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Developments in the Fields of Accounting and Tax

Robert Willens

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DEVELOPMENTS IN THE FIELDS OF ACCOUNTING AND TAX

ROBERT WILLENS*

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I. DEVELOPMENTS IN THE FIELD OF ACCOUNTING

A. *FASB Seeks to Eliminate Pooling – But There is a Silver Lining*

In September 1999, the Financial Accounting Standards Board (FASB) published an Exposure Draft, the centerpiece of which was a proposal to eliminate the pooling-of-interests method of accounting for a business combination. In a pooling, the acquired entity's assets and liabilities are not revalued. Instead, they are recorded on the acquirer's financial statements at their historical book values and, as a result, reported earnings are not penalized by the need to amortize and depreciate the assets at the stepped-up-basis characteristic of a purchase accounting transaction. Pooling, however, carries with it certain onerous conditions and restrictions, most notably, the acquirer must offer and issue solely voting common stock in the acquisition and, if the acquirer has more than one class of common stock outstanding, it must issue the majority class. Additionally, the acquirer may pay cash (or other property) for less than 10 percent of the voting common stock of the target, only if such cash is used to acquire the entire interest of one or more target shareholders who wish to exchange their stock for stock in the acquirer, or to pay cash in lieu of issuing fractional shares.

This ten percent basket is reduced *pro tanto* if, and to the extent that, either corporation holds tainted treasury stock and to the extent of any inter-

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corporate investments. Neither corporation can have been a subsidiary, or division of another corporation, at any time during the two-year period preceding the *initiation* (the date on which the major terms of the plan, including the exchange ratio, are publicly announced) of the pooling. Furthermore, the corporation cannot have reacquired voting common stock during the period beginning two years before such initiation. Such tainted treasury stock, the presence of which can impede a pooling, includes shares repurchased during the six month period following the pooling, and the maximum number of shares contemplated by repurchase plans that are announced before, and within six months after, the pooling. Accordingly, neither corporation can have made certain changes in its voting common stock equity interests (including, for example, unusual distributions and accelerated vesting of options not contractually provided for in the option arrangement at least two years prior to initiation) during the two-year interval prior to initiating the pooling; the consideration must be completely resolved at closing (no earn-outs or contingent share arrangements are permissible), and the combined company may not intend or plan to dispose of a significant part of the assets of any combining company during the two-year period following consummation of the pooling. For this purpose, assets representing 10 percent of revenues, operating income or assets (on either a book or fair value basis) are regarded as significant and, as an additional restriction, the gain from disposal may not exceed 10 percent of operating income. If FASB is successful in its efforts to eliminate pooling, the *purchase* method of accounting would, by default, emerge as the sole option for accounting for a business combination.

In such a purchase, where the acquirer's cost for the target's stock exceeds the net fair market value of the latter's identifiable assets, both tangible and intangible, the excess is characterized as goodwill. Under the authority of APB No. 17, such goodwill must be amortized over the expected period of benefit, but in no event more than 40 years. However, in a purchase, to the extent the target's assets consist of assets used in research and development activities, or consist of R & D projects in process, the portion of the purchase price properly allocable to these items is, under the authority of FASB Interpretation No. 4 (FIN 4), immediately charged as an expense. The amount so allocated reduces the amount that would otherwise be allocated to goodwill. FIN 4's somewhat counterintuitive approach (assets with substantial value are, nonetheless, immediately written off) is grounded in sound accounting theory. Purchased R & D should be, for accounting purposes, treated in a manner equivalent to internal R & D, which, as required by SFAS No. 2, is expensed as it is incurred. The Exposure Draft, which concluded that pooling should be abolished, also embodied certain changes to the purchase method. For example, the

document concluded that identifiable intangible assets—items as diverse as customer lists, subscriber lists, assembled work force, etc.—should generally be amortized over periods not exceeding 20 years. However, longer amortization periods would be countenanced in cases where, among other things, the intangible asset produced identifiable cash flows expected to last for more than 20 years.

In addition, an intangible asset would not have to be amortized at all if there was an observable market for such intangible asset and it possessed an indefinite useful life—a life the length of which could not be determined with reasonable accuracy. With respect to goodwill, the residual intangible asset, the document concluded that this item would also have to be amortized over the expected benefit period, but such period could not exceed 20 years. On the plus side of the ledger, the Exposure Draft recommended certain well-received alterations to the manner in which goodwill amortization is presented. Thus, goodwill amortization would occupy a separate line item on the face of the income statement, and this separate line item would, itself, be preceded by a new entry entitled, “income before goodwill amortization and extraordinary items.” In each case, per share amounts would be appended. Many observers concluded, without any overt encouragement from FASB, that this latter item, popularly referred to as cash earnings, signaled an acknowledgement by FASB that such cash earnings constituted an appropriate means of evaluating a corporation’s performance and, with the imminent demise of pooling, the notion of cash earnings as the *principal* measure of such performance gained some degree of traction.

Despite this silver lining in what was otherwise a decidedly unpopular document, powerful forces began to line up in opposition to FASB’s views. In fact, legislation was introduced in the last session of Congress for the purpose of completely derailing, or at least decelerating, FASB’s efforts to alter the ground rules for acquisition accounting. These opponents argued that FASB’s proposed changes would have a chilling effect on acquisition activity, which should be encouraged—and that FASB’s views on goodwill amortization were not theoretically sound: Goodwill, it was argued, should not be amortized at all, as this item is not a wasting asset. Since such an asset typically appreciates, it would be not only misleading, but also unduly punitive, to mandate that goodwill be amortized. Moreover, because a corporation incurs deductible expenditures, such as for advertising, to ensure that goodwill maintains its value, a requirement that it be amortized would doubly penalize the entity’s earnings. To its credit, FASB has heeded this advice.

B. *Goodwill and Impairment*

In a stunning reversal, the Board, in December 2000, decided that purchased goodwill should not be amortized as proposed in the Exposure Draft; rather it should be tested, episodically, for *impairment*. Goodwill should be so tested when an event, or series of events, occurs, indicating that the goodwill associated with a *reporting unit* might be impaired. Events that would precipitate an impairment review would include: 1) a current period loss coupled with a history of losses or a forecast of continuing losses, 2) a decline in the market capitalization of an entity, to a level below the carrying amount of its net assets, that is properly classified as other than temporary, 3) a significant, and other than temporary, decline in the market price of the entity's common stock and a decline in its credit rating to a level below investment grade. For this purpose, goodwill should be considered impaired if the implied value of the reporting unit's goodwill is less than its carrying amount. The implied value of goodwill, in turn, should be determined by subtracting the fair value of the *recognized net assets* of the reporting unit (excluding goodwill) from the fair value of the reporting unit. Thus, the amount of the impairment loss would equal the difference between the carrying amount and implied value of goodwill.

An impairment loss, once sustained, cannot be restored. Moreover, the Board's decisions relating to the accounting for purchased goodwill would apply not only to goodwill arising from acquisitions completed after the date of issuance of the final Statement, but also to goodwill arising from acquisitions completed before that date. The Statement, expected to be issued in June 2001, would be effective for ensuing interim and annual reporting periods. Early adoption would not be permitted nor would retroactive application to prior period (interim or annual) financial statements. However, in the period of adoption, and thereafter until the Statement is fully implemented, net income, computed on a *pro forma*, will be required to be displayed for all periods presented.

For these purposes, an intangible asset should be recognized separately from goodwill if, and only if, (1) control over the future economic benefits of the asset results from contractual or other legal rights (regardless of whether those rights are transferable), or (2) the asset is capable of being separated or divided and sold, transferred, rented, or exchanged, either individually or with a group of related assets, regardless of whether there is an intent to do so or whether a market exists for that asset. An intangible asset not meeting either of these separate recognition criteria should be included in the amount recorded as goodwill. An acquired intangible asset, recognized separately from goodwill, should be amortized over its useful

economic life and should be reviewed for impairment in accordance with the standards set forth in SFAS No. 121. The Board decided to eliminate the presumption proposed in the Exposure Draft, an acquired intangible asset (other than goodwill) has a useful economic life of 20 years or less. Further, an acquired intangible asset, recognized separately from goodwill, with an indefinitely useful economic life, should not be amortized, (regardless of whether it has an observable market), until such time its life is determined to be finite, if ever. Such an intangible asset should be recorded at the lower of its carrying amount or fair value. This new approach has received virtually unanimous approbation and, in the process, should go a long way towards blunting the impact of the elimination of pooling. In fact, most observers are expressing the view that a purchase accounting model, in which goodwill need not be amortized, compares quite favorably with a world in which pooling is still an option. As indicated above, pooling, despite its obvious benefits, has its drawbacks including restrictions on the entity's ability to repurchase stock, dispose of unwanted assets and alter, even in the most innocuous ways, its capital structure. It appears that FASB's business combination proposal, as altered, will be adopted without serious opposition from any of its many constituents.

II. DEVELOPMENTS IN THE FIELD OF TAX

A. *The Timber Group Effects a Morris Trust Transaction*

The Timber Group, a wholly owned subsidiary of Georgia-Pacific, whose performance is evidenced by a class of tracking stock issued by G-P, will be distributed by G-P to the holders of such tracking stock, in exchange for their stock. As part of the plan, The Timber Group will be merged with and into Plum Creek Timber, a REIT. In the merger, the shareholders of The Timber Group will receive more than 50 percent of the stock of Plum Creek. This variety of transaction is known as a reverse Morris Trust transaction; it is such a reverse Morris Trust transaction because the separated entity, as opposed to the distributing parent, is the party to the second step business combination.¹ If the parties obtain a ruling from the I.R.S., and such a ruling is expected, the transaction will make tax history.

Historically, the I.R.S. did not permit a corporation that was the subject of a spin-off, or split-off, to convert itself into, or merge with, a REIT. Such a conversion or merger would cause the separation to run afoul of Section 355's active business requirement: To be tax-free, both the distributing and

¹ See Rev. Rul. 98-27.

distributed corporations must, immediately after the separation, be engaged in the active conduct of a trade or business, and such business must have been actively conducted throughout the five year period ending on the date of the separation, and such business must not have acquired, within that interval, in a transaction in which gain or loss was recognized, in whole or in part, and control of a corporation conducting such business must not have been acquired by another corporation, in a wholly or partially taxable transaction, within the five year period. In general, a trade or business is actively conducted only if the corporation itself, through its employees, directly performs, with respect to such trade or business, active and substantial management and operational functions; the activities of independent contractors are not considered.² Historically, a REIT operated, largely, through such independent contractors and, thus, was precluded from directly performing the requisite management and operational activities and, as a result, was not considered, by definition, engaged in the active conduct of a trade or business.³ In the years that followed the publication of this ruling, however, the REIT provisions of the tax code have evolved to the point that a REIT is now permitted to directly perform a sufficient quantum of management and operational activities such that it can be seen as actively engaged in the conduct of its business—the expected ruling will confirm this new view of a REIT's active business credentials and, in the process, open up interesting possibilities for other corporations that want to explore a tax-efficient separation of their real estate holdings from their operating businesses.

B. *Ford Engineers a Recapitalization*

The Ford family possesses a class of super-voting stock that enables it to control the corporation. However, if the number of shares owned dips below certain specified levels, the family is constrained to forfeit a substantial portion of its voting power. The family, however, had a need for liquidity and the super-voting stock was certainly, for the reasons discussed, an exceedingly poor candidate for such monetization.

To satisfy these pressing liquidity needs, the Ford Motor Co. engineered a complex recapitalization in which shareholders were offered the opportunity to exchange their existing holdings for packages of consideration consisting, variously, of shares, cash and shares, or solely cash. The hope was that the public would opt for the cash and stock, or solely cash, alternative,

² See Rev. Rul. 73-234.

³ See Rev. Rul. 73-236.

while the family would elect the stock alternative. The family would, in the recapitalization, receive low-vote stock that it could deploy, through monetization, to achieve its liquidity objectives and, at the same time, its ownership of high-vote stock would not dip below the levels with respect to which the family would suffer an irreparable loss of its voting privileges. The plan worked as intended and, in the process, approximately \$6.5 billion was conveyed to the non-family shareholders who elected the cash and stock, or cash, alternatives.

Had the company accomplished these goals through an outright distribution of cash (to the public) and stock (to the family), the results, from a tax viewpoint, would have been nothing short of disastrous: The distribution of cash would have taxed as a dividend, at top marginal rates, and the receipt of stock would also have been regarded as a taxable dividend. Thus, Section 305(b)(2) provides that a distribution of stock is taxable if the distribution has the result of a receipt of cash (or property) by some shareholders and an increase in the proportionate equity interests of other shareholders, the precise result that would have obtained with respect to such an outright distribution.

However, by accomplishing this result through the mechanism of a recapitalization, the parties were able to avoid these untoward tax results. Thus, a recapitalization will be treated as a distribution to which Section 301 applies, a dividend, if, as here, (1) the proportionate equity interest of any shareholder is increased, (2) as here, the distribution has the result described in Section 305(b) and, unlike the instant case, (3) such recapitalization is pursuant to a plan to increase, periodically, the proportionate equity interest of any shareholder, or group of shareholders. More specifically, in Rev. Rul 86-25, the I.R.S. confirmed that a reshuffling of an entity's capital structure will be respected as a recapitalization exchange, to which Section 305(b) does not apply, so long as it has a bona fide business purpose and is not part of a plan to increase, periodically, the proportionate equity interest of any shareholder. Thus, the recapitalization, because it was an isolated transaction, did not create, under Section 305(c), a constructive distribution of stock to which Section 305(b) could apply. The family was able to obtain additional stock in the company on a tax-free basis. Moreover, the shareholders who elected cash, in whole or in part, obtained that cash on a tax-favored capital gains basis. Such shareholders participated in a transaction characterized as a recapitalization with boot. Thus, their realized gains would be recognized, but in an amount not more than the boot.⁴

⁴ I.R.C. § 356(a)(1) (2000).

The boot gain would be taxed as a dividend (to the extent of the shareholder's ratable share of Ford's accumulated earnings and profits) if, and only if, the exchange had the effect of the distribution of a dividend.⁵ However, the exchange did not have the proscribed effect and, hence, the boot gain was taxed as a capital gain. In single-entity reorganizations, applying the principles of Section 302, dealing with stock redemptions, makes the determination of whether the exchange has the proscribed effect.⁶ In each case, a hypothetical redemption would qualify for sale or exchange (rather than distribution) treatment because the exchanging shareholder suffered a sufficient reduction in his or her proportionate interest in the corporation.⁷ Accordingly, those who opted for cash extracted such cash on a capital gains basis. The moral of the Ford story, a highly tax-efficient transaction, is this: Where the goal is to shift equity interests *inter se*, that objective should be accomplished not through an outright distribution of cash to some shareholders and equity to others but, instead, through an isolated recapitalization.

C. Will Chris-Craft's Merger Constitute a Reorganization?

Not long ago, Chris-Craft announced it had reached an agreement in which it, along with its majority-owned subsidiaries, would be merged into an affiliate of News Corporation. The consideration consists of a mix of NWS ordinary shares and cash in proportions designed to insure that the merger will meet the continuity of interest requirement necessary for a merger to qualify as a reorganization (some 70 percent of the aggregate consideration will consist of equity, an amount sufficient to insure that a substantial part of the value of the target's proprietary interests will be preserved in the transaction; most observers believe that, to meet this requirement, as little as 40 percent of the consideration need be comprised of equity). Nevertheless, the parties are not certain that the transaction, as structured, will qualify as a reorganization and they are taking the unusual step, in the event reorganization status is not available, of reserving the right to restructure the deal (it will take the form of a reverse subsidiary merger) and, if the right to restructure is elected, the acquisition price will be increased to take account of the fact that the restructured transaction, because it cannot qualify as a reorganization under Section 368(a)(2)(E), will be fully taxable to the CCN shareholders. Why the uncertainty?

⁵ See I.R.C. § 356(a)(2) (2000).

⁶ See Rev. Rul. 84-114.

⁷ See I.R.C. § 302(b)(1) (2000).

The merger, if not restructured, will take the form of a forward triangular merger in which CCN and its affiliates will be merged into a newly created, first-tier, domestic subsidiary of News Corp. Such a triangular merger qualifies as a reorganization, under Section 368(a)(2)(D), as long as the subsidiary acquires substantially all of the target's assets, no stock of the subsidiary is used to compensate the target's shareholders, and the general reorganization requirements (continuity of interest, continuity of business enterprise and business purpose) are complied with.⁸ The acquired assets can be transferred to a subsidiary of the acquiring corporation without disqualifying the reorganization.⁹ In fact, under Reg. Section 1.368-2(k), a transaction, otherwise qualifying as a reorganization, shall not be disqualified by reason of the fact that all or part of the acquired assets are transferred to corporations controlled, within the meaning of Section 368(c), in each transfer, by the transferor. Thus, it is clear that acquired assets can be transferred, vertically, to lower-tier subsidiaries of the acquirer, so long as each such transferee is an 80 percent or greater subsidiary of the corporation conveying the acquired assets. Here, however, the acquired assets will ultimately come to rest in Fox Entertainment Group (FEG). However, FEG is not a subsidiary of the acquiring corporation. The regulations, moreover, do not explicitly provide for lateral or diagonal transfers of acquired assets because a sister corporation (FEG) is not controlled, within the meaning of Section 368(c), by its brother corporation even though both are, ultimately, controlled by the same parent (News Corp.). Section 368(c) defines control in terms of direct ownership of stock and not in terms of practical control.¹⁰ Thus, it appears that the parties are, prudently, planning for the possibility of an adverse decision on this transaction's claim to reorganization status. Clearly, yet inexplicably, the post-acquisition asset transfers envisioned by News Corp. are not expressly permitted by the regulations and, although they may meet the spirit of the I.R.S.'s commitment to eliminate the doctrine of remote continuity, the I.R.S. may feel no compulsion to, effectively, expand its regulations and permit other than vertical asset transfers.

D. Tangential Acquisition Costs are Deductible

The battle over the proper¹¹ scope of the *Indopco, Inc. v. Commissioner*¹¹ decision rages still. In that case, the Supreme Court held that expenses incurred by a target, in connection with a friendly acquisition (the expenses

⁸ See Rev. Rul. 74-297.

⁹ See Rev. Rul. 72-576.

¹⁰ See Rev. Rul. 56-613.

¹¹ *Indopco, Inc. v. Comm'r*, 503 U.S. 79 (1992).

there were for a fairness opinion rendered by the target's investment banker and for legal services performed by such target's outside counsel), were non-deductible *capital expenditures* because the acquisition resulted in long-term benefits to the target. Significantly, the Court rejected the argument, derived from its *Commissioner v. Lincoln Savings & Loan*¹² decision, that the expenses were deductible, by definition, because they did not result in the creation or enhancement of a separate and distinct additional asset. The *Indopco* decision, because of its breadth, emboldened the I.R.S. to the point where many heretofore deductible expenses that, as virtually all expenses do, have some future benefit aspect were subjected to its scrutiny and, in many cases, the I.R.S. asserted that these expenses ought to be considered capital expenditures.

The lower courts, however, have begun to restrict the I.R.S.'s expansive approach to the question of the nature of an expenditure and, recently, in the *PNC Bancorp v. Commissioner*¹³ case, rejected its attempt to require the capitalization of loan origination expenses incurred by a bank in the ordinary course of its business. Now, as a result of the Eighth's Circuit reversal of the Tax Court's decision in *Wells Fargo v. Commissioner*,¹⁴ additional limits will be placed on the I.R.S.'s heretofore-unrestrained enthusiasm for disallowing the deduction of expenses.

In *Wells Fargo*, Norwest (a predecessor of Wells Fargo) and a prospective target commenced discussions. Later, as these discussions proved to be amicable, an Agreement and Plan of Reorganization was entered into—its effectiveness was subject to both shareholder and regulatory approval of the transaction. These approvals were secured and, eventually, the target became a wholly owned subsidiary of Norwest. At issue was the deductibility of certain legal fees and officers' salaries the target had paid.

The legal fees related to services performed concerning Norwest's due diligence review and, as well, about investigating whether Norwest's director and officer liability coverage would protect the target's directors and officers. The target's officers worked on various aspects of the transaction and the I.R.S. sought to disallow as deductions (along with the legal fees) their salaries attributable to services performed with respect to the transaction. Re Rev. Rul. 73-580, a pronouncement that pre-dates *Indopco*, foreshadowed this latter disallowance, where the I.R.S. concluded that the portion of an executive's salary attributable to work performed in connection with consummated acquisitions would be capital in nature.

¹² *Comm'r v. Lincoln Sav. & Loan Ass'n.*, 403 U.S. 345 (1971).

¹³ *PNC Bancorp. Inc. v. Comm'r*, 212 F.3d 822 (3d Cir. 2000).

¹⁴ *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000).

The Eighth Circuit, with respect to the issue of whether a portion of such salaries should be capitalized, summarily rejected the Service's argument. It held that it is not proper to decide that a cost must be capitalized solely because the cost is incidentally connected with a long-term benefit (here, the acquisition transaction). *Indopco* amply supported this approach; the Court stated that the mere presence of an incidental future benefit might not warrant capitalization.

Indopco, the court pointed out, addressed costs which were directly related to the acquisition and, by contrast, the instant case involved costs which were (only) indirectly related thereto: There was only an indirect relation between the salaries (which originated from an employment relationship) and the acquisition and such indirect relationship was evidenced by the fact that: 1) there was no increase in the executives' salaries attributable to the acquisition, and that 2) they would have been paid such salaries whether or not the acquisition took place. Accordingly, the rationale of Rev. Rul. 73-580 was soundly rejected and the salaries were ruled to be fully deductible.

With respect to the legal fees, the taxpayer was less successful. The court agreed with the I.R.S.—and the position the agency adopted in Rev. Rul. 99-23—that investigatory expenses, which pre-date the final decision to acquire, ought to be capitalized. Here, that final decision date was the date on which the parties entered the Agreement and Plan of Reorganization and, since the fees were incurred after that date, they were subject to capitalization. Nevertheless, as indicated in Rev. Rul. 99-23, (which deals with the question of when such investigatory costs are start-up costs eligible, under Section 195, for 60 month amortization), the I.R.S. usually takes a narrower view of when the final decision to acquire is reached. Accordingly, even this aspect of the case is positive since it stands for the proposition that the date of final decision is later in the process than originally thought with the result that a larger quantity of these investigatory expenses will fall within the beneficial start-up expense category.

E. I.R.S. Further Eases the Continuity of Interest Requirement

Section 368(a)(1)(A) of the tax code provides that a statutory merger (or consolidation) will qualify as a tax-free reorganization. Oddly, the statute itself places no restrictions on the type of consideration that may be used so that an exchange may qualify as a reorganization—even if money changes hands—as long as a judicial doctrine, that was created to distinguish reorganizations from taxable sales, the doctrine of *continuity of interest*, is satisfied. Thus, according to the courts, the term, reorganization, presupposes a continuance of interest on the part of the former shareholders

of the acquired corporation in the properties transferred by such acquired entity.

Specifically, continuity of interest requires that a substantial part of the value of the proprietary interests in the target be preserved in the potential reorganization.¹⁵ For this purpose, a proprietary interest is preserved if it is exchanged for a proprietary interest in the issuing corporation. Conversely, a proprietary interest is not so preserved (so it detracts from continuity of interest) if it is acquired by the issuing corporation for consideration other than stock, or where, in connection with the reorganization, stock of the target is redeemed by the target or where, in connection with the potential reorganization, stock of the issuing corporation, furnished in exchange for a proprietary interest in the target, is repurchased by such issuing corporation (or by a related person).

The modern version of the continuity of interest rules, which was promulgated in 1998, provides that a mere disposition of stock of the target (prior to the reorganization), to persons not related to the target or the issuing corporation, is disregarded, as is a mere disposition of stock of the issuing corporation (received in the reorganization) to persons not related to such issuing corporation. These major concessions, on the I.R.S.'s part, eliminated the notions of historical shareholder continuity—under which only stock received by the historical shareholders of the target counted for continuity purposes—as well as post-merger continuity under which a pre-conceived plan or arrangement to dispose of stock could cause that stock to be excluded in the computation of continuing equity.¹⁶ Thus, except in the case of a repurchase of stock, before or after the merger, that is found to have been undertaken in connection with such merger, continuity now focuses solely on the quality of consideration furnished in the merger exchange, without regard to whom it is furnished (historical shareholder or otherwise), and without regard to what those persons, to whom the consideration is furnished, do with it once it is received.

In addition, as some recent pronouncements demonstrate, the I.R.S. is not taking a hard line with respect to the question of when redemption is undertaken concerning the reorganization. Thus, in Rev. Rul. 99-58, a corporation with a pre-existing stock repurchase program acquired another corporation in a merger. To prevent dilution, it modified the repurchase program such that it would now repurchase an amount of its stock equivalent to the amount it issued in the merger. The I.R.S., graciously, ruled that the repurchases would not be seen as in connection with the reorganization and,

¹⁵ See Reg. Section 1.368-1(e).

¹⁶ Cf. Rev. Rul. 66-23.

hence, would not detract from continuity of interest. The redemptions were not disruptive because there was no understanding between the issuing corporation and the target shareholders that their ownership would be transitory and because the repurchases would be made on the open market, and thus the identities of the sellers of the stock would be unknown, the repurchase program did not favor participation by the former target shareholders. Thus, except in rare and extraordinary circumstances, post-merger buybacks will not detract from continuity of interest.

Now, with the promulgation of Reg. Section 1.368-1(e)(1)(ii), the same can be said of pre-merger stock buybacks (and extraordinary distributions) effected by the target. These regulations provide that a proprietary interest in the target is not preserved (so that continuity of interest is adversely affected) if consideration received prior to the merger (by the target shareholders), either in redemption or in a distribution with respect to stock (i.e., a special dividend), is treated as other property for purposes of Section 356. This reference to Section 356, confirmed by the example embodied in the regulations, indicates, happily, that the I.R.S. has taken an exceedingly narrow view of when a pre-merger redemption (and/or special dividend) will be seen as in connection with a merger. Thus, in the example, a corporation (T) had two shareholders, Mr. A and Ms. B. An unrelated corporation, (P) desired to acquire T in a merger in which the sole consideration would be P stock. However, Ms. B had no interest in owning P stock and, to facilitate the merger, T redeemed all of Ms. B's stock in T immediately before the merger. If one employs the conventional meaning of the term, it would certainly appear that the buyback was in connection with the ensuing merger. However, because of the reference to Section 356, the example concludes that the buyback was not in connection with the merger and, hence, did not adversely affect continuity of interest. This was because P provided no funds with respect to the buyback, which was apparently financed with T's own assets or, perhaps, with loan proceeds that were obtained solely on the strength of T's own credit capacity. Thus, except to the extent that the issuing corporation participates in the buyback, through a direct or indirect provision of funds therefore, a pre-merger buyback (and/or special dividend) will not detract from continuity of interest.

In this regard, Rev. Rul. 75-360 illustrates the type of participation that would conflict with these rules. There, immediately before an attempted 'B' reorganization, the target borrowed funds for redeeming a portion of its outstanding stock. The share for share exchange ensued and, almost immediately thereafter, the acquiring corporation contributed funds to the target to enable the latter to defray the buyback indebtedness. Since, in substance, the funds to accomplish the buyback were actually furnished by the acquirer, the transaction was found to violate the solely for voting stock

condition necessary for a 'B' reorganization and the overall transaction was viewed, simply, as a taxable sale or exchange.¹⁷ Undoubtedly, a similar set of facts, played out in the context of a merger, would, even under the newly liberalized rules, call the transaction's claim to the requisite continuity of interest into question. A more difficult question would arise in cases where the acquirer does not contribute capital to a recently acquired target—to enable it to defray the buyback indebtedness—but, merely, guarantees such indebtedness for the purpose of lowering the target's borrowing costs. Should this involvement in the buyback process be considered a provision of funds by the acquirer such that the buyback detracts from continuity of interest? The answer would appear to be no but the regulatory example does not definitively answer the question. Nevertheless, these latest regulations, when combined with the stance the I.R.S. adopted in Rev. Rul. 99-58, certainly diminishes the odds that a stock buyback, whether occurring before or after a merger, will cause such merger to run afoul of the venerable continuity of interest rule.

F. *Spin-Offs Preceded by a Control Gathering Recapitalization*

When a corporation owns an appreciated equity stake in another corporation, which does not, however, represent a controlling interest, a spin-off of that stake is still possible, but only if certain preliminary steps are taken. These steps, which feature a recapitalization, are designed to place the distributing entity in control of the investee such that the stake can then be distributed on a tax-efficient basis.¹⁸

For this purpose, control means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote (voting power is generally measured by a class' relative ability to elect directors)¹⁹ and at least 80 percent of the total number of shares of each class (if any) of non-voting stock.²⁰ It is important to note that the control definition does not require the ownership of any particular percentage of the value of the investee's stock. Thus, control can be rather easily attained if the investee is willing to alter its capital structure through the creation of both a high vote and low vote class of stock. If it is so willing, the parent can then swap its existing stock for the newly created class of high vote stock, and if such stock possesses the requisite percentage of the voting

¹⁷ See also Rev. Rul. 75-493.

¹⁸ For a spin-off to be tax-free, the distributing corporation must, immediately before such spin-off, be in control of the corporation whose shares and securities it is distributing.

¹⁹ Rev. Rul. 84-6.

²⁰ See I.R.C. § 368(c) (2000) and Rev. Rul. 59-259.

power of the outstanding stock, the parent has gained control of the investee. At this point, the parent is positioned to distribute that stock on a tax-free basis because such control (although acquired within the five year period preceding the spin-off) has been attained in a permissible manner, that is, via a wholly tax-free transaction, the recapitalization exchange.²¹

LTR 200048030 appears to address St. Joe's spin-off of Florida East Coast Industries. Such spin-off will be undertaken for compelling business reasons; separating Florida East Coast from St. Joe would enable the latter to increase its borrowing capacity and, in the process, enable it borrow on better terms. These better terms would include a lower interest rate on St. Joe's borrowings. The cost savings to be realized would be substantial, within the meaning of Rev. Proc. 96-30, because they would exceed one percent of the base period net income of the St. Joe group (the group's net consolidated financial income) for the three-year period preceding the separation. Since, however, St. Joe did not possess a controlling interest in Florida East Coast, the spin-off was preceded by the type of recapitalization referred to above. In this case, the holders of the high vote stock would, unequivocally, possess a controlling interest in the issuer because such holders, in the aggregate, are entitled to elect exactly 80 percent of the members of the issuer's board of directors.²²

Among the drawbacks of operating with a two-class stock structure is that it heightens the issuer's vulnerability to a cheap takeover; an unwanted suitor can gain, through the acquisition of the high vote stock, an undue amount of influence for a relatively modest cost. In this case, however, the parties have come up with a solution to this problem—such solution parallels the strategy adopted by GartnerGroup in connection with its separation (also preceded by a control gathering recapitalization) from IMS Health. Thus, Florida East Coast, in connection with the alteration of its capital structure, will adopt a charter amendment. The amendment will provide that a holder of *t* percent of the high vote stock may only vote the amount thereof that is proportionate to the holder's economic interest in Florida East Coast. The I.R.S. is amenable to these anti-takeover devices—it does not view them as an abrogation of the voting power shift caused by the recapitalization—and while such an amendment will not conclusively prevent a takeover, it will certainly go a long way towards interdicting an opportunistic one. Further, LTR 200050017, issued to Waddell & Reed, strongly suggests that, even though the preliminary recapitalization is supposed to effect, as indicated in

²¹ See I.R.C. § 355(b)(2)(D) (2000) and Rev. Ruls. 56-117 and 69-407.

²² See Rev. Rul. 69-126.

Rev. Rul. 69-407, a permanent realignment of voting control, the two class capital structure can, in fact, be collapsed with a degree of alacrity.

There, at the time of the spin-off, management represented that it harbored no plan or intention to propose a change to the voting rights of either class of stock. Nevertheless, less than two years after the spin-off, the company proposed a second recapitalization—pursuant to which the high vote stock would be converted into low-vote stock—because the company had experienced unanticipated (but unspecified) problems from having two classes of stock. The Service, without a great degree of difficulty, concluded that this reverse recapitalization would not adversely affect the tax-free tenor of the spin-off. Thus, it would appear that an arbitrage opportunity has been created: An astute investor can identify the companies whose capital structures, due to a prior spin-off, feature two classes of stock, and the investor can then short the high priced class, secure in the knowledge that the gap will be closed when, inevitably, the issuer petitions the I.R.S. for a ruling regarding the benign nature of a reverse recapitalization.

G. I.R.S. Issues Proposed Regulations Under Section 355(e)

Historically, a corporation could effect a separation and acquisition, on a tax-free basis, if the proper form for this integrated transaction was adhered to. That proper form was known as the Morris Trust pattern and it entailed a preliminary spin-off of the unwanted (from the acquirer's perspective) assets followed by a merger of the target (which now possessed only the wanted assets) into the acquirer in exchange solely for the acquirer's stock and the latter's assumption of the target's liabilities. (If the merger consideration did not consist solely of the acquirer's stock, the spin-off would likely run afoul of the device test which is activated in cases where a separation is coupled with a pre-arranged sale of all or a portion of the stock of one of the corporate parties to the spin-off).²³ This reliable Morris Trust pattern could always be used to accomplish, on a tax-free basis, a separation and acquisition. However, in the mid-'90s, the pattern began to be abused as the so-called monetizing Morris Trust transaction came to the fore. In a monetizing Morris Trust transaction, (the first known example of which was Times Mirror's divestiture of its cable TV assets to Cox Cable), the target would effect a preliminary borrowing of an amount substantially equal to the value of the wanted business; the loan proceeds would be conveyed to the entity that would continue to conduct the unwanted business yet the obligation to repay the borrowing would remain with the target and,

²³ See Rev. Rul. 68-603, 1968-2 C.B. 148.

effectively, be assumed by the acquirer as a result of the second step business combination. Thus, the proceeds of the loan would be separated from the obligation to defray it and this, in Congress' judgment, amounted to an effective sale by the continuing entity of the wanted business to the acquirer; such sale, however, was not recorded as such for tax purposes because it was carried out under the auspices of the tax law's spin-off and reorganization rules.

Congress reacted to this development by enacting, in 1997, Section 355(e). That section taxes the target, under Section 311(b), with respect to the gain it realizes on the distribution of the stock of the corporation containing the unwanted business, whenever the spin-off transaction is found to be part of a plan (or series of related transactions) pursuant to which one or more persons acquire stock representing a 50 percent or greater interest in either the distributing or distributed corporation. Moreover, according to Section 355(e)(2)(B), any such acquisition, occurring within the four-year period beginning two years before the spin-off, is presumed to be part of a plan including spin-offs. Thus, if a spin-off and acquisition are found to be part of the requisite plan (or series of related transactions), and the target shareholders do not emerge from the transactions with a greater than 50 percent interest in the corporations then existing, the spin-off will be taxable, at the corporate level, since the distributed stock will, as a result, forfeit its status as qualified property within the meaning of Section 355(c)(2) or, if the spin-off is part of a 'D' reorganization, Section 361(c)(2). The classic Morris Trust transaction, in which a spin-off was, immediately, followed by an acquisition, is, of course, no longer viable except in those rare cases where the target shareholders emerge with in excess of 50 percent of the stock of the acquirer. More difficult, however, is the case where a spin-off occurs and, LATER, an acquisition takes place. If the events are regarded as part of a plan, then penalties exacted by Section 355(e) will be imposed.

The proposed regulations (Prop. Reg. Section 1.355-7) attempt to define the circumstances under which a prohibited plan will exist. Thus, a plan exists if, and only if, the target, or the distributed subsidiary, or any of their controlling shareholders (persons who own at least five percent of the stock and who actively participate in the management or operation of the corporation), INTENDED, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution. Importantly, the un-communicated intentions of the acquirer are not relevant; the only intentions that matter for this purpose are those harbored by the distributing group and its controlling shareholders. The regulations outline useful safe harbors. The satisfaction of these provisions means the spin-off will not be burdened by the penalties of Section 355(e). One such safe harbor operates in cases where: (1) the acquisition occurred more than

six months after the distribution, (2) there was no agreement, understanding, arrangement or substantial negotiations, concerning the acquisition, before six months had elapsed following the distribution, and (3) the distribution was motivated by a business purpose other than to facilitate an acquisition. This safe harbor, however, is complicated by the fact that the regulations also feature certain operating rules that can abrogate the avowed business purpose for the separation. Thus, if at the time of the separation, it was reasonably certain that, before six months had elapsed, an acquisition would occur, or an agreement, understanding, arrangement or substantial negotiations would take place; this reasonable certainty is evidence of a business purpose to facilitate an acquisition. Therefore, the presence of reasonable certainty can eliminate the efficacy of the safe harbor by casting aspersions on the purported business for the separation. Accordingly, perhaps a more useful, albeit arduous, safe harbor is the one that operates without regard to the business purpose motivating the separation. This safe harbor applies in cases where: (1) the acquisition occurs more than two years after the distribution and (2) there was no agreement, understanding, arrangement or substantial negotiations, concerning the acquisition, at the time of the distribution or within six months thereafter.

Where the safe harbors do not apply, the regulations set forth a series of factors tending to show that the distribution and acquisition are part of the requisite plan. These factors focus on the presence of discussions between the distributing group and the acquirer, or a potential acquirer, before the spin-off, focusing on the time proximity between the steps. Did the acquisition and distribution occur within six months of one another, or was there an agreement regarding the second transaction within six months of the first? Was the business purpose to motivate the distribution, or was it to facilitate the acquisition or a similar acquisition?

The regulations, graciously, also set forth factors tending to show that the distribution and acquisition were not part of the requisite plan. These non-plan factors include the absence of discussions (between the distributing group and the acquirer or a potential acquirer before the separation), the presence of a pure business purpose for the separation; the distribution was NOT motivated by a purpose to facilitate the acquisition or a similar acquisition, a showing that the second step acquisition was motivated by an identifiable, unexpected change in market or business conditions or a showing that the separation would have occurred at approximately the same time, and in similar form, regardless of the acquisition or a similar acquisition.

These regulations will only apply to distributions occurring after the date they are published in the Federal Register as final regulations. Oddly, current law in this area seems to be liberal than the proposed regulations.

Thus, in LTR 200104024, a spin-off and acquisition did not run afoul of Section 355(e) *EVEN THOUGH* there had been, prior to such spin-off, discussions (not rising to the level of an agreement), regarding the acquisition, between the acquirer and a controlling shareholder of the distributing corporation. In this case, the distribution *WAS* motivated by a pure business purpose—a purpose to achieve significant cost savings—rather than a purpose to facilitate an acquisition and this fact, notwithstanding the preliminary discussions, may have tipped the scales. In any event, with respect to transactions taking place during this interregnum, prior to the finalization of the proposed regulations (which we expect will take place sometime early in 2002), it would be wise to adhere, to the extent possible, to their tenets. After all, the proposed regulations reflect the I.R.S.'s considered views on when a prohibited plan exists and the agency can be expected, albeit unofficially, to evaluate most cases according to the dictates of the proposed regulations.

