

TAX UPDATE

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Deductibility of Transaction Costs for a Target Company: No Safe Harbor in Deemed Asset Deals



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On June 10, 2016, the Internal Revenue Service released a Chief Counsel Memorandum dated July 8, 2015, addressing the issue of whether a target S-corporation, which participated in a transaction in which the parties made a Section 338(h)(10) election, could avail itself of the safe harbor election of Revenue Procedure 2011-29 for purposes of deducting certain success-based fees. As described below, the Service's view is that the target S-corporation cannot make such an election, and all deductible expenses need to be determined under the applicable law.

General Rules for Deduction vs. Capitalization of Transaction Costs

In general, Treas. Reg. Section 1.263(a)-5, *et seq.*, was adopted to provide a regulatory regime for the treatment of transaction costs incurred to facilitate an acquisition of a trade or business. The Internal Revenue Code, Treasury Regulations, Service rulings and case law have historically found that taxpayers may divide transaction-related costs into three categories: (i) costs deductible under Sections 162 and 165; (ii) costs capitalizable and amortizable under Sections 167, 168, 195, 197 and 248 or other authorities; and (iii) costs capitalizable under Section 263, *INDOPCO v. Commissioner*¹ and other authorities

Section 162(a) generally allows a current deduction for those ordinary and necessary business expenses incurred in a taxpayer's trade or business. A cost that is otherwise deductible may not be immediately deducted if it is considered a "capital expenditure" — a cost that yields future benefits to the taxpayer's business. Section 263 requires capitalization of certain nondeductible expenditures.

Under Treas. Reg. Section 1.263(a)-5(a), a taxpayer must capitalize an amount paid to facilitate any one of 10 specified transactions. The Treasury Regulations clarify that investigatory costs are considered facilitative unless there is a specific exception.² Treas. Reg. Section 1.263(a)-5(e) provides a significant exception for certain transaction costs that are incurred in connection with "covered transactions," which include (i) "[a] taxable acquisition by a taxpayer of assets that constitute a trade or business," (ii) a taxable acquisition of the ownership interests in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) where the acquirer and the target are related immediately after the transaction, and (iii) a reorganization generally described in Section 368(a)(1)(A), (B) and (C) and, in certain instances, Section 368(a)(1) (D).

Success-Based Fees

Treas. Reg. Section 1.263(a)-5(f) provides that an amount paid that is contingent on the successful closing of a transaction specifically described in Treas. Reg. Section 1.263(a)-5(a) (a "success-based fee") is deemed an amount paid to facilitate such transaction. Treas. Reg. Section 1.263(a)-5(f) provides that a taxpayer may maintain sufficient documentation that establishes that a part of the success-based fee is allocable to activities that did not facilitate the transaction, allowing the taxpayer to deduct the portion of the success-based fee sufficiently substantiated as not facilitative of the transaction.

To resolve difficult issues for both the Service and taxpayers in providing relevant documentation for success-based fees, on April 8, 2011, the Service issued Revenue Procedure 2011-29, which provides a safe harbor method for allocating success-based fees between those activities that are facilitative of a transaction and those that are not. The Revenue Procedure applies only to transactions that are covered transactions as defined in Treas. Reg. Section 1.263(a)-5(e)(3), and it allows taxpayers to elect to treat 70 percent of the success-based fees paid or incurred by the taxpayer in taxable years ended on or after April 8, 2011 as amounts that do not facilitate a transaction under Treas. Reg. Section 1.263(a)-5, while requiring that the remaining 30 percent of the success-based fees be capitalized.

CCA 201624021 (July 8, 2015)

The issue before the Chief Counsel's office was whether a target S-corporation, which used the Section 338(h)(10) election to treat the stock sale as a deemed asset sale, could make the safe harbor election under the Revenue Procedure and treat 70 percent of its success-based fees as nonfacilitative fees. The Service stated that, "[w]ith regard to an acquired taxpayer in an asset acquisition, the transaction is not a 'covered transaction' under Treas. Reg. § 1.263(a)-5(e)(3)."

In denying the ability of the target corporation to make the safe harbor election, the Service focused on the language of the covered transaction rule in Treas. Reg. § 1.263(a)-5(e)(3)(i), which "uses the phrase 'taxable acquisition *by the taxpayer*'" (emphasis in original), and found that, in the present case, the "taxpayer" did not make a taxable acquisition. Here, the taxpayer was the seller of the assets, not the buyer. The Service did acknowledge that the taxpayer could perform a traditional analysis with respect to its transaction costs and, if consistent with its facts, could document that a portion of the success-based fees at issue were properly deductible.

Pepper Perspective

The Service took the view that the specific language in Treas. Reg. 1.263(a)-5(e)(3)(i) must be followed and thus disallowed the safe harbor election under the Revenue Procedure to a target corporation electing to treat the sale of its stock as a deemed asset sale under Section 338(h)(10). This approach seems consistent with the historical view of the treatment of transaction costs in an asset sale, which is that such costs are generally treated as an offset to the sales proceeds received in exchange for the assets. See Treas. Reg. § 1.263(a)-5(g)(2)(ii) and Section 1060. Thus, rather than taking what might be an ordinary deduction under Section 162 for 70 percent of the success-based fees, the taxpayer is required to treat such selling costs as an offset to the sales proceeds in the deemed asset sale. This alternative treatment can result in the reduction of capital gains in certain situations (where a significant amount of the assets being sold are capital assets), and, thus, it may be less desirable than a deduction of such costs under Section 162 on the S-corporation's final tax return. Presumably, the same conclusions would be reached by the Service if an election were made under Section 336(e) to treat certain stock sales as asset sales. In those situations, as with the CCA, the target corporation would not be able to make the safe harbor election under the Revenue Procedure. The highly factual nature of the analysis of transaction costs demonstrates the need for contemporaneous documentation during the pendency of the transaction and consultation with a tax advisor who is familiar with these rules to maximize the potential recovery of costs associated with corporate transactions. Consultation

with a tax advisor on these types of issues becomes very important if the parties to the transaction are providing for the benefits of the anticipated transaction cost deductions as part of the deal terms. This approach is becoming more common, and, thus, the federal income tax treatment of transaction costs needs to be resolved, in many of these cases, prior to the close of the transaction. Taxpayers cannot determine the deductibility of a particular cost through a provision in their agreements. They can provide for the economic benefits of any potential deductions to be allocated between the contracting parties, but it is a matter of federal income tax law whether or not a particular transaction cost can be deducted.

Endnotes

1. 503 U.S. 79 (1992). See, e.g., I.R.S. Priv. Ltr. Rul. 2008-30-009 (Apr. 11, 2008) (determining that allocation of transaction costs among various categories is appropriate).
2. Treas. Reg. § 1.263(a)-(5)(b), (e).

Disregarded Entities and Cancellation of Debt Income: Are They Really Disregarded if They Are in Bankruptcy or Insolvent? Will We See More Guidance on When They Are Disregarded?



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When the debt owed by a debtor is cancelled or forgiven, the debtor generally has cancellation of indebtedness (COD) income. COD income is generally includable in gross income, but may be excluded under section 108 of the Internal Revenue Code in some instances. A statutory exclusion exists for COD income that arises in a title 11 bankruptcy case or when the taxpayer is insolvent. Final regulations were issued recently that apply these exclusions to a grantor trust or a disregarded entity (DRE). According to the regulations, DREs include single-member LLCs that do not elect to be classified as corporations, corporations that are qualified REIT subsidiaries and corporations that are qualified Subchapter S subsidiaries.

For example, if a corporation owns 100 percent of an LLC subsidiary and the subsidiary has lent money to a third party, and that debt is forgiven, the LLC has COD income that flows through to the corporate owner. But, what if the LLC is legally in bankruptcy? Or the LLC, on a standalone basis, is insolvent? On one hand, it is appealing to say that, if the entity is legally in bankruptcy, it cannot have COD income. On the other hand, a DRE is disregarded for all federal tax purposes, unless the Internal Revenue Code or regulations provide otherwise (e.g., a DRE has payroll compliance responsibilities and has its own liabilities for payroll taxes).

In the case of determining COD income, the final regulations, effective for COD income occurring after June 9, 2016, provide that the bankruptcy and insolvency exclusions are applied at the owner level; the regulations define the term “taxpayer” for purposes of these exclusions as the owner of a grantor trust or the owner of a DRE. Consequently, if a grantor trust or DRE is insolvent, but the owner of the grantor trust or of the DRE is solvent, according to the regulations, the insolvency exclusion does not apply and the COD income is recognized.

Similarly, for the bankruptcy exclusion to apply, the owner of a grantor trust or DRE must itself be under the jurisdiction of the court as the title 11 debtor. The preamble to the regulations concludes that extending the bankruptcy exclusion to the owner of a grantor trust or DRE who is not in bankruptcy would be inconsistent with the intended purpose of the bankruptcy exclusion, as reflected in its legislative history. The preamble notes that that that debtor’s “fresh start” under the Bankruptcy Reform Act of 1978 is conditioned upon the debtor committing all of its nonexempt assets to the jurisdiction of the bankruptcy court, either for sale by the trustee or to determine an appropriate plan to repay creditors, and that the bankruptcy COD exclusion was enacted in the Bankruptcy Tax Act of 1980 to supplement the Bankruptcy Reform Act. As stated in the preamble:

Congress did not intend that a solvent, non-debtor owner of a grantor trust or a disregarded entity, which has committed some but not all of its nonexempt assets to the bankruptcy court’s jurisdiction, have an exclusion from discharge of indebtedness income merely by virtue of having some of its assets subject to the jurisdiction of the bankruptcy court.

Accordingly, for a taxpayer to claim the bankruptcy exclusion, the taxpayer must actually file a bankruptcy petition, *i.e.*, a discharge of the debt in a petition filed by the DRE or grantor trust will not trigger the exclusion. For a partnership, section 108(d)(6) provides

that the insolvency and bankruptcy exclusions apply at the partner level, and not at the partnership level. The regulations state that, if a partnership holds an interest in a grantor trust or DRE, the bankruptcy and insolvency exclusions are tested by looking at each partner to whom the income is allocable. Such partner must be under the jurisdiction of the court in a title 11 case of that partner as the title 11 debtor, or must be insolvent, for the exclusions to apply.

The position of the regulations regarding the bankruptcy exclusion is contrary to the Tax Court's holdings in the related cases of *Gracia v. Commissioner*, T.C.Memo 2004-147; *Mirachi v. Commissioner*, T.C. Memo 2004-148; *Price v. Commissioner*, T.C. Memo 2004-149; and *Estate of Martinez v. Commissioner*, T.C. 2004-150, known as collectively as *Gracia*. In *Gracia*, some of the general partners who executed personal guaranties on the loan of a partnership that was in title 11 reached a settlement with the bankruptcy trustee to pay agreed-upon sums to the bankruptcy estate to receive discharges from their liability. Pursuant to an order, the Bankruptcy Court discharged the taxpayer (the partner) from all liability to the trustee, the bank and all creditors of the partnership. In the same order, the Bankruptcy Court explicitly asserted its jurisdiction over the partners for purpose of the discharge. Because the Bankruptcy Court had asserted jurisdiction over non-debtor partners for certain matters, the Tax Court upheld the application of the bankruptcy exclusion to the partners of the partnership, even though the partners were not title 11 debtors. The preamble to the regulations states that the IRS's position is that these cases failed to interpret correctly the limited scope of the bankruptcy exclusion, which applies only to partners that are also title 11 debtors. In February 2015, the IRS issued Action on Decision 2015-1, nonacquiescing in the *Gracia* cases.

There are several areas that the Department of the Treasury and the IRS anticipate addressing in more detail in future guidance. These include when debt of a DRE is taken into account in determining an owner's insolvency and how a grantor's share of the liabilities of a multiple-owner grantor trust should be determined for purposes of assessing the owner's insolvency. Although not included in the regulations, the preamble states that Treasury and the IRS are of the view that indebtedness of a grantor trust or a DRE is indebtedness of the owner and that, assuming that the owner has not guaranteed the debt and is not otherwise liable for it, the debt should generally be treated as nonrecourse debt for purposes of the insolvency exclusion. The preamble states that Treasury and the IRS will continue to review these views and provide additional guidance for further clarification. The IRS requests comments on these topics. The final regulations apply to COD income occurring after June 9, 2016.

Under these COD exclusion regulations — even though the grantor trust or DRE is the party that is the debtor, either in or outside of bankruptcy, and is the party that is legally responsible for the debt — the owner is not permitted to utilize the bankruptcy and insolvency exclusions. However, in other areas of the tax law, an owner that has no legal liability for debt can benefit from the debt of a DRE or grantor trust. For example, if a single-member LLC is a shareholder of an S corporation and lends money to the S corporation, the owner of the LLC will get basis in its S stock, even though the owner has no legal liability for the debt. Similarly, when a DRE that is created under foreign law pays foreign income taxes, such taxes are treated as taxes paid by the owner for purposes of obtaining a foreign tax credit, even though the legal liability for the taxes is that of the DRE. The difference in these instances from the bankruptcy COD exclusion relates to the specific purposes for the exclusion as set forth in the legislative history to the bankruptcy acts. The bankruptcy acts make explicit that it is the owner's assets that must be committed to the bankruptcy court's jurisdiction, and, therefore, conducting business through a DRE or grantor trust that enters into bankruptcy does not achieve that result. With regard to the insolvency exclusion, if it applied at the entity level, every business venture could become eligible for the exclusion if the business did not go well simply by being conducted by a DRE or grantor trust.

Pepper Perspective

The position of the final regulations had been set forth in the proposed regulations, and, therefore, taxpayers were on notice concerning the IRS's views. As to the bankruptcy exclusion, the preamble makes it clear that the IRS's position is that the owner must be a title 11 debtor; the IRS does not accept the holding in *Gracia* that the bankruptcy exclusion applied to the partners of the partnership because the Bankruptcy Court had asserted jurisdiction over the non-debtor partners for certain matters, even though the partners were not title 11 debtors. The position of the final regulations that the owner of a DRE or grantor trust must be insolvent prevents taxpayers from taking advantage of the COD rules by conducting business in the form of a DRE or grantor trust.

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