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M&A Tax, International Tax & Tax Accounting Update

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HIGHLIGHTS

Recent Inversion News

Although IRS issued notices in each of the last two years aimed at curbing inversions (Notice 2014-52 and Notice 2015-79), two U.S. corporations recently announced plans to merge with foreign corporations. While these transactions may not be entirely within the scope of the Notices, some consider these transactions to be inversions. Section 7874 and most of the operative rules of Notice 2014-52 and Notice 2015-79 apply only to situations in which the shareholders of the U.S. corporation ultimately own at least 60 percent of the resulting foreign parent. However, section 367 imposes a shareholder level tax (but no corporate level tax) on U.S. shareholders in many inversion transactions in which the U.S. shareholders ultimately own more than 50 percent of the resulting foreign parent.

On January 19, Texas-based Waste Connections Inc. announced that it will invert into Canada after merging with the Canadian-based Progressive Waste Solutions Ltd. Waste Connections stockholders are expected to own approximately 70 percent of the combined company. As a result, this transaction could be subject to the proposed rules outlined in Notice 2014-52 and Notice 2015-79, if such rules were finalized

On January 25, Johnson Controls, Inc. announced that it will merge with Tyco International Ltd., a previously inverted company, under a new foreign parent resident in Ireland. According to the announcement, Johnson shareholders will own 56 percent of the shares in the new foreign parent. In contrast to the Waste Connections Inc. transaction, this transaction generally would not be subject to the rules in Notice 2014-52 and Notice 2015-79. However, if the transaction otherwise qualified as a tax-free reorganization under section 368(a), section 367 would subject the Johnson Controls, Inc. shareholders to shareholder level tax.

IRS is widely expected to issue regulations implementing aspects of Notice 2014-52 and Notice 2015-79 within the next few months. While some IRS officials have publicly stated that they are continuing to draft guidance to address earnings stripping, they have also indicated that such guidance is not likely to be included with the first set of regulations to be released. Because it appears that IRS and Treasury will be issuing guidance under the notices in a piecemeal fashion, time likely remains for taxpayers to urge the government to limit the scope of any such guidance to what is truly necessary to limit inversions.

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Forthcoming Regulations on Device and Active Trade or Business

As promised in Notice 2015-59, IRS has now stated publicly that it is working on a guidance project on device and active trade or business issues in section 355 transactions. The device requirement was created to prevent taxpayers from using section 355 to convert dividend income into taxable gain. This usually involved a transaction in which the shareholder of the distributing corporation sold the stock of the distributing corporation or the controlled corporation immediately after an otherwise valid tax-free spin-off. Notice 2015-59 indicated that IRS is considering issuing guidance to extend the concept of device to reach *General Utilities* repeal.

At the recent ABA Tax Section meeting in Los Angeles, a Treasury Department official indicated that it had no particular transaction in mind when it referenced *General Utilities* repeal in Notice 2015-59. We believe that this indicates that IRS and Treasury have not yet reached a view regarding the exact scope of any new device regulation. As a result, those corporations who could be adversely impacted by such guidance should consider actively lobbying IRS and Treasury to limit the scope of any such guidance.

Tax Accounting News from the ABA Tax Section Meetings

Ivins' Les Schneider led a panel discussion at the recent ABA Tax Section meeting in Los Angeles on the topic "Ratable Service Contracts."

IRS panel members had some interesting observations on accounting for service contracts under the accrual method. These positions have not previously been reported in any published guidance.

For example, if a taxpayer is obligated to provide services to a customer under a contract that is result-oriented (*i.e.*, not divisible into separate performances), no portion of the contract price need be reported as revenue until the completion of the contract, if the contract does not provide for progress billings.

Moreover, even if such a contract contains progress billings, the progress billings may be deferred from revenue recognition by the service provider for up to one year as advance payments pursuant to Rev. Proc. 2004-34, if the progress billings are deferred as revenue for financial reporting purposes. With the GAAP rules on revenue recognition changing in 2018, it may become easier to satisfy this financial conformity requirement.

Also, in satisfying the second part of the accrual requirement for deductions (*i.e.*, whether an amount that is owed is reasonably determinable), case law provides that information that is determinable from a taxpayer's own book and records satisfies this requirement. IRS now extends this principle to information in the hands of a third party with whom a taxpayer has a contractual relationship. For example, if a service provider is billing a job by the hour, the contractor's knowledge as to the number of hours worked by year end is attributed to the client for deduction purposes, even if the client does not receive a bill by year end.

Private Letter Ruling Released in Spin-off in Which Active Business Acquired in Anticipation of the Transaction

IRS released a private letter ruling (PLR 201603020) which rules on the active trade or business requirement under section 355. The entity which was distributed to shareholders in a spin-off ("Controlled") sought to satisfy the active trade or business requirement based on the business of an S corporation it had recently acquired in a type-B reorganization. The taxpayer received a favorable ruling on the small size of the active trade or business assets, a ruling which is of limited value to other taxpayers because the PLR contains no numbers and this is currently a "no-rule" area as IRS studies the issue further.

The taxpayer also received a ruling that the active trade or business requirement could be satisfied by the line of business which was acquired by Controlled. While this ruling is entirely consistent with section 355(b), many corporations are surprised to discover that it is possible to satisfy the "5-year active trade or business requirement" with an active trade or business acquired less than five years before the spin-off, provided that the business was acquired in a tax-free transaction.

Although it is not clear from the ruling itself whether the active trade or business was acquired for the purpose of being able to satisfy the active trade or business requirement, it may be possible for taxpayers to do so if the planned spin-off otherwise has a good business purpose and satisfies the other requirements of section 355.

Private Letter Ruling Released in Spin-off in Which Losses are Triggered

IRS released a private letter ruling (PLR 201603002) involving a spin-off in which the requested rulings involved, not the spin-off itself, but instead whether losses from intercompany transactions carried out in anticipation of the spin-off would be taken into account at the time of the spin-off. The losses at issue involved not only sales of active business assets, but also the sale of built-in loss notes issued by a third party in connection with an earlier acquisition, in each case for fair market value consideration. IRS ruled that the losses realized upon the intercompany sales would be taken into account once the assets left the consolidated group and the section 267(f) controlled group as part of the controlled corporation in the spin-off.

The taxpayer represented to IRS that the spin-off would have taken place regardless of whether the losses would be recognized, but there is no indication in the private letter ruling that the sale of the third-party notes was motivated by anything other than the desire to obtain the tax benefit of the losses. This private letter ruling serves as a reminder to taxpayers to consider whether they have similar losses that could be harvested in connection with a spin-off.

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Litigation Update

On January 29, the plaintiffs in *Florida Bankers Association v. Department of the Treasury* (*see* our September 2015 update) filed a petition for certiorari seeking Supreme Court review of the D.C. Circuit decision holding that the case was barred by the Anti-Injunction Act.

The government has until February 29 to file a response to the petition, but it is common for the government to seek and receive one or more extensions of time to file responses to certiorari petitions. It is likely that there will be several amicus briefs filed in support of the petition.