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Selected M&A Tax Topics

Chicago Tax Club
May 12, 2008

George R. Goodman
Foley & Lardner LLP

- Restructuring after Tax-Free Acquisitions
- Form and Substance
- Illinois Franchise Tax Base

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I. Restructuring after Tax-Free Reorganizations

- Acquiror and Target businesses set up so that desired results cannot be obtained by single transaction qualifying as tax-free reorganization
- Tax-Free treatment accorded "to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms." Reg. §1.368-1(b).

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Requirements for Tax-Free Reorg

- Meet §368 Statutory Definition/Pattern
- Business Purpose
- Continuity of Shareholder Interest ("COSI")
- Continuity of Business Enterprise ("COBE")
- "In determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine." Reg. §1.368-1(a).

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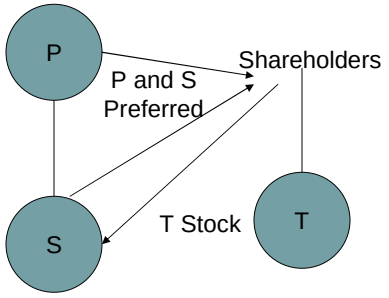
Groman v. Commissioner, 302 U.S. 82 (1937)



- P not "a party to a reorganization"
- P and S cannot be collapsed – P stock represented participation in P assets, not S assets

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Legislative Relief

- 1954: Triangular §368(a)(1)(C), and asset drop-downs following straight A or C under §368(a)(2)(C)
- 1964: Triangular §368(a)(1)(B), and stock drop-down following straight B under §368(a)(2)(C)
- 1968-1970: Triangular §368(a)(1)(A) under §368(a)(2)(D) and §368(a)(2)(E)

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Administrative Practice

- Prior to 1998, fairly strict adherence to §368
- T.D. 8760 (1998)
  - Added Reg. §1.368-1(e) COSI rules: Target stockholders not required to retain stock of acquiring corporation
  - Amended Reg. §1.368-1(d) COBE rules:
    - COBE applied on "Qualified Group" basis
    - Aggregate theory applied to partnerships
  - Added Reg. §1.368-2(k) to implement §368(a)(2)(C):
    - Successive drop-downs to controlled corps allowed in A, B and C reorgs
    - Mixed treatment of partnerships

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Admin Practice, Cont'd

- Rev. Rul. 2001-24: Drop-down of controlled Sub stock after §368(a)(1)(A)/(a)(2)(D) reorg permitted
  - §368(a)(2)(C) "permissive rather than exclusive or restrictive"
- Rev. Rul. 2002-85: Drop down after §368(a)(1)(D) reorg permitted
  - both §368(a)(2)(C) and Reg. §1.368-2(k) "permissive and not exclusive or restrictive"

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T.D. 9361 (10/25/1997)

- Expands COBE "Qualified Group" (amended Reg. §1.368-1(d))
- Supplants §368(a)(2)(C) (amended Reg. §1.368-2(k))

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COBE "Qualified Group"

- Old QG: P and one or more chains of subs each directly controlled by its immediate parent
- New QG: P, at least one sub directly controlled by P, and each sub control of which is held by other subs in the aggregate
- Control still defined by §368(c)

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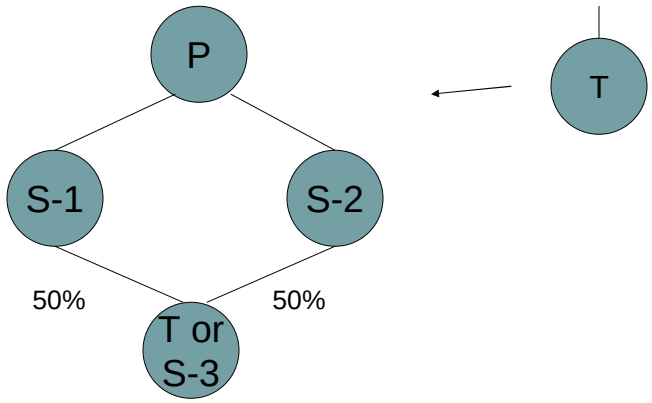
Diamond Structure



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Partnerships

- Stock owned by a "§368(c) controlled partnership" treated as owned by QG members
- "§368(c) controlled partnership" defined as partnership in which members of QG own interests "meeting requirements equivalent to §368(c)"

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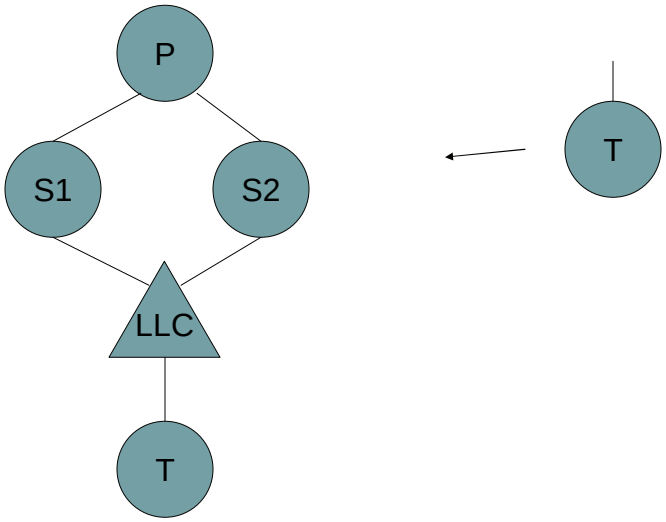
Partnerships



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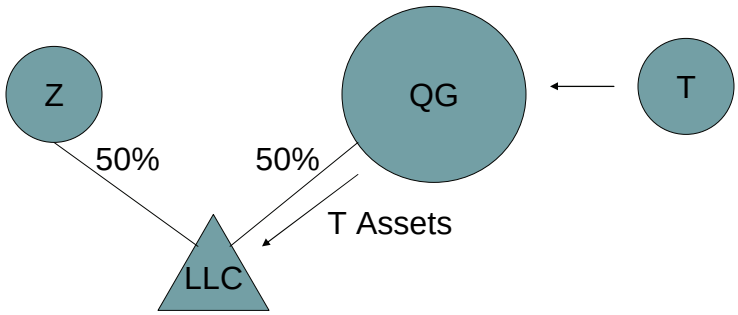
Partnerships



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New Reg. §1.368-2(k)

- Post-acquisition transfer will not disqualify reorganization treatment if—
  - COBE satisfied, and
  - Transfer qualifies as "distribution" under (k)(1)(i) or "other transfer" under (k)(1)(ii)
- Covers all types of reorgs, including §368(a)(1)(D) reorgs

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"Other Transfers"

- Drop-downs, cross-chains, sales, etc.
- Stock or assets of acquired, acquiring, or surviving corporation, or a combination thereof
- Stock transfer cannot cause corporation to cease being member of COBE QG
- Acquired, acquiring or surviving corporation's existence does not terminate

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"Distributions" or "Push-Ups"

Distribution (including with liability assumption) to shareholder consisting of--

- Assets of acquired, acquiring, or surviving corporation, but not so much as would result in a liquidation for Federal tax purposes (disregarding prior assets of acquiring or merged corporation)
- Stock of acquired corporation, but not all that was acquired in transaction, and corporation must remain member of COBE QG
- Combination

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Other Considerations

- Intercompany Gain or Loss
- Location of Target's Tax Attributes, Reg. §1.381-1(b)(2)
- State Tax Consequences

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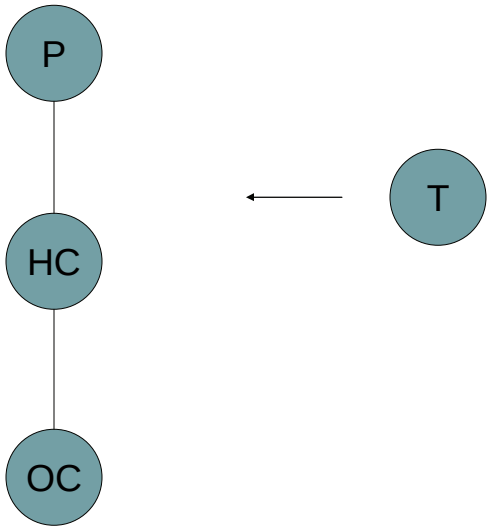

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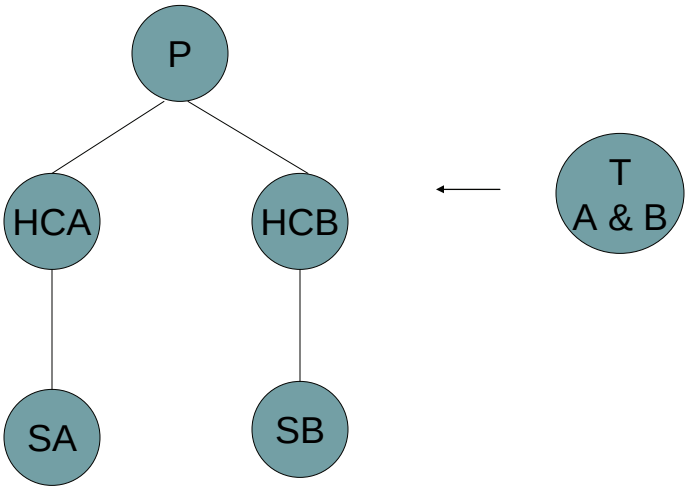

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Observations

- COBE rules play increasing important role
- Reg. §1.368-2(k) needed to hold off step transaction doctrine so initial acquisition fits §368 statutory definition
  - Flexibility not limitless; still some traps, or formal vestiges
  - Should §368 be amended to apply on QG basis?
- If outside Reg. §1.368-2(k), then step transaction doctrine may apply

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II. Form and Substance

- Intermediary or "Midco" Transactions, Enbridge Energy Company, Inc. v. U.S., Dkt. 4:06-cv-00657 (S.D. Tex. 3/31/08) (2008 TNT 64-9)
- Boulware v. U.S., 128 S.Ct. 1168 (3/3/08)

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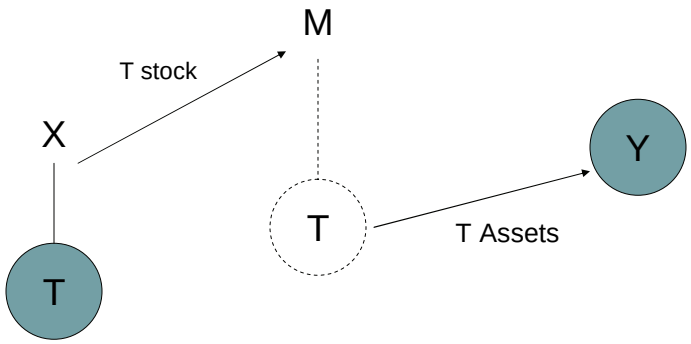
Basic Midco Format



IRS Position

- "Listed Transaction" under Notices 2001-16 and 2008-20; CIP (12/19/02); Appeals CIP Settlement Guidelines (10/15/04); CC 2001-023.
- Disallow Loss Offset to M. See Nicole Rose Corp., 117 T.C. 328 (2001), aff'd, 320 F.3d 282 (2nd Cir. 2002).
- Disregard M and Recast Transaction
- Assert Penalties

Recast

- M disregarded as conduit
- Asset Sale: T sells assets, liquidates to X
- Stock Sale: Y buys T stock, after which T liquidates into Y under §332 or §331

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Enbridge Energy

- Conduit Theory Applied
- Court Holding, Davant, Blueberry Land, and Reef Cases
- Factors:
  - Whether agreement between principals prior to M's involvement
  - Whether M was an independent actor
  - Whether M assumed risk
  - Whether M brought to transaction at taxpayer's behest
  - Whether nontax-avoidance business purpose for M's participation

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M held to be conduit because –

- X and Y had conducted negotiations prior to M's entry
- Y's tax advisor brought M into deal and helped structure transaction
- No evidence of negotiation by M
- Y indemnified M's obligations
- After purchase by M, T did not conduct significant activity
- M's only purpose for participating was to facilitate tax avoidance

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Recast

- Y treated as having purchased T stock and liquidated it
- Liquidation qualified under §332
- Y has carryover basis in assets – additional depreciation disallowed

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20% Substantial Understatement Penalty

- Transaction found to be a "tax shelter"
- Even if not a tax shelter, penalty applied
  - Weight of authorities was against taxpayer
  - No disclosure
- Reliance on tax advisor was not reasonable/good faith cause

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Boulware

Footnote 6:

"We have also recognized that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U. S. 465, 469 (1935). The rule is a two-way street: "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, ... and may not enjoy the benefit of some other route he might have chosen to follow but did not," Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U. S. 134, 149 (1974); see also id., at 148 (referring to "the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred"); Founders Gen. Corp. v. Hoey, 300 U. S. 268, 275 (1937) ("To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty"). ***The question here, of course, is not whether alternative routes may have offered better or worse tax consequences, see generally Isenbergh, Review: Musings on Form and Substance in Taxation, 49 U. Chi. L. Rev. 859 (1982); rather, it is "whether what was done ... was the thing which the statute[, here §§301 and 316(a),] intended," Gregory, supra, at 469."***

See also TAM 9743001

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III. Illinois Franchise Tax

- Tax is based on "paid-in capital" to the extent apportioned to IL based on location of property and business transacted.
- ""Paid-in capital" means the sum of the cash and other consideration received, less expenses, including commissions, paid or incurred by the corporation, in connection with the issuance of shares, plus any cash and other consideration contributed to the corporation by or on behalf of its shareholders, plus amounts added or transferred to paid-in capital by action of the board of directors or shareholders pursuant to a share dividend, share split, or otherwise, minus reductions as provided elsewhere in this Act." 805 ILCS 5/1.80.

805 ILCS 5/15.40, Basis for computation of franchise taxes payable by domestic corporations: "(c) In case of a statutory merger or consolidation of domestic corporations, the basis for an additional franchise tax payable by the surviving or new corporation shall be the increased amount represented in this State, determined in accordance with the provisions of this Section, of the paid-in capital of the surviving or new corporation immediately after the merger or consolidation over ***the aggregate of the amounts represented in this State of the paid-in capital of the merged or consolidated corporations*** . . ."; see also 5/15.70(c) (same rule for foreign corporations).

805 ILCS 5/14.35, Report following merger or consolidation: "Whenever a domestic corporation or a foreign corporation . . . is the surviving corporation in a statutory merger . . . , it shall . . . file . . . a report setting forth: * * * **(6)** A statement, expressed in dollars, of the amount of paid-in capital of the corporation after giving effect to the merger or consolidation, which amount, except as provided in subsection (f) of Section 9.20 of this Act, ***must be at least equal to the sum of the paid-in capital amounts of the merged or consolidated corporations before the event."***

- E&E Hauling, Inc. v. Ryan, 713 N.E.2d 178 (Ill. App. 4th Div. 1999): "an increase in paid-in capital due to push down accounting adjustments made to a corporation's balance sheet following a stock [purchase] and section 338 election constitutes a statutory increase in paid-in capital for franchise tax purposes."
- USX Corp. v. White, 817 N.E.2d 896 (Ill. App. 1st Div. 2004): Parent in reverse triangular §368(a)(1)(A)/(a)(2)(E) merger not entitled to apply aggregation rule; paid-in capital increased by FMV of acquired Target stock.
- Attorney General Op. 92-107 (9/24/92): "You have stated that the Department of Business Services has traditionally calculated the paid-in capital of the corporation surviving a merger as the sum of the paid-in capital of each of the merging corporations. This method is satisfactory when neither of the merging corporations owns shares of the other (a "horizontal merger")."

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- IL Franchise Tax on To-Do List
- Straight Merger
  - Does aggregation rule trump purchase accounting?
- Purchase Accounting
  - Any exception, e.g., nonacquisitive?
  - Assign step-up to valuation surplus or similar?
  - Effect of push-down accounting on subsidiaries?
- Capitalization of Merger Sub
- Apportionment
- Other Strategies

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George R. Goodman
Of Counsel
Foley & Lardner LLP
321 N. Clark St., Suite 2800
Chicago, IL 60610
(312) 832-4545
grgoodman@foley.com