Release date: December 23, 2016

Cite: PR 2016-011

Code Sections: 1034.04(g)(1)(A)

Topic: Type A Reorganization

Act: 1-2011

Date issued: December 20, 2016

Text

By letter of June 26, 201X, you requested our rulings with respect to the tax treatment of the transactions described below under the provisions of the Internal Revenue Code of Puerto Rico of 2011, as amended (Code) and the applicable Regulations. Our opinion is based on the following facts submitted for our consideration.

I. STATEMENTS OF FACTS

You represented that Company A is incorporated in State X and is duly authorized to do business in Puerto Rico. Company B was incorporated under the laws of the Commonwealth of Puerto Rico. Both Company A and Company B are producers and retailers of W products and services and are part of the corporate structure of Parent Company.

You also represented that Company B had, at the time of the transaction referred below, undistributed earnings and profits from industrial development income, from the tax decree, and from fully taxable operations; net operating losses carryover for regular and alternative tax purposes; and an income tax overpayment. It has been represented that, as of the date of issuance of this ruling, the applicable income tax for the possible subsequent distribution of the earnings and profits with regards to Company B's fully taxable operations has been satisfied.

With the exception of Company A, Company B, and another entity not pertinent to this ruling, all of the entities that are part of the corporate structure of Parent Company are not engaged in a trade or business in Puerto Rico. Company A and Company B have been ultimately wholly owned by Parent Company during the 5 year period ending on the Transaction Date. Although the previous direct owner of Company B was merged with and into Company C in 200X, both the direct owner and Company C were indirectly owned by Parent Company.

Pursuant to a Plan and Agreement of Merger, effective on the Transaction Date, Company A and Company B merged, with Company A being the surviving entity, and Company B ceasing its corporate existence (merger).

In order to complete the merger transaction, Company A and Company B are deemed to have followed these steps: Company B is deemed to have transferred all of its assets to Company A

in exchange for Company A' shares. Company B is deemed to have exchanged its shares in Company A for its own shares owned by Company C. Company B ceased its corporate existence by the cancellation of its stock.

Pursuant to the Plan and Agreement of Merger, these are some of the effects of the merger transaction: Company A acquired all of the rights, privileges, powers and franchises of a public as well as of a private nature, and shall be subject to all the restrictions, disabilities, obligations and duties of Company B, except as otherwise provided there, and except as otherwise provided by law. Company A was vested, without further action, with all property, be it real, personal or mixed, and all debts due to Company B on whatever account as well as all other things in action or belonging to Company B. All property, rights, privileges, powers and franchises of Company B shall be thereafter effectively the property of Company A as they originally were of Company B, but all rights of creditors and all liens upon any property of Company B shall be preserved unimpaired, and all debts, liabilities, obligations and duties of Company B shall thenceforth attach to, and may be enforced against Company A to the same extent as if such debts, liabilities, obligations and duties had been incurred or contracted by it.

After the Transaction Date, Company A has continued with its operations in Puerto Rico, as well as with the operations previously conducted by Company B.

As represented, the purpose of this merger and asset acquisition was to consolidate and maximize the use of the assets and operating efficiencies by streamlining the corporate structure in Puerto Rico. Housing all Puerto Rico operations in one legal entity optimizes the administration and management of the business. This consolidation would reduce administrative costs as well as other expenses associated with a multiple corporate structure.

II. RULINGS REQUESTED

1. For purposes of Section 1034.04(i) of the Code, the transfer of all assets and liabilities of Company B to Company A shall not be treated as having the purpose of avoiding Puerto Rico income tax.

2. The transfer of all the assets and liabilities of Company B to Company A, and the subsequent dissolution of Company B will be treated as a tax-free reorganization within the meaning of Section 1034.04(g)(1)(A) of the Code.

3. Pursuant to Section 1034.04(b)(4) of the Code, no gain or loss shall be recognized by Company A upon the deemed transfer of its stock to Company B in exchange of Company B's assets. In addition, no gain or loss shall be recognized by COMPANY C upon the deemed exchange of Company B's shares in Company A for its own shares owned by COMPANY C.

4. Pursuant to Section 1034.04(k) of the Code, Company B's liabilities assumed by or agreed to be paid or discharged by Company A will not constitute *other property or money* received as part of the transfer. Therefore, no gain or loss shall be recognized to the extent of such liabilities assumed or agreed to be paid or discharged.

5. Pursuant to Section 10.10 of the General Corporations Law, as amended, a corporation party to a reorganization may, under certain conditions, carry over certain tax benefits and privileges. Such attributes, among others, are:

    - Any net operating loss carryovers of Company B at the time of the transfer.
    - Any overpayments that may be reflected in the returns of Company B as of the date of the transfer would be available for Company A in subsequent taxable years.
    - Any earnings and profits of Company B.
    - Alternative Minimum Tax credits reflected in the returns of Company B as of the date of the transfer.

6. Pursuant to Section 1034.02(a)(7)(B) of the Code, the basis of each asset received by Company A from Company B shall be the same as the basis of that asset in the hands of Company B immediately before the transfer.

7. Pursuant to Section 1034.01(g)(2) of the Code, the holding period of all Company B's assets transferred to Company A shall include the period during which Company B held said assets.

8. Company A and Company B have been ultimately owned by Parent Company during the 5 year period ending on the Transaction Date. Although the previous direct owner of Company B was merged with and into COMPANY C in 200X, both the direct owner and COMPANY C were indirectly owned by Parent Company. Thus, the merger of Company B into Company A in 2011 should meet the control rule of Reg. Art. 1124(b)(2)-2.

9. Company A and Company B are engaged in the same commercial activity, trade or business.

10. The net operating loss carryover of Company B would be considered as arising from the same and/or integrated commercial activity, within the meaning of the Section 1033.14 of the Code and Code Regulation Article 1124(b)(2)-2. Therefore, Company A would be able to use the available NOL's of Company B to offset its income without restriction.

11. Pursuant to Code Regulation Article 1124(b)(2)-2(c), any change in the shareholders of Parent Company, the entity that ultimately wholly owns Company A, should not be considered a change in its identity, or its trade or business or commercial activity.

III. LAW AND ANALYSIS

Section 1034.04(i) of the Code provides that if in relation to an exchange described Section 1034.04(b)(3) and (4) of the Code a person of Puerto Rico transfers property to a foreign corporation, to determine the limit to which earnings shall be recognized in such exchange, a foreign corporation shall not be considered as a corporation unless it is demonstrated to the satisfaction of the Secretary, within a period of one hundred eighty-three (183) days after such exchange is effected, that the same does not have the purpose of avoiding the payment of income taxes levied by the Government of Puerto Rico. For these purposes, the term "person of Puerto Rico" means a domestic corporation, or a resident corporation, including a foreign corporation doing business in Puerto Rico. See Article 1112(i)-1(c)(1) of the Regulations under

Section 1112 of the Puerto Rico Internal Revenue Code of 1994, as amended (the "1994 Code"), precursor to Section 1034.04 of the Code (the "Regulation under the 1994 Code"), which is still in effect pursuant to Section 6091.01 of the Code.

However, Article 1112(i)-2(c)(2)(vii) of the Regulation under the 1994 Code states that in order for the Secretary to determine if the transaction does not have the purpose of avoiding the payment of income taxes, the Taxpayer must represent that any income tax resulting from any gain recognized in the exchange has been paid, or is in the process of being paid.

Company A stated that the purpose of this merger and asset acquisition was to consolidate and maximize the use of the assets and operating efficiencies by streamlining the corporate structure in Puerto Rico. Also, as of the date of issuance of this ruling, the applicable income tax for the possible subsequent distribution of the earnings and profits with regards to Company B's fully taxable operations has been satisfied.

Section 1034.04(g)(1)(A) of the Code defines a reorganization as a statutory merger or consolidation. Article 1112(g)-2(b)(1) of the Regulation further states that, in order for the transaction to qualify under Section 1112(g)(1)(A) of the Code: (i) one corporation (the acquiring corporation) must acquire substantially all of the properties of another corporation (the acquired corporation) in exchange for stock of a corporation which is in control of the acquiring corporation (the controlling corporation), (ii) the transaction would have qualified under Section 1112(g)(1)(A) of the Code if the merger had been into the controlling corporation, and (iii) no stock of the acquiring corporation is used in the transaction. The determination as to whether the transaction would have qualified under Section 1112(g)(1)(A) of the Code if the merger had been into the controlling corporation means that the general requirements of a reorganization under Section 1112(g)(1)(A) of the Code (such as a valid business purpose, continuity of business enterprise, and continuity of interest) must be met in addition to the special requirements of Section 1112(g)(2)(B) of the Code. The merger transaction between Company B and Company A appear to meet the requirements under Section 1034.04(g)(1)(A) of the Code and the Regulation. A valid business purpose has been represented, Company A will continue with Company B's businesses, and Company A will continue to be owned by the same owners.

Section 1034.04(b)(4) of the Code states that no gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization. On the other hand, Section 1034.04(b)(3) of the Code states that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Company B's transfer of assets and liabilities to Company A and Company A receipt of Company B's stock pursuant to the Merger qualify under Section 1034.04(b)(4) and (b)(3) of the Code.

Section 1034.04(k) of the Code states that where upon an exchange the taxpayer receives as part of the consideration property which would be permitted by Section 1034.04(b)(4) of the Code to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumes a liability of the taxpayer or acquires

from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer and shall not prevent the exchange from being exempt; except that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition was to avoid income tax of the Government of Puerto Rico on the exchange, or, if not such purpose, was not a bona fide business purpose, such assumption or acquisition (in the amount of the liability) shall be considered as money received by the taxpayer upon the exchange. In any suit or proceeding where the burden is on the taxpayer to prove that such assumption or acquisition is not to be considered as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence. The liabilities assumed by Company A by reason of the Merger shall not be considered "other property or money" which may trigger the recognition of a gain.

With regards to the applicable tax basis of the transferred assets in the merger, Section 1034.02(a)(7)(B) of the Code states that if a property was acquired in a taxable year beginning after December 31, 1953, by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This is only applicable if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee (or of a corporation which is in control, determined under Section 1034.04(h) of the Code, of the transferee) as the consideration in whole or in part for the transfer. With regards to the applicable holding period, Section 1034.01(g)(2) of the Code states that to determine the period for which the taxpayer has held property, however acquired, there shall be included the period during which such property was held by any other person, if under the provisions of Section 1034.02 such property has, for purposes of determining gain or loss from a sale or exchange, the same basis, in whole or in part, in his hands as it would have in the hands of such other person. Therefore, the tax basis and holding period of the assets transferred to Company A pursuant to the Merger are the same as where for such assets as in Company B's hand.

Article 10.10 of the General Corporations Act provides the corporate legal rules with regards to corporate consolidation and mergers. Such Article establishes, generally, in a merger transaction all rights, properties, and credits will be transferred to the surviving entity. However, with regards to the transfer of tax attributes, we must first analyze the Code to determine the applicability of such transfers. Section 1034.04(t) of the Code states, in general, that in the case of the acquisition of assets of a corporation by another corporation in a transfer to which section 1034.04(b)(4) of the Code (relating to nonrecognition of gain or loss to corporations) applies, if in connection with a reorganization under Section 1034.04(g)(1) of the Code, the acquiring corporation shall succeed to and take into account, as of the close of the day of distribution or transfer, the tax attributes of the distributor or transferor corporation, subject to the conditions or limitations specified therein. As stated in Section 1034.04(t)(3) of the Code, the tax attributes includes net operating loss carryforward, earnings and profits, and other items as determined by the Secretary.

The treatment of the net operating loss carryforward deduction after an exchange described in Section 1034.04(b)(4) is governed by Section 1033.14(b)(2) of the Code. Such section states that, subject to the provisions of paragraph (3) of Section 1033.14(b), a transferee who acquires all or substantially all the assets of a transferor in an exchange described in section 1034.04(b)(4) of the Code may claim the net operating loss deduction for the taxable years of the transferee ending after such exchange with respect to (A) net operating losses incurred by the transferor during taxable years ending on or before such exchange and otherwise available, provided, however, that the amount of the net operating loss of the transferor that qualifies as a net operating loss carryover to a taxable year of the transferee shall be an amount equal to the net income for such year derived from the same commercial activity or trade or business that generated the losses; and the (B) net operating losses of the transferee for taxable years ending on or before said exchange, provided, however, that the amount of said losses may be claimed as a deduction only against net income derived from any commercial activity or trade or business of the transferee, other than the commercial activity or trade or business acquired from the transferor in the exchange. However, Section 1033.14(b)(4) of the Code specifically states that the provisions of paragraph (2) of Section 1033.14(b) shall not apply to a net operating loss that is subject to section 1034.04(t)(3)(A). Furthermore, Section 1034.04(u) of the Code limits the use of net operating losses following an ownership change, if applicable.

Therefore, since the merger qualified as an exchange under Section 1034.04(b)(4) of the Code, the amount of Company B's net operating losses transferred to Company A that may be claimed as a deduction in future years shall be determined under Sections 1034.04(t)(3)(A) and (u) of the Code. The Department has not issued regulations under Section 1034.04(t)(3)(A) or (u) of the Code. However, such provisions are similar to the provisions under Sections 381(c)(1) and 382 of the United States Internal Revenue Code of 1986, as amended (the "US IRC").

With respect to the net operating losses accumulated by Company A as of the date of the exchange, Article 1124(b)(2)-2(a) of the Regulation under Section 1124 of the 1994 Code, precursor to Section 1033.14 of the Code, provides that the net income generated by a transferee after carrying out an exchange, which at the same time is part of a liquidation or reorganization, shall be treated as entirely attributable to the commercial activity, trade or business of the transferor or the transferee that generated the net operating losses if: (1) during the 5-year period ending on the date of the exchange or the period of existence of the corporations, whichever is less, in the case of an exchange described in Section. 1112(b)(4) of the 1994 Code, the same person or persons have control of both, the transferor and transferee corporations; and (2) during the period described in (1), both the transferor and the transferee corporations are engaged in the same commercial activity, trade or business, or in commercial activities, trades or businesses that are integrated. As represented, the transaction meets the requirements under (1) and (2) above, therefore the net operating losses accumulated by Company A as of the date of the transaction will be considered as arising from the same and/or integrated commercial activity of Company B, within the meaning of Section 1033.14 of the Code and Article 1124(b)(2)-2 of the Regulation under the 1994 Code, and Company A will be able to use such net operating losses to offset Company B's net income.

Furthermore, Article 1124(b)(2)-2(a)(3) of the Regulation under the 1994 Code state that if during the carryover period there is a change in identity of the person or persons having control of the

transferor or the transferee changes, or a change in the commercial activity, trade or business, the net operating loss deduction for the taxable year in which such change takes place and for subsequent years, shall be subject to the provisions of Article 1124(b)(2)-1 of the Regulation under the 1994 Code.

IV. CONCLUSION

Based solely on the facts and representations submitted for our consideration, the provisions of the Code, and the applicable Regulations, this Department rules that:

1. For purposes of Section 1034.04(i) of the Code, the transfer of all assets and liabilities of Company B to Company A shall not be treated as having the purpose of avoiding Puerto Rico income tax. However, the applicable withholding of the tax at the source shall be effected and paid to this Department with respect to Company B's accumulated taxable earnings and profits as of the date of the transaction, as provided in Ruling No. 5 below.

2. The transfer of all the assets and liabilities of Company B to Company A, and the subsequent dissolution of Company B will be treated as a tax-free reorganization within the meaning of Section 1034.04(g)(1)(A) of the Code.

3. Pursuant to Section 1034.04(b)(4) of the Code, no gain or loss shall be recognized by Company A upon the deemed transfer of its stock to Company B in exchange of Company B's assets. In addition, pursuant to Section 1034.04(b)(3) of the Code, no gain or loss shall be recognized by COMPANY C upon the deemed exchange of Company B's shares in Company A for its own shares owned by COMPANY C.

4. Pursuant to Section 1034.04(k) of the Code, Company B's liabilities assumed by or agreed to be paid or discharged by Company A shall not constitute *other property or money* received as part of the transfer. Therefore, no gain or loss shall be recognized to the extent of such liabilities assumed or agreed to be paid or discharged.

5. Pursuant to Section 1034.04(t) of the Code, Company B's tax attributes as of the date of the transaction shall carryover to Company A, including, but not limited to net operating losses (subject to Ruling No. 8 below), earnings and profits, tax credits provided by the Code and other special laws, and overpayments of taxes, if any available, provided that Company B's income tax overpayment shall be reduced by the 10% withholding tax at source applicable to Company B's accumulated taxable earnings and profits as of the date of the transaction as provided in Ruling No. 1 above.

6. Pursuant to Section 1034.02(a)(7)(B) of the Code, the basis of each asset received by Company A from Company B shall be the same as the basis of that asset in the hands of Company B immediately before the transfer.

7. Pursuant to Section 1034.01(g)(2) of the Code, the holding period of all Company B's assets transferred to Company A shall include the period during which Company B held said assets.

8. The use by Company A of the Company B's net operating losses carryover may be subject to the limitations provided under Section 1034.04(t)(3) and 1034.04(u) of the Code if, at any time such net operating loss carryover is available as a deduction to Company A, there is an ownership change in Company A within the meaning of Section 1034.04(u)(6) of the Code. Until the Department issues regulations under Sections 1034.04(u) of the Code, Company A may rely on the corresponding regulations issued under Sections 381 and 382 of the US IRC, for these purposes.

9. The net operating losses accumulated by Company Aas of the date of the transaction shall be considered as arising from the same and/or integrated commercial activity of Company B, within the meaning of the Section 1033.14 of the Code and Article 1124(b)(2)-2 of the Regulation under the 1994 Code. Therefore, Company A would be able to use its available net operating losses against the income generated by Company B after the date of the transaction, subject to compliance with Article 1124(b)(2)-2(a)(3) of the Regulation under the 1994 Code.

No opinion is expressed as to the tax treatment of the above transaction under any other provision of the Code or the applicable Regulations that may also be applicable thereto, or as to the tax treatment of any condition existing at the time of the transaction, or any effect resulting therefrom, that is not specifically covered by this ruling. This ruling is based on the factual representations as described above. Any misrepresentation or hiding of a material fact shall render this ruling null and void. The opinion expressed herein shall be valid only upon the continued existence of the facts as submitted for our consideration. This opinion is issued exclusively to Company B and Company A, and may not be relied upon by any other person.

Cordially,

Elisa Vélez Pérez
Assistant Secretary
Tax Policy Area