate Finance Committee and the House Ways & Means Committee each noted that it "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in an abuse of the U.S. tax system."

SECTION 367 ISSUES—367(d)

- **Treasury and the IRS say they are aware that, in the context of outbound transfers, certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an <u>inappropriately large share</u> (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under § 367.**
- **Treasury and the IRS say they are aware that some taxpayers value the property transferred in a manner contrary to § 482 in order to minimize the value of the property transferred that they identify as § 936(h)(3)(B) intangible property for which a deemed income inclusion is required under § 367(d) and to maximize the value of the property transferred that they identify as exempt from current tax.**

SECTION 367 ISSUES—367(d)

- Treasury and the IRS say that, for example, some taxpayers (1) use valuation methods that value items of intangible property on an item-by-item basis, when valuing the items on an aggregate basis would achieve a more reliable result under the arm's length standard of § 482, or (2) do not properly perform a full factual and functional analysis of the business in which the intangible property is employed.
- Compare temporary regulations under § 482 issued nearly concurrently with the proposed regulations, reemphasizing recourse to an aggregate approach throughout § 482
- The perceived issue, therefore, is under § 482. Nevertheless, the proposed regulations seek to "fix" this issue through § 367.

SECTION 367 ISSUES—367(d)

- **The proposed regulations would eliminate the foreign goodwill exception under Temp. Treas. Reg. § 1.367(d)-1T and limit the scope of property that is eligible for the active foreign trade or business exception generally to certain tangible property and financial assets.**
- **Accordingly, under the proposed regulations, when there is an outbound transfer of foreign goodwill or going concern value, the U.S. transferor will be subject to either current gain recognition under § 367(a) or the tax treatment provided under § 367(d).**

SECTION 367 ISSUES—367(d)

- Proposed Treas. Reg. § 1.367(a)-1(d)(5) modifies the definition of intangible property.
- The modified definition facilitates both the elimination of the foreign goodwill exception as well as the addition of a rule under which U.S. transferors may apply § 367(d) with respect to certain other outbound transfers of property that otherwise would be subject to § 367(a) under the U.S. transferor's interpretation of § 936(h)(3)(B).

SECTION 367 ISSUES—367(d)

- In addition, the proposed regulations eliminate the existing rule of Temp. Treas. Reg. § 1.367(d)-1T(c)(3) that limits the useful life of intangible property to 20 years. The preamble states that if the useful life of transferred intangible property exceeds 20 years, the limitation might result in less than all of the income attributable to the property being taken into account by the U.S. transferor.
- Accordingly, proposed Treas. Reg. § 1.367(d)-1(c)(3) provides that the useful life of intangible property is the entire period during which the exploitation of the intangible is reasonably anticipated to occur, as of the time of the transfer.

SECTION 367 ISSUES—GRAs

- Final regulations amend the rules governing failures to file gain recognition agreements and related documents, or to satisfy other reporting obligations, associated with transfers of property to foreign corporations.
- The § 367(a) regulations provide exceptions to the general income recognition rule of § 367(a) for certain transfers by a U.S. transferor of stock or securities to a foreign corporation. These exceptions generally require the U.S. transferor to file a GRA and other related documents.
- Under the terms of a GRA, the U.S. transferor must agree to include in income the gain realized but not recognized on the initial transfer of stock or securities and to pay interest on any additional tax due if a gain recognition event occurs during the five-year term of the GRA.

SECTION 367 ISSUES—GRAs

- **A failure to comply with the GRA rules can trigger gain recognition.**
- **An example is the failure to file an annual certification. The previous regulations provided that if there was a failure to comply with the GRA rules, the U.S. transferor would have to recognize the full amount of gain realized on the initial transfer of stock or securities unless the transferor could demonstrate that the failure was due to reasonable cause and not willful neglect.**
- **Treasury and the IRS were concerned that the previous reasonable cause standard might not be satisfied by U.S. transferors in many common situations even though the failure was not intentional and not due to willful neglect.**

SECTION 367 ISSUES—GRAs

- The new regulations revise the § 367(a) GRA regulations to provide that a U.S. transferor seeking either to (1) avoid recognizing gain under § 367(a) on the initial transfer as a result of a failure to timely file an initial GRA, or (2) avoid triggering gain as a result of a failure to comply in all material respects with the § 367(a) GRA regulations or the terms of an existing GRA, must demonstrate that the failure was not a willful failure.
- For this purpose, the term “willful” is to be interpreted consistent with the meaning of that term in the context of other civil penalties (for example, § 6672), which would include a failure due to gross negligence, a reckless disregard, or willful neglect.

APPENDIX 1

High Tech Spin-offs: Extracting Value

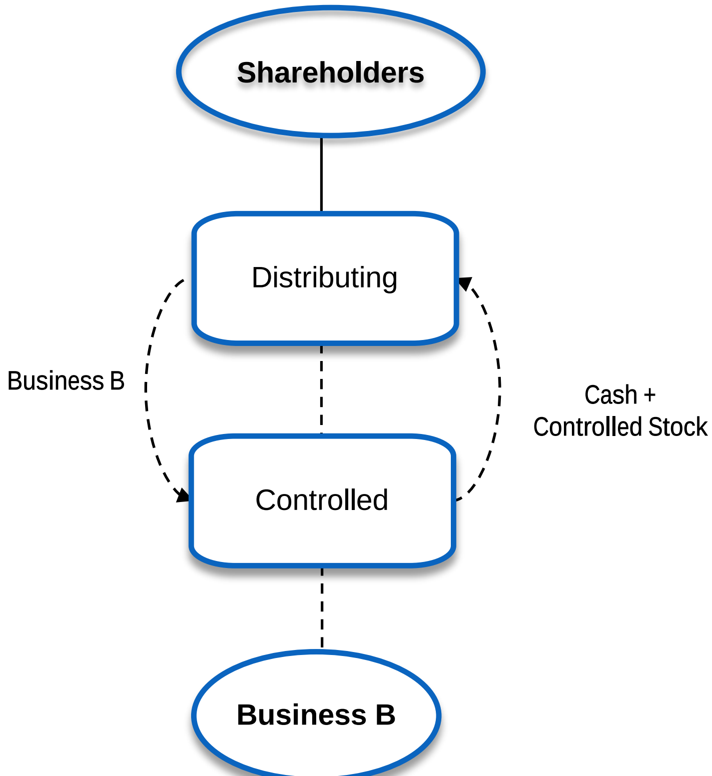
SPIN-OFFS – EXTRACTING VALUE

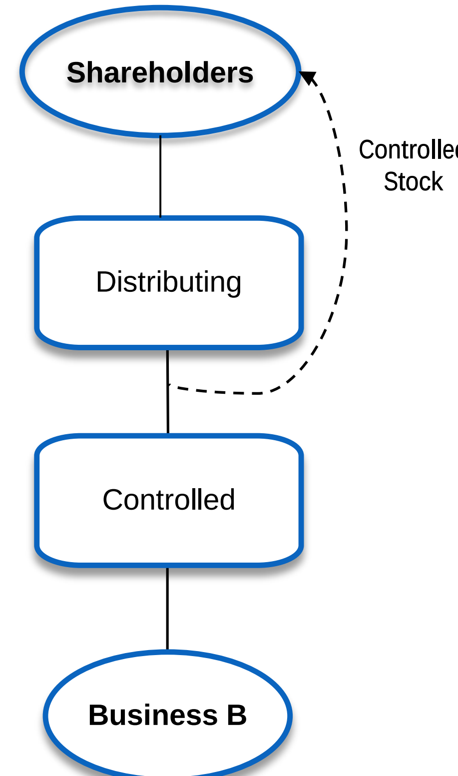
- **Cash distribution:** Controlled distributes cash to Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Liability assumption:** Controlled assumes a liability of Distributing as part of a Section 368(a)(1)(D) reorganization.
- **Securities-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock and Controlled securities (*i.e.*, long-term debt). Distributing repays Distributing debt with the Controlled securities and distributes Controlled stock to its shareholders.
  - Current holders of Distributing debt may prefer cash. Investment bank may be able to facilitate by acquiring Distributing debt for cash, but not as Distributing's agent. 5/14 Standard--No exchange agreement between Distributing and bank for at least 5 days after bank acquires Distributing debt, and no exchange for at least 14 days.
  - Only old and cold debt or newly issued debt too? Debt issued in anticipation of spin-off has been on no-rule list since 2013, which would include "traveling notes" exchangeable for Controlled securities. Rev. Proc. 2016-3.
- **Stock-for-debt exchange:** Distributing transfers business to Controlled in exchange for Controlled stock. Distributing uses up to 20% percent of the Controlled stock to repay debt and distributes the balance of the Controlled stock to its shareholders.
- **Reverse spin-off:** Distributing borrows money [or receives a distribution from Controlled 1], contributes the proceeds, along with business, to Controlled [2] and then distributes the Controlled [2] stock to its shareholders.

SPIN-OFFS – EXTRACTING VALUE (cont'd)

- **Cash distributions to Distributing and liability assumptions by Controlled are subject to additional limitations:**
  - Basis limitation – For the cash distribution or liability assumption by Controlled to be tax-free to Distributing, the amount of cash distributed/liabilities assumed cannot exceed Distributing's basis in its Controlled stock (if Controlled is a preexisting subsidiary) or Distributing's basis in the contributed assets (if Controlled is newly formed in connection with the transaction).
    - Section 357(c) limits the amount of Distributing liabilities Controlled may assume without tax to Distributing 's basis in the assets it transfers to Controlled in the reorganization.
    - Section 361(b)(3) limits non-recognition on the distribution by Distributing to its creditors of cash received from Controlled to Distributing's basis in the assets transferred to Controlled.
  - Use of proceeds limitation – Cash received by Distributing as part of a Section 368(a)(1)(D) reorganization will be taxable boot unless used to pay off debt or distributed to shareholders. Distribution to shareholders is not subject to basis limitation, but also does not result in monetization for Distributing.
- **Securities-for-debt exchanges, stock-for-debt exchanges and reverse spin-offs generally are not subject to basis limitation.**

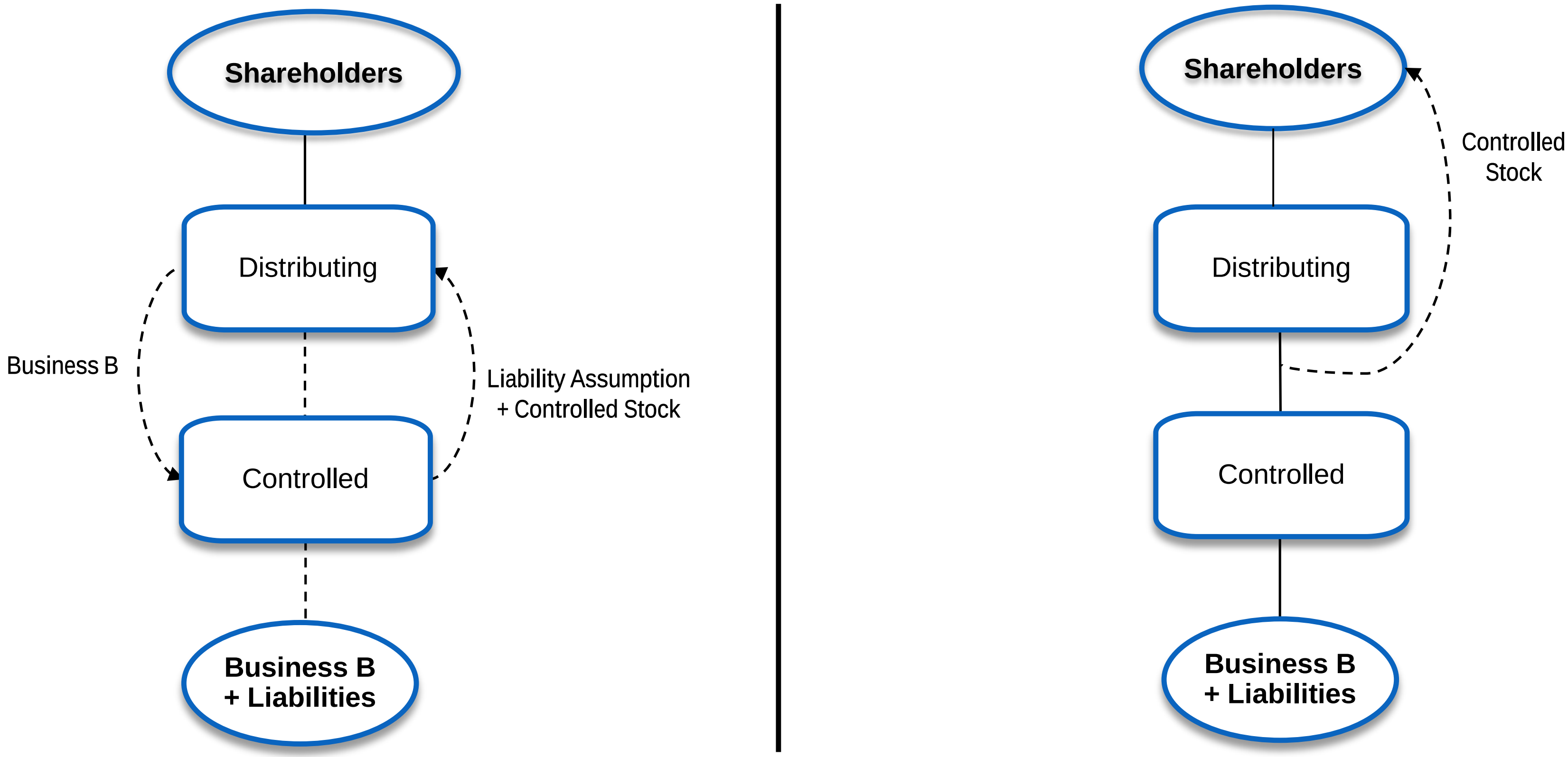
SPIN-OFF TRANSACTIONS – CASH DISTRIBUTION





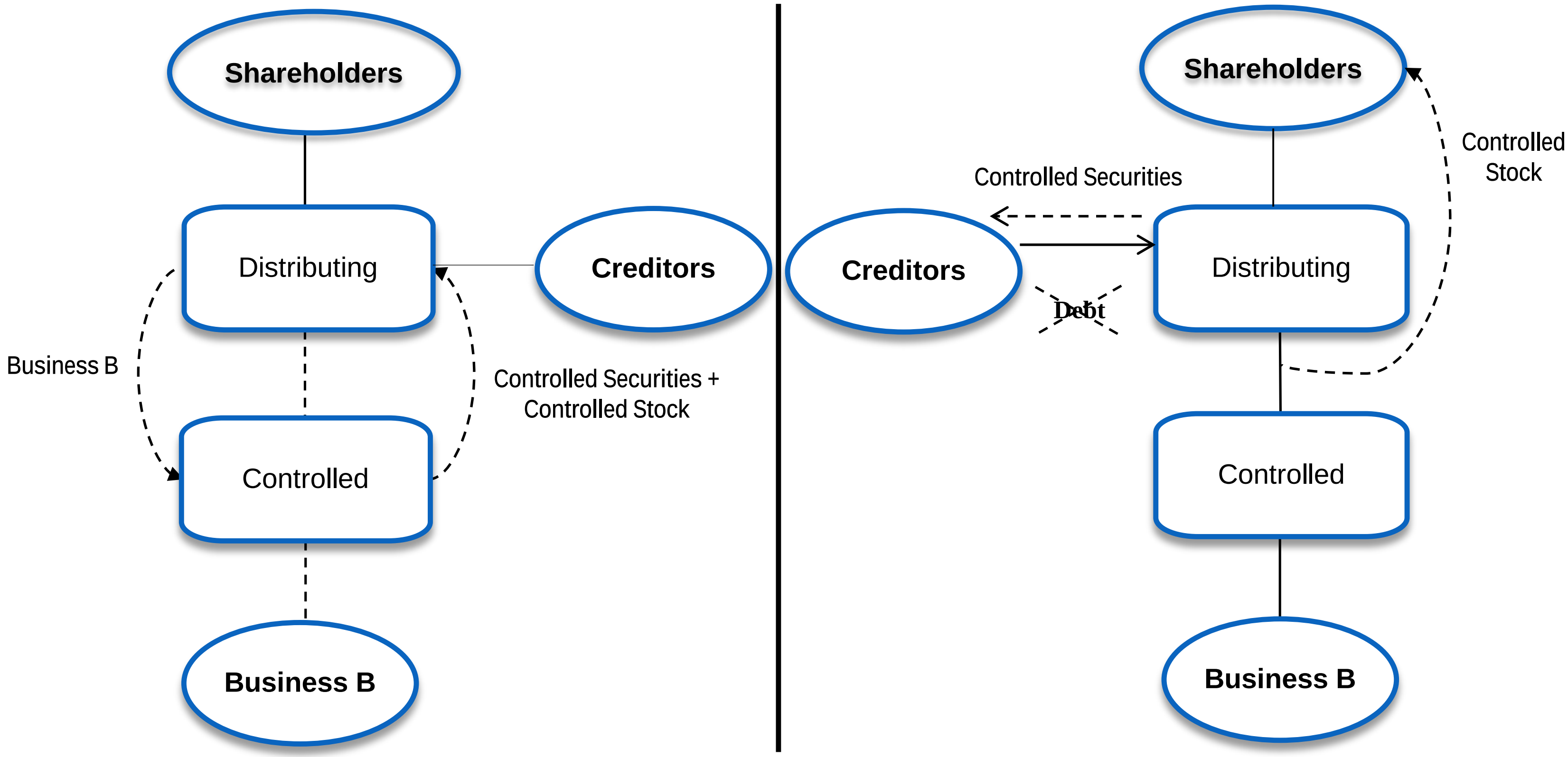
- Cash distributed by Controlled in excess of tax basis in contributed assets generally will have gain implications.
- Boot purging rule of Section 361--Cash distributed pursuant to plan of reorganization within 18 months to repay debt, make distributions to shareholders or for stock buybacks is not treated as boot in Section 361(a)(1)(D) reorg, subject to basis limitation where used to repay debt.
- Debt repaid can be incurred post-distribution and may include ordinary course liabilities (e.g., compensation).

SPIN-OFFS – LIABILITY ASSUMPTION



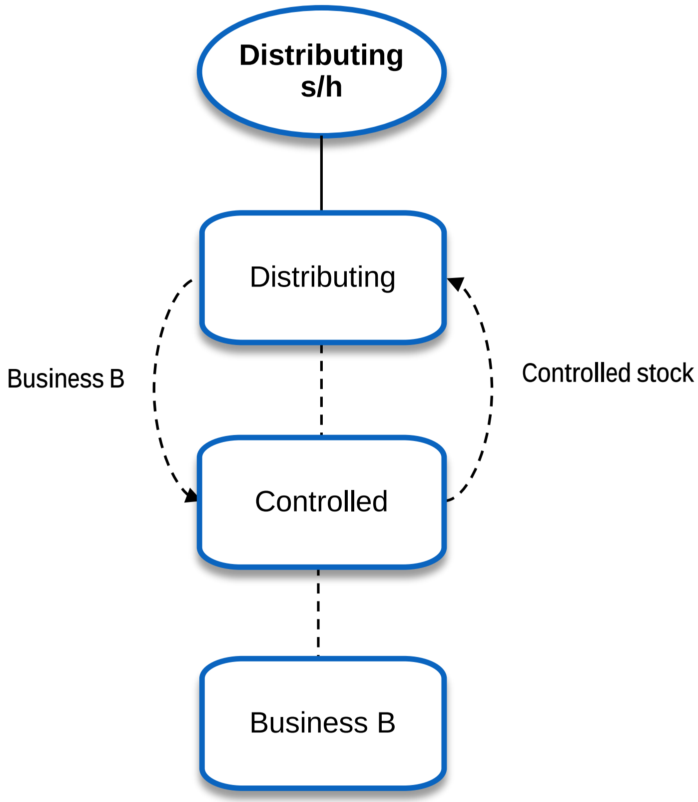
– Distributing recognizes gain on contributed assets if liabilities assumed by Controlled exceed basis in contributed assets.
– Gain is recognized under Section 357(c) rather than as an ELA under consolidated return rules. Treas. Reg. Sec. 1.1502-80(d)(1).

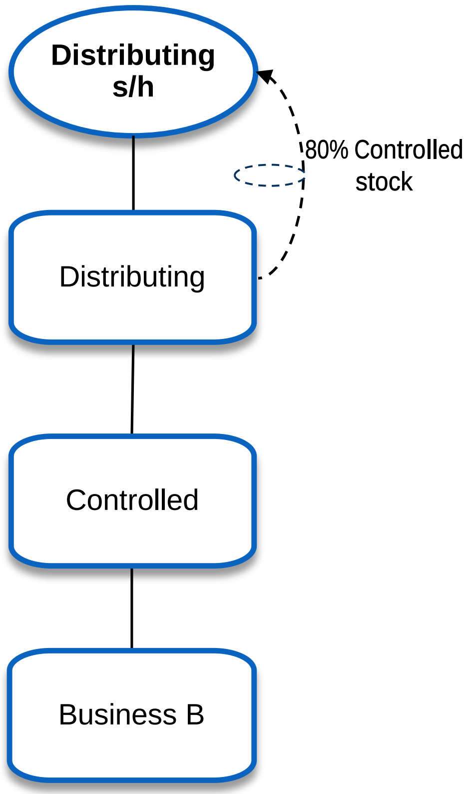
SPIN-OFFS – DEBT EXCHANGE



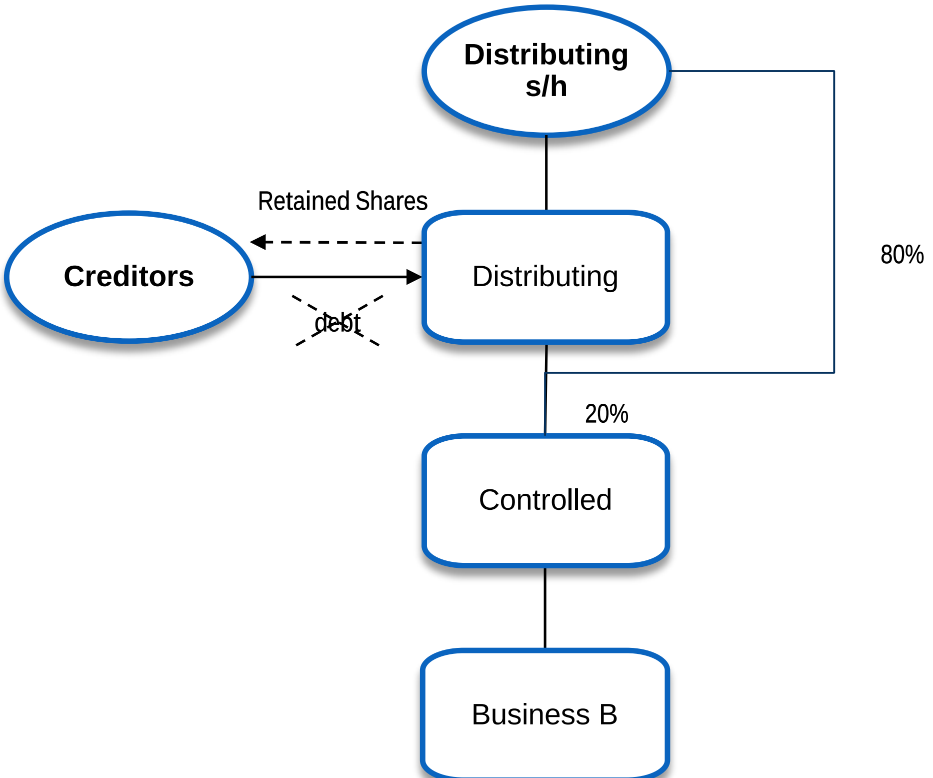
- Contribution of Business B in exchange for Controlled stock and securities is reorganization under Section 368(a)(1)(D). Controlled securities can be transferred tax-free to Distributing creditors as part of the plan of reorganization, whether or not the creditors hold Distributing securities. Section 361(c)(3).
- Basis limitation does not apply.
- Debt exchange may be facilitated by an investment bank, subject to 5/14 Standard. *See, e.g.,* PLR 200808006.

SPIN-OFFS – RETAINED SHARES





SPIN-OFFS – RETAINED SHARES



- Retained share transfer may be facilitated by an investment bank, subject to 5/14 Standard . Bank may enter into hedging arrangements (for interest and/or credit risk) with respect to debt. Retained shares should be transferred to Bank within 18 months after the distribution (but no sooner than 14 days after bank acquires debt).
- Within [18 months] retained shares may also distributed to Distributing shareholders as a distribution or in exchange for shares of Distributing under Section 355. If not used to repay debt or distributed to shareholders, within five years shares will be sold.
- Consider business purpose, continuing relationships, overlapping board. Representation that there is no tax avoidance motive.
- *See, e.g.,* PLR 201409002.