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More Economic Substance Woes: Part I

By Robert W. Wood • Wood and Porter • San Francisco

Economic substance seems to be on the wish lists of taxpayers and of the government. Taxpayers think they have it, and they most certainly want it. The government thinks it often doesn't exist. Some parts of the government also want to codify it. If the IRS mentions economic substance, it is usually to say it is lacking. It is a shorthand way of saying that you are doing something for tax reasons and not for economic reasons.

The phrase has a curious history, and yet it is part of something we all understand, at least on a visceral level. While most of us are now well tutored in the notion that we should not do things *only* for tax reasons (and perhaps that we should not even do things *principally* for tax reasons), people have been known to do so unabashedly. Even charitable contributions are in some sense tax motivated.

President Obama recently received flack for suggesting that the tax donation available for charitable contributions should be curtailed, so that a low-paid worker would receive the same tax benefit from a charitable contribution as a top income-earning executive. Many charities screamed bloody murder, certain that their sources of funding would shrink were this to occur. People admire charities (we think), but people admire tax deductions even more. Perhaps taxpayers should not receive a charitable contribution—even if they do not receive a *quid pro quo*—if they are motivated by a desire for tax benefits and not by a desire to give to charity.

Of course, it is around such issues that we often revert to the learned teachings of Judge Learned Hand, who famously quipped that there is no patriotic duty to pay higher taxes than are required. Vice President Biden contradicted Judge Hand when he linked paying more tax to patriotism on the campaign trail. All of this was on my mind as I recently read Chief Counsel Advice 200915033 (Dec. 24, 2008).

ALSO IN THIS ISSUE

In this hot-off-the-press ruling, the IRS concluded that a company that acquired a target when it emerged from bankruptcy could not use the target's NOL against the target's post-change income. Although the transaction—in form—met the requirements of Code Sec. 382(l)(5), the IRS said that this form did not reflect the economic reality of the deal.

Bankruptcy Exception

As M&A TAX REPORT readers are well aware, Code Sec. 382 specifies the amount of a loss corporation's taxable income that may be offset by pre-change-of-ownership losses. The provision is triggered when there is an ownership change. The limit for each year is equal to the product of the fair market value of all of the stock of the loss corporation immediately before the ownership change, multiplied by the applicable long-term tax-exempt rate.

An ownership change is a change in the percentage of ownership of the loss corporation's stock owned by the five-percent shareholders of more than 50 percent over a three-year testing period. Code Sec. 382(l)(5) has a special rule for bankruptcy. Here, a loss corporation's pre-change losses will not be limited after an ownership change if two simple requirements are met. First, the loss corporation (immediately before the ownership change) must be under the jurisdiction of the court in the bankruptcy case.

Second, the shareholders and creditors of the loss corporation (determined immediately before the ownership change) must end up owning stock of the new loss corporation that has at least 50 percent of the total combined voting power and 50 percent of the total value of the stock of the new loss corporation. Put simply, this is a continuity of stock ownership requirement.

Just the Facts

To see where the IRS was going with its economic substance argument, you need to look at the facts. In somewhat abbreviated form, here is basically what happened in CCA 200915033:

1. Investor owns no part of Debtor Corporation.
2. Investor buys less than five percent of Debtor's stock (the rest of the stock is owned by three more-than-five-percent shareholders and the general public).
3. Investor and principle creditor enter into an agreement calling for a prepackaged bankruptcy of Debtor.
4. Under the bankruptcy plan, Investor contributes cash for more stock, cash used to buy out public shareholders, to buy out one of the five-percent shareholders and eventually to pay off 100 percent of the creditors.
5. Debtor's two remaining historic shareholders and the Investor (counting only Investor's less-than-five-percent purchase that occurred earlier in the year in step 2 above) now own just over 50 percent of Debtor's stock. However, counting *all* of Investor's stock, they now own 100 percent of Debtor's stock. That means an ownership change has occurred, or will occur in conjunction with the next event.

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EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

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6. Two weeks after the bankruptcy reorganization, the two remaining five-percent shareholders are redeemed out. They receive the same price per share as was paid to the other shareholders in the reorganization. Investor now holds 100 percent of the stock of Debtor. At the beginning of the calendar year, keep in mind, Investor owned no Debtor stock!