

# Tax Update

**Pepper Hamilton LLP**  
Attorneys at Law

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## Definition of a Liability at the Forefront of Court Decisions: *Klamath & Coltec*

*District court holds regulation invalid in Klamath; Court of Appeals for the Federal Circuit validates the economic substance requirement in Coltec*

**A**s we go to press, two cases of note have been decided: *Klamath Strategic Investment Fund, LLC v. US*, U.S. District Court for the Eastern District of Texas, case 5:04-cv-00278-TJW, filed July 20, 2006; and *Coltec Industries, Inc. v. US*, 98 AFTR 2d 2006-XXXX, July 12, 2006. We will address them in more detail in the August Update, but highlight key items here.

### Klamath

The transactions involved were the topic of Notice 2000-44. Very simply, in 2000 the taxpayer borrowed \$41 million from a bank. The bank also paid \$25 million to the borrower, in exchange for an agreement that the \$41 million loan bear a higher rate of interest. The obligation to repay the

\$25 million was conditional on the prepayment of the \$41 million loan. Taxpayer transferred the obligations to a partnership. The issue was whether the taxpayer had transferred a liability of \$66 million to the partnership, which would have triggered a reduction in basis in the partnership interest of \$66 million. The taxpayer had taken the position that the only obligation was the \$41 million, because the obligation to repay the \$25 million was conditional. The government took the position that the arrangement was the functional equivalent of a borrowing of \$66 million with a lower interest rate. The government also relied on Treas Reg. Section 1.752-1(a)(4)(ii), which states that for purposes of the basis rules in Section 752, liabilities include "any fixed or contingent obligation...without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code." The regulation was promulgated in 2003 and was effectively applicable only to transfers that occurred between 1999 and 2003.

The court had two holdings - the loan premium of \$25 million was not a liability under case law that existed in 2000, because it was contingent, and

## Speaker's Corner

**David Kaplan** was a guest lecturer at the Temple Law School Graduate Tax Program on "Stock Option Pricing -- Law, Policy and Practice" on July 20, 2006.

**Philip Cook** will present state and local tax updates for the Community College of Allegheny County CPA Continuing Education Program on August 3, 7, and 9, 2006. Each session is three hours.

**Chuck Potter** will present a state and local tax update on September 4, 2006 to the P.I.C.P.A. Pittsburgh Chapter.

**Joan Arnold** will speak at the International Fiscal Association joint US-German meeting in Cologne Germany on September 14-16, 2006. Her topic is working with the German Thin Capitalization Rules in Acquisitions.

the retroactivity of the regulation is effective to taxpayers who made transfers before the issuance of 2000-44.

### Coltec

*Coltec* is a much anticipated decision, because it considered a Court of Federal

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Claims decision that held that the economic substance doctrine was unconstitutional because it violated the separation of powers. The appeals court wasted no time in announcing that the lower court ruling was simply untenable and wrong, and held that the economic substance test has viability and applicability. But the case did not stop there. *Coltec*, like *Klamath*, involved the definition of liabilities for purposes of determining basis, although *Coltec* applied Section 358, in the context of a transfer to a corporation pursuant to Section 351. The court in *Coltec* ultimately decided that the transaction in question met the requirements of the Code, but failed the economic substance test; therefore, the anticipated tax benefits would not be realized. In getting to that answer, the Court decided that contingent liabilities were liabilities for purposes of Section 358. The analysis, at least at first blush, has some difficulties, which we will review further next month.

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## To Step or Not to Step

One of the most vexing issues in structuring acquisitions is whether the steps of the acquisition will be collapsed with the resulting tax treatment being other than what was expected. On July 5, 2006, the IRS released regulations under §338(h)(10) that provide helpful guidance in the area.

In Rev. Rul. 90-95, the IRS advised that if an acquisition is a “qualified stock purchase,” it would be treated as independent from subsequent events, even if they were pre-planned. A QSP is a purchase by a corporation of more than 80 percent of the stock of the target in a transaction that does not give the buyer a carryover basis. For example, if Company T bought all of the stock of Company A for cash and immediately liquidated A into T, the independence of the steps would be respected, and there would be (1) a purchase of the A stock and (2) a liquidation of A into T, pursuant to §332. The goal was to provide that the only way to get into deemed asset sale treatment was through the making of an election under §338.

Rev. Rul. 90-95 dealt solely with transactions that could not have been reorganizations governed by §368 even if they were stepped together, because they would not have met the continuity of proprietary interest test. A healthy debate developed over the impact of Rev. Rul. 90-95 on the use of the step transaction doctrine to determine if a multi-step structure resulted in a tax free reorganization and the potential impact on the

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***The benefit of a §338(h)(10) election can be quite substantial and frequently impacts the sales price of a company. The IRS offers helpful guidance.***

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ability to make a §338 election. For example: T acquires 100 percent of A's stock for T stock worth \$100 and cash of \$1.00. T immediately liquidates A into T pursuant to a prearranged plan. If the steps were respected, the first step results in a taxable stock purchase (the cash blows the "B" reorganization), and the second step is a tax free liquidation under §332. But, if the steps are collapsed, the overall transaction may well qualify as a “C” reorganization under §368(a)(1)(C). Thus the question: was the acquisition of the A stock a QSP? If the transaction were a reorganization, there would be a carryover basis in the stock, which would preclude QSP status. Rev. Rul. 2001-46 settled this issue by providing that if the steps were collapsed and the overall transaction meet the tests of §368, it would be a reorganization and Rev. Rul. 90-95 would not prevent such a conclusion. As a result, a §338(h)(10) election could not be made for the target because there would not have been a QSP. Tax professionals were quick to ask for a middle ground and the IRS

responded with Treas. Reg. §1.338(h)(10)-1(c)(2).

Under the regulations, a taxpayer may choose to effectively apply Rev. Rul. 90-95 to separate two steps in a transaction if it wishes to make the election under §338(h)(10) with respect to the stock acquisition, even if the overall transaction would otherwise qualify as a reorganization if the steps were collapsed.

Example: P owns 100 percent of the stock of Y. A owns 100 percent of the stock of T. P wants to acquire the stock of T. Y merges with and into T, T survives and A receives P stock and cash of equal value. Immediately thereafter, T merges into P.

The first step is a QSP, if viewed independently, because there is too much cash to qualify as a reorganization under §368(a)(2)(E). But, if the transaction is viewed as one integrated transaction, it qualifies as a reorganization under §368(a)(1)(A), and thus there is no QSP.

If both of T and A agree to make an election pursuant to §338(h)(10) as to the first step, the regulations provide that the acquisition of the T stock will be a QSP. If no election is filed, the transaction will be a reorganization pursuant to §368(a)(1)(A).

It's important to note that these rules apply solely to elections made pursuant

to §338(h)(10). They do not apply to §338(g) elections. Thus, acquisitions in which a §338(h)(10) election cannot be made are still governed by Rev. Rul. 90-95 and Rev. Rul. 2001-46.

### Pepper Perspective

The benefit of a §338(h)(10) election can be quite substantial and frequently impacts the sales price of a company. The ability to make the election and not worry about it being tainted by subsequent events is welcome relief.

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## Selling and Buying From Yourself - Negative Tax Results of Related Party Transactions

The notion that transactions between affiliated corporations filing consolidated returns are subject to a series of complex rules that may defer or disallow the recognition of related items of deduction or loss (among other items) is generally familiar to many taxpayers. Perhaps slightly less well known is the notion that transactions between “related” taxpayers are subject to a similar series of complex rules that may defer or disallow the recognition of related items of deduction or loss (among other items).

A recent Chief Counsel Advice Memorandum, 200617036 (January 12, 2006), highlights a case where the purported loss that was generated by sales and transfers

between certain related parties was disallowed by the Internal Revenue Service (IRS) under Section 267 and Treas. Reg. Section 1502-13.

### In General

Section 267 of the Internal Revenue Code generally provides that no deduction shall be allowed in respect of any loss from the sale or exchange of property between certain related parties. Related parties include, but are not limited to, two corporations that are members of the same “controlled group.”

In an exception to the general disallowance rule of Section 267(a), Section 267(f) provides that, with respect to any loss from the sale or exchange of property between

members of the same “controlled group,” such loss shall not be disallowed, but shall generally be deferred until the property is transferred outside such controlled group. However, to the extent the buying member transfers the property to a related nonmember, the loss or deduction is taken into account only to the extent of any income or gain taken into account as a result of the transfer. The balance is treated as a loss that can only be used to offset gain on a later disposition of such property.

### Controlled Groups

Section 267(f) also provides that the term “controlled group” generally refers to corporations that would meet the requirements of a controlled

group under the consolidated return regulations if the threshold ownership requirements were reduced from “at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of stock” to “more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock.”

While fairly simple on its face, in application this rule can be quite complex. For example, in *Turner Broadcasting Systems, Inc. v. Commissioner*, 111 T.C. 315 (1998), the court examined the issue of when the determination must be made as to whether the corporations involved in the transaction were members of a “controlled group.” In that case, pursuant to a plan, the shareholders of MGM (including Tracinda) sold their MGM shares to TBS; MGM sold the shares of its wholly-owned subsidiary, UA, to

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***Caution is warranted when structuring exchanges between related parties. A company involved in transactions with related parties should evaluate the impact of the rules before taking into account items of income, gain, deduction and loss on their tax return.***

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Tracinda at a loss; and Tracinda sold some of the UA shares received to certain public shareholders. The parties stipulated that prior to the UA sale, Tracinda, MGM and UA were all members of a controlled group; after completion of the UA sale, MGM was no longer part of such controlled

group. The court, following an evaluation of the legislative history of Section 267 and the consolidated return regulations, concluded that the appropriate time to determine whether corporations are part of a controlled group is “immediately after” the transaction and not the time the parties enter into a “binding commitment” to undertake such transaction. As a result, MGM was entitled to deduct its loss on its sale of UA shares to Tracinda since MGM and Tracinda were not members of a controlled group immediately after the sale of the UA shares.

#### **Chief Counsel Advice 200617036**

In Chief Counsel Advice 200617036, the IRS evaluated a similar issue and took the position that the purpose of Section 267 prevented a taxpayer from structuring a transaction in order to claim a loss on a sale of distressed securities where such taxpayer effectively retained control over such distressed securities. The IRS and the

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taxpayer agreed that the transactions at issue in that case should be viewed for tax purposes as follows: 1) Parent sold its distressed securities to Subsidiary (a wholly-owned subsidiary) in exchange for Subsidiary Class A and Subsidiary Class B stock; 2) Subsidiary contributed the distressed securities to Partnership (a partnership wholly-owned by members of Parent's consolidated group) under Section 721; and 3) Parent sold the Subsidiary Class A stock to Bank Sub. Parent and Bank also agreed that so long as Bank held stock in Subsidiary, Parent would control Partnership.

### **Basis of Disallowing the Loss**

In arguing that the loss purportedly generated by the sale of distressed securities between related parties could not be taken into account by the taxpayer, the IRS argued that immediately after the sale of distressed securities to Subsidiary and before the sale of the Subsidiary Class A stock, Subsidiary was a member of the controlled group of corporations that included Parent (Parent Controlled Group), and as a result, the loss on the sale should be deferred. To reach this result, the IRS disregarded the remaining steps of the transaction and simply looked to the relationship of the parties immediately after the sale of the distressed securities to Subsidiary. The IRS then examined the consequence of the transfer of the distressed securities to Partnership and concluded that such transfer was a transfer to a related party that should be disallowed because the taxpayer still retained effective control over the property "transferred." Thus, the transaction should be viewed as merely an intercompany transaction under Treas. Reg. Section 1.1502-13.

In addition, the IRS argued that, even if the Subsidiary was not a member of the Parent Controlled Group immediately after the sale, the transaction fell under the anti-avoidance rules of the regulations because of the mechanical attempts to remove the transaction from the literal language of the disallowance provisions. In making this argument, the IRS asserted that because of the dominion and control by the taxpayer over the partnership and the reversion rights under the agreements, the facts of this case were even stronger than those set forth under an example in the regulations to which the anti-avoidance rules were applicable.

Finally, the IRS disagreed with the taxpayer's selective application of the step transaction doctrine, and concluded that the appropriate application of the step transaction doctrine would be a deemed sale by Parent of the distressed securities to Partnership. In taking this approach, the IRS argued that the anti-avoidance rules were intended to apply to disallow the loss as it applies to sales between a corporation and a related partnership. In addition, the IRS concluded that the taxpayer's attempts to interpose a non-consolidated corporation as an interim holder of the property at issue had no economic significance, and thus, must be disregarded for federal income tax purposes.

### **Pepper Perspective**

The rules characterizing the tax consequences of transactions between "related" taxpayers are numerous. Section 267 and Treas. Reg. Section 1.1502-13 include just a few examples of these rules, and when viewed in light of the IRS's willingness to invoke its

authority under the anti-avoidance rules provided by the regulations, caution is warranted when structuring exchanges between related parties. Thus, a company involved in transactions with related parties should evaluate these and other rules to determine the impact of such rules before taking into account items of income, gain, deduction and loss on their tax return. In addition, when evaluating a potential target company for acquisition, purported losses should be evaluated carefully to ensure that these related party provisions were not implicated in generating losses on the target company's books.

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