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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

3 Unanswered Tax Questions Facing M&A Attorneys

By **Amy Lee Rosen**

Law360 (September 25, 2019, 3:11 PM EDT) -- From the treatment of gains realized on property contributed to a newly formed partnership to the active trade or business requirement for tax-free spinoffs, mergers and acquisitions attorneys face additional unanswered questions despite recent Internal Revenue Service guidance.

Recent IRS guidance has addressed many issues in mergers and acquisitions but other areas remain unclear. (AP)

While the IRS has addressed many topics in mergers and acquisitions — such as issuing proposed rules on how to treat built-in gains and losses when a corporation undergoes an ownership change, and finalizing 2016 temporary regulations that imposed a corporate-level tax on certain property transfers from corporations to real estate investment trusts that had been deemed overly burdensome — other areas remain unclear.

For example, in the aftermath of the IRS' revocation of several revenue rulings from the 1950s, it is unknown what will happen with certain types of spinoffs, particularly in technology and pharmaceutical businesses, and what qualifies as an active trade or business.

Here, Law360 examines three important tax issues for mergers and acquisitions attorneys for which additional guidance would be helpful.

Treatment of Contributions to Partnerships

There are some situations in which the purchasing of an equity interest in a limited liability company could trigger the gain from that sale to be treated as ordinary income rather than capital gains, and the IRS has not clearly explained if certain ordering would help avoid that result.

There are two similar transactions that involve a buyer purchasing an interest in an LLC, but the ordering can trigger dissimilar tax results in how the partnership distributions are treated, according to Mark Melton, a partner at Holland & Knight LLP.

In the first example, a buyer purchases an interest of less than 50% in an LLC that was previously wholly owned by a seller, but after applying Revenue Ruling 99-5, that purchase is an undivided interest in the assets followed by a contribution of those assets to the LLC or partnership, which means that the buyer is treated as the purchaser of the asset, he said. Typically, in a 99-5 transaction the seller is treated as selling a percentage of each asset to the buyer, then each party contributes their undivided interests in each asset to a new partnership, in which the gain generally will be capital gains, Melton said.

In a second example, if the buyer contributes the same cash to the LLC or partnership, and that entity then distributes cash to the seller, this is treated as though the buyer made a cash contribution after the new entity became a partnership for tax purposes, which means the LLC purchased an undivided interest in the assets, he explained.

The second situation can be treated as a taxable sale between the partnership and seller, in which rules for asset sales will apply to determine which parts of the gain are capital and which are ordinary gains. But what can happen next is if the LLC is a related party, then Section 1239 of the tax code may recharacterize part of the gain to ordinary income instead of as capital gains because the seller is retaining a controlling interest, Melton said.

"This doesn't happen in the former structure as long as buyer isn't related to seller [and] it just seems odd you could get this bad result by simply doing the transaction the wrong way," he said. "It would be nice if Treasury could clarify in regulations that 1239 wouldn't apply to this kind of situation where the substance of the transaction is one that is actually among an unrelated buyer and seller."

When he has clients that are dealing with this issue, Melton said he makes sure that he drafts the documents to treat the transaction as occurring in an order that gets the right answer.

"But there still isn't any assurance that our deemed order would be respected," he said.

This fact pattern becomes even more complicated when the buyer is using a bank loan for the acquisition and the bank is making the loan to the LLC and not to the buyer. However, there is still no problem if the loan proceeds are distributed to the seller right before the transaction, while the LLC remains a disregarded entity, Melton said.

"But if the loan proceeds are treated as being distributed immediately after the LLC becomes a partnership, that distribution will be treated as disguised sale proceeds to the extent the underlying debt is allocated to buyer under Section 752," he said. "Once again, this could result in a Section 1239 recharacterization of part of the gain."

Right now there is no guidance on whether the distribution happens before or after the LLC becomes a partnership. But if the transaction really is between two unrelated parties, then Section 1239 may be applied in a way that doesn't achieve its policy purpose, which is to stop someone from selling an asset and recognizing capital gain at a 20% tax rate and having the controlled entity depreciate that asset at a new stepped-up basis while generating deductions against ordinary income tax at 37%, Melton said.

"It's an unintended consequence of the statute," he said.

Active Trade or Business in 355 Spinoffs

Section 355 is a provision of the tax code that allows a corporation to give its shareholders the stock of a subsidiary in a spinoff in a tax-free manner so that no dividend income is triggered for those shareholders. But some murkiness lies in what qualifies as an active trade or business requirement that can successfully be spun off for that tax benefit.

Historically, Revenue Ruling 57-492 said that when a petroleum or refining company tried to separate its exploration business, which had a lot of expenditures but not much revenue, from its production business, it could not qualify as an active trade or business for purposes of Section 355, according to Devon M. Bodoh, a partner at Weil Gotshal & Manges LLP.

"The idea is that to be active you have to be engaged in a commercial activity that generates revenue," he said. "But the IRS revoked those rulings in order to study whether a business can qualify for active trade based on entrepreneurial activities that take place with the purpose of earning revenue in the future even though no revenue has been realized currently."

Spinoff transactions, which involve distributing stock and securities of a controlled subsidiary to shareholders, have garnered closer scrutiny from the IRS since September 2015, when it said it had learned some businesses were using Section 355 to distribute their earnings and profits improperly.

But is unclear how the ruling's suspension affects pharmaceutical companies, which may have a lot of value but little in revenue, as well as technology or other startup companies, Bodoh said. For example, if a company is established to create a drug that cures cancer, it must go through trials and invest in refining the drug and making a delivery mechanism before the drug can generate revenue.

"At some point in time someone would pay you for that business because there's future income that will be coming, assuming you can bring it to market and continue the investment," he said. But it's unclear what the revocation of the 1950s regulations means for businesses such as pharmaceutical companies, technology businesses or other random startups and whether they will be able to do Section 355 spinoffs.

"I hope they end up with the proper answer and I think the proper answer is that if a company is seeking revenue and is operating like a business with the idea of capturing revenue, whether they currently capture the revenue or not should be irrelevant," he said. "It's not a passive endeavor to invest in a business prerevenue."

How to Treat Holdback of Proceeds Contingent Upon Employment

One area practitioners are grappling with has to do with what happens when a company buys the shares of another company, but ties a portion of the proceeds to employment, since it is unclear if those payouts are compensation, taxed at an individual rate or instead are share proceeds that are subject to capital gains.

Sarah-Jane Morin, a partner at Morgan Lewis & Bockius LLP, told Law360 sometimes when a company takes over another company, like a startup, the owners of the startup receive a cash payout, but the deal may be contingent upon retaining one or more employees for a certain period of time after the acquisition. In that situation, the retained employee would get a certain percentage paid for their shares — say 80%, which would give rise to capital gains — but the tax treatment of the remaining 20% paid for working there is unclear, she said.

"The baseline issue is that they're just getting money, but part of their money is deferred to make sure that they actually stick around, and that’s where we get into this complication,” Morin said. “What is the 20%? Is that compensation? Although that’s being paid for the purchase of shares, it is handcuffed to one year of employment, so is it now one year of compensation or is it share proceeds subject to capital gains?”

Morin told Law360 that the controlling company may not want to treat the 20% as a holdback of proceeds subject to capital gains tax because the acquiring company may be worried about the risk of an audit. This is especially true with large multinational corporations that are engaging in a lot of these types of transactions, which carry with them a lot of frequent reporting requirements, she said.

“So they could open the door for all of their acquisitions where all of these holdback arrangements are examined and go back and withhold as if they paid compensation, which would trigger interest, and worst case, penalties, for failing to withhold in the first place,” Morin said.

But the shareholders who are selling their stock to the new controlling company would want the proceeds to be treated as capital gains, since that carries a lower tax rate than the individual tax rates, she said.

For now, practitioners have to rely on case law to analyze whether the holdback of proceeds is compensation or not, but it is currently not on the IRS’ priority guidance list, Morin said.

“I think proposed rules would be great, but I’m not hopeful,” she added.

--Additional reporting by Vidya Kauri. Editing by Tim Ruel and Neil Cohen.