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# TAXATION OF CORPORATE REORGANIZATIONS

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Tax cases for which he has had responsibility over the last decade have involved the tax-free nature of the AT&T divestiture, international intercompany pricing, stock-debt and other related corporate party issues, appellate review and reversal of criminal tax convictions, net operating losses, and issues arising in major corporate bankruptcy litigation. In addition to his extensive trial experience, he has argued tax appeals before most of the Federal Courts of Appeal as well as the United States Supreme Court.

Mr. Ferguson graduated from Cornell University in 1952 and received his law degree from the Cornell Law School in 1954. From 1954-1959, he served as a trial attorney and special assistant to the Attorney General in the Tax Division, and was one of the original 30 lawyers in the Department's Honor Graduate Program. He earned an LL.M. in Taxation from New York University School of Law in 1960 and, for the next 17 years, was a professor of law at Iowa, Stanford and New York University, where he was the Charles L. Denison Professor of Law.

Mr. Ferguson was of counsel to the firm of Wachtell, Lipton, Rosen & Katz from 1968 to 1977. From 1977 until 1981, he was the Assistant Attorney General of the United States in charge of the Tax Division of the Department of Justice. He joined Davis Polk in 1981 at the end of the Carter Administration.

Mr. Ferguson is the author of several books and articles on aspects of federal taxation. He is a member of the American Bar Association and former Chairman of its Tax Section, as well as a member of the New York State and City Bar Associations. A lecturer on taxation and consultant to government and non-profit groups, Mr. Ferguson is vice chair of the Board of Trustees of Lewis & Clark College and serves on the Council of Cornell

Professor John DAVIDIAN: Good morning. My name is John Davidian. I am on the faculty at St. John's School of Law. Welcome to our second panel of the day, which will deal with several recent developments in the taxation of corporate reorganizations. St. John's University School of Law is truly fortunate to be able to present a group of speakers who are leading figures in the field of tax generally and specifically in the area of corporate taxation.

The panelists have selected topics for discussion that have been the subject of recent governmental activity. The first to be considered will be Treasury Regulations that were issued earlier this year that generally relax the requirement for what we call continuity of shareholder interest in connection with corporate reorganizations.<sup>1</sup>

Thereafter, consideration will be given to the 1997 amendments to the Internal Revenue Code which modified the corporate spin-off rules of section 355 of the Code and which have come to be commonly known as the anti-*Morris Trust* rule.<sup>2</sup>

Finally, the panel will examine the effect of other 1997 amendments to the Code that treat the receipt of non-qualified preferred stock as boot in corporate reorganizations.<sup>3</sup>

University and the Board of Visitors of the Cornell Law School.

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Mr. Kohl received his B.S. in Mathematics, *summa cum laude*, from Tufts University in 1978. He is a member of Phi Beta Kappa. He received his J.D. in 1981 from Yale Law School, and his LL.M. in Taxation from New York University School of Law in 1983, where he received the Harry J. Rudnick Memorial Award.

Mr. Kohl was Acting Assistant Professor at New York University School of Law from 1983-1984 and lectured at Stanford University from 1990-1993.

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<sup>1</sup> Treas. Reg. § 1.368-1(e) (as amended in 1998).

<sup>2</sup> I.R.C. § 355(e) (1998) (setting forth rules for recognizing gain on certain distributions of stock or securities in connection with acquisitions).

<sup>3</sup> See I.R.C. § 351(g) (1998) (listing instances where nonqualified preferred stock is not treated as stock); I.R.C. § 354(a)(2)(C) (1998) (setting forth limitations to exchange of stock and securities in certain reorganizations); I.R.C. § 356(e) (1998) (excluding non-qualified preferred stock from term "other property" to extent receipt without recognition

To give the panel some direction, Jim Eustice has been kind enough to prepare a problem set dealing with each of the three topics.<sup>4</sup> It is my distinct pleasure at the moment to turn over the proceedings to Jim Eustice to begin the discussion with the continuity of interest regulations.

Mr. James S. EUSTICE: We are doing a typical tax panel start here by going to the back end of the problem and starting with what, for lack of any other term, has come to be known as continuity of shareholder interest. This, by the way, is the only good news that we have for you this morning. Everything that follows in this program is going to be, in relative terms, bad news and yet another complex, ill-considered exercise in poor legislation.

Mr. Glen Arlen KOHL: I am not sure I agree with that.

MR. EUSTICE: Well, I knew you would not Glen.

MR. KOHL: But I am only one of six.

MR. EUSTICE: Okay.

PROF. DAVIDIAN: Well, it took 30 seconds for a person to disagree with him. We are right on schedule.

MR. EUSTICE: Well, it is legislation this time and not a regulation. I have a feeling that one of these days there is going to be a tax bill out there with my number on it that is going to match me when I am too old to learn and too young to quit. This one has not done it yet but it is getting close.

Actually, I think it is worthwhile stepping back a moment to decide what it is the new continuity regulations were all about—and I agree with these January '98 regulations. They really represent a return to basics—and I mean basics. What inspired them, I am not sure. Maybe it was the Bar Association reports, but whatever it was, it is welcome news indeed.

I think there were two critical cases that came down within recent memory, other than the old Supreme Court continuity cases<sup>5</sup> which hopefully everybody here is familiar with. If you

of gain would be permitted).

<sup>4</sup> See generally James S. Eustice, *Corporate Reorganizations—Current Developments and Issues*, appended herein as Appendix I, at 66-74.

<sup>5</sup> *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) (concluding “that it is immaterial that the transfer shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation”); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Nelson v. Helvering*, 296 U.S. 374 (1935) (holding that in order to be considered a reorganization, seller must acquire definite substantial interest in purchaser); *Pinellas Ice & Cold Storage v. Commissioner*, 287 U.S. 462 (1933) (introducing continuity of interest doctrine and holding that in order to fall within reor-

read those cases, you get a sense of unreality about whether the *Roebing* case<sup>6</sup> 50-year debt security that was secured by a mortgage was any different in reality from the redeemable preferred stock issued in the *Nelson* case.<sup>7</sup> The Supreme Court thought they were.

But you could extract almost anything from these decisions, other than a fundamental explanation of what true continuity of interest is. However, I think the regulation project certainly was concerned with one particular case that came out of my home state, *McDonald's of Illinois*. It started out as *McDonald's of Zion, Illinois*, which is the southern part of Illinois. In the Tax Court opinion, I think Judge Hall got the matter entirely right saying that the stock issued in the acquisition, even though the parties knew they wanted to sell it as quickly as they could (and they wanted registration rights), that fact did not break the reorganization.<sup>8</sup> Unfortunately, the case got appealed to the 7th Circuit and the 7th Circuit said this was a violation of continuity of interest.<sup>9</sup>

Well, everybody learned to live with *McDonald's*. They had the eventual successor cases. How long is long enough? Were they thinking about selling or was it new? This went on for a while and eventually, the regulation project focused almost exclusively on getting rid of the *McDonald's* post-reorganization stock sale problem.

Mr. Philip J. LEVINE: Yes, if you look at the cases, sometimes they said there was good continuity. Sometimes they said there was not. The facts were virtually indistinguishable. The one unifying theme was that the government always lost, which may have had something to do with why this regulation project was

ganization exemption, seller must acquire "an interest in the affairs of the purchasing company more definite than that incident to ownership of its short term purchase money notes").

<sup>6</sup> *Roebing v. Commissioner*, 143 F.2d 810 (3d Cir. 1944) (holding that there was no continuity of interest when proprietary interest was surrendered when shareholders exchanged their stock of old corporation for long-term bonds of new corporation).

<sup>7</sup> *Nelson v. Helvering*, 296 U.S. 374 (1935) (finding continuity when consideration consisted 62% of cash and 38% of non-voting preferred stock).

<sup>8</sup> *McDonald's of Zion, Illinois v. Commissioner*, 76 T.C. 972, 994-95 (1981) (holding that postmerger holding period for qualified reorganizations is not required to fulfill continuity of interest test).

<sup>9</sup> *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520, 528 (7th Cir. 1982) (holding that sales redemptions and other dispositions subsequent to exchange which are part of reorganization will be considered in determining continuity of interest).

undertaken.

Mr. M. Carr FERGUSON: Well, it is hard to defend the 7th Circuit judges in *McDonald's*, but let me try for just a second. The Internal Revenue Service helped them into their confusion. The Court pointed out that if the taxpayers had approached the Service with a request for a ruling in circumstances which included a representation that the selling shareholders getting the McDonald's stock intended immediately to dispose of it, they would have been rebuffed. The ruling guidelines of the Service included a requirement that taxpayers represent that there not be a current intent to dispose of too much of the stock obtained. Built into those guidelines was an assumption on the part of the Internal Revenue Service that, to be part of and to qualify as a tax-free reorganization, shareholders had to demonstrate an intent to hold their stock indefinitely, which evidenced their continuity of interest.

This post-transaction continuity idea, built into the rulings process, prompted the 7th Circuit, faced with the Government now claiming that there *was* continuity, to rule that the IRS could not have it both ways. It could not insist on post-transactional retention for ruling purposes and yet ignore it in litigation.

MR. EUSTICE: The damage was a taxpayer victory. It was the buyer who wanted to step-up basis.

MR. FERGUSON: The buyer wanted section 334(b)(2), tax-free basis step-up included as a "purchase." An interesting footnote to *McDonald's* is that the same Big 8 (at that time) accounting firm gave an opinion to the sellers that it was tax-free and to the buyer that it was a section 334(b)(2) step-up. It turned out that they were right on both occasions.

MR. EUSTICE: Another excellent reason for the issuance of these new regulations.

MR. KOHL: In terms of the issuance of the regulations, there has been a lot of speculation. Phil, Bill and I almost never agree, and so probably will not agree with this but I think the reason why we initiated that regulation project is the same reason seminars like this are a good idea. There was an ABA seminar in Washington where they talked about continuity and questioned where the law had been and said maybe it is really just a question of what we have got as opposed to what you did with it.

Then we all talked afterward and thought this was an area that we should look at, along with *Seagram*.<sup>10</sup>

MR. FERGUSON: That was the other case that I think was important here.

MR. KOHL: But in fact, I do not think it had anything to do with the continuity regulations, and, if anything, that case might have slowed things down because we have the issue of not wanting to interfere with the litigation. Also, as an aside I should note that this regulation project was one of the few topics where, in the beginning, we all seemed to agree on the general direction.

MR. FERGUSON: Well, that was one of the changes between the proposed and the final regulation.

MR. LEVINE: I think *Seagram* did have something to do with it. I think *Seagram* really caused us to think about what the principles should be in continuity. One of the major players in the regulation process was also a very heavy participant in the *Seagram* litigation. So, it is always very hard to figure out how these things started, but at least in this case it was a cure and not a disease.

MR. EUSTICE: Of course, the final regulations blessed the *Seagram* result. *Seagram*, of course, was a rather strenuous tender offer struggle over Conoco Oil between DuPont and *Seagram*'s. I think DuPont had bought a little over a half of the shares for cash and *Seagram*'s had bought about 30 percent for cash. The eventual winner, DuPont, went on to squeeze out the rest of the people with a merger. Here was eighty percent, roughly, of the total consideration consisting of cash, which sort of makes people's continuity of interest antenna vibrate.

But the Court held, in essence, that DuPont's cash purchases cut against continuity, which the regulations now agree with, obviously, but that *Seagram*'s purchases did not. They just jumped into the pool of what became this moiling fungible pool of shareholders, whether you knew who they were or not, and that is the view taken in the final regulations as well: *Seagram*'s purchases do not affect continuity but the acquirer, DuPont's, purchases do.

<sup>10</sup> J.E. *Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) (holding that continuity of interest existed where approximately 54% of outstanding stock was exchanged for stock in new corporation).

If you go through our little set of examples, examples one, two and three are essentially what the regulations were after. For example, in example 1 parts A, B, and C, post acquisition continuity, is no problem.<sup>11</sup> What you do with it afterwards just does not count, although I think the final regulations backed up just a little here. They had a binding contract, or a "collar," I guess, in one of the examples in the proposed regulations from this morning's Financial Products Panel. That, of course, would be irrelevant now with constructive sale treatment after the 1997 Act, so it does not get you anywhere.

MR. LEVINE: I do not think we intended to back up. I think we figured that if a sale right afterwards would be okay, then it was redundant to say that a hedge right afterwards would also be okay.

MR. EUSTICE: It is good to see brevity creeping into the regulation process.

MR. LEVINE: Yes, every once in a while. It is a simplification.

MR. EUSTICE: Rarely does brevity arise in this business. Alternative C, of course, is the DuPont and *Seagram* case. As a wonderful little aside to the *Seagram* case, if you wondered why *Seagram's* dropped its appeal, it was not revealed until people picked up the *New York Times* in May of 1995. There it was, this marvelous tax lawyer's dream of the *Seagram* sellback of its DuPont stock, which intentionally resulted in dividends treatment because of the dividends received deduction ["DRD"] saved them roughly \$1.5 billion in tax. And there is —

MALE VOICE: Over capital gain.

MR. EUSTICE: Over capital gain. I might add, the 1997 Act specifically amended section 1059, which was the perpetrator of this wonderful transaction, to catch the *Seagram's* deal in virtually anything else. This is ancient history. *Seagram's* certainly had a rich and colorful tax history in the 1990's.

The good news, of course, is example one. That is what you can do and the bad news is example two, what you cannot do.<sup>12</sup>

Mr. William D. ALEXANDER: Before we leave example one, I think it is important to point out that if you went through the

<sup>11</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 1(A)-(C)).

<sup>12</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 2(C)).



problems, the one omitted fact that you have to ask about is who is buying the stock. If the person buying the stock winds up with too much stock or already had too much stock in P, then you have a problem. Otherwise, clearly you do not, but that is what you have to ask today.

MR. EUSTICE: If the person buying the stock is related?

MR. ALEXANDER: Right.

MR. EUSTICE: That is bad. So is a devious acquisition by an affiliate of the acquirer.

MR. LEVINE: Or a buyer that becomes related.

MR. EUSTICE: There is a protection against "ends-around" acquisitions, which I think everybody assumes is fair. You can just dump it back into the market. You might have to do a little tracing, but if you want to play step transaction games, you are going to have to take the risk of a step transaction attack. Which of course, is question two part A.<sup>13</sup> If P shortly thereafter redeems the stock that was issued, then you have got a step transaction risk. If that transaction is linked to the acquisition deal, then you are going to have a continuity problem. If it is not, then you will not (and you cannot use a relative to do the same thing).

On the other hand, example two, alternative C is really a predecessor of the continuity project.<sup>14</sup> It grew out of a series of semi-inscrutable Tax Court decisions involving the *Yoc Heating Company*<sup>15</sup> on the one hand and Mrs. Kass<sup>16</sup> on the other, all of which eventually got mixed up in the clutches of section 338. But the bottom line today is that the transaction in alternative C (if you do not elect section 338) is a good reorganization for the acquiring parent and its purchased subsidiary, T. In other words, if you do a section 338 stock "purchase," what the section 338 regulations now allow you to do is move the target stock or assets up, down, or sideways inside of the purchaser's group without triggering a recognition event.

<sup>13</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 2(A)).

<sup>14</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 2(C)).

<sup>15</sup> *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973) (holding that there was invalid reorganization because continuity of interest did not exist).

<sup>16</sup> *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd without op.*, 491 F.2d 749 (3d Cir. 1974).

But Mrs. Kass, the minority interest, holding 15 percent of target stock does not get to play in reorganization land. This is still a bad reorganization for her. This, in the new regulations, is example 4(ii).<sup>17</sup>

MR. ALEXANDER: Right, that is because the reorganization result does not stem from anything in the reorganization provisions themselves, except by virtue of the policies in section 338.

MR. EUSTICE: They are protecting section 338 as the exclusive route to a stepped-up basis. That is what is behind all of this, but it is a case where your cash acquisition does not kill reorganization treatment for some of the people but does kill it for Mrs. Kass. If you go read the example in Regulation 1.338-2(c)(3)(iv)—the regulation drafters, in a moment of poetic justice, use the minority shareholder designation of “K.” That is Mrs. Kass. The one that continues to get taxed.

Another bad news example is example three; of course, there were not really many cases with facts like example three.<sup>18</sup> When you read the continuity cases, which say that an acquiring company cannot pay too much cash, but how much is too much for this purpose? The ruling guideline is 50 percent. People would give opinions down to 40, maybe even down to 30, but 85 percent, obviously is on the high side (or the low end of continuity).

Next, suppose instead of the acquirer paying 85 percent in cash, the target itself either pays a gigantic debt dividend or redeems a big portion of its stock and shrinks in a major way? The companion regulations to the finalized continuity of interest regulations take the position, this is section 1.368-1T (temporary), that these two transactions will violate the continuity of interest. Either an extraordinary dividend, or an excessive stock redemption is fatal; the number used here was 85 percent. When you get to non-extraordinary dividends, the regulation preamble says you cannot rely on section 1059's definition of extraordinary. It is some place above that, but how far above? The examples, example 10 and 11, in the temporary regulation, use 85 percent. Is 84 percent going to be trouble? You know, the beat goes on. Continuity never dies, it just moves to a new ball-

<sup>17</sup> Treas. Reg. § 1.338-2(c)(3)(iv) ex. 4(ii) (as amended in 1998).

<sup>18</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 3).

park.

MR. LEVINE: Yes, the reason that we moved in this direction was first of all, as we talked about earlier, the focus became what consideration shareholders received from the corporate level and it seemed both from a policy and an administrative standpoint, that where you have companies that are merging and they are momentarily going to be one entity, it should not matter whether the cash came out from the target or from the acquiring corporation. You do not inquire with respect to post-reorganization redemptions as to what the source of the cash was and we felt that the fact that it was done before the reorganization should not matter either.

Moreover, everybody agreed that it would be bad if there was a case where the target's redemption was really financed by the acquiring corporation. Then we concluded that from an administrative point of view, if target merges into acquiring and they borrowed in order to be able to make the distribution or redemption, how would we ever determine who was the ultimate source of the money to pay the shareholders. So, rather than to get into that morass, we came up with a black letter rule that I think makes both administrative and policy sense.

MR. EUSTICE: The classic case here, of course, is a Tax Court decision in *Arthur D. McDonald*<sup>19</sup> where the Service in the litigation went after the cash portion of the deal and argued it was a dividend equivalent, then suddenly woke up to the fact that there was a lot of cash going around in a circle. This was purportedly a Type B reorganization.

They issued the extraordinary ruling a year or so later saying that even though what we did in the *McDonald* case was chase the wrong prong of the consideration, do not do it again because we will not make the same mistake twice.<sup>20</sup> Example three<sup>21</sup> is the *Arthur D. McDonald* case, or an extension of it.

MR. ALEXANDER: Before we leave problem three, I think it is worth pointing out that, although problem A and problem B have the same answer from a continuity of interest standpoint, and both will result in tax at the corporate level, at the shareholder

<sup>19</sup> *McDonald v. Commissioner*, 52 T.C. 82 (1969).

<sup>20</sup> Rev. Rul. 75-360, 1975-2 C.B. 110.

<sup>21</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 3).

level, these are very different transactions. The first transaction is a *Zenz* transaction.<sup>22</sup> You will have recovery of basis in the redemption. The second transaction looks more like the *Durkin* case.<sup>23</sup> You are going to have a dividend, which will be taxed like a dividend, followed by a sale.

MR. EUSTICE: Which for corporate shareholders is fine.

MR. ALEXANDER: Right, but for an individual, it may not be.

MR. EUSTICE: There are always two players out there in shareholder land and they have dramatically different interests but you are never going to change that fact of Subchapter C life.

MR. ALEXANDER: Even the corporate shareholder may have to deal with section 1059.

MR. EUSTICE: Well, section 1059 is making life much less pleasant today after the 1997 Act. I think they have finally driven a stake through the heart of section 304. At least I cannot think of any way out of it yet. But maybe something will turn up—the new statute is still young.

MR. ALEXANDER: Speak for yourself.

MR. EUSTICE: I just could not resist because they finally put into a regulation what everyone has assumed about the *Bausch & Lomb* case.<sup>24</sup> Example four<sup>25</sup> in the problem is example seven of the continuity regulations.<sup>26</sup> That example holds the upstream merger in the *Bausch & Lomb* case pattern, which is a good reorganization (this is example four in the problem). That is the case of the old-and-cold, but uncontrolled 70 percent owned subsidiary, and which was another inscrutable opinion in the continuity line of decisions that has led to the death of many trees and numerous complex transactions trying to escape from the taxable result reached in *Bausch & Lomb*. We now at last have a codification in the regulation of the 1958 published ruling that said one way out of *Bausch & Lomb* is a merger. Do not do anything else.

<sup>22</sup> *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) (holding that complete redemption of all stock and failure to retain any beneficial interest is not equivalent of distribution of taxable dividend).

<sup>23</sup> *Estate of Durkin v. Commissioner*, 99 T.C. 561 (1992) (finding that transaction was not redemption, but was in fact bargain sale to be treated as dividend).

<sup>24</sup> *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 25 (2d Cir. 1959).

<sup>25</sup> See Eustice, Appendix I, *supra* note 4, at 74 (Continuity of Shareholder Interest, Example 4).

<sup>26</sup> Treas. Reg. § 1.368-1(e)(6) ex. 7 (as amended in 1998).

I am not even going to talk about the *Groman*<sup>27</sup> and *Bashford* line of cases.<sup>28</sup> I still get a headache when I try to teach this area, but there are also new regulations on this topic as well. While we have focused only on continuity of interest, this was also another large package of regulations adopted at the same time which dealt with continuity of business enterprise limitation. That is for next year's panel. Also included in this package were the drop-down rules under section 368(a)(2)(C), which I call the anti-*Bashford* regulations, and which basically hold that you can pass acquired assets (or stocks) down a chain of controlled subsidiaries without limit if you follow the math at 80 percent of 80 percent of 80 percent of 80 percent, etc. . . ., you can get so attenuated at the bottom tier subsidiary that you're down to two or three percent. I can only multiply 80 times 80 two or three times comfortably but you can get way, way down there under these new regulations (but each link in the chain of affiliates has to satisfy the 80 percent test of section 368(e)).

Now, however, it is time to move on to the bad news, because that is where you have to be very, very careful. You still have to be careful generally; and you always have to be careful in the tax field, especially Subchapter C, but we are trying to be helpful here.

MR. FERGUSON: Well, let us look at the second of our two topics and also some very helpful lines and boxes prepared by Glen Kohl<sup>29</sup> to take us into what is called the anti-*Morris Trust* legislation—the changes in section 355.

Let me introduce this simplistically. What we are talking about here is selling part of a corporate group, selling a business, maybe several businesses, but keeping others and doing it tax-free both at the corporate and shareholder level.

In *Morris Trust*,<sup>30</sup> a state bank had an opportunity to merge

<sup>27</sup> *Groman v. Commissioner*, 302 U.S. 82 (1937) (holding that Glidden was not party to reorganization because it acted more like agent and therefore stock received was taxable as "other property").

<sup>28</sup> *Helvering v. Bashford*, 302 U.S. 454 (1938) (holding that continuity of interest requirement was lacking and that Atlas Powder Co. was not party to reorganization).

<sup>29</sup> See generally Glen Arlen Kohl, Illustrations, appended herein as Appendix II, at 74-78.

<sup>30</sup> *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966) (holding that control requirement of spin-off corporation immediately after transfer was met and established 50% threshold for continuity of interest). See, e.g., Glen Arlen Kohl, *Morris Trust* (Base Case), at. (illustrating fundamentals of *Morris Trust* transaction).

into a federal bank in a situation in which the owners of the state bank would wind up with more than 50 percent of the combined banking enterprise. A sticking point to merging their state banking activities into the federal bank was an insurance business which is not something a federal bank could own. It was perfectly all right under state law, but it had to be disposed of to step into the federal bank arena. The shareholders of the target, therefore, spun-off to themselves, pro rata, the insurance business in a transaction which qualified them under section 355 and was tax-free at the corporate level.

Thereafter, the remaining business, T, was merged into the federal bank with the old owners of the state bank receiving over half of the combined enterprise. At that point, they owned separately their insurance business and their stake in the federal bank. The 4th Circuit found that that too, qualified for tax-free treatment. The first step was a good spin-off, because control was maintained by the shareholders of their spun-off company, and there was no subsequent disposition which would have evoked the device clause. It was a good merger because the consideration received back was all stock. The continuity of business rules clearly were met with a continuation of the banking entity.

It was from that rather harmless beginning that over the next three decades practitioners and their clients found increasingly aggressive ways to dispose of an wanted business, prefatory to a tax free acquisition. For example, let us put some numbers on your few boxes in that first example.<sup>31</sup> The insurance business that was spun-off, T1, was worth 15 percent. T2 and T3 were worth 85 percent, which was enough to support owning, say 54 percent of transferee after the transaction. But reverse those numbers for a moment. Suppose that T1 was worth 85 percent and T2 and its subsidiary were worth 15 percent. If they were worth more than that to begin with, suppose you had T3 or T2 borrow money, and distribute it up to T, reducing their value to 15 percent. T would contribute it down to T1, to fatten it up significantly, and reduce the value of the target that is to be absorbed by P. So, suppose that the percentage of P owned is not 50 percent but 4 percent. It begins to look a lot more as if T, the

<sup>31</sup> See Kohl, Appendix II, *supra* note 29, at 75 (Morris Trust, Examples 1-1(A)).

old T, had transferred the stock of T2 and T3 perhaps for P stock. That would have been tax-free at the corporate level all right but if there had then been an attempt to transfer out that new P stock to the shareholders, it would have been taxable. There is no reorganization which fits that particular mode and to turn, if I may say so, the natural form of the transaction into a *Morris Trust* form, so that most of the value of the business is stripped out as alleged unwanted assets and only the shell, with the one wanted business is transferred, it begins to make us uncomfortable about how far *Morris Trust* ought to be pushed.

We worry both because of the diminished interest in the continuing business of P, the acquiring company, and because of the opportunities for leveraging, moving cash around. Suppose the insurance business, for example, had debts, and as part of the pre-tailoring, the bank business borrowed funds, put them in the insurance business to get rid of the debts and maybe create a big cash reserve, and spun off a very different working business. You would begin to think that maybe this is not a reorganization at all. Maybe this is largely a cash purchase for reasons that occurred to the Service too late for the *Roberts*<sup>32</sup> case but clearly were implicated there.

MR. EUSTICE: This is how the tax lawyers spend their days, Carr, moving stuff around.

MR. LEVINE: Shifting boxes, lines, and dollar signs to articulate the needs most advantageous to their clients rather than those of the Internal Revenue Service.

MR. EUSTICE: It would be malicious to say the client with its little pig eyes.

MR. LEVINE: There were enough of these transactions finally to result in section 355(e), which was designed to prevent a spin-off from being tax-free at the corporate level, where it was either preceded by or followed by a disposition of the rest of the business, in what might otherwise look like a tax-free transaction.

Now, once you have decided to attack this pattern, there are a number of choices, and indeed the legislation's history last year showed us that different choices were taken at different places along the line.

Who should be taxed? Should the tax occur at the shareholder

<sup>32</sup> *Roberts v. General Instr. Corp.*, available in 1990 WL 118356.

level? Does it occur at the corporate level? Or, should it occur at both? If it is at the corporate level, should you look to the company which is retained by the old shareholders or the company that goes over? How do you measure the gain?

At one point, the legislation looked as if Congress said, "Let's not make any choices. Let's just tax whatever yields the most gain." The idea is to stop these transactions, not to work out some scientific tax equity on higher principles.

In the end, choices were made and, rightly or wrongly. With the simplified regime of section 355(e) there is still a fair opportunity for gaming, as these examples indicate.

MR. EUSTICE: Actually, *Morris Trust* itself is still non-taxable because the target was the larger of the two companies.

MR. KOHL: A point we made repeatedly during the process when people were saying we overruled *Morris Trust*.

MR. LEVINE: Right, the results of *Morris Trust* are unchanged.

MR. EUSTICE: When I heard Dan Rather talking about *Morris Trust* on the 7:00 o'clock news, I knew we were in deep trouble here and it turned out we were.

MR. LEVINE: Now is a good time for Glen to defend the legislative history.

MR. EUSTICE: An impossible task, but go ahead.

MR. KOHL: Before I do, there were quite a few transactions that had the leverage feature that Carr just mentioned, but many did not, and there are various points during the debate where Bar groups were saying, "Well, why don't you focus on the debt?" Analytically, Treasury and the Hill resisted. So people say, "Is the debt irrelevant?" The answer is no. The debt gave the issue sizzle. So, now, politically you could do it, notwithstanding the Bar groups' criticism. When you criticize the Treasury, if it is just in the tax press, the politicians generally do not really focus on it. But if it gets in *USA Today*, then, all of a sudden, they focus on it, and, in fact, the unions picked up on this one, and there were all these ads in papers about this big anti-labor loophole.

So where this proposal came from procedurally was as part of the effort to balance the budget. In terms of policy, let me start down the policy path by noting how this topic was introduced. I actually wrote down how you introduced the topic, Carr. You



said that what we are talking about here is “selling part of a corporate group.” If you went to seminars, investment bankers would say here [the *Morris Trust* structure] is how you sell a business without paying tax.

MR. EUSTICE: It is called a reorganization.

MR. KOHL: Yes, that would be —

MR. EUSTICE: In a sense calling a four-legged dog a five-legged dog does not make the tail a fifth leg.

MR. KOHL: So, it was clear— Jim, I am not going to go near that.

MR. EUSTICE: That would be fraught with danger.

MR. KOHL: So, here is the case where it seemed corporate America was buying and selling companies and not paying tax, and it seemed that maybe this was an appropriate time for a recognition event. The public reaction has been very harsh, and I think it is still the case that you could probably count only about six people<sup>33</sup> who support the legislation. I believe one of the reasons is that this is one of the dwindling number of areas where corporate Subchapter C lawyers can play Merlin the Magician and really require the corporate lawyers to do it their way.

MR. EUSTICE: There was a right way and a wrong way to do this. At one time, this was not known as a *Morris Trust* problem, it was known as the *Elkhorn Coal*<sup>34</sup> problem.

MR. KOHL: Right. The other thing I want to add is that it seems clear from a policy perspective that section 355 was broken; that it mattered—and the reason why Subchapter C lawyers had all this power is that it mattered—if you spun-off the wanted assets or the unwanted assets; it mattered whether you used a new entity or an old entity. So it seemed from a policy perspective, whatever you think the answer should be, those trivial differences in form should not make that much of a difference in substance.

This can be seen if you go to the reverse *Morris Trust* picture<sup>35</sup> where T spun-off T1 and then T1 was acquired by P. Thus, after T spins off T1, T shareholders end up with P stock.

<sup>33</sup> See Michael Schler, Letter to Editor, *Yes to Section 355(e), No to Mandatory Section 338*, 98 TAX NOTES 153-77 (Aug. 10, 1998) (for one of few commentators who has publicly expressed support for section 355(e) legislation).

<sup>34</sup> *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937).

<sup>35</sup> See Kohl, *supra* note 29, appended herein at 76 (Reverse *Morris Trust*, Examples 2-2(A)).

On the other hand, the result would be different had you reversed the order of those steps, and had P first acquired T1 from T for P stock that T then distributed. In other words, before any spin-off, P just acquired T1 in a tax free reorganization and T was left with the P stock consideration, because T was the shareholder of T1 of P stock, and then T distributed that P stock to its shareholders, then there would be a section 311 *General Utilities* tax at the corporate level.

So, all of a sudden, we have a transaction where if you spin a subsidiary and then the subsidiary is acquired there is no tax, but if the subsidiary is acquired and you spin-off the acquisition consideration, there is a tax. Again, through policy perspective, it seems like those two answers should be the same and I will point back to something a long, long time ago. Back in a *General Utilities*<sup>36</sup> [GU] world, before it was repealed, before old section 337 was enacted, if a corporation distributed assets and then the shareholders sold the assets, there was no corporate level tax, but if the assets were sold at the corporate level and then the sales proceeds distributed, there was a corporate level tax and Congress said, "Wait, that's ridiculous. They should be treated the same," and Congress enacted old section 337, which said those two transactions are the same for tax purposes. It should not matter what order you do the transactions in.

In a post-GU world, Congress similarly concluded, by virtue of the 1997 Act's introduction of section 355(e) into the Code, that yes, once again it shouldn't matter in what order the steps are taken, and so that means, regardless of the form, there should be a GU tax. Now, I admit, there is a perfectly coherent, sound position that says, "No, I'm a big believer and unless the ultimate basis in the hard assets is stepped up, then there shouldn't be a corporate level tax." Someone who believes this axiom does not like, among other things, the section 355(e) legislation.

MR. EUSTICE: It is kind of like section 355(d) in this respect, right?

MR. KOHL: That is right. That is another provision this person would not like. One could take the position in response how-

<sup>36</sup> *General Utilities & Oper. Co. v. Helvering*, 295 U.S. 730 (1935), *rev'd*, 296 U.S. 200 (1935). Prior to its reversal, the General Utilities Doctrine provided for nonrecognition by a distributing corporation on distribution of property to its shareholders on either liquidating or nonliquidating distributions.

ever, that that rubicon had been crossed with much of the “anti-mirror” transaction and other legislation. In other words, section 355(e) can be viewed as an extension of the anti-mirror legislation.

So, that was the basic origin of the proposal. It was clear that everyone but the tax world viewed *Morris Trust* transactions as sales and so we decided to do so as well. I will tell you now that I am in private practice and from a personal revenue (rather than tax policy) viewpoint, I sort of wish we had not enacted it, but that was the logic behind the Treasury proposal which, ultimately, Congress bought.

MR. LEVINE: Yes, the one thing about this legislation that went a little beyond section 355(d) and mirrors before it is that there was not even an outside basis step-up in this instance. In section 355(d) and *Esmark*,<sup>37</sup> you had somebody purchasing stock for cash and getting the assets out. Whereas, in this case, you are talking about a reorganization on the shareholder level.

MR. EUSTICE: Three levels of tax here in effect.

MR. FERGUSON: Glen, I may not be quite of Jim’s persuasion, but I suspect your description of the rationalization of the law may be a little too optimistic. It is true that the concern here, which the IRS, the Treasury and, ultimately, Congress sought to address, was the apparently irrational distinctions which *Morris Trust* and its progeny had spawned between qualifying spin-offs, followed by tax-free acquisitions and other transactions substantially similar in effect which were taxable. Many of these distinctions were irrational and are well disposed of.

I also happen to agree with the basic choice made in section 355(e), that the point at which you can bring into symmetry the most tax results is to impose tax at the corporate level. In the perfect world, however, you are going to push the symmetry to a sale of a business at the corporate level, followed by a distribution. You would also tax the shareholders. That does not happen here. Section 355(a) still works once the corporate toll charge has been paid, the transaction is still tax-free at the shareholder level.

Secondly, the legislation is at pains to say that even though

<sup>37</sup> *Esmark, Inc. & Affiliated Cos. v. Commissioner*, 90 T.C. 171 (1988), *aff’d without opinion*, 886 F.2d 1318 (7th Cir. 1989) (holding petitioner’s transaction liquidating its assets through distribution and sale to its shareholders was nontaxable).

there is a corporate recognition of gain, there is no corporate step-up in basis. This seems to me to be curious, but, perhaps, Glen, that fits into the symmetry in a way that I have not seen. Could you turn the prism around so that it looks symmetrical to us, as well?

MR. KOHL: Well, I guess that there are compromises made along the way. The engine for this was GU repeal. First of all, Carr is 100 percent right that the extra consequences he mentioned, if you follow the model all the way through, would be part of the proposal. They were not, however, for several reasons, and I can only speak from my own opinions, as I had already been booted out of the Government by the time this happened, but —

MR. EUSTICE: So you are not at fault?

MR. KOHL: No, I cannot say that.

MR. EUSTICE: And you got to do debt-like preferred, right?

MR. KOHL: But, basically, it was GU driven. One could observe that to go only after the corporate tax and not to affect the shareholders might be more politically acceptable. Of course, the issue of no basis step-up in the assets and how you would do that is still out there. There is section 336(e)<sup>38</sup> and, for example, on some of the section 355(d) situations, the Service has the ability to issue those regulations. They have not been issued, and the reason why we did not, or when I was there, we did not focus on it — I am still screwed up with the “we’s” and the “they’s”— is that, as a practical matter, this is going to be a situation where the corporate tax up front is just going to kill the deal. There are only a finite number of projects that Treasury and IRS can work on. Even if they actually went through the process of issuing regulations that give the basis step-up and they also issued all sorts of ancillary interpretive guidance that would be needed to make the regulation work, the fact of the matter is that no one would ever avail themselves of the new rules because the up front tax is so great generally. Thus, it would be an inefficient use of government resources.

<sup>38</sup> I.R.C. § 336(e) (1998) (indicating Treasury has regulatory authority to permit a company that distributes stock of a subsidiary to treat such distribution as a distribution of the subsidiary’s assets). *See also* I.R.C. § 334(a) (1998) (indicating to the extent it were treated as a distribution of assets, the tax basis in the assets would be stepped up to their fair market value, whereas a taxable distribution of stock increases only the stock basis, not the asset basis).

MR. EUSTICE: We are not going to intentionally do these transactions and incur that kind of tax under section 355(c).

MR. KOHL: Exactly. But your criticism is valid that we did stray from the model.

MR. LEVINE: Well, yes and no. As you pointed out to the extent you are talking about the fact that had P invested in C beforehand and then D spun it off, you would have seen section 311 gain. If you had section 311 gain on the stock, you also would not have had an asset basis step-up. So, there was a little logic here.

MR. KOHL: Is this a partial support?

MR. LEVINE: No comment.

MR. FERGUSON: You would have to distribute it. The two key phrases, Glen, that I take from your explanation of how this is rational is first politically driven and second practical considerations, and that, in effect, sums up an awful lot of the legislative decisions. What we have to describe here is, in some ways, no more logically defensible than old law. It may chill the greedy taxpayers with the little pig eyes, but —

MR. EUSTICE: Unless you want to incur the tax here, you can use it as a poison pill defensive tactic.

MR. KOHL: No.

MR. FERGUSON: I am not at all sure that the section 355(e) legislation will drive out *Morris Trust* type transactions. What it will do, however, now that we have focused where the gain is to be realized and what the tax consequences are, is change planning for disposing of one corporate business and getting the tax-free proceeds to the shareholders, but it is not going to stop these deals from being done.

MR. LEVINE: I think it will give me more grey hair to figure out where it applies and where it does not. That is certainly true.

MR. KOHL: I do not think that this proposal was politically driven. The political aspect was limiting how far the legislation would go, the same way in the non-qualified preferred stock proposal (new sections 351(g), 354(a)(2)(C), and 356(e)) where you have an exception for family recaps (section 354(a)(2)(C)(ii)). This exception has a political quality to it, but the proposal itself, was GU-policy-based, which only justifies a corporate tax.

The other thing I would add is that section 355(e) really

started out as a very modest proposal and I will mention that, in fact, Lee Sheppard, in one of her pieces, caught it.<sup>39</sup> The original notion, at least in some people's minds, for this proposal was very narrow. It was two things.

One, under old law, the control requirement applied to the spun-off subsidiary, but not to distributing. So, it mattered in certain transactions whether you used the distributing company or the control company. We felt that, from a policy perspective, again, the two should be the same. So, at its narrowest, this proposal was nothing more than applying the "control immediately after" test to both the distributing and the controlled at a lower 50 percent threshold, and then just the modest proposal of giving the IRS power to reorder steps the way I described, in my early example, in these wired transactions. In other words, the legislation was simply overruling *Esmark* in this one context, and it was just to the extent that we were going with the legislation. But a lot of people disagree, and virtually everyone I know disagrees, with this proposal. While we may have made a political compromise in how far we follow the model (in not capturing more than GU gain), I think the proposal's engines were fueled by a belief that it was the right answer from a tax policy.

MR. EUSTICE: Let's talk about what we did, not why we did it. Nobody knows for sure. What we did is create a host of tax problems, basically, and there is a little list of some of these questions that can be found at the bottom of Page 4.<sup>40</sup> The foremost one is the transactional structure, of course, namely who is playing and, to some extent, when did they play.

The earlier version, as Glen pointed out, was in the Treasury proposal, but that proposal was not quite so fierce in scope; it had a specific carve out for surprise hostile takeovers following the spin-off, a perfectly logical reaction. You spin out a subsidiary and then all of the sudden somebody makes a bid for it. That little safe harbor is definitely not mentioned at all in either the House, the Senate or the Conference Report.

So, the inevitable question is whether it is the distributing

<sup>39</sup> See Lee A. Sheppard & Sheryl Stratton, News Analysis, *Proposed Business Tax Changes in Administration's 1997 Budget*, 96 TAX NOTES 65-6 (Apr. 2, 1996) (describing tax changes in recent budget).

<sup>40</sup> See Eustice, Appendix I, *supra* note 4, at 68 (Morris Trust Transactions, Example 6).

parent's plan? Is it the acquirer's plan? Must the plan be mutual? Is this the plan of reorganization? Or to go back to a wonderful old section that is now basically moribund (but still twelve pages long), section 341, there was a nebulous statute or test as to whether you had a "view" to collapse; but the regulations expanded that test to include a mere recognized possibility of collapse. Is there a recognized possibility of an acquisition? Is that the section 355(e) plan or arrangement test we have to look forward to?

MR. LEVINE: I just want to point out that we have an annual guidance priority list and section 355 is on it, and we are going to be looking at issues under section 355(d) and (e). That does not mean that we will necessarily be able to answer anything, because this stuff gets very factual. As Glen knows from being in the Government, a lot of times when you are trying to give guidance on something, the grey areas become so controversial, even within the Government, that you end up giving such clean guidance that in some ways, it does less to help tax practitioners than it does to make them nervous about a lot more than they would have been otherwise.

MR. EUSTICE: Bright lines make for bright ideas, too.

MR. LEVINE: That's right. This is very factual. I think we are going to have to, over the years, try to have to figure out ourselves how this should apply in various factual settings. It will be difficult.

MR. EUSTICE: For one thing, it is clear that you have now imposed the statutory step transaction test to determine the existence (or lack thereof) of the prohibited disposition as linkage to the spin-off. Whatever that test may be, there is also the point that the statute also imposes a presumptive linkage for a four-year period spanning the spin-off date. That is a long time in corporate America, particularly if you are a public company.

But the other key definitional leg here is a change of control (of either distributing or distributed corporation), and that test should immediately make you think of section 382(g). If you start thinking along those lines, you are going to be unhappy, because if you read the 382 owner change regulations, there aren't any of the nice little safe harbor exceptions built into those rules either. This is just a freestanding change of control rule. You are going to say, "See section 382(g) for change of control," be-

cause it is the same test, but without any of the exceptions that exist under the section 382 rules.

MR. ALEXANDER: In looking at regulatory solutions in this area, because there is very broad regulatory authority, we are going to have to weigh the issues as to whether we want to go with an approach that is conceptually simple, which appears to be the design of the statute on its face, but practically difficult, or something more like section 382, which is conceptually more complex because of a large number of accommodations to practical concerns.

MR. FERGUSON: Bill, all I can say is that by the time you get finished with the change of control question here, which taxpayers' counsel are also thinking about, I think it may have rivaled the questions you have under section 382(g).

Be that as it may, if we can just sum up here because we want to make sure we leave time for the third topic which is —

MR. EUSTICE: The worst.

MR. FERGUSON: — dessert, I think.

MR. EUSTICE: Dessert? Vinegar is more like it.

MR. FERGUSON: Just desserts for all of us. The new rule, bright line as it may be, that if there is a change of control with respect to either the distributing company or control and two years before and two years after, there is a problem. A big problem of recognition of gain at the level of distributing with respect to the amount of realization that would occur if distributing had sold the controlled company.

The questions are there in the outline, but if we spent the rest of the day on them with you we would not, I am afraid, have answers to it. In light of our time constraints, we probably ought to turn rather quickly to the third topic, non-qualified preferred stock as equity boot. As fun as selling part of the company is, the use of preferred stock in tax-free transactions, I think, is probably more widespread and the effect of these new rules will be of immediate concern to all of us in more deals.

MR. EUSTICE: I have a special fondness for Mary Archer Morris and her transactional tailoring gambit, Carr. I wrote my best exam in Gerry Wallace's reorganization class [at the New York University Law School's Graduate Tax Program], and ended up getting hired to teach reorganizations because before *Morris Trust* was decided, the pre-tailoring transaction area was



known as the *Elkhorn Coal* problem (which is still with us even after the 1997 legislation). So I waved goodbye to Ms. Morris with great reluctance, but wave goodbye we must. She's history.

MR. KOHL: We have some comments that we will go through, but we also thought we would frame the issue. We are talking about the 1997 bill that treated certain non-qualified preferred stocks as boot for tax purposes. That meant it could not be received tax-free in a section 351 exchange and it was taxable in a reorganization. To the extent there was a model here, it was to treat these kinds of preferred stocks a little more like debt securities because it functions like debt. An example would be on the non-qualified preferred stock example,<sup>41</sup> T owns T1— you do not really need a T1— that owns some hot tub assets and you have a P that owns some sauna business assets.

MR. LEVINE: You can tell Glen is from California.

MR. KOHL: And basically— again I am trying not to judge it— this is a disguised sale, an acquisition by P of the hot tub assets but how it is structured in the form of a joint venture with Newco, where P is going to contribute its sauna assets down and some cash, in exchange for all of the common stock. T1 is going to contribute its hot tub assets down, and get back a preferred stock. It might be redeemable in ten years. It will pay some dividends. Newco can be included in P's consolidated return. The new legislation would say: "No, this transaction is taxable to T1." Thus, in this case, T1 has to recognize gain or loss as it would, for example, if it had received a debt security. This is the base case. The next one has a lot of arrows.<sup>42</sup> I will go through it. We realize this is a little complex. You can ask Phil about it later. This is *National Starch*.<sup>43</sup> It has a great history, with the Government flipping and flopping in the 1980's.

In a nutshell, you can use section 351 so that even if the limit on cash in a reorganization is 30 percent or 38 percent or what-

<sup>41</sup> See Kohl, Appendix II, *supra* note 29, at 77 (Nonqualified Preferred Stock, Examples 3-3(A)).

<sup>42</sup> See Kohl, Appendix II, *supra* note 29, at 78 (Nonqualified Preferred Stock, Example 4: *National Starch*).

<sup>43</sup> *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1989) (a well-known transaction similar to Rev. Rul. 84-71, 1984-1 C.B. 106). See also Rev. Rul. 84-71, 1984-1 C.B. 106 (overruling Rev. Rul. 80-284, 1980-2 C.B. 117 and Rev. Rul. 80-285, 1980-2 C.B. 119 by stating that section 351(a) tax-free status applies to both stock and asset acquisitions that are part of "larger acquisitive transactions" which fail to receive tax-free treatment).

ever, using section 351 you can get it down to as narrow as you want. You would do this by having a little section 351 in the middle of a big acquisition. That would be the Newco here and I is the person who wants stock. Everyone else is going to get cash, but I would contribute its stock to N in exchange for a preferred stock.

A would put down the cash and then N would acquire T for cash. That amount here was 86 percent cash. Again, T is in A's consolidated return. I has tax-free treatment in a preferred stock and if he or she holds it until death, it would get a basis step-up.

MR. EUSTICE: I is a well-advised Mrs. Kass.<sup>44</sup>

MR. LEVINE: Right. You can think of I as a person looking forward to the rewards of maturing his or her estate plan which includes section 1014, and therefore not willing to take a capital gain in the declining year, but rather to wait for the tax-free step up which the executor will certainly look forward to.

MR. KOHL: Correct, and the last thing I am going to say—and then we will go through the problems—is that the legislative proposal essentially said that this kind of non-qualified preferred stock is boot. Underlying that, I think, was the notion that (1) it seemed a bit too much like debt, and then (2) another notion that even though all the old cases said this kind of stock could carry continuity and be tax-free, that maybe when you change from an equity interest with upside and go to this more fixed return instrument, maybe that is not enough to justify continuing non-recognition. Again, people may disagree with this.

MR. LEVINE: You can look at this, Glen, in some ways as the other choice to the one that was made in the anti-*Morris Trust* legislation. There the tax level which occurred at was the corporate level and not at the shareholder, and here it is the other way around. Here by treating non-qualified preferred as boot at the shareholder level, you will find that for most corporate purposes, the results are unchanged. It is still stock.

MR. EUSTICE: With debt-like equity for all purposes other than recognition of gain (until regulations provide otherwise).

MR. LEVINE: This issue is not on the 1998 business plan, but

<sup>44</sup> See *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd without op.*, 491 F.2d 749 (3d Cir. 1974).

there is a lot of regulatory authority —

MR. EUSTICE: "Huge" is a better term than "a lot."

MR. LEVINE: The Service and Treasury, over the course of years, could do a lot to change what happens at the corporate level and a variety of other things.

MR. EUSTICE: If you want a sample of this, you can go through my totally ineffective Tax Notes article<sup>45</sup> that lists a few of the many potential problems that are thrown off by this regulation delegation, (none of which seemed to have bothered anybody in Congress), although the Conference Report says as of this moment, this thing is non-stock only for three code sections.

MR. FERGUSON: Those are shareholder non-recognition sections, section 351 —

MR. LEVINE: In every other way, it says it is stock. Until prospective regulations, prospective underlined, provide otherwise. It depends on where that regulation project goes.

MR. EUSTICE: Let's do a few of these cute little problems, because as these problems basically summarize, you can now have boot in a B reorganization. You can now get a capital gain bailout using section 304, because it is still not property under section 304. You can have fully taxable reorganizations at the shareholder level, but not at the corporate level, et cetera.

MR. LEVINE: One thing also to keep in mind is that there are very big classification issues here in deciding what is preferred stock and what is non-qualified preferred stock. So, the fact that something is labeled preferred stock is not the end of the inquiry; you need to look and see what the characteristics are.

MR. ALEXANDER: In fact, in terms of speaking about future guidance and regulatory authority, as you go through the problems, you may see that we should have an answer for pretty much every problem down here. You may or may not personally feel that it is a satisfying answer, but assuming the characterization of the instrument, we could answer most of these questions. Whereas our understanding is that there are many difficult questions about actually characterizing these instruments.

MR. LEVINE: Well, we should mention there is one regulation out there now, Regulation 1.356-6T, that tells you the obvious

<sup>45</sup> James S. Eustice, *'Debt-Like' Equity & 'Equity-Like' Debt: Treasury's Anti-Hybrid Proposals*, 96 TAX NOTES 1657 (June 17, 1996).

result that an option to acquire non-preferred stock is also non-qualified preferred stock.

MR. KOHL: At one point someone observed that it is funny that a Treasury/IRS that would propose this preferred stock proposal would also issue the warrant regulation overruling 40 years and allowing warrants to be —

MR. EUSTICE: It is “non-boot” debt.

MR. KOHL: It is worth noting that warrants had the worst of all worlds and that you take the most vanilla case of a reincorporation of a company from let’s say California to Delaware which has —

MR. EUSTICE: The *Phellis*<sup>46</sup> case?

MR. KOHL: — a capital structure where common stock could be rolled over tax-free. Debt securities could be rolled over tax-free and even employee options could be rolled over tax-free. The one instrument in a capital structure that is taxed in this nothing transaction is warrants. A warrant-for-warrant rollover, particularly after the *Cottage Savings* decision,<sup>47</sup> was very clearly a taxable event.

So to bring you back—as you know, I always have trouble staying on the topic—to bring you back to non-qualified preferred stock. Non-qualified preferred stock can still be rolled over to other non-qualified preferred stock tax-free the same way debt security can be rolled over.

MR. EUSTICE: Yes, the key thing about taxability here is whether the holder’s equity interest is being stepped-up, right? If it is not being stepped-up you will be okay (like the security-for-security swap rule).

MR. KOHL: Right because —

MR. LEVINE: You cannot roll over nonqualified preferred stock. Not in section 351 transactions, or under section 1036, so that is another interesting feature.

MR. KOHL: But you cannot receive debt in section 1036.

<sup>46</sup> U.S. v. *Phellis*, 257 U.S. 156 (1921) (finding duPont’s reincorporation into Delaware resulted in a taxable dividend). See also *William H. Bateman v. Commissioner*, 40 T.C. 408 (1963) (holding receipt of warrants in merger acquisition held taxable capital gain boot); see generally BORIS BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 12-154, ¶12.41 [4] (6th ed. 1994).

<sup>47</sup> *Cottage Savings Ass’n v. Commissioner*, 499 U.S. 554 (1991) (holding that exchange of property constitutes “disposition of property” only if property received in exchange is materially different).

MR. EUSTICE: You cannot give warrants for stock either, because they are still debt. This is weird if you think about it. We now have debt that is okay under the boot rules (non-taxable), and equity that is not okay (taxable); and when you try to explain these contrasting results to someone, they think you are joking (or worse).

MR. FERGUSON: We are far away from simplification here, I think.

MR. EUSTICE: We have never even been close.

MR. FERGUSON: As an eager consumer of simplification, this is not on my plate at all. If you think about this, this tax treatment of stock which—preferred stock, whatever that might mean—which is likely to be redeemed within 20 years, whatever that means, is stock for corporate purposes in a reorganization, but it is not stock in the hand of its shareholders, whatever it is. It does not mean that the dividends paid are non-dividends apparently. It does not make them interest.

It does, indeed, give Phil and Bill many wonderful and exciting new regulation projects and definitional questions, and it gives taxpayers and their lawyers and accountants lots of fun things to do. But has it advanced our understanding of how corporate earnings ought to be taxed? I, for one, am in deep doubt.

Whenever something has these chameleon-like qualities of being debt for some purposes and equity for others, is one more admission to me of the basic fallacy in our tax law that debt and stock need to be treated so differently. Yet, this is not really even debt. It is —

MR. EUSTICE: You are not going to get an interest deduction at the corporate level for sure.

MR. FERGUSON: It is paper which is not debt and not stock. It is boot.

MR. EUSTICE: The Treasury's current 1998 budget bill even proposes to take away the section 243 DRD for corporate recipients without giving an interest deduction to the issuer.

MR. FERGUSON: You can just take one of the consequences from the list of questions that Jim Eustice put forth a minute ago and that involves section 304. Section 304, we know, is there to tell us that where there is an attempt to contribute stock from one company to another related company and take back what looks like capital gains property, a sale will be recharacterized as

a distribution and dividend treatment can result under sections 304 and 302.

Well, with this new concept, this new animal in the Subchapter C zoo, which is sometimes stock and sometimes other property, Congress has told us, at least until Phil and Bill and their friends can sort this out for section 304 purposes, this is not to be deemed stock. Section 304 has been neutered with respect to these animals and we can now go directly to capital gain treatment without stopping to consider the dividend consequence. There are a number of questions just in the simple section 351 transaction as to how a party is to be treated. Should this stuff that a party receives, which is stock for section 368 purposes and therefore has to be counted in the control interests, be treated as stock for that purpose? Well, apparently so until we get regulations on that point.

Some of these new animals, new redeemable preferreds that we thought we knew what they were last year, may no longer be the kind of corporate interest which have to be considered for control. Whichever way the regulators go in making that decision, either treat them as part of control or do not treat them as part of control, there will be new areas for gaming the system.

MR. EUSTICE: Like a teeter-totter. Push down one side and up goes the other.

MR. KOHL: That is a perfect analogy. A lot of these provisions clearly are still just on the same Subchapter C debt-equity playground where it has been going up and down for years. There certainly are broader simplification proposals that would make a lot of this irrelevant.

I am always nervous talking financial products without asking Clarissa if I am saying the right thing, but I believe that if, for example, you just put all publicly traded securities for everyone on a mark-to-market system at the end of the year, shareholders would not care whether the reorganization is taxable or not. They would not care if what they got is boot or not. At the end of the year they would be taxed either way. That would be a brave new world, or at least a different world, but it would make a lot of these provisions at the shareholder level and no one would care.

MR. EUSTICE: That it would. Do you think that is going to happen?

MR. KOHL: Probably not in this century.

MR. FERGUSON: Let me ask a question. If transactions like *National Starch* were the target here, couldn't that have been hit with a little more precision bombing than the saturation bombing that took place and destroyed such a large area of the Code?

MR. EUSTICE: I would call it a nuclear response, and one that responded to what, in my opinion, was not even a problem.

MR. KOHL: Listen, I can only speak for myself. Even when I was in the government most people did not listen, but there were several motivations for this proposal. One was the continuity of interest issue I mentioned earlier. The other was a very narrow one that namely, if you look back at that first example, that prevent people from getting around the section 453A interest charge on installment sales.

So maybe something as simple as figuring out a way to come up with an interest charge on these kinds of preferred stocks for the deferred gain was all you needed. We thought about that but it was the road not taken. Also relevant was the notion behind the other debt-equity proposals in the President's budget for the effect that when you have this type of instrument, the clever New York lawyer could make debt seem like equity and equity seem like debt. That line was impossible to patrol.

MR. EUSTICE: So you give everybody the worst of both.

MR. KOHL: Yes, the only way to not have people have the best of both worlds was to create this buffer zone, this demilitarized zone or this abyss where they suffered the worst of all worlds.

MR. EUSTICE: You succeeded brilliantly on that score.

MR. ALEXANDER: One thing that we should point out is: Among the regulatory powers that we were granted is the possibility of creating an installment sales regime for these instruments.

MR. KOHL: That is right.

MR. ALEXANDER: Not to say that it exists today, but it —

MR. EUSTICE: With an interest charge, too.

MR. ALEXANDER: —presumably.

MR. LEVINE: Another thing to point out —

MR. EUSTICE: Now you have really wasted a lot of ink. If we are going to end up with installment sale treatment here, why was this thing necessary in the first place?

MR. LEVINE: To the extent that there was a question about

step-ups at death and everything like that, the legislation does carve out the family corporations.

MR. EUSTICE: Only in Texas, I presume. This is not a broadly crafted exception, to say the least.

MR. FERGUSON: The estate planning use of such stock at the end of the day was also taken back off the table.

MR. KOHL: As it was mentioned, you have a section 355 proposal which in fact did not touch the result in *Morris Trust* and you have non-qualified preferred stock, which, at least in the non-public context did not touch *National Starch*.

I will tell you, again, just speaking for myself, *National Starch* was not the target of this legislation at all. In other words, it was not that you can have too much cash in a reorganization. It really was the nature of the instrument. So, for example, a situation where in that picture—I have already lost it, where if I got common stock then again, even in a public context that continues to be tax free.

So, an engine for this was not backing up the cash limits in an acquisition. I think it was really just going to the nature of the instrument and part of that—again, once we did not just do the narrow installment sale thing—part of the narrow—this is another one of those instruments that is real close to the line that is kind of like debt and showed debt-like results in this context.

MR. FERGUSON: You know if this were really aimed at truly redeemable preferred like debt, wouldn't that have been an easy thing to do?

MR. KOHL: Well, we learned from the early 1980's that whatever bright line you draw and call it debt or call it equity, you are going to end up creating something that will beat you up. All of a sudden you will have DRD-bearing instruments with creditors rights.

MR. FERGUSON: This was really an attempt to avoid having a bright line?

MR. KOHL: Yes, to avoid the borderline issues. This is the demilitarized zone.

PROF. DAVIDIAN: One of the fascinating things, at least for me, in this discussion and I hope it is the same particularly for the students in the group, is that not only do you get the substance of these changes, but you also get a glimpse of the thought process that goes into the amendment to the Code and the pro-



duction of regulations. So, I think we have all been somewhat enhanced, not only by the substance, but also by some knowledge of the process as well.

MR. EUSTICE: John, do you really think that any member of Congress had any idea at all of what they were doing here?

MR. LEVINE: Yes and the process in terms of regulations is not always as civil as this discussion. This was a love fest.

PROF. DAVIDIAN: Well, again I thank you all very, very much. You did an excellent job.

## APPENDIX I

# CORPORATE REORGANIZATIONS (CURRENT DEVELOPMENTS AND ISSUES)

PROFESSOR JAMES S. EUSTICE

### INTRODUCTION

Considered herein are various factual scenarios relating to the three topics we will consider today: (1) amendments to § 355 by the Taxpayer Relief Act of 1997 (the anti-*Morris Trust* provisions); (2) nonqualified preferred stock under § 351(g) (so called debt-like preferred stock); and (3) the new continuity of interest regulations for tax-free reorganizations under § 368, issued in January 1998.

### GENERAL FACTS

T is a publicly traded operating company (and has no 5-percent shareholders) with two wholly-owned subsidiaries, T1 and T2; T2 owns all of a second-tier subsidiary, T3. The T group files consolidated returns. Unless otherwise stated, all corporations are profitable, and all corporate assets of the T group (including stock interests in subsidiaries) are worth more than their basis (viz., all have built-in gain).

P is a publicly traded corporation, which also has various subsidiaries (P1, P2, etc.), which may be arranged in various configurations. The P group also files consolidated returns. Like T, the P group is also profitable (and its assets, including subsidiary stock) are worth more than basis.

All corporations are on the calendar year, and use the accrual method of accounting. All transactions are effected for a valid business purpose.

## I. MORRIS TRUST TRANSACTIONS

### A. PRIOR LAW

1. Base Case: T spins-off “unwanted” sub T1 prior to merging into P – no gain to T or its shareholders under § 355(c.) or § 355(a) on step-one, and no gain or loss to T or its shareholders on step-two under §§ 368(a)(1)(A), 361, and 354 respectively (the pure *Morris Trust* “pre-tailoring” transaction).

2. Same as 1, except that P acquires T stock in a Type B exchange offer (same results).

3. Unavailable formats (if T1 is sufficiently “large” so as to violate “substantially all” limitation); Type C, direct or triangular, or the “triangular” mergers (forward or reverse) – the *Elkhorn Coal* problem exists here if the § 355 and § 368 steps are linked under STD principle.

4. Reverse *Morris Trust* pattern – Revenue Ruling 75-406 – T first spins-off wanted sub T1, after which T1 merges directly into P (or P acquires the T1 stock in a Type B):

a. Generally same results as 1 and 2, viz., nonrecognition to all parties on both steps;

b. But Revenue Ruling 96-30 caveat if pre-§ 355 “negotiations” etc. to dispose of T1;

c. Advantage here is T’s avoidance of § 311(b) tax if order of steps is reversed (e.g., T disposes of T1 stock to P for P stock, and then distributes P stock as dividend (tax to both P and its shareholders on this step)).

5. Also different results if T1 sub newly organized by T as part of the disposition plan – Revenue Ruling 70-225 “decontrol” problem here (which would cause failure of Type D-§ 355 transaction and taxation of spin-off step to both T and its shareholders).

6. Variant on Revenue Ruling 75-406 pattern, the “leveraged spin-off”: T3 borrows from unrelated L and distributes the proceeds as dividend to T2 (tax-free); T2 then spins-off T3 to T (tax-free to T2 and T, and also purging any ELA in T3 stock under Regulation 1.1502-19(g), Ex. 3(b)); T then spins-off T3 (again tax-free to T and its shareholders), after which P acquires T3 stock (or assets), likewise tax-free (this, in simplified form was the Viacom transaction structure).

a. Transaction resembled sale here because T group got cash (from loan proceeds), while debt attached to disposed of T3 assets;

b. Key to success here was recently revised Regulation 1502-19 that provided for purging of ELA account in an intra-group spin-off (a new goodie granted by the 1995 revised regulations).

c. Another variant involved § 351 drop-down of “over-leveraged” assets (§ 357(c.) does not apply in consolidation), and purging of resulting ELA in new sub stock by intra-group spin.

d. These transactions attracted lots of comment and probably were behind the ensuing 1997 crack down on § 355 at the corporate level.

B. CURRENT LAW - §§ 355(e) and (f)

1. Pure *Morris Trust* case (Ex. 1 and Ex. 2 above): Will trigger tax to T on distribution of T1 stock if P's acquisition "linked" to prior spin-off transaction under broad (very broad) 4-year STD test period:

a. Archer-Roth initial version would have taxed T1 on T's post-spin-off built-in gains!

2. The reverse *Morris Trust* (Revenue Ruling 75-406) pattern: T also taxed on distribution of T1 stock in Ex. 4 if the disposition of T1 is "linked" to the § 355 distribution (§ 311(b) parity with corporate-level Type B, followed by distribution of P stock by T, although T shareholders still get § 355(a) nonrecognition here).

3. Intra-group spin-off (e.g., Ex. 6) likewise are hit by § 355(f), if later disposition of spun-off sub linked to the § 355 transaction (the intra-group spin-off is denied § 355 altogether here);

a. Alternatively (or in addition) may have basis adjustments under § 358(g) under generally prospective regulations, unless transaction "abusive."

4. Also, new "decontrol" problem under §§ 351(c.) and 368(a)(2)(H) if T shareholders fail to retain more than 50 percent control of spun-off sub (vote *and* value):

a. Result here is failed Type D, with tax at *both* corporate and shareholder levels;

b. New § 355(e) no longer applies, however, because application of § 355(a) required.

5. Overall result of 1997 legislation is now two corporate level taxes (instead of one as under prior law): § 355(e) tax on spin-off (with no basis adjustment), P-level tax (because no basis step-up for acquired sub stock or assets), and T shareholder-level tax on sale of T or P stock (again because of no basis step-up).

a. Similar results to § 355(d) (enacted in 1990 to block *Esmark*-type transactions).

b. *General Utilities* repeal “defense” has gone well beyond the original 1986 model!

6. The numerous unanswered questions of § 355(e):

a. Whose “plan arrangement” (e.g., ITT-Hilton poison pill defense)?

b. Surprise post-spin-off tenders?

c. How is change of ownership test applied? (Are we in for a § 382-style reg project).

d. How are asset acquisitions treated?

e. Is parent fully exposed to potential § 355(e) tax for full 2-year presumption period?

f. What transactions are *not* covered here?

g. What does new § 368(a)(2)(H) control test add to Revenue Ruling 70-225, if anything?

## II. NONQUALIFIED PREFERRED STOCK (EQUITY BOOT)

In the following examples, reference to "preferred stock" assumes that such stock is § 351(g) nonqualified preferred stock ("NQPS"). Also assume that A is the shareholder of T (A may be a single individual, a public group of less than 5-percent shareholders, or a corporate parent of T as the facts so indicate).

### Example 1:

- (a) T has, in addition to common stock, an outstanding class of nonvoting preferred (that is NQPS); P acquires all of T's common for P voting common and all of T's preferred for P's nonvoting preferred?
- (b) Suppose the P preferred is voting (but is also NQPS)?
- (c) Suppose P acquires only the T common?
- (d) Alternatively, the transaction in (a) is structured as a Type C (and the T preferred class is only 10 percent of T's equity value)?

### Example 2:

- (a) A is a corporate parent of T, and A drops all of its T stock into new subsidiary S for a mixture of S common and preferred (nonvoting)?
- (b) Suppose the S preferred is voting?
- (c) Suppose in (b) the S preferred is exchanged for a comparable issue of T nonvoting preferred?
- (d) T and P jointly create new S; T transfers appreciated business assets for all of S's common stock, and P transfers cash for all of S's NQPS?

### Example 3:

- (a) T merges into P's subsidiary (S) for P preferred (convertible into P common), worth \$90, and S preferred (also convertible into P common) paid by S and worth \$10?
- (b) Alternative, P pays the entire consideration consisting of its own nonconvertible NQPS?

**Example 4:**

- (a) T has outstanding common and nonvoting preferred stock (that is NQPS); P acquires T in a reverse merger under § 368(a)(2)(E) (paying cash for T preferred and voting stock for T common)?
- (b) Alternatively, T redeems its NQPS shortly before the merger with P?
- (c) Same as (a) except that P pays entirely with its voting NQPS?

**Example 5:**

- (a) T plans to spin-off T1, but T1 has an outstanding issue of § 1504(a)(4) preferred (that is also NQPS) held by outsiders; T1 redeems the preferred, after which T distributes all the T common to A.
- (b) Alternatively, T1 exchanges new voting preferred to replace its nonvoting preferred (lowering T's control from 100 to 90 percent)?
- (c) Alternatively, T acquires the T1 stock for its voting common?

**Example 6:** T has outstanding the following classes of stock and securities—(1) common; (2) convertible preferred; (3) “straight” preferred (but *not* NQPS); (4) NQPS; (5) long term debt securities; and (6) warrants.

- (a) T issues its NQPS in exchange for part of its common, and all of its convertible preferred class?
- (b) Suppose the exchange was for all of the NQPS class? For the debt? For all of the “straight” preferred? For all of the warrants?
- (c) Suppose the NQPS holders made exchanges among themselves?
- (d) Suppose the exchange in (a) also included warrants in addition to T's NQPS? Suppose in addition, T included some of its “straight” preferred?



### III. CONTINUITY OF SHAREHOLDER INTEREST (COSI)

Assume that T is publicly owned by A (no 5-percent shareholders) while P is publicly owned by similar public group, B.

#### Example 1:

- (a) P acquires all of T's stock for P voting stock in a public exchange offer; shortly thereafter, A sells 70-percent of the P stock received in the transaction?
- (b) Alternatively, T merged into P for half cash and half P stock (and A promptly sold 70-percent of the P stock as it always intended to do)?
- (c) Alternatively, A sold all its T stock to unrelated buyer C, who subsequently exchanged the T stock in a later merger for half cash and half P stock?

#### Example 2:

- (a) T merges into P solely for P stock; shortly thereafter P redeems all of its stock issued to A in the prior merger?
- (b) Alternatively, P's subsidiary, P1, buys back the stock issued to A in the merger?
- (c) Prior to the merger, P buys 90-percent of the T stock from the A group; shortly thereafter, T merges into P1 (for P stock)? What difference here if P does not elect § 338?

#### Example 3:

- (a) T redeems 85-percent of its stock from the A group; shortly thereafter, T merges into P (solely for P stock)?
- (b) Alternatively, shortly before the merger, T pays a dividend in debt securities of T (worth 85-percent of T's value)?

#### Example 4:

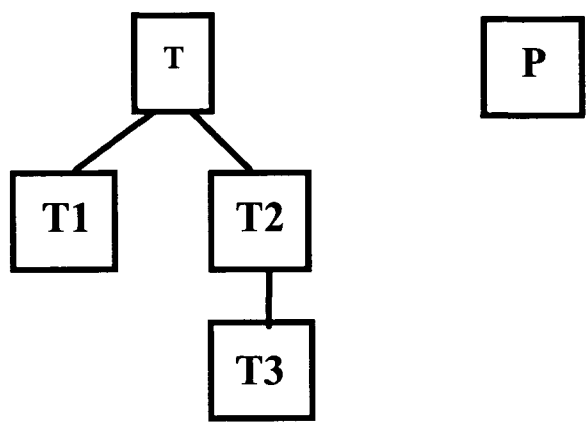
- (a) P owns 70-percent of T (old-and-cold) and the A group owns 30-percent; T merges into P and A receives cash in the merger?

# APPENDIX II

## ILLUSTRATIONS

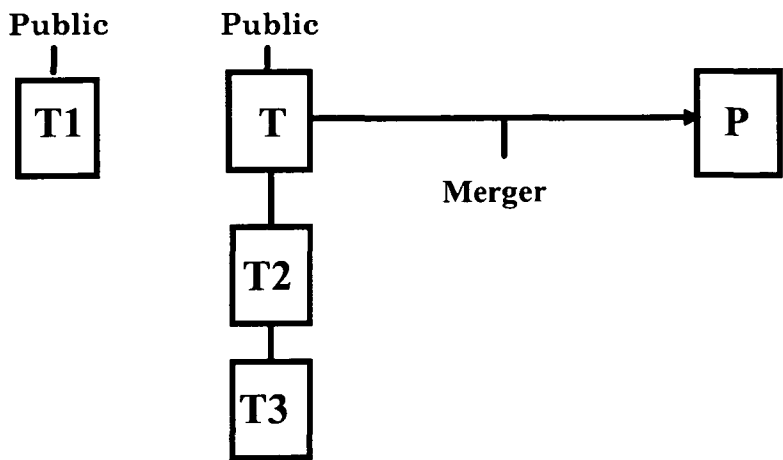
GLEN A. KOHL

EXAMPLE 1- MORRIS TRUST (BASE CASE)

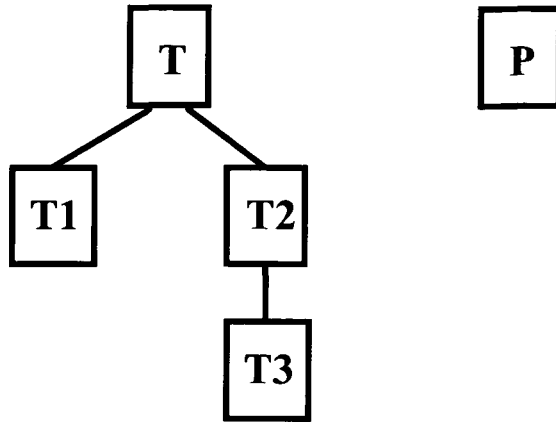


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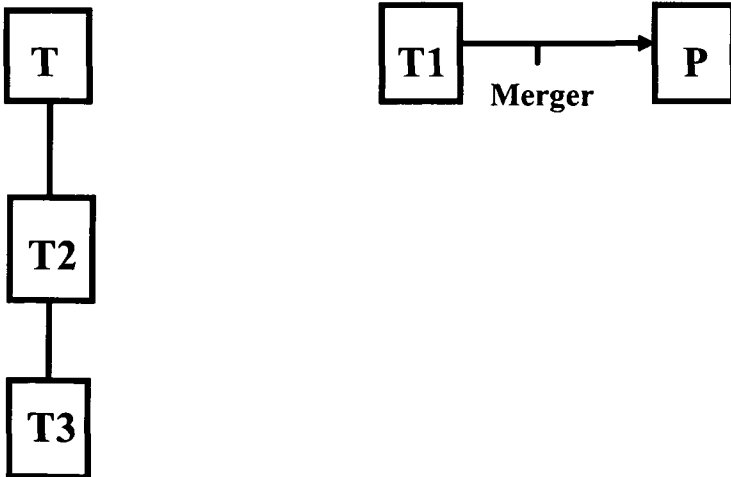
EXAMPLE 1(A)-T SPINS OFF T1; T IS MERGED INTO P



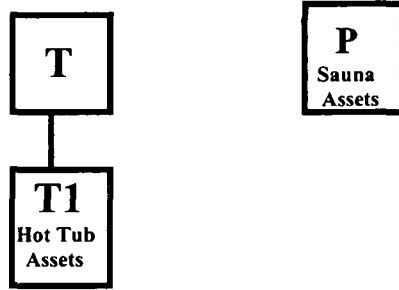
EXAMPLE 2: REVERSE MORRIS TRUST



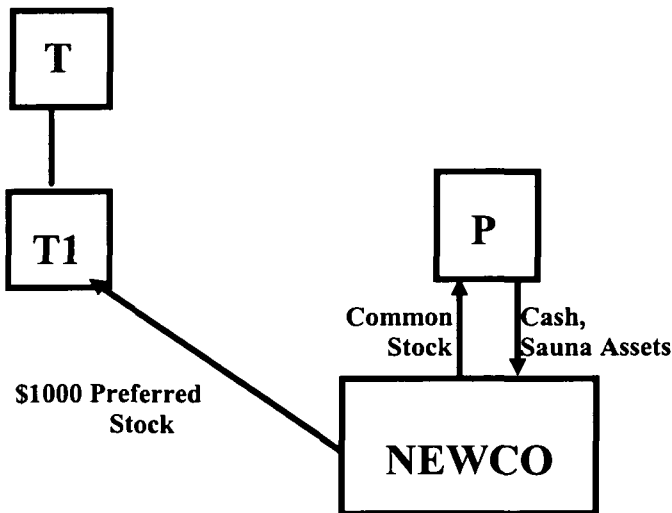
EXAMPLE 2(A): T SPINS OFF T1, T1 IS MERGED INTO P



EXAMPLE 3: NONQUALIFIED PREFERRED STOCK

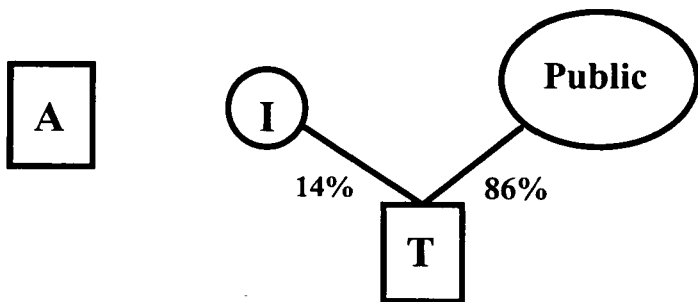


EXAMPLE 3(A): T1 DROPS ITS HOT TUB ASSETS INTO A NEWLY FORMED CORPORATION (“NEWCO”), RECEIVING \$1000 OF NONVOTING, NONQUALIFIED PREFERRED STOCK; P CONTRIBUTES ITS SAUNA ASSETS PLUS SOME CASH TO NEWCO IN EXCHANGE FOR ALL OF NEWCO’S COMMON STOCK (WORTH \$2000), P INCLUDES NEWCO IN ITS CONSOLIDATED RETURN.

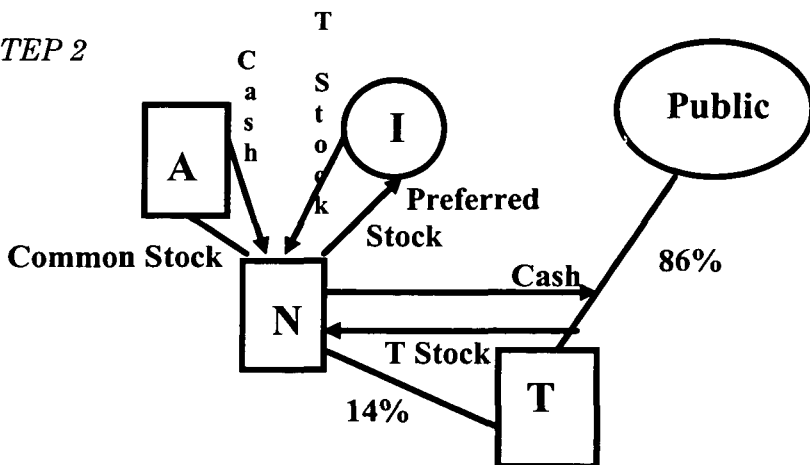


EXAMPLE 4: NONQUALIFIED PREFERRED STOCK - NATIONAL STARCH

STEP 1



STEP 2



STEP 3

