

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: July 11, 2007

to:

from:

(Large & Mid-Size Business)

subject: C
Tax Year 2

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

B =

B1 =

C =

C1 =

D =

Year 1 =

State =

M

Month =
1 =

Month =
2 =

Month =
3 =

Year 2 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Year 3 =

X city =

Y city =

Date 7 =

Date 8 =

\$x =

\$y =

z% =

Sec. =
00

Sec.
11

Sec.
22

ISSUES

B, formerly B1 (hereinafter B except as necessary for the narrative to make sense), separated its business activities in a tax free reorganization and spin-off. The taxpayer, C, formerly C1 (hereinafter C except as necessary for the narrative to make sense), which was the spun-off entity, was required by law and by contract to pay B an amount to be determined as a “retail clawback,” which was meant to at least partially reimburse B for “stranded costs.” The issue is whether C may deduct the clawback payment of \$x it claimed as a royalty payment on its Year 1 tax return.

CONCLUSION

C may not deduct the amount paid as a retail clawback to B, as a royalty payment or as anything else.

FACTS

In Month 1 of Year 1, the legislature of the State of M adopted an electricity restructuring law which amended the regulatory structure governing electric utilities. State M intended to allow retail electric competition for all customer classes beginning in Month 2 of year 2. In furtherance of this plan, State M Public Utility Code Section 00 required the business separation, or unbundling, of utility functions, although it did not require the creation of a separate publicly traded entity. Pertinently, the statute required the separation of regulated utility activities and customer energy services business activities. The three business units required by the statute were 1) a power generation company, 2) a retail electric provider, and 3) a transmission and distribution utility. This could be done through the creation of separate affiliated companies owned by a common holding company, or non-affiliated companies, or through the sale of assets to a third party. The statute required separation of personnel, information flow, functions, and operations.

In response to this legislation, B adopted a business separation plan to separate its regulated and unregulated business operations. Under the separation plan, on Date 1, B incorporated C (the taxpayer, eventually renamed) and transferred to C its unregulated businesses. This meant that the unregulated wholesale and retail markets would belong to C, while the regulated operation would remain with B. B filed its business separation plan with the Public Utility Commission of State M.

On Date 2, B and C entered into a Master Separation Agreement. On Date 3, B received authorization from the Securities and Exchange Commission to adopt a new holding company structure under the name of B, allowing it to complete the spin-off of C, and separate B into two companies. On Date 4, the Internal Revenue Service issued

a supplemental ruling confirming that the spin-off of C from B would be tax-free to B and its shareholders, assuming the spin-off was completed within six months. On Date 5, B spun off its interest in C by distributing to holders of record of its common stock as of Date 6, the shares it held of C common stock. Distribution of the C stock was the final step in the separation of B into two companies, with B as the new holding company to continue to conduct the regulated business of the former company, and C as the provider of unregulated wholesale and retail energy services in competitive markets. This is when B1 became B. And in Year 2, in a somewhat confusing maneuver, C1 changed its name to C (the same name as B1). After the unbundling was complete, B was the transmission and distribution utility, and C was the retail electric provider. All power generation assets and functions were transferred to D in a section 351 incorporation.

The statute required what is known as a “true up” proceeding. This was meant to allow the transmission and distribution utility to recover some of its “stranded costs.” A few pages that we have from B’s application to determine stranded costs and true-up balances offer some explanation. The theory behind the recovery of stranded costs was that utilities by regulation were required to invest in power generation equipment that might prove unprofitable in a competitive market, *i.e.* they were forced to spend money in an unprofitable way. The statute defined stranded costs generally as the difference between market value and book value, with book value being presumably higher. The retail clawback was a way for B to recover some of the stranded cost (unprofitable investment). C benefits from the money B was previously required to invest in power generation equipment, and therefore had to reimburse B for some of that expense in the true-up proceeding. Each transmission and distribution utility, its affiliated retail electric provider, and its affiliated power generation company were required to file papers to determine the actual stranded costs, and to reconcile those costs with the estimated stranded costs.

Pursuant to the statutory requirement, the Master Separation Agreement Article 10.12 stated that C would pay B the lesser of (i) the amount required to be credited to B by its affiliated retail electric provider pursuant to Sec. 11 of the Utilities Code or (ii) \$y multiplied by the number of residential or small commercial customers served by the affiliated transmission and distribution utility that were buying electricity from the affiliated retail electric provider at the “price to beat” on the second anniversary of the beginning of competition, minus the number of new customers obtained outside the service area.

The “price to beat” is a certain price the incumbent electric utility in a given market must charge, and is expressed in kilowatt hours. It is set by the State M Public Utilities Commission. The incumbent is the electric utility which previously had a monopoly in that market. This encourages competition by allowing a competitor to charge a lesser amount that it knows the incumbent cannot match. This allows not only small electricity providers to compete in the X city market, but also larger electricity providers which are actually the incumbent providers in other markets. Conversely, the

X city incumbent is allowed to compete as a non-incumbent in other cities. C in fact competes as a non-incumbent in Y city, and the Y city incumbent competes as a non-incumbent in X city.

A price to beat customer was one who remained with the incumbent utility. In effect, C was required to pay B \$y for each retail customer that it acquired from B and had retained as of Date 7, minus the aforementioned new customers.

While the statute contemplated a payment of up to \$y per customer, it was also possible for C to be exempted from making any payment at all. The available exemption was contingent on whether z% of the electric power consumed by residential customers was provided by nonaffiliated retail service providers (Sec. 22 of the Utilities Code). No retail clawback payment would be required if the retail electric provider was found to have lost z% of customers within the two years following the start of competition. However, no State M utility met this z% requirement for exemption from payment of the clawback with respect to residential customers. (State M Senate Committee on Business and Commerce, Electric Utility Restructuring, Interim Report, Date 8, page 16). The clawback was *de facto* a mandatory payment, or in other words an obligation subject to defeasance.

The Year 3 tax return of C contains a deduction for "Royalty Payment \$x". C paid this amount as the retail clawback payment to B under the terms of the aforementioned Master Separation Agreement between C and B, and as required by State M statute.

The Year 3 Form 10K Income Tax Footnote (12), on page F-50 states: "Pursuant to the State M electric restructuring law, we made a payment of \$x to B in Month 3 of Year 3 related to our residential customers. For further discussion of this payment, see note 13(d). We believe such business expense is deductible for income tax purposes in Year 3. No assurance can be given, however, that the Internal Revenue Service would not assert, or that a court would not sustain, a contrary position."

LAW AND ANALYSIS

The B incorporation of C qualifies as a reorganization under I.R.C. § 368(a)(1)(D), because B transferred its unregulated wholesale and retail business to C in exchange for C stock, and distributed that stock to its shareholders in a transaction which qualified under I.R.C. § 355. If the clawback payment is seen as being part of the reorganization and distribution, there is no tax consequence to C, because it was part of a tax free reorganization.

The character of the clawback payment thus depends on whether it is considered to be a part of the reorganization, or to be a payment which is completely independent of that event. If it is not part of that event, the nature of the payment, and its possible deductibility, become problematic.

Review of the reorganization and separation documents discloses that there was an obligation to make the clawback payment as of the time of the business separation, subject to defeasance. The Master Separation Agreement required C to pay B an amount to be determined in the future. The requirement for the payment could be defeated upon the happening of certain events, but this does not change the fact that the obligation was put in place by the transaction documents at the time of the original separation.

Arrowsmith v. Commissioner of Internal Revenue, 344 U.S. 6, *reh'g denied*, 344 U.S. 900 (1952) controls the disposition of this case. In *Arrowsmith*, stockholders of a defunct corporation were obligated to pay a judgment against the corporation as transferees of its assets. The Commissioner argued that the payments should have the same character as profits paid as liquidating distributions in the years 1937-1940, *i.e.* they should be classified as capital loss since the profits had been classified as capital gain. The taxpayer argued that because of the principle that each taxable year stands as a separate unit for tax accounting purposes, what would have otherwise been a capital transaction was transformed into an ordinary business transaction. The Court observed that had the judgment been paid during the year 1940 it would have admittedly been classified as capital, sealing its classification as capital loss. The Court endorsed the Commissioner's view that the 1944 payment was part of the original liquidation transaction and thus was required to be classified the same as the rest of the liquidation transaction, even though the taxpayers paid the judgment years later.

The case for arguing that the retail clawback relates back to the original transaction is even stronger than in *Arrowsmith*. A lawsuit and liability for a judgment were not part of the original transaction in that case. These events came later, were not addressed in the original transaction documents, and may not have been contemplated. The cause of action against the original corporation existed at the time of the liquidation transaction, and that was enough for the court to consider it as part of the liquidation transaction. Viewing the clawback payment as an obligation subject to defeasance would seem to strengthen our argument, but is not essential. That it was explicitly provided for as part of the reorganization is enough to have it treated as such.

PLR 200518014 and cases cited therein confirm that the Service still applies the principles of *Arrowsmith*. In the ruling, two entities entered into a purchase and sale agreement for subsidiaries owned by one of them. The agreement contained a tax indemnity section, under which the selling corporation was to pay all pre-closing taxes, and would also be entitled to the benefit of any loss or deduction relating to the pre-closing period. The selling corporation owned any refund of pre-closing period taxes, and the buying corporation would also carry forward all losses which might otherwise be carried back to the pre-closing years, meaning the buying corporation would benefit from any net operating loss that might have otherwise been carried back.

Four years later, the subsidiary corporations, now owned and operated by the buying corporation, incurred net operating losses. Congress had amended the law to allow a carryback period of five years. The buying corporation then entered into an agreement with the selling corporation under which the buying corporation would carry the NOLs back to years when they were owned by the selling corporation. Under this agreement, the selling corporation would pay the buying corporation two-thirds of the refund to the buying corporation. The selling corporation wanted to deduct that payment, and the buying corporation would include it in income. The issue was whether the *Arrowsmith* relation back doctrine would apply.

The Service ruled that the doctrine would not apply, but in doing so affirmed the doctrine's vitality. The Service held the payment to be includable by the buying corporation under general income tax principles. The real issue was how the selling corporation, which made the payment, was to treat it. If the payment related back to the original agreement, it would be considered as being part of that capital transaction. Instead, the Service ruled the payment arose out of an entirely new agreement the parties made four years later. In so doing, the Service did not vitiate the *Arrowsmith* doctrine, but rather pointed out that the doctrine was affirmed in a line of cases. See *United States v. Skelly Oil Company*, 394 U.S. 678 (1969) (taxpayer not entitled to deduct the full amount of refunded overcharges, rather an offset was required equal to the amount of the depletion deduction in prior years, because the subsequent refund related back to the original charges); *Wener v. Commissioner*, 24 T.C. 529 (1955) (a subsequent renegotiation of a contract held to relate back to the original transaction because the original agreement was completely revamped); and *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974) (settlement proceeds paid out were capital rather than ordinary because they were considered to be an adjustment to the purchase price of oil and gas leases, rather than an unrelated business expense). See also PLR 200717014, for a case in which *Arrowsmith* was applied affirmatively in a D/355.

This reasoning applies to C's clawback payment. The requirement for the then future retail clawback payment was part of the original transaction which caused the separation. It did not exist apart from the separation, nor was it the result of a new agreement made by the parties after the fact. The tax classification into which the clawback payment fits therefore was determined by the role it played in the separation and unbundling. The clawback payment was part of a tax free reorganization, meaning C has no deduction for making this payment. Deductions are a matter of legislative grace, and the taxpayer claiming a deduction for a certain payment must locate a specific provision in the Internal Revenue Code which allows it. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). Nothing allows a deduction for this type of payment in the context of a corporate reorganization, and C may therefore not have one.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The Service is currently considering the tax consequences of this D/355 to a transactionally related taxpayer. The reader should not construe anything in this document as expressing any opinion pertaining to any other taxpayer besides the one named herein.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ at _____ you have any further questions.

Sincerely,

Associate Area Counsel,
(Large & Mid-Size Business)

By: _____

Attorney
(Large & Mid-Size Business)