

# Corporate Reorganizations, Spin Offs, and Merger & Acquisitions: Current Tax Planning Issues

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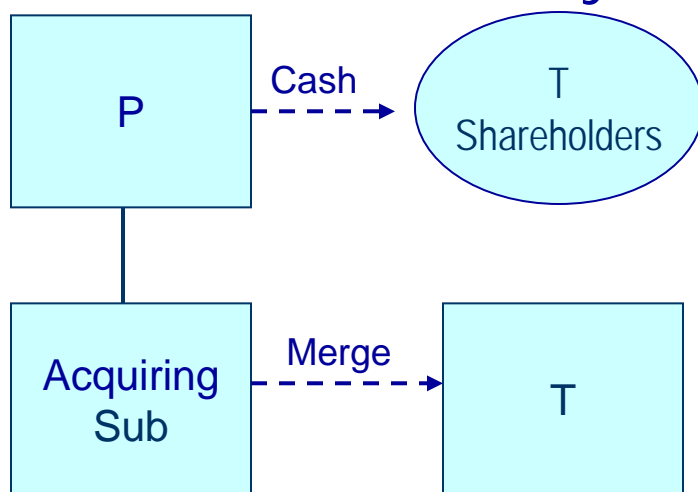
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# Avoiding Corporate-Level Gain in a Broken Reorganization

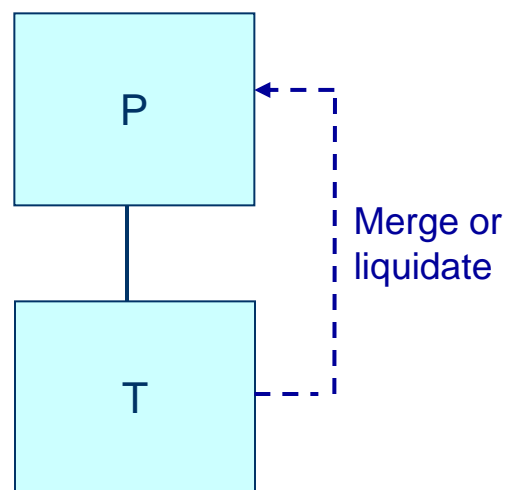
# Rev. Rul. 90-95\*

## Exclusivity of Section 338

Step 1.



Step 2.

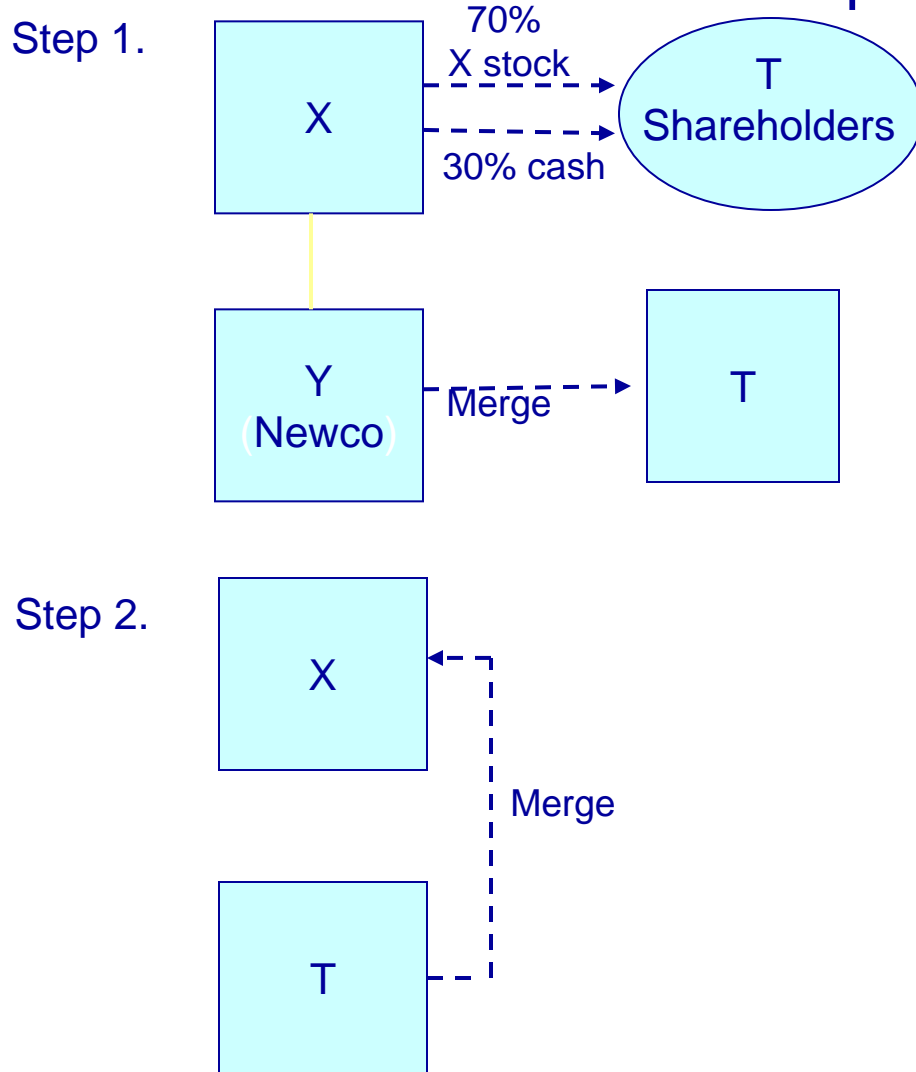


1. Does step-transaction doctrine apply? (Cf. Rev. Rul. 69-6, 1969-1 C.B. 104).
2. Exclusivity of Sec. 338: Step 1 is treated as purchase of T stock, a QSP. Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 73-427, 1973-2 C.B. 301.
3. In the case of a QSP, a Sec. 338 election is the exclusive route to step-up treatment.
4. Step 2 is therefore a Sec. 332 liquidation – carryover asset basis, if no election is made.

\* 1990-2 C.B. 67.

# Rev. Rul. 2001-46 – Situation 1\*

## 2-step Merger

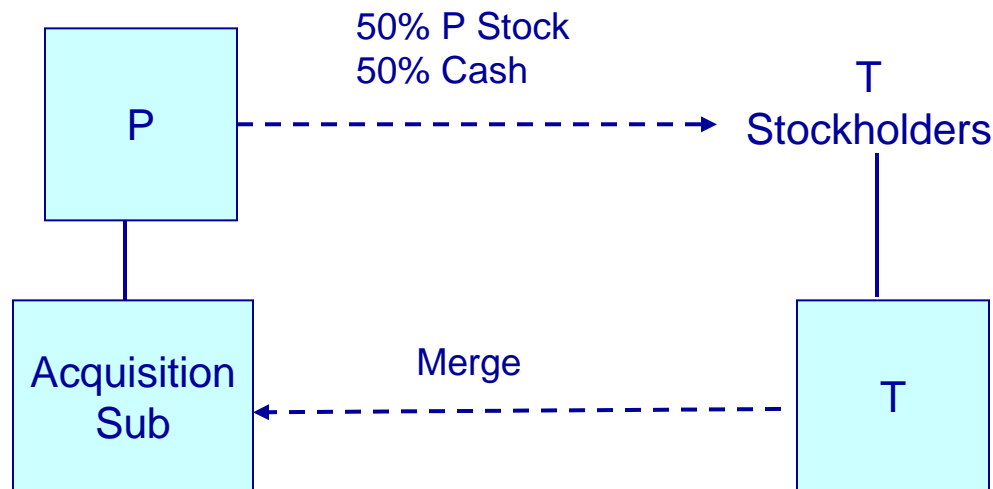


1. Step 1, viewed independently, is a QSP (Sec. 368(a)(2)(E) requirements are not met). Viewed that way, Step 2 would be a Sec. 332 liquidation. Rev. Rul. 90-95.
2. If Steps 1 and 2 are integrated, transaction is collapsed into a tax-free “A” reorganization. Cf. Rev. Rul. 67-274, 1967-2 C.B. 141.
3. Rev. Rul. 2001-46 holding: “The policy underlying §338 is not violated” by applying approach 2. Accordingly, A reorganization treatment applies; no §338 election may be made.
4. Reg. § 1.338(h)(10)-1 T provides that if Step 1 standing alone is a QSP, the parties may nonetheless make a joint Sec. 338(h)(10) election (and avoid reorganization treatment).

\* 2001-2 C.B. 321.

# Example 1 – Avoiding Risk of Corporate Level Gain

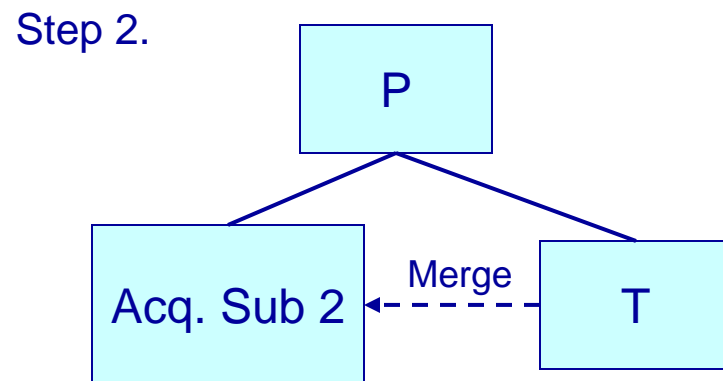
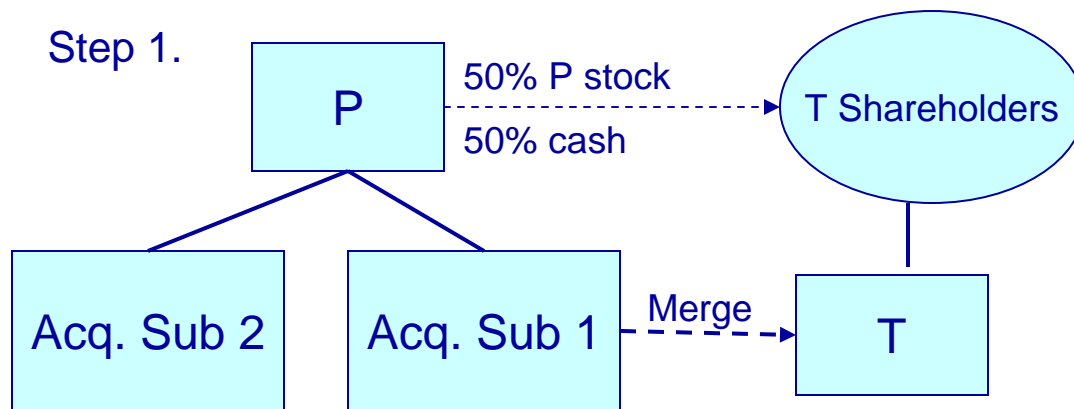
## Proposed Transaction



1. Intended treatment: Sec. 368(a)(2)(D) reorganization.
2. Risk of failed reorganization treatment:  
Taxable asset sale by T. Rev. Rul. 69-6. P incurs liability for T gain.

# Example 1 – Avoiding Risk of Corporate Level Gain

## Restructured Transaction – Two Step Acquisition



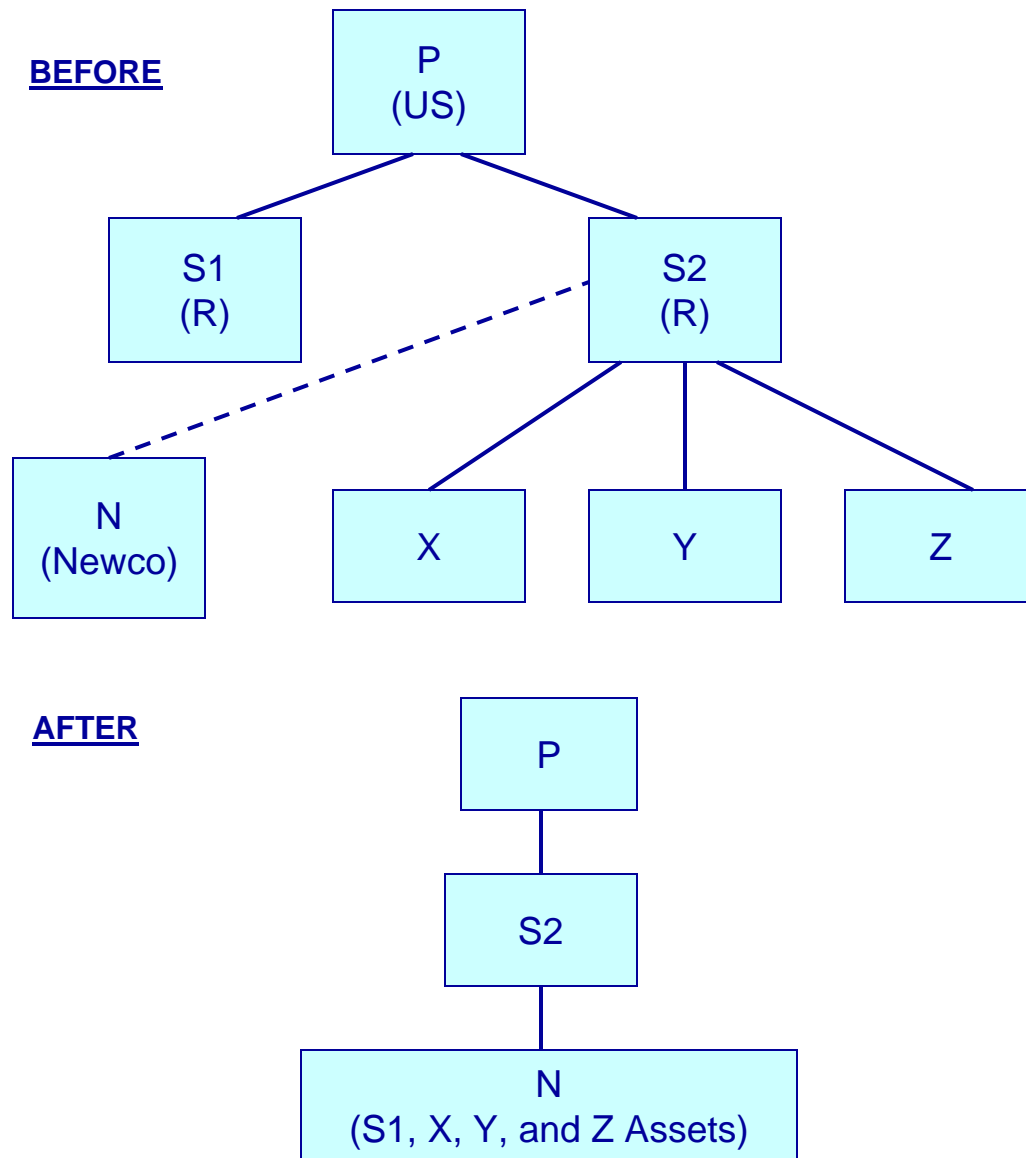
Result. Per Rev. Rul. 2001-46:

1. Steps will be integrated if the result is a good reorganization. Transaction should thus qualify under Sec. 368(a)(2)(D).
2. If reorganization treatment fails, Step 1 is a QSP. Step 2 is a “D” (or “F”) reorganization. See Rev. Rul. 2001-46; Regs. § 1.338-3(d).
3. Therefore, worst case is QSP, carryover basis to Acq. Sub 2, no corporate - level gain.

# **“D” Reorganizations and Section 304: Current Issues**

# Rev. Rul. 78-130\*

## Stock Transfer and Liquidation



Steps:

1. P transferred S1 stock to S2 in exchange for additional S2 stock.
2. S2 incorporated N.
3. S1, X, Y and Z each transferred substantially all of their assets to N for N common stock.
4. S1, X, Y, Z liquidated distributing all of the N stock to S2.

\* 1978-1 C.B. 114.

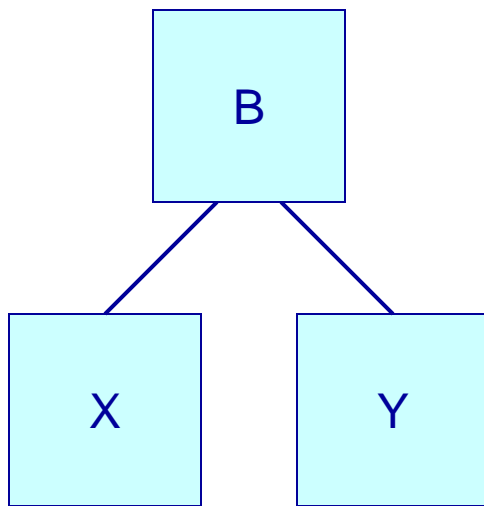


# Rev. Rul. 78-130 Analysis

1. P's transfer of S1 stock to S2 ignored – Sec. 351 does not apply.
2. S1 instead is treated as directly transferring its assets to N. See Rev. Rul. 67-274, 1967-2 C.B. 147.
3. So characterized, transaction did not qualify as a “D” reorganization because neither S1 nor P controlled N (under then-applicable law).
4. Service, however, recast as a triangular “C” – S1 viewed as transferring substantially all of its assets to N in exchange for voting stock of S2 (parent of N).
  - See also Rev. Rul. 76-123, 1976-1 C.B. 94; Rev. Rul. 72-405, 1972-2 C.B. 217; Rev. Rul. 75-383, 1975-2 C.B. 127; Rev. Rul. 2004-83, 2004-32 I.R.B. 157.

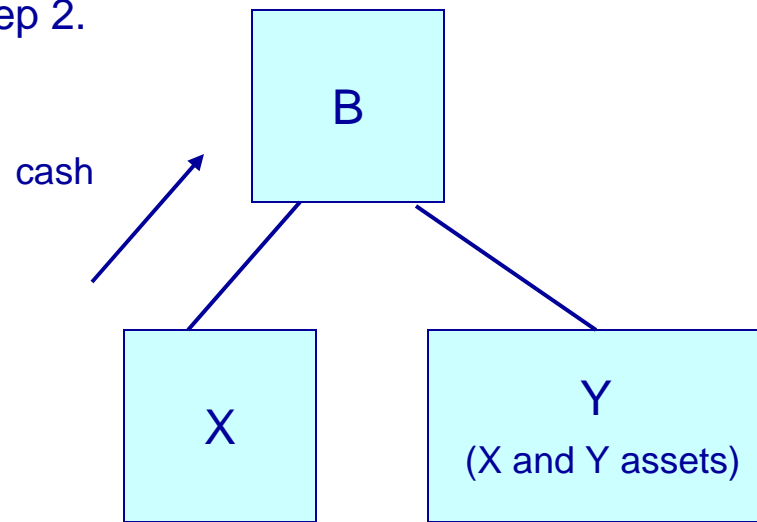
# Rev. Rul. 70-240\* "All-Cash D" Ruling

Step 1.



X sells its assets to Y for FMV

Step 2.



(liquidates)

X liquidates, transferring to B the cash remaining after paying the X creditors

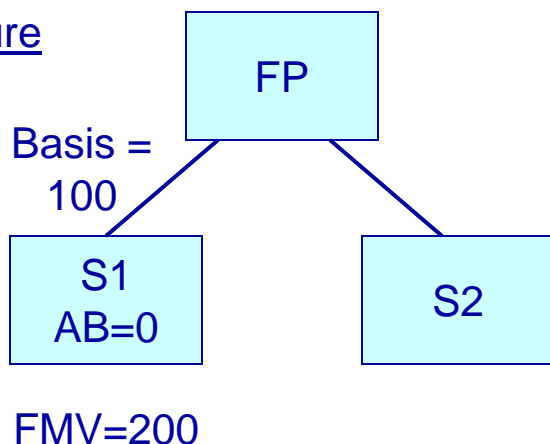
\* 1970-1 C.B. 81.

## Rev. Rul. 70-240 Analysis

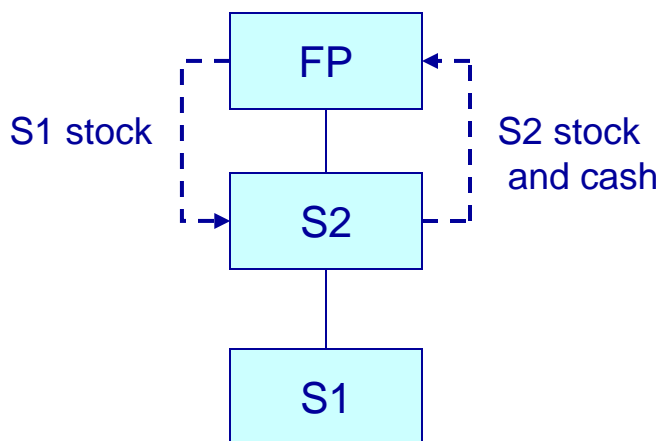
- “[A]lthough no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all of the stock of Y.”
- Sec. 354 exchange therefore deemed to occur (or requirement waived).
- Implicitly, COI treated as satisfied.
- Transaction is therefore a “D” reorganization. See also Rev. Rul. 2004-83.
- See Prop. Reg. § 1.368-1(f)(4) (exception in NNV proposed regs for cash D reorganizations).

# Example 2 --- Scope of 78-130

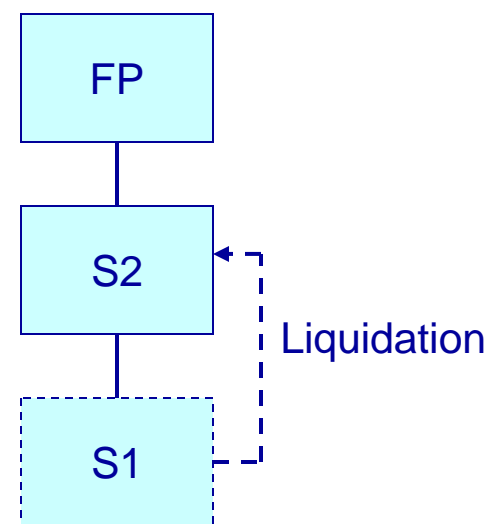
## Initial Structure



Step 1. P transfers S1 stock to S2 for \$150 additional S2 stock and \$50 cash



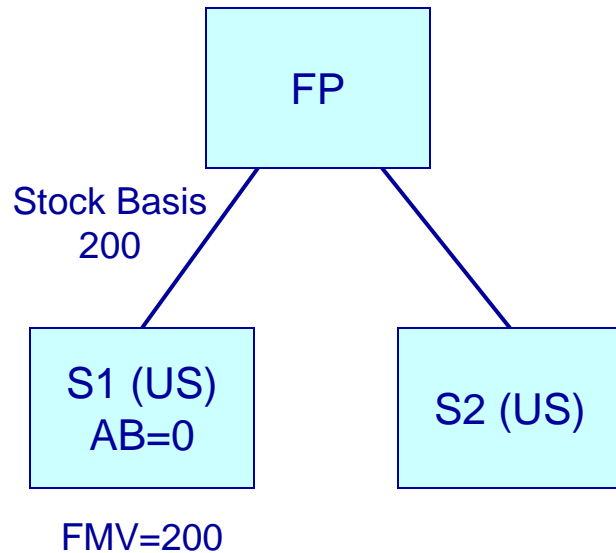
Step 2. S1 liquidates into S2 (or S1 checks-the-box).



## Example 2 - Analysis

1. Transaction treated as a “D” reorganization (assuming reorganization requirements are met).
2. Sec. 351 does not apply to transfer of S1 stock.
3. Neither does Sec. 304 (Rev. Rul. 2004-83, 2004-32 I.R.B. 157).
4. Cash received by FP is thus taxed under Secs. 354/356.

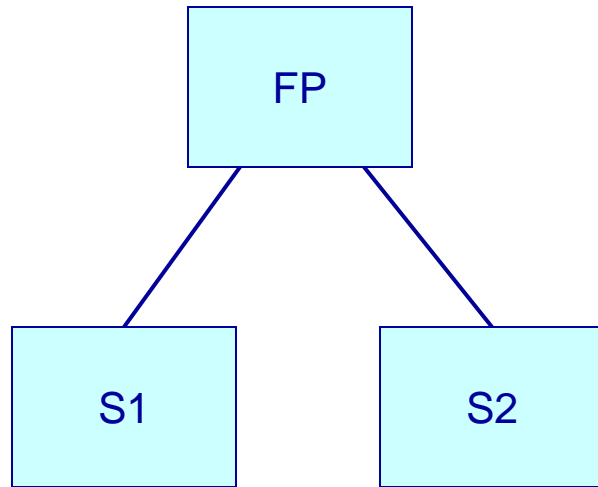
# Example 3 – Recently Acquired Stock



Same facts as Example 2, except FP's basis in S1 is \$200.

1. Same analysis as Example 2
  - D reorganization treatment applies
  - Sec. 304 does not apply.
2. Treatment of the cash –
  - “Dividend within gain rule” (see Sec. 356(a)).
3. Suppose S1 stock was transferred to S2 for \$200 cash (no S2 stock).
4. Does the result change if S2 is a Newco?  
See Reg. § 1.301-1(l); Prop. Reg. § 1.368-2(m)(4).

# Example 4 – Busted D



Same as Example 2, except in a third integrated step, S2 drops the S1 assets into PRS, in which S2 holds a 5% non-managing interest.

## Alternative Analyses

### 1. “Asset Transfer” characterization controls

- Taxable asset transfer from S1 to S2: \$200 gain to S1, step up to S2
- Sec. 304 does not apply
- Sec. 267 applies to losses

### 2. Form controls.

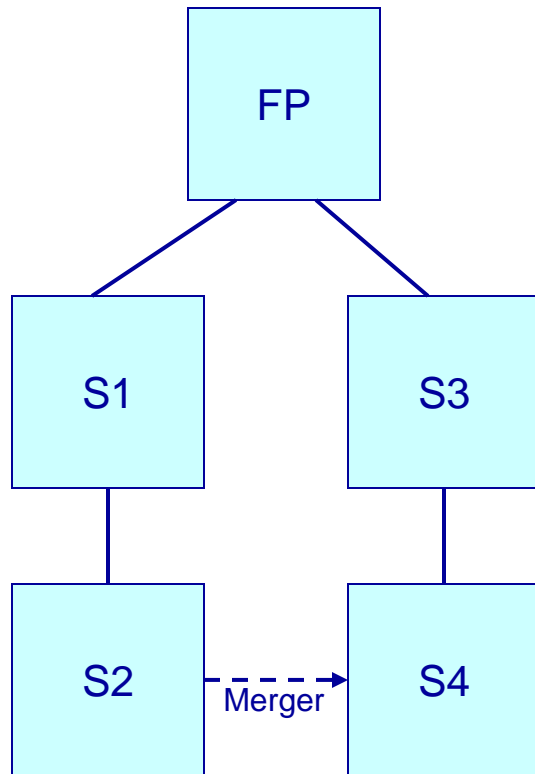
- good Sec. 351 drop of S1 stock to S2.
- Sec. 332 liquidation S2 into S1.
- both tax-free transfers, but Sec. 304 applies.

# The 78-130 Construct Re-examined

- Principles have not been applied to cause a tax-free transaction to become taxable.
- Authorities for respecting form:
  - See
    - In Re Chrome Plate, 614 F.2d 990 (5th Cir.), cert. denied, 449 U.S. 842 (1980).
    - Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), affd. Mem., 886 F.2d 1318 (7th Cir. 1989).
    - Tracinda Corp., Inc. v. Commissioner, 111 T.C. 315 (1998).
- General principle that failure to qualify under one “tax-free” provision does not preclude “falling back” to another.



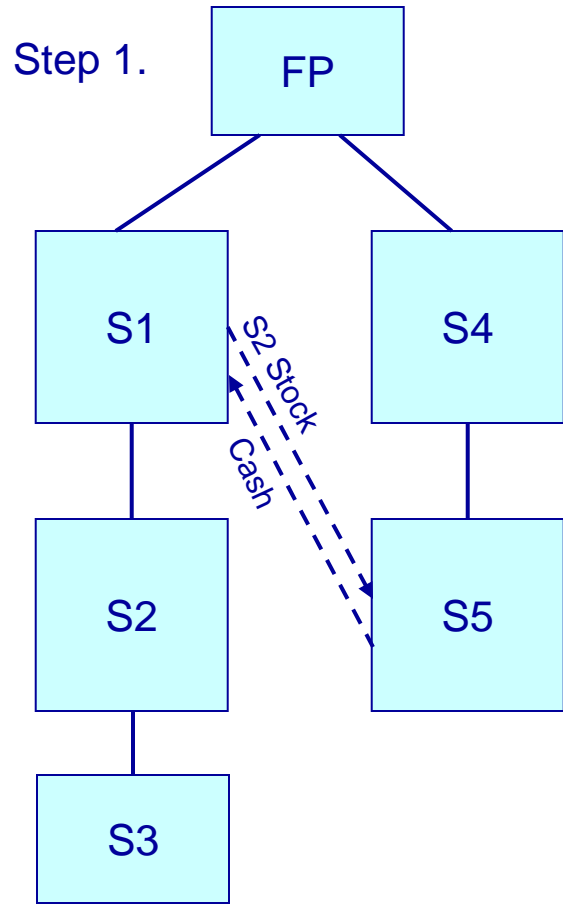
# Example 5 – Lower-Tier Cross-Chain Transfers



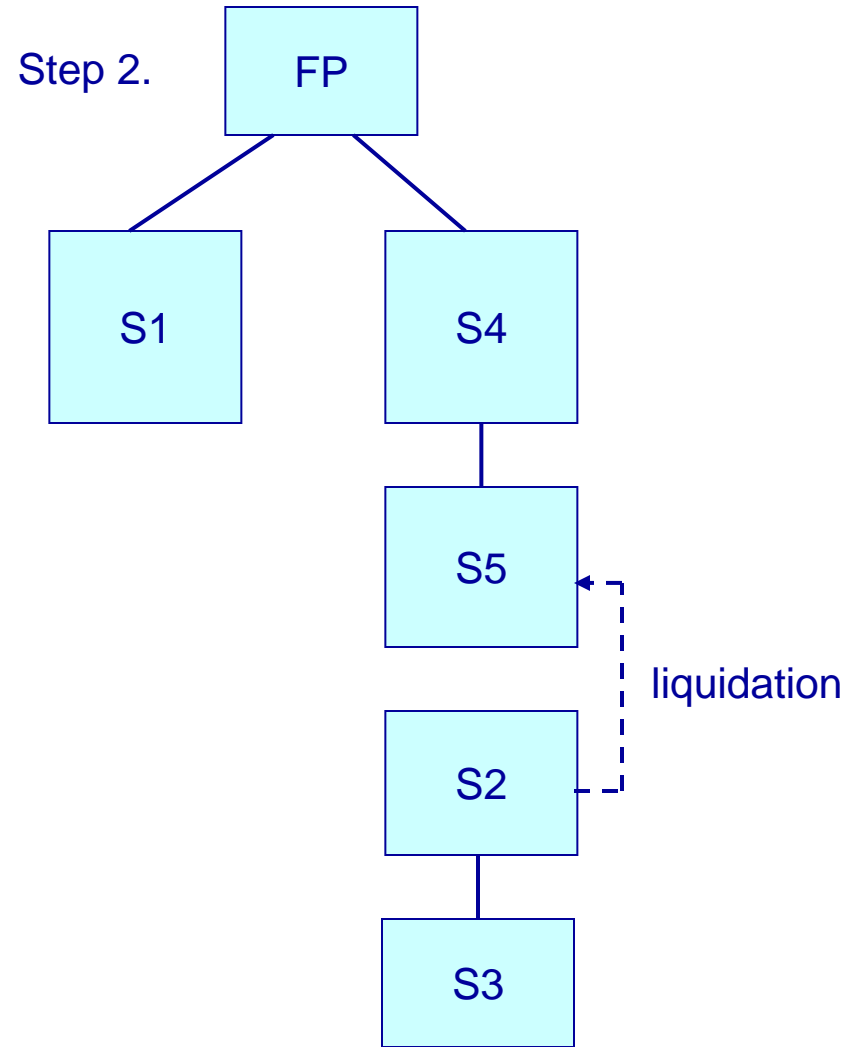
S2 merges into S4 for no consideration.

1. Is the transaction a good “D” reorganization.
  - control requirement is satisfied.
  - but is failure to issue stock a “meaningless” gesture (cf. Rev. Rul. 70-240)?
2. If transaction is a good “D”, what is the construct? Is S4 stock deemed issued to S1, then transferred to FP (then dropped to S3)? Sec. 311 gain / withholding tax on the deemed distribution? See PLR 8911067, PLR 9229026, PLR 9336029.

# Example 6 – Lower-Tier Cross-Chain Sales



S1 sells stock of S2 to S5 for FMV



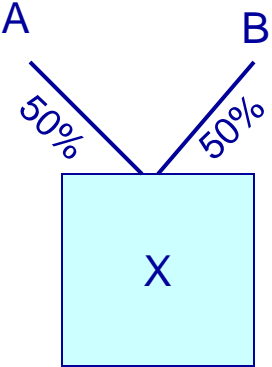
S2 liquidates into S5 (or checks-the box)

## Example 6 - Analysis

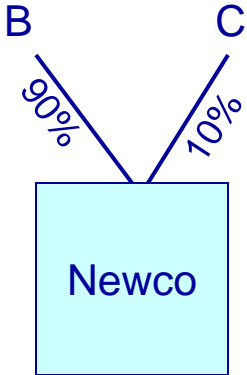
- Is this a good “D” reorganization? Cf. Rev. Rul. 70-240. Does “meaningless gesture” analysis apply?
- If not, would issuance by S5 to S1 of a small amount of stock qualify the transaction as a “D”? How much?
- Would it matter if it were later determined that the FMV of the S2 stock was less than the amount of cash paid by S5 in Step 1?
- Does Sec. 304 apply to the transfer of S3 stock to S5? See Sec. 304(b)(3)(A) as amended by Deficit Reduction Act of 1984, P.L. 98-369, § 712 (l) (2), at 1984-3 (Vol. 1) C.B. 461; legislative history to Deficit Reduction Act of 1984, P.L. 98-369, H.R. Rep. No. 98-432 Pt. 2, 1624 (1984).

# Example 7 – Less Than 100% Common Ownership

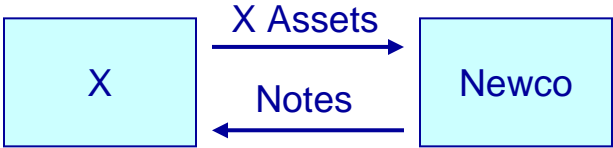
## Initial Structure



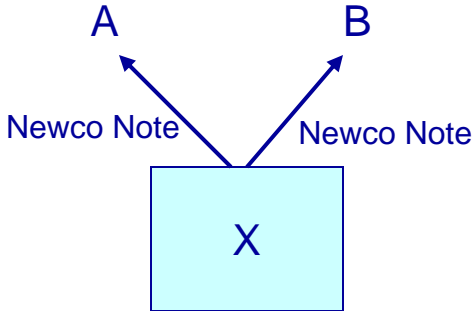
## Step 1.



## Step 2.

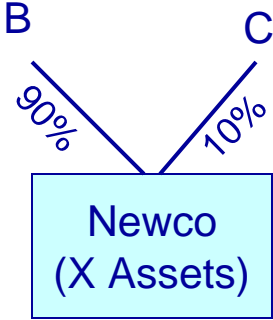


## Step 3.



X liquidation

## Result

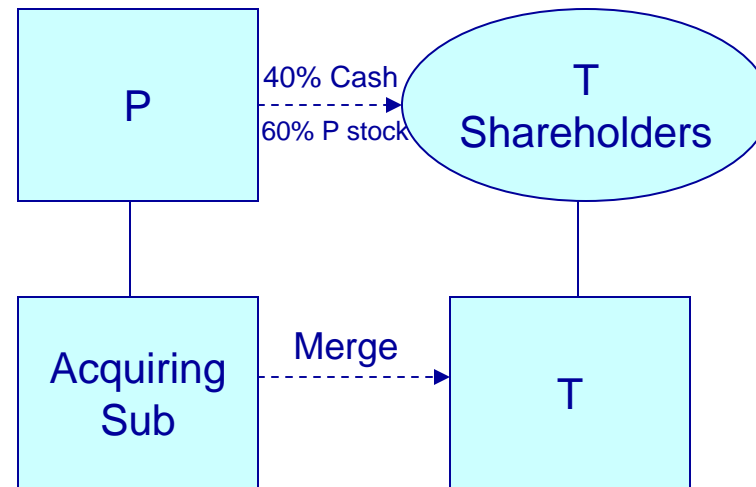


## Example 7 Analysis

1. Is this a good “D” reorganization?
  - See PLR 200551018 (Not a “D”).
  - See also *Warsaw Photographic Assoc. v. Comm’r.*, 84 T.C. 21 (1985).
2. Would issuance of nominal stock have qualified the transaction as a “D” reorganization?
3. What if A and B each owned 49.5% of Newco and C owned 1%?

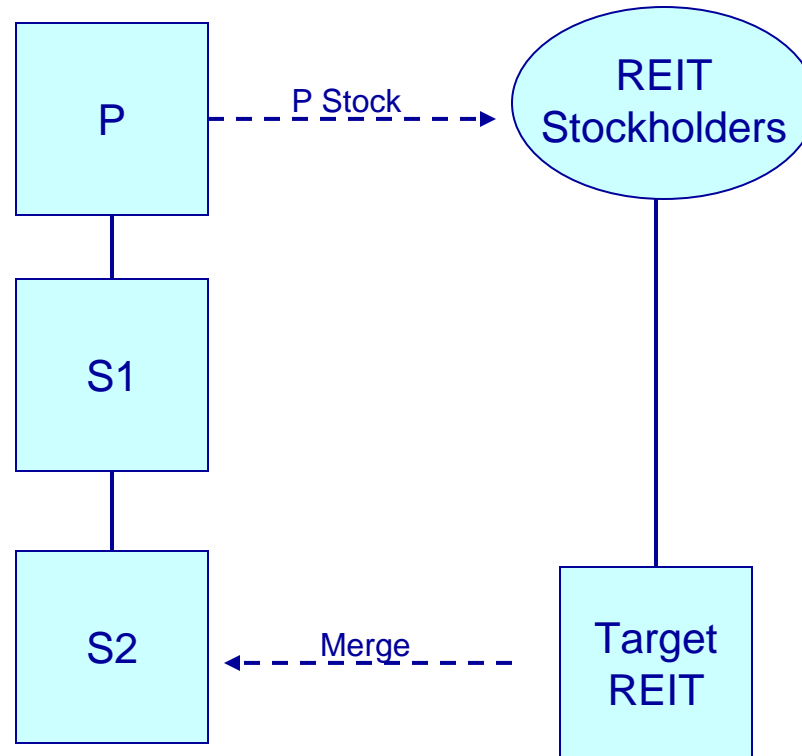
Breaking Reorganization or Section 351  
Treatment to Achieve a  
Taxable Stock or Asset Transfer

# Example 8 – Busted Reorganization to Achieve FMV Stock Basis



1. Analysis: No B Reorganization or Sec. 368(a)(2)(E).
2. Considerations: (1) Do public shareholders of T care in light of boot within gain rule of Sec. 356?; (2) Basis step-up facilitates later planning.
3. Is there a policy basis for directional difference?
4. Compare to Sec. 351 with Smaller Percentage of Stock.

# Example 9 – Use of Grandparent Stock



Target REIT merges into S2.

REIT stockholders receive P (grandparent) stock.

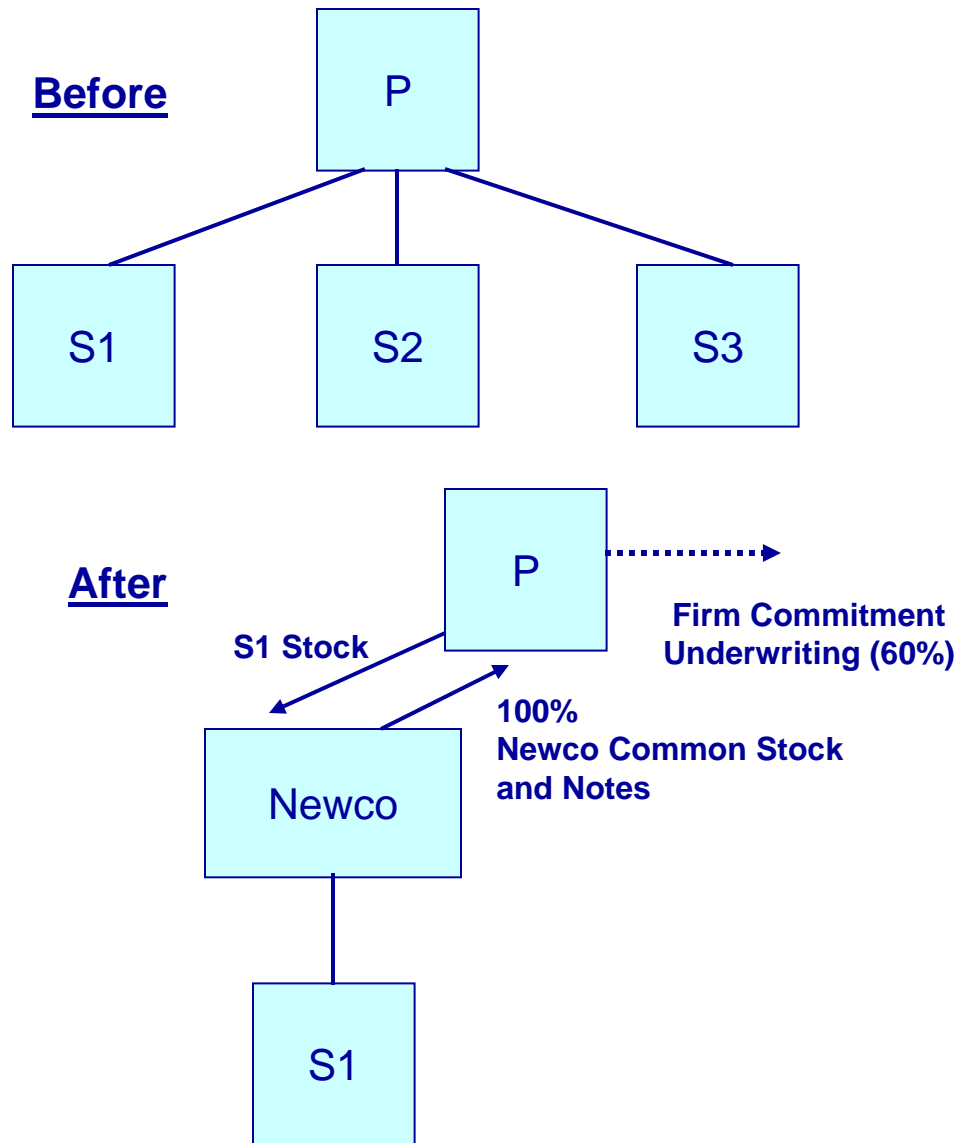
Parties intend “taxable asset sale” treatment. See Rev. Rul. 69-6.



# Example 9 Analysis

1. Statute permits only parent stock to be used in a triangular reorganization. Sections 368(a)(2)(D); 368(c). Grandparent stock would thus (apparently) disqualify the transaction.
2. In so-called “cause to be directed” situations, however, PLRs have recast direct mergers of targets into “lower tier” subs as “over the top” acquisitions by a qualifying entity followed by dropdowns. See, e.g., PLR 8923046, PLR 8923047, PLR 9532029, PLR 9617051. See also Rev. Rul. 58-93, 1958-1 C.B. 188; Rev. Rul. 64-73, 1964-1 C.B. 142; Rev. Rul. 70-224, 1970-1 C.B. 79.
3. Would IRS seek to recast here?
4. What is the continuing viability of “cause to be directed” structures and rulings?

# Example 10 – Busted 351/Qualified Stock Purchase



Goal: P wants to sell 60% of its interest in the S1 business, retain 40%, and step-up the basis of the S1 assets.

Steps:

1. P forms Newco.
2. P transfers S1 stock to Newco in exchange for 100% of Newco common and Newco notes.
3. Prior to Step 2, P enters into a firm commitment underwriting pursuant to which underwriter will sell 60% of P's Newco shares in an IPO.

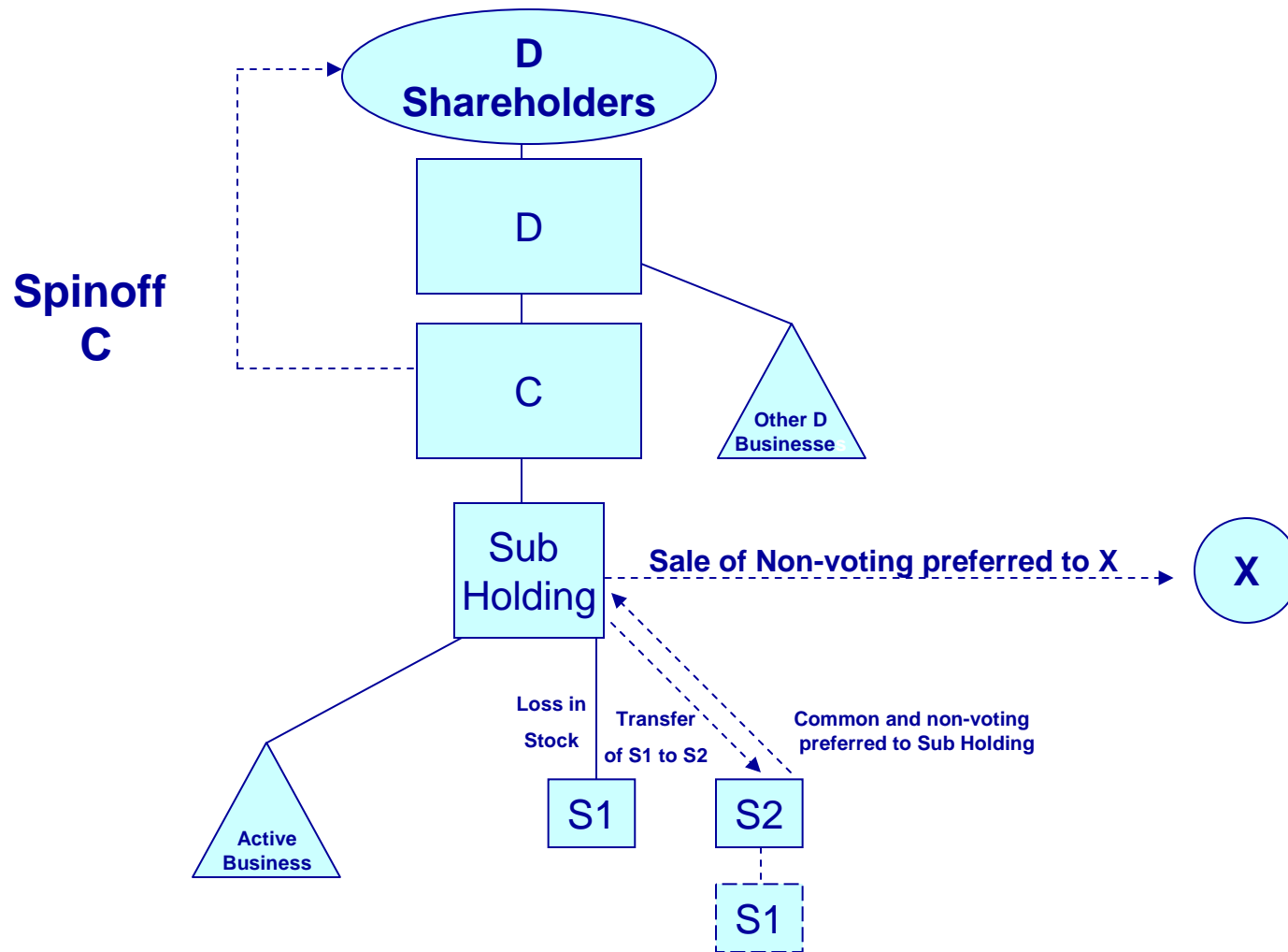
# Example 10 Analysis

- Transfer of S1 stock to Newco does not qualify under Sec. 351, because prior to the transfer P has a binding commitment to sell more than 20% of the Newco stock to non-transferors. Rev. Rul. 79-70, 1979-1 C.B. 144.
- Because the exchange of S1 stock for Newco stock is pursuant to an integrated plan which includes the sale of shares in the IPO, Newco is not “related” to P for purposes of Sec. 338 (h) (3) (A) (iii). Reg. § 1.338-3 (b) (3) (ii) (C).
- Because 351/354 do not apply and Newco does not acquire the S1 stock from a related party, Newco has made a QSP. Newco and P can make a Sec. 338 (h) (10) election. See Reg. § 1.338-3 (b) (3) (iv), Ex1.

## Example 10 – Issues

- What result if P transferred the S1 stock to Newco solely for S1 common stock? See Reg. § 1.368-1 (e) (1).
- What result if in the IPO, Newco sells some of its stock in a primary offering? See Rev. Rul. 79-194, 1979-1 C.B. 145.
- What if the S1 business was held in a division (or DRE) instead of in a subsidiary?
- What if P sells more than 20 % of the Newco stock in the IPO, but “intends” to sell an additional 40 percent within the next two years? See PLR 200427011.

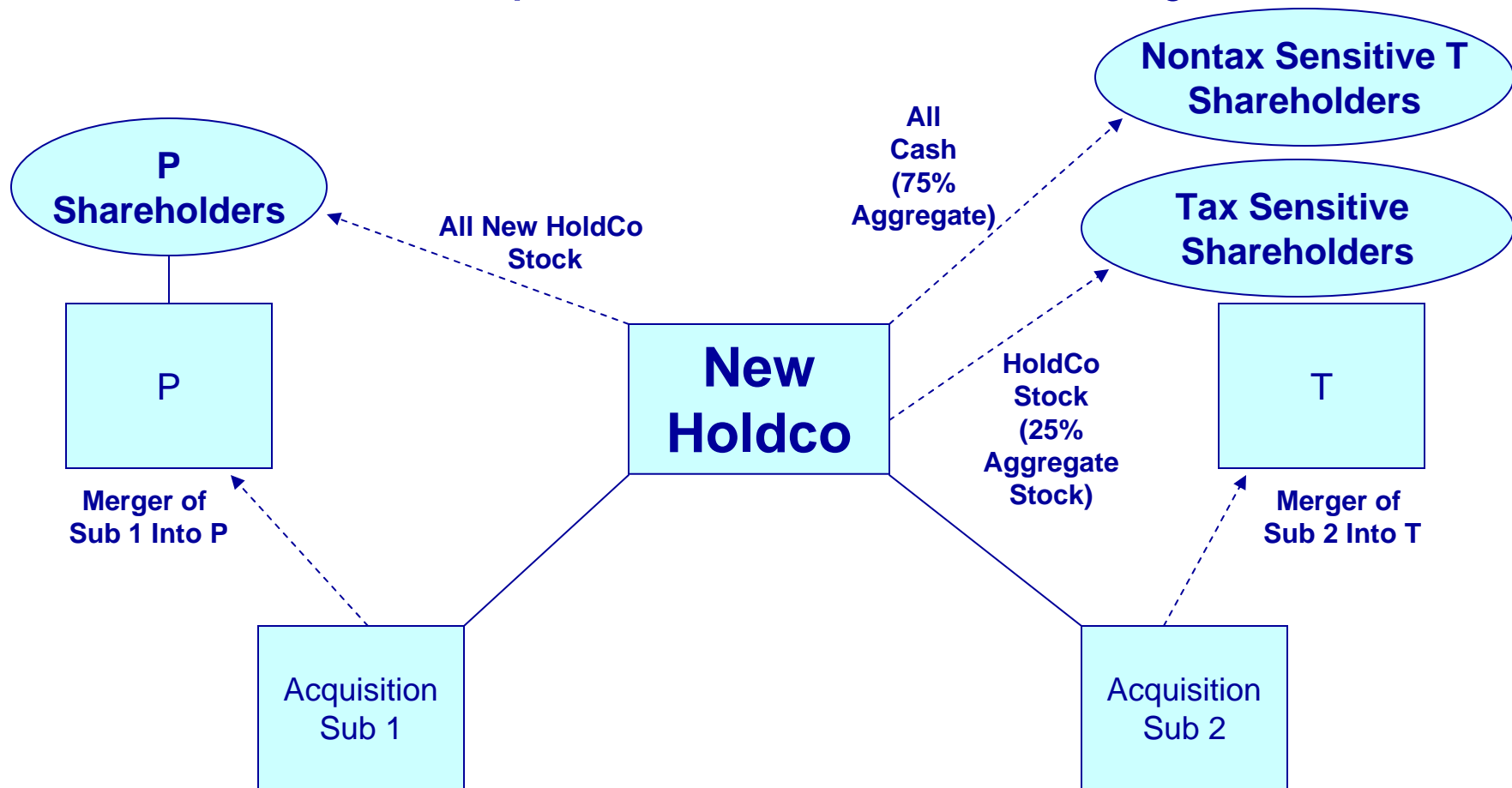
# Example 11 – Busted Section 351 in Tax-Free Spinoff



1. How much preferred is necessary to break Sec. 351?
2. Trade or business analysis. See Sec. 355(b)(2)(A).
3. Is selectivity a policy issue?
4. Spinoff breaks Sec. 267 relationship. See Reg. §1.267(f) (application of consolidated return principles).

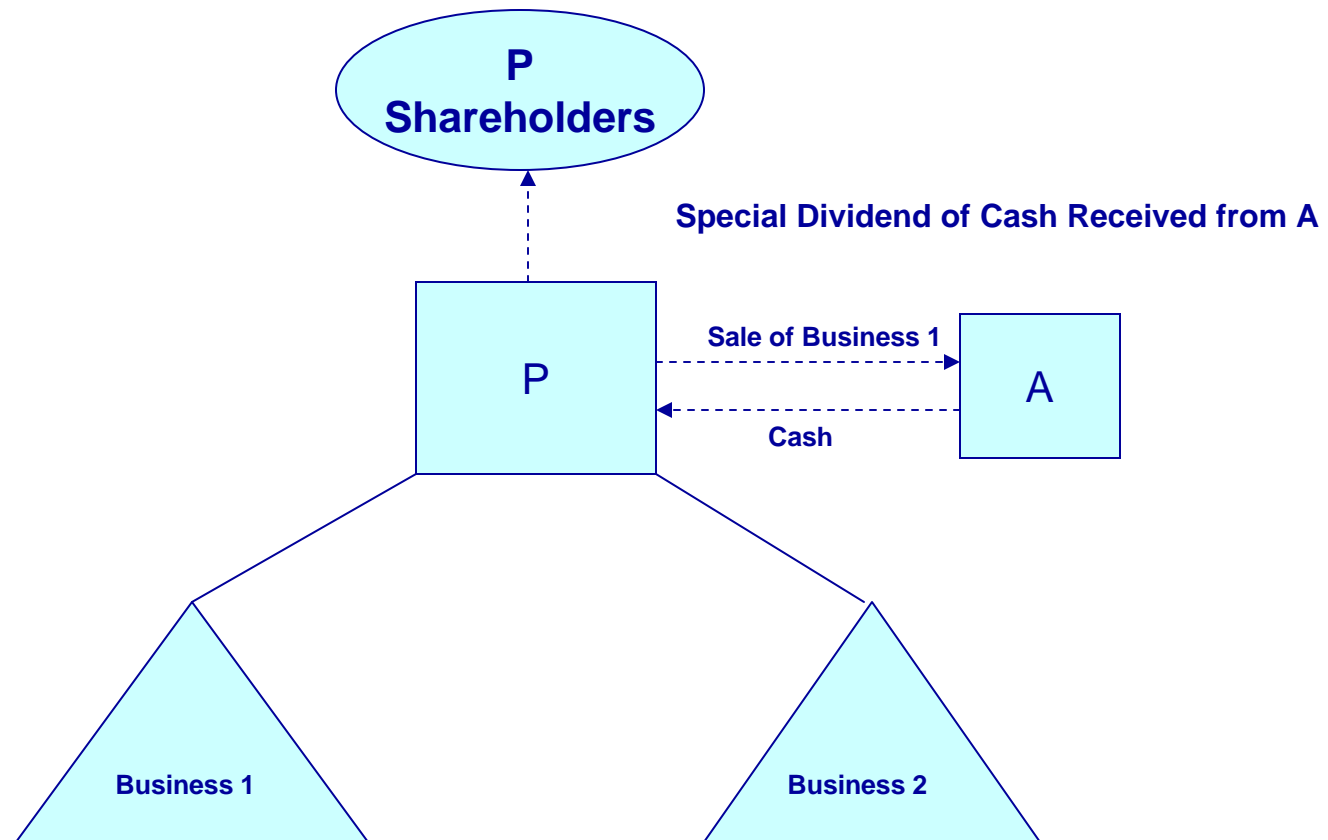
# Achieving Favorable Tax Results for Exchanging Shareholders

# Example 12 – Double-Dummy



1. Transaction is subject to Sec. 351: stock of P and T treated as contributed to New Holdco by shareholders.
2. Business Rationale: Only some Stockholders are tax sensitive; and large portion cash.
3. Transferor analysis: transferors (which must meet 80 percent control test) must receive at least some stock.
4. Does it make a difference if shareholders get only 1 percent?; 5 percent?

# Example 13 – Partial Liquidation By Special Dividend

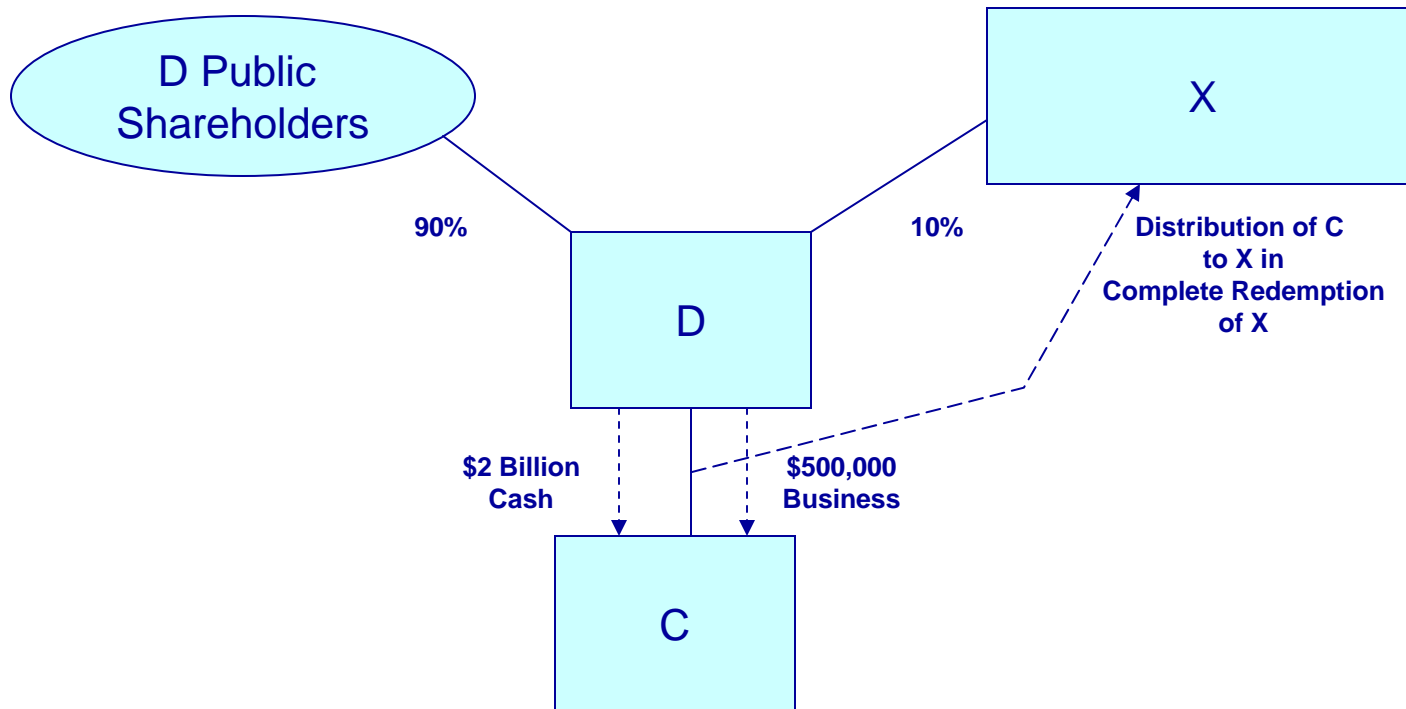


1. What are advantages of capital gain treatment of partial liquidation in a world with special treatment of dividends?
2. Should distribution in form of dividend be subject to Sec. 302(b)(4)? See Rev. Rul. 77-245, 1977-2 C.B. 105.
3. See PLR 200550021.



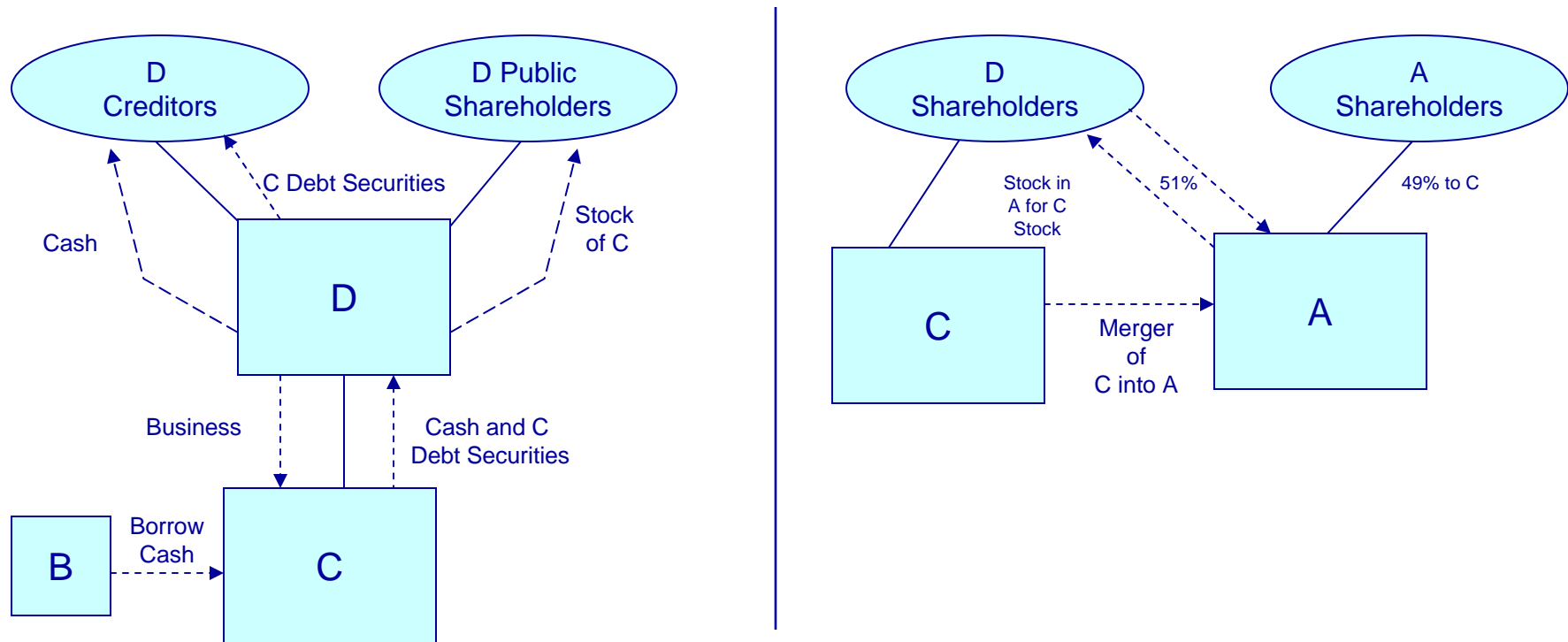
## Other Spin Off/Split-Off Issues

# Example 14 – Cash Rich Splitoff



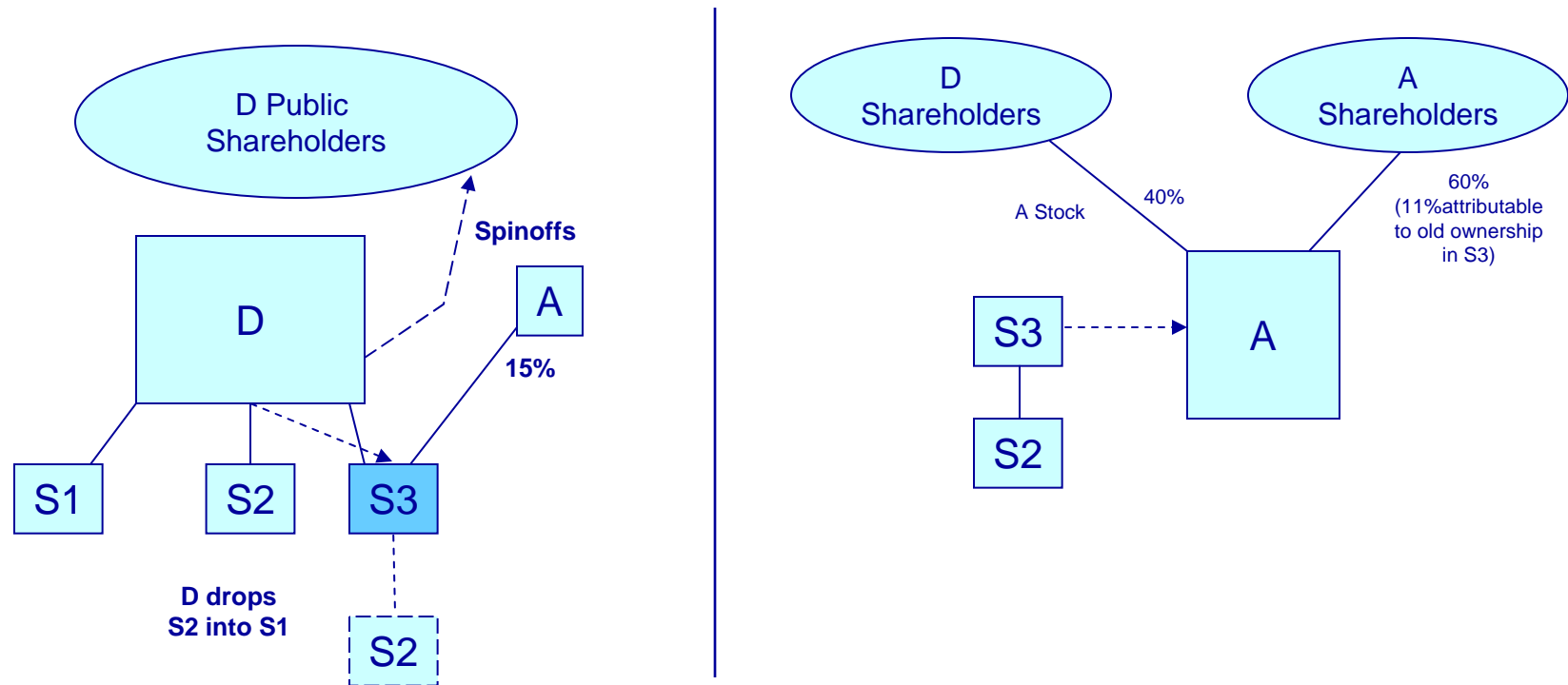
1. Treatment Under Current Law: Tax-free Division Possible Because Device Clause Does Not Apply and Low Threshold for Trade or Business.
2. See Administration Proposal and Proposed Legislation.

# Example 15 – Leveraged Spinoff and Merger



1. The Sec. 355(e) constraint: A shareholders get no more than 49%.
2. Note limits on leveraging after 2004 Legislation.
3. Policy Proposal sponsored by Investment Banks: Taxability on Change in Control only if Excess Leveraging.

# Example 16 – Predecessor/Successor and Section 355(e)



1. Should S1 be predecessor of S3 or S3 a successor of S1?
2. Policy Analysis: is this fundamentally different than splitoff?; Should it matter parties could not have done deal with respect to S2?