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IRS Memorandum May Offer Taxpayer Benefits Relating to Conversions of Insolvent Foreign Corporations Into Partnerships

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The Internal Revenue Service's recently issued general legal advice memorandum (GLAM) should provide beneficial results to certain taxpayers that use a check-the-box election to convert an insolvent foreign corporation into a partnership.

Overview

The Internal Revenue Service (IRS) recently issued a generic legal advice memorandum, AM2011-003 (the GLAM), that is quite noteworthy. The GLAM addresses a common fact pattern where a check-the-box election is made to convert an insolvent foreign corporation into a partnership. As described below, the GLAM will be of primary significance for taxpayers under audit or in litigation.

Five divisions of the Office of Chief Counsel at the IRS were involved in drafting the GLAM, and it was directly approved by the by Chief Counsel. The GLAM thus can be viewed as the current position of the entire IRS with respect to the transaction it addresses.

The GLAM contains a number of surprising and far-reaching conclusions of law. Most of these conclusions are favorable to taxpayers. Moreover, the few conclusions that could be viewed as adverse should not be binding on taxpayers, because the GLAM does not have the force of law and its legal analysis with respect to these issues is not well supported.

It should be noted, however, that there are significant questions regarding the extent to which the favorable results described in the GLAM can be relied upon by taxpayers when planning transactions or reporting uncertain tax positions. First, the GLAM does not address a central issue (a debt-equity concern) presented by its facts that would need to be developed in an actual case. Second, the GLAM's reasoning appears inconsistent in some respects with existing law, as well as the IRS's previously stated positions, on a variety of issues (including an IRS notice addressing a listed transaction). Third, a GLAM cannot be used or cited as precedent. Finally, the GLAM was not issued in consultation with the Treasury Department, and thus Treasury's views regarding the GLAM are unclear. In short, it may be difficult to issue legal opinions based on the GLAM with respect to some of the GLAM's most important conclusions.

Nonetheless, taxpayers under audit or otherwise before the IRS should be entitled to invoke the GLAM, as it represents the current position of the Chief Counsel. In addition, taxpayers can cite the GLAM as evidence of the IRS's informal views on a variety of issues that may arise in litigation.

Following is a technical analysis of the GLAM, with a focus on corporate tax issues and some discussion of more general tax principles that are implicated by the GLAM.

Analysis

The GLAM discusses two situations. In Situation 1, the foreign corporation is insolvent because of recourse debt owed to a shareholder. In Situation 2, the foreign corporation is insolvent because of nonrecourse debt owed to a third party.

Following is a summary of Situation 1. The facts set forth below are simplified and modified in order to highlight the GLAM's conclusions more starkly.

A. SIMPLIFIED FACTS

Domestic corporation P owns 100 percent of foreign corporation S and 80 percent of foreign corporation T; S owns the remaining 20 percent of T. P has a $100 basis in the T stock and S has a $30 basis in the T stock.

P also owns a $100 recourse note from T (the Note). T has a single asset (Asset X) that is worth $5, and T is insolvent because of its debt to P.

T elects to be a partnership under the entity classification regulations. As a result, T is deemed to distribute all its assets and liabilities in liquidation to P and S; P and S are then deemed to contribute these assets and liabilities to a newly formed partnership (New T). (See Treas. Reg. 301.7701-3(g)(1)(ii).)

The GLAM provides the IRS's views on the consequences of the deemed liquidation of T and the deemed formation of New T.

B. CONSEQUENCES OF THE DEEMED LIQUIDATION OF T

1. Although the Note is extinguished in the deemed liquidation, it is also reconstituted immediately thereafter upon the formation of New T (i.e., it becomes a $100 obligation from New T to P). The GLAM concludes that this series of deemed transactions does not result in a significant modification of the Note under the rules governing the modification of debt instruments in Treas. Reg. § 1.1001-3 because the Note is never extinguished. In effect, the GLAM is applying a type of step transaction doctrine under the modification regulations; it looks at the Note before the check-the-box election and then at the end of the series of deemed transactions (disregarding the momentary extinguishment of the Note), and concludes that the Note remains essentially the same.

In the abstract, a step transaction analysis for debt modifications makes logical sense. However, as described below, the GLAM extends this concept—which is the driving force behind the remaining analysis in the GLAM—so broadly that several illogical conclusions are reached.

The first point regarding the GLAM's analysis of the debt modification regulations is that it neglects to consider the effects of recently issued Treas. Reg. § 1.1001-3(f)(7). This provision clarifies that a modified debt instrument will not be treated as equity solely by virtue of a deterioration in the financial condition of the issuer (which, helpfully, prevents many routine debt modifications from resulting in a taxable exchange of debt for equity). However, Treas. Reg. § 1.1001-3(f)(7)(ii)(B) provides that the relief from a debt-equity analysis in the regulation does not apply when there is a substitution of a new obligor on the debt instrument.

In the GLAM, New T is a new obligor on the debt to P. Therefore, Treas. Reg. § 1.1001-3(f)(7) would not appear to protect the newly issued obligation to P from being re-tested for debt-equity status. Accordingly, taxpayers should undertake a debt-equity analysis when applying the GLAM rationale to their transactions.

2. P is entitled to a worthless stock deduction of $100 for its T stock if it otherwise meets the requirements of section 165(g)(3) because P does not receive any payment for the stock in the deemed liquidation. (See, e.g., Rev. Rul. 2003-125.) Because S also does not receive any payment on its T stock in the deemed liquidation, S should have a capital loss of $30 under section 165(g)(1).

3. As mentioned above, the Note is not treated as extinguished in the deemed liquidation; therefore, P does not obtain a $95 loss from the liquidation. This is one of the few adverse conclusions in the GLAM. However, if the Note were treated as extinguished, P's loss would likely be capital (see section 1271(a)). By deferring P's loss on the Note, the GLAM positions P to claim a partial bad debt deduction of $95 in the future (which would be ordinary).

As the GLAM indicates in a footnote, the Note would be extinguished under Rev. Rul. 2003-125 if T were a wholly owned subsidiary of P that elected to become a disregarded entity. In that case, the Note would not be reconstituted immediately after the liquidation, and the extinguishment would thus be permanent.

4. The GLAM correctly states that the deemed liquidation should be treated the same as an actual liquidation of T. The GLAM then assumes that, in a hypothetical actual liquidation under state law, P and S would each receive a pro rata share of the assets and liabilities of T. This assumption is questionable, since the Note would provide P with a priority claim on all of T's assets. As described below, the hypothetical liquidation model will shift some loss away from P to S, and permit S to claim noneconomic losses in excess of its $30 investment in T.

5. Perhaps most significantly, the GLAM appears to answer the age-old question (left unresolved by the Supreme Court in Crane and Tufts) of when a buyer can claim basis in an asset in excess of the asset's value by assuming excess recourse or nonrecourse debt. The GLAM suggests that, as long as the debt was not originally created in a tax shelter, Estate of Franklin, Pleasant Summit and similar cases do not limit the buyer's basis in an asset resulting from a subsequent assumption of the debt. Therefore, the buyer is entitled to basis in the asset equal to the full face amount of the assumed liability. Although the fact pattern discussed in this email (Situation 1) involves recourse debt, the GLAM provides the same answer for excess nonrecourse debt in Situation 2.

Accordingly, by virtue of a deemed assumption of the $100 Note, the buyers are entitled to a $100 basis in Asset X, although Asset X, and the Note, are only worth $5. The GLAM essentially permits P to retain a $95 built-in loss in the Note while replicating that loss through a $100 basis in Asset X, all in connection with a taxable transaction.

Considering the IRS's vigorous pursuit of basis-inflation transactions, many of which have exploited assumed liabilities, it is very surprising that the IRS would voluntarily renounce the principles of Estate of Franklin and similar common-law authorities that limit basis from excess debt and enable such planning opportunities (particularly in connection with a check-the-box election). For example, in Notice 2002-21, the IRS designated as listed transactions certain arrangements where taxpayers claimed inflated basis in property from the assumption of excess recourse debt that was not intended to be satisfied by the entity assuming the debt. Notice 2002-21 has not been revoked.

The GLAM does not mention the cases the IRS cited in Notice 2002-21 to challenge the listed transactions described in the notice, and we understand that the GLAM reflects a deliberate choice by the IRS to construe Estate of Franklin principles narrowly. Thus, it appears that the IRS currently believes that taxpayers may claim basis in property for assumed liabilities in excess of the amount that will be repaid, but that such transactions must nonetheless be disclosed under Notice 2002-21. This generous interpretation of Estate of Franklin should have far-reaching consequences outside of the check-the-box context.

In addition, because P, T and New T are related parties, it is unclear whether the deemed off-market sale of Asset X for the assumption of excess liabilities would be respected under section 482. It is possible that the IRS believes that section 482 does not apply to excess debt assumptions where the initial debt was incurred in a bona fide transaction, or perhaps even that section 482 does not apply to check-the-box elections. However, the GLAM does not discuss section 482 at all. Therefore, section 482 is another provision that should be carefully analyzed before relying on the GLAM reasoning

The principle downsides for taxpayers are that (i) $95 of potential cancellation of indebtedness income (COD) is preserved for the future (because the Note will continue to have an adjusted issue price of $100 and a value of $5 after the transaction), and (ii), as discussed immediately below, the liquidation may result in gain for T. However, these issues will be manageable in many cases. In all events, the GLAM analysis should not be binding on taxpayers that choose to report the transaction using more traditional principles.

6. Although the GLAM focuses on the treatment of P and S, the treatment of T in the liquidation that follows from the Note remaining in existence could be quite adverse in some circumstances.

When a subsidiary that is insolvent by virtue of debt to its parent liquidates, the treatment of the transaction at the subsidiary level is not completely settled. Under Rev. Rul. 2003-125, an insolvent liquidation is clearly not a "complete liquidation" under section 331. However, there has been some debate about whether the subsidiary is treated as distributing its assets to the parent, subject to the liability, in a complete liquidation for purposes of section 336(b). The alternative is to treat the subsidiary as repaying its debt to the parent in a section 1001 exchange.

Section 1001 treatment is almost always preferable from T's standpoint. Under the section 1001 characterization, T would be treated as repaying $5 of its debt with Asset X, and having $95 of COD that would be excluded from T's income under section 108(a). By contrast, if section 336(b) (which adopts the principles of Tufts) is applied, T would be treated as selling Asset X to P in exchange for P's assumption of $100 of debt. Thus, if T has a $5 basis in the asset, section 1001 will not result in any income or gain to T, while section 336(b) will cause T to have $95 of gain.

The IRS has issued at least two private letter rulings indicating that section 1001 should apply in these cases. We believe the IRS will continue to rule that section 1001 applies when the debt is extinguished (e.g., where T becomes a disregarded entity). However, since the debt is treated as assumed by P under the GLAM facts, it appears that the IRS will apply section 336(b) (or at

least Tufts) when T becomes a partnership. The GLAM obscures this issue of potential gain recognition at the corporate level because T has a built-in loss in Asset X under the actual facts stated in the GLAM.

7. As mentioned, P and S are deemed to receive their pro rata share of the assets and liabilities of T in the deemed liquidation. Thus, P is treated as receiving $4 of Asset X and assuming $80 of the liability on the Note, while S is treated as receiving $1 of Asset X and assuming $20 of liability on the Note. P obtains an $80 basis in its portion of Asset X, and S obtains a $20 basis in its portion of Asset X.

8. Treating P and S as receiving the assets and liabilities of T pro rata, based on their stock ownership in T, would yield even more surprising results if S owned the majority of the T shares but no T debt. For example, if S owned 99% of the T shares but no T debt, then S would be treated as receiving 99% of Asset X and assuming $99 of T's liability on the Note (and thus obtain a $99 basis in Asset X). Once again, this result would not arise under an actual state law liquidation, as P would be entitled to all of Asset X (and all of the resulting basis in Asset X) in such a case.

C. CONSEQUENCES OF THE DEEMED FORMATION OF NEW T

1. P and S are deemed to contribute the assets and liabilities of T to New T. The GLAM concludes that the transfer of assets and liabilities to New T qualifies for tax-free treatment under section 721.

2. The question of whether the transfer of assets encumbered by excess liabilities to a partnership qualifies as a section 721 exchange (in whole or in part) has been debated for many years. The IRS and Treasury Department issued proposed regulations in 2005 (the "no net value" regulations) which generally take the position that transfers of underwater assets to a corporation does not satisfy the "exchange" requirements in sections 351 or 368 because the transferor does not, economically, receive any stock in the transaction. However, these regulations have not (and may never be) finalized. The GLAM thus rejects the theory of the no net value regulations for section 721 transactions.

3. The GLAM's conclusion regarding section 721 transactions is interesting, and may be correct from a policy standpoint. Unfortunately, the GLAM provides no analysis for the section 721 conclusion. Therefore, it may be difficult to rely on the GLAM's conclusion unless and until further guidance is issued by the IRS or Treasury Department.

4. It should also be noted that, if a newly formed partnership issues a debt instrument to a transferor in connection with a section 721 exchange, the debt is treated as property for purposes of section 707. (See Treas. Reg. § 1.721-1(a)). The GLAM implicitly concludes that the reconstituted Note held by P following the section 721 exchange is not taken into account as property under section 707. This conclusion is consistent with the general theory of the GLAM that the Note is an "old and cold" liability that is being assumed by New T.

5. For purposes of section 752(c), Asset X is treated as property subject to the $100 liability on the Note, and New T is treated as assuming such liability, but only to the extent of the $5 value of Asset X. Thus, P and S transfer their portions of Asset X (with bases of $80 and $20, respectively) to New T, and New T assumes $5 of liability on the Note.

P is treated as having $4 of liability assumed and, because P bears the economic risk of loss for the $5 liability, P's share of partnership liabilities also increases to $5. Therefore, P has a net increase in its basis in New T of $1 under section 752. P ends up with a total basis in New T of $81 ($80 from Asset X plus $1 from the section 752 adjustments).

S is treated as having $1 of liability assumed, resulting in a net decrease of $1 in S's basis in New T under section 752. S ends up with a basis in New T of $19 ($20 from Asset X minus $1 from the section 752 adjustments).

These results are curious. S invested only $30 in T and yet is permitted to obtain both a $30 loss on the deemed liquidation and, in the future, a subsequent $19 loss on the disposition, abandonment or write off of its worthless partnership interest. This result occurs because S is credited with a momentary assumption of $20 of liability in the deemed liquidation, even though this liability immediately shifts back to P under section 752. P, on the other hand, will have $19 less of future loss with respect to its basis in New T.

New T obtains a $100 basis in Asset X under section 723.

Conclusion

THE GLAM GIVES RISE TO A NUMBER OF INTERESTING TECHNICAL ISSUES AND SURPRISING RESULTS. IN THE SHORT RUN, THE GLAM SHOULD PROVIDE BENEFICIAL RESULTS FOR MANY TAXPAYERS. IN THE LONG RUN, THE REASONING IN THE GLAM WILL LIKELY BE REVISITED BY THE IRS AND THE TREASURY DEPARTMENT AS ITS IMPLICATIONS ARE FURTHER DEVELOPED.

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