The American Jobs Creation Act of 2004 Affects Domestic Mergers and Acquisitions Tax Issues

The American Jobs Creation Act of 2004 (the Act) was recently passed by Congress and signed by the President on October 22, 2004. The Act makes certain significant reforms that relate to domestic mergers and acquisitions and will be of interest to U.S. taxpayers. As described more fully below, the Act includes provisions that:

- Clarify the definition of “nonqualified preferred stock” under Section 351 of the Internal Revenue Code;
- Limit the transfer and importation of built-in losses;
- Reform certain rules regarding acquisitive and divisive reorganizations;
- Reform the treatment of contributions of built-in loss property to partnerships and the partnership basis adjustment rules for partnerships with substantial built-in losses;
- Clarify that the cancellation of indebtedness income rules apply when a partnership transfers a capital or profits interest in satisfaction of its debt;
- Expand the disallowance of deductions for interest on convertible debt;
- Expand the disallowance of installment sale treatment to all readily tradable debt;
- Affirm Treasury’s consolidated return regulation authority; and
- Require reporting of taxable mergers and acquisitions.

Nonqualified Preferred Stock

Section 351 currently treats “nonqualified preferred stock” as taxable boot if it is received in an otherwise tax-free transfer of property to a controlled corporation. If a person transfers property to a corporation in a section 351 exchange and receives common stock and nonqualified preferred stock in exchange therefore, the person will generally recognize gain to the extent of the value of the nonqualified preferred stock. Section 351 defines “preferred stock” for this purpose as stock that is limited and preferred as to dividends, but does not participate in corporate growth to any significant extent. The Act amends Section 351 to clarify that stock will not be treated as participating in corporate growth to any significant extent unless there is a “real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.” This provision is targeted at taxpayers who might try to evade taxable boot treatment in a Section 351 transaction by issuing stock that seeks to avoid being characterized as nonqualified preferred stock by providing illusory participation rights.
Due to the fact that the reorganization provisions and certain other provisions of the Code refer to the non-qualified preferred stock definition under Section 351(g), the significance of this change goes beyond Section 351 transactions. As a result, this definition will also apply with respect to the receipt of nonqualified preferred stock in a reorganization or corporate division, or in the exchange of nonqualified preferred stock for other preferred stock in the same corporation. This amendment applies to transactions entered into after May 14, 2003.

Limitation on Transfer and Importation of Built-in Losses

The Act limits a corporation's basis in property transferred to it in a Section 351 exchange and in a reorganization to the fair market value of the property transferred if the transferred property has an aggregate built-in loss. Property has an aggregate built-in loss where the adjusted basis of the transferred property exceeds the fair market value of the property immediately after the transfer. Generally, when a person transfers property to a controlled corporation in a 351 exchange or a reorganization, the transferee corporation receives a carryover basis in the transferred property, increased for any gain recognized by the transferor. The Act modifies this rule when the transferred property has an aggregate net built-in loss, so that in such a case, the transferee corporation's aggregate basis in the transferred property is limited to the aggregate fair market value of the transferred property. This step-down in basis is allocated to each property in proportion to its respective built-in loss. The Act allows the transferor and transferee to elect to limit the basis in the transferor's stock to the aggregate fair market value of the transferred property in lieu of limiting the basis in the assets transferred.

Additional Reorganization Reforms

Transfers to Creditors in a Divisive Reorganization

Under current law, in a “spin-off” transaction the parent distributing corporation will not recognize gain if it receives money or other property in exchange for the contribution of property to the controlled subsidiary corporation where that money or other property is distributed to the parent's shareholders or creditors. Prior to the Act, the amount of property that could be distributed to creditors or shareholders of the distributing parent corporation without gain recognition was unlimited. This treatment is to be contrasted with another, less favorable rule that limits the assumption by the controlled subsidiary of parent corporation debt to an amount equal to the tax basis of the assets contributed to the controlled subsidiary. The Act limits the amount of the money plus the fair market value of other property that a parent distributing corporation can distribute to its creditors (but not to its shareholders) to the adjusted tax basis of the assets contributed to the controlled subsidiary, similar to the rule with respect to subsidiary assumption of parent debt. This provision is effective for transactions occurring on or after the date of enactment.

Acquisitive Reorganizations No Longer Subject to Section 357(c)

Prior to the Act, the contribution of assets to a controlled corporation in a 368(a)(1)(D) reorganization was taxable under Section 357(c) to the extent that the liabilities assumed exceeded the tax basis in the assets transferred. The Act provides that acquisitive reorganizations under Section 368(a)(1)(D) are no longer subject to this rule of Section 357(c). Section 357(c) continues to apply to section 351 exchanges and to divisive 368(a)(1)(D) reorganizations.
These provisions will apply to transactions occurring on or after the date of enactment.

Transfers of Built-in Loss Property to a Partnership, and Basis Adjustments in Partnerships with Substantial Built-in Losses

Contributions of Built-in Loss Property
Generally, a partner recognizes no gain or loss on the contribution of property to a partnership. The partnership takes a carryover basis in the contributed property, and the contributing partner increases its basis in its partnership interest by the adjusted basis of the contributed property. The Act modifies these rules where built-in loss property is contributed to a partnership to prevent the contributing partner from transferring any part of a built-in loss in contributed property to the noncontributing partners. Under the Act, such built-in losses may only be taken into account by the contributing partner, and the basis of the contributed property allocated to the other partners is limited to the fair market value of the property at the time of contribution. In addition, if the contributing partner transfers its partnership interest, the partnership’s basis in the built-in loss property will be adjusted to equal the fair market value of the property at the time of contribution, thereby eliminating the built-in loss.

Transfers of Partnership Interests and Distributions of Property in Partnerships with Substantial Built-in Losses
Prior to the passage of the Act, unless a partnership had a Section 754 election in effect, the partnership could not adjust the basis of partnership property following the transfer of a partnership interest. Adjustments under Section 754 and Section 743(b) for transfers of partnership interests are intended to put the transferee partner in the position it would have been in had that partner purchased its share of partnership property directly. The Act requires that a partnership is required to adjust the basis of partnership property when an interest is transferred in a partnership that has a “substantial” built-in loss. A built-in loss is substantial if the built-in loss is more than $250,000. There is an exception to this rule for electing investment partnerships and securitization partnerships. Investment partnerships may include certain private equity funds. The Act applies a similar rule to make basis adjustments mandatory under Section 734(b) when a distribution of partnership property to a partner would have given rise to a “substantial” (i.e., more than $250,000) basis reduction had a Section 754 election been in place. These provisions shall apply to contributions, transfers and distributions occurring after the date of enactment.

Satisfying Debt with Partnership Interest
Generally, a corporation must recognize cancellation of indebtedness income (COD) when it transfers shares of its own stock to satisfy a debt if the fair market value of the stock is less than the amount of debt being satisfied. Under Section 108(e)(8), the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. The Act extends this rule to partnerships by providing that when a partnership transfers a capital or profits interest in the partnership to satisfy a partnership debt (whether recourse or nonrecourse), the partnership will be treated as if the debt were satisfied with money equal to the fair market value of the partnership interest. Any COD income required to be recognized as a result of satisfying partnership debt with an interest in the partnership will be allocated to the partners who hold partnership interests.
partnership interests immediately before the debt is satisfied. This provision is effective for COD transactions occurring on or after the date of enactment.

Restrictions Relating to Certain Debt

Currently, no interest deduction is allowed for interest or original issue discount on debt of a corporation (or a partnership, to the extent of its corporate partners) that is payable in stock of the corporation or a related party, including debt of which a substantial amount is mandatorily convertible or convertible at the issuer’s option into stock of the corporation or a related party. For this purpose, the debt is treated as payable in stock of the issuer or a related party if a substantial portion of the principal or interest is or may be determined by reference to the value of such stock. The Act expands this disallowance of interest deductions by prohibiting an interest deduction where indebtedness of a corporation is payable in equity of any other person held by the corporation or a related party. There is an exception for debt issued by an active securities dealer (or related party) if the debt is payable in or by reference to stock held by a securities dealer in its capacity as such a dealer. This provision is effective for debt instruments that are issued after October 3, 2004.

In addition, the Act expands the disallowance of installment sale treatment to any debt that is readily tradable. Prior to the Act, this disallowance applied only to the readily tradable debt issued by a corporation or a government or political subdivision thereof. This amendment applies to sales occurring on or after the date of enactment.

Affirmation of Consolidated Return Regulation Authority

The Act provides that in issuing consolidated return regulations, IRS may prescribe rules applicable to corporations filing consolidated returns that are different from other provisions of the Code that would apply if those corporations filed separate returns. This change is made retroactive for all years prior to the date of enactment.

This provision is being enacted by Congress in response to the Federal Circuit Court of Appeals’ decision in Rite Aid Corporation v. United States, 255 F.3d 1357 (Fed. Cir. 2001), holding that a provision of the consolidated return loss disallowance regulations was invalid. The Act specifically does not overturn the holding in Rite Aid, but it does preempt future challenges to other consolidated return regulations that might be brought on the basis of the holding in Rite Aid.

Information Reporting of Taxable Mergers and Acquisitions

Under the Act, the acquiring corporation in any “taxable acquisition” (generally an acquisition by a corporation of stock in, or property of, another corporation if any shareholder of the acquired company is required to recognize gain as a result of the acquisition) must file an information return with the IRS and must provide a written statement to each shareholder of the acquired company. This provision is effective for taxable transactions occurring after the date of enactment.
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If you have any questions about this Client Alert, please contact any of the persons listed below or any member of the Tax Department in any of the firm’s U.S. offices.

**Chicago**
Stephen S. Bowen  
+1-312-876-7700

**New York**
David S. Raab  
+1-212-906-1200

**Silicon Valley**
Joseph M. Yaffe  
+1-650-328-4600

**Los Angeles**
Laurence J. Stein  
+1-213-485-1234

**San Diego**
David C. Boatwright  
+1-619-236-1234

**Washington, D.C.**
Joseph D. Sullivan  
+1-202-637-2200