SUTHERLAND

LEGAL ALERT

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You Can't Spell "Subchapter C" Without E&P: Proposed Treasury Regulations Clarify the Rules Concerning the Allocation of Earnings and Profits in Tax-Free Transfers

On April 13, 2012, Treasury and the Internal Revenue Service (the IRS) issued proposed regulations that aim to clarify the rule of Treas. Reg. § 1.312-11(a), which concerns the allocation of earnings and profits in tax-free transfers between corporations (the Proposed Regulations). In brief, the Proposed Regulations clarify that, except as provided in Treas. Reg. § 1.312-10, which concerns the allocation of earnings and profits in corporate separations under section 355, if property is transferred from one corporation to another and no gain or loss is recognized, no allocation of the earnings and profits of the transferor is made to the transferee unless the transfer is described in section 381(a). The Proposed Regulations further clarify that, in a transfer described in section 381(a), only the acquiring corporation, as defined in Treas. Reg. § 1.381(a)-1(b)(2), succeeds to the earnings and profits of the distributor or transferor corporation (within the meaning of Treas. Reg. § 1.381(a)-1(a)). In this regard, the Proposed Regulations remove Treas. Reg. § 1.381(c)(2)-1(d).

Background

Section 381(a) generally provides that, in the case of the acquisition of the assets of a corporation in a distribution to which section 332 applies or in an acquisitive asset reorganization to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, the acquiring corporation succeeds to and takes into account, as of the close of the day of transfer, the items of the transferor corporation described in section 381(c). *See also* Treas. Reg. §§ 1.381(a)-1(a), 1.381(a)-1(b)(1). The items described in section 381(c) include earnings and profits. *See* § 381(c)(2).

Treas. Reg. § 1.381(a)-1(b)(2)(i) provides that only a single corporation may be an acquiring corporation for purposes of section 381 and the Treasury regulations promulgated thereunder. *But see* Treas. Reg. § 1.1502-80(g) (providing special rules applicable to situations where multiple members of a consolidated group acquire the assets of a corporation in a complete liquidation to which section 332 applies). Accordingly, in the context of an acquisitive asset reorganization to which section 381(a) applies, the acquiring corporation is the corporation that, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in such a transaction, no one corporation ultimately acquires all of the assets transferred by the transferor corporation, the corporation that directly acquires the assets so transferred will be the acquiring corporation for purposes of section 381 and the Treasury regulations promulgated thereunder, even if such corporation ultimately retains none of the assets so transferred. *See* Treas. Reg. § 1.381(a)-1(b)(2)(i). Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all of the facts and circumstances. *Id.*

Treas. Reg. § 1.312-11 concerns the effect on earnings and profits of certain tax-free exchanges, tax-free distributions, and tax-free transfers from one corporation to another. Specifically, Treas. Reg. § 1.312-11(a) provides that "proper adjustment and allocation of the earnings and profits of the transferor shall be made as between the transferor and the transferee" in the case of asset transfers in connection with reorganizations and other nonrecognition transactions and cross-references the Treasury regulations promulgated under section 381 for specific rules. Some practitioners, reasoning that Treas. Reg. § 1.312-11(a) must have some effect, have concluded that earnings and profits of an acquired corporation may be allocated between multiple corporations following a reorganization and a related contribution of less than all of the acquired corporation's assets. In support of this assertion, Treas. Reg.

§ 1.381(c)(2)-1(d) oftentimes is cited. Treas. Reg. § 1.381(c)(2)-1(d) provides that, where some of the acquired assets are transferred to one or more controlled corporations, or all of the acquired assets are transferred to two or more controlled corporations, the allocation of earnings and profits "shall be determined without regard to section 381" and cites Treas. Reg. § 1.312-11(a).

The Proposed Regulations

As explained in the preamble to the Proposed Regulations, the IRS historically has interpreted the regulations promulgated under section 312 as providing that the earnings and profits of a transferor corporation do not move to the transferee in whole or in part other than in a transfer described in section 381(a) or, to the extent provided under Treas. Reg. § 1.312-10, in a divisive reorganization. Moreover, the IRS has interpreted the Treasury regulations to provide that, in a corporate reorganization described in section 381(a), the acquiring corporation, as defined in Treas. Reg. § 1.381(a)-1(b)(2), succeeds to the full earnings and profits account of the transferor corporation. Thus, the earnings and profits account is not divided if the acquiring corporation in an acquisitive asset reorganization subsequently transfers target assets to one or more controlled subsidiaries.

Consistent with the historic approach of the IRS to the allocation of earnings and profits on account of a corporate reorganization, the Proposed Regulations clarify that, except as provided in Treas. Reg. § 1.312-10, if property is transferred from one corporation to another and no gain or loss is recognized, no allocation of the earnings and profits of the transferor is made to the transferee unless the transfer is described in section 381(a). The Proposed Regulations further clarify that, in a transfer described in section 381(a), only the acquiring corporation, as defined in Treas. Reg. § 1.381(a)-1(b)(2), succeeds to the earnings and profits of the distributor or transferor corporation (within the meaning of Treas. Reg. § 1.381(a)-1(a)). In this regard, the Proposed Regulations remove Treas. Reg. § 1.381(c)(2)-1(d). Thus, it could be said that the Proposed Regulations provide for electivity in respect of the placement of earnings and profits of the target corporation following a reorganization. Of course, the Proposed Regulations beg the question as to whether the direct acquirer's retention of $1 of the target corporation's assets following a reorganization would be sufficient to prevent the target corporation's earnings and profits from being allocated to the ultimate transferee of all of its other assets.

As described in the preamble to the Proposed Regulations, Treasury and the IRS believe that the modifications made by the Proposed Regulations are appropriate because earnings and profits measures the capacity of a corporation to pay dividends to its shareholders, and the corporation that has an interest, directly or indirectly, in all of the target's assets has the dividend-paying capacity that is most comparable to that of the target corporation. Furthermore, Treasury and the IRS believe that the rules for the allocation of earnings and profits should conform to the rules for the allocation of other tax attributes under section 381.

The modifications made by the Proposed Regulations will apply to transactions occurring on or after the date of publication in the Federal Register of the Treasury decision adopting these modifications as final regulations. Before the Proposed Regulations are adopted as final regulations, however, Treasury and the IRS have indicated that they will consider any written or electronic comments that are submitted timely to the IRS.

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