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Taxpayer Bound by Form in Which Transaction Cast

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Some leveraged acquisitions are structured in a manner designed to enable the acquirer to execute a section 338 election regarding the target. This goal can be thwarted if the acquisition of the target's stock does not constitute a qualified stock purchase, a designation that may prove elusive if one or more of the target's shareholders become members of the buyout group by investing in the entity created to accomplish the acquisition. The circumstances under which the IRS will conclude that such an investment will have that effect are unclear, and the case law lacks a unifying theme.

Insilco Corp. (IC), owned 66 percent of the stock of Times Fiber Communication Inc. (TFC), and the public owned the balance. Under an integrated plan, the following transactions were undertaken:

- TFC made a self-tender offer to purchase the shares held by the public for $15.25 per share;
- IC *sold* its TFC shares to LPL Investment Group Inc. (Newco), in exchange for $15.25 per share;
- IC paid $20 million to Newco to *purchase* 200,000 shares of Newco preferred stock;
- IC and five other investors paid a total of $8 million to *purchase* Newco's common stock; and
- Newco acquired the remaining shares of TFC stock held by the public (by means of a reverse cash merger) for $15.25 per share.

A separate document was prepared for each of these transactions. On its original 1985 federal income tax return, IC reported that it *sold* the TFC stock, recognizing a gain of approximately $75 million. It also treated the Newco preferred stock and common stock as *purchased* for $20 million and $897,068, respectively. Newco reported the TFC stock as a *purchase* for cash and elected to have section 338 apply: availability of the section 338 election (under which a purchase of stock can be treated as a purchase of assets resulting in a cost basis in the target's assets with consequent depreciation and amortization benefits) "was critical to the success of the negotiations between Newco and IC." In fact, Newco's CEO stated that it would not have gone through with the deal without assurances that a section 338 election could be made regarding Newco's acquisition of TFC's stock.

In 1991 IC amended its 1985 federal income tax return and claimed a refund of taxes. IC maintained that under "substance over form" principles, the transaction should be treated as an exchange of TFC stock for (a net amount of) cash and Newco stock. Thus, IC sought to collapse the separate purchase and sale transactions into a single transaction.[1] By collapsing the transaction in this manner, IC would be entitled to a refund of taxes previously paid and, also, Newco would not be entitled to the section 338 election. Collapsing the transaction in the manner proposed by IC would mean that Newco's acquisition of TFC's would not constitute a *qualified stock purchase*, the predicate for the execution of a section 338 election.[2] The court, however, would not permit IC to collapse the transaction along the lines outlined in its amended tax return. See *Insilco Corporation v. United States*, 53 F.3d 95 (5th Cir. 1995).

'*Danielson* Rule' Followed

The court of appeals concluded that the bankruptcy court correctly held that the rule of *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1976), applies to preclude IC from recharacterizing its transaction. In *Danielson*, the court distinguished the case in which the taxpayer seeks to raise a substance-over-form argument from cases in which the IRS resorts to such argument. To allow, the court said, the commissioner alone to pierce formal arrangements does not involve any disparity of treatment because taxpayers have it within their own control to choose, in the first place, whatever arrangements they

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[1]*See* M. Ginsburg and J. Levin, *Mergers, Acquisitions, and Buyouts* at para. 1402:

> when an old T shareholder, (A), purchases Newco stock, so that A both receives cash for his T stock . . . and contributes cash to Newco in exchange for Newco stock, the two transactions may be treated as . . . a single transaction. . . . *If the two steps are treated as a single transaction, then A is treated as participating in the Sec. 351 formation of Newco by contributing T stock to Newco in exchange for both Newco stock and a net amount of cash*. . . . It frequently is unclear whether a shareholder's purchase of Newco stock and the shareholder's sale of T stock to Newco will be treated as a single transaction because of the irreconcilable results in the decided cases.

[2]A qualified stock purchase is defined (in section 338(d)(3)) as a transaction, or series of transactions within a 12-month period, in which the acquiring corporation *purchases* the amount of stock in the acquired corporation specified in section 1504(a)(2); stock possessing at least 80 percent of the total voting power of all outstanding stock and having a value of at least 80 percent of the total value of the outstanding stock (excluding, for this purpose, certain "plain vanilla" preferred stock of the type described in section 1504(a)(4)). *See* section 338(h)(3)(A).

care to make. To allow one party to recharacterize a transaction at a later date would, the court noted, be tantamount to granting that party a unilateral reformation of the contract with a resulting "unjust enrichment."

IC then argued that the "*Danielson* rule" was inapplicable in this case because sections 304 and 351 are mandatory. The court disagreed.

The transaction, it noted, was structured as purchases and sales of stock for cash, not as an exchange of stock for stock. Did Newco acquire stock (in TFC) in exchange for property from a person or persons in control of each such corporation? If the answer is yes, section 304 governs the tax consequences of the transaction. However, such common control (of TFC and Newco) was not present here. Clearly, IC was in control of TFC before the transfer. IC argued that it had control of Newco under section 304(c)(2)(A) which provides that "where one or more persons in control of the issuing corporation (TFC) transfer stock of such corporation *in exchange for* stock of the acquiring corporation, the stock received shall be taken into account in determining whether such person or persons are in control of the acquiring corporation." (Emphasis added.) Here, the persons in control of the issuing corporation did not acquire their stock in the acquiring corporation *in exchange for* stock in the issuing corporation, with the result that such acquiring corporation stock cannot be taken into account in determining whether the relevant person or persons were in control of each such corporation before the commencement of the transaction.

Even if section 304 applied, Newco's acquisition of TFC's stock would still have been a qualified stock purchase if the redemption constructed by section 304(a)(1) qualified for treatment as a distribution in part or full payment in exchange for stock and not as a distribution of property to which section 301 applies. In that case, Newco would obtain a cost basis in the TFC stock and not a basis determined, in whole or in part, by reference to IC's basis in such TFC stock.[3] To achieve a result that fits within section 304 requires that we recharacterize the transaction, which is, as indicated, precluded by the *Danielson* rule.

As with section 304, the court observed, IC's argument that section 351 applies *hinges on its characterization of the transaction as an exchange*. However, the transactions were not structured as an exchange and IC's attempt to say otherwise is not permitted.[4] Thus, the transaction was taxed in accordance with its form: IC sold stock to Newco and recognized the gain thereon; in a separate transaction, IC purchased preferred stock and common stock from Newco; and Newco's acquisition of TFC's stock constituted a qualified stock purchase with the result that its section 338 election regarding such qualified stock purchase was accorded full force and effect.[5]

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[3]*Compare* Rev. Rul. 77-427, 1977-2 C.B. 100.

[4]*Compare* LTR 9708001 (Oct. 14, 1996), *Doc 97-5201*, *97 TNT 36-12*. TP and I each owned 50 percent of the stock of T Corp. (T). On date 1, T and Acquiring Corp. (AC) entered into an agreement which provided that T would merge with and into AC on date 3: In the merger, each share of T would be converted into cash. On date 2, TP, AC, and "the Investors" (INV) entered into an agreement providing that INV would invest "$z" in AC and *TP would reinvest the cash it would have received under the merger agreement in exchange for 96 percent of AC's stock*. On date 3, T merged with and into AC. I received "$x" per share of its T stock. TP, by contrast, received 96 percent of AC's stock. TP never received any cash. The issue was whether the transaction qualified as a reorganization. If it did not, the "movement" of assets, from T to AC, would be taxable, and TP would be taxed on the exchange of its T stock for cash. *See also* Rev. Rul. 69-3, 1969-1 C.B. 104, and *C.T. Investment Co. v. Commissioner*, 88 F.2d 582 (8th Cir. 1937). Obviously, it is difficult to reconcile the results of LTR 9708001 with the contrary results reached by the court in *Insilco*, 53 F.3d 95.

[5]*See Stevens Pass, Inc. v. Commissioner*, 48 T.C. 532 (1967). The stock of Oldco was owned as follows: DGA — 50 shares of Class A voting common stock; BK — 50 shares of Class A voting common stock; and JC — 33⅓ shares of Class B nonvoting common stock. On November 4, 1960, Newco entered into a written agreement with DGA, BK, and JC to purchase their shares for $650,000. The stock of Newco was owned as follows: BK — 110 shares of voting common stock; JC — 80 shares of voting common stock; and all other shareholders — 210 shares of voting common stock. The acquisition was closed on November 30, 1960. On December 1, 1960, Oldco was liquidated into Newco. The issue was whether Newco was entitled to a "cost" basis regarding Oldco's assets received in the liquidation. The IRS determined that it was not so entitled. The crux of the dispute is whether Newco acquired the stock of Oldco by "purchase." The Service contended that the stock acquired from BK and JC was acquired in a transaction to which section 351 applied. The Service argued that the transaction should be viewed *as an exchange* by BK and JC of cash and stock in Oldco for a combination of stock, debentures, cash, and an installment obligation issued by Newco. The Service contended that the "control" requirement of section 351 was satisfied because the outside investors contributed cash, effectively simultaneously, with the transfer by BK and JC so that they may all be considered as one "transferor group." The court disagreed. It stated that:

> we can hardly ignore the fact that, whereas in *Houck v. Hinds*, 215 F.2d 693 (10th Cir. 1954), the ownership remained essentially the same throughout, in this case DGA's 50 percent ownership disappeared, BK's 50 percent ownership was reduced to less than 30 percent, and JC's 100 percent non-voting stock interest was changed to a 20 percent voting interest, and that over 50 percent of Newco is owned by persons who possessed no interest in Oldco.

Thus, here, the sale of Oldco's stock and the purchase of Newco's stock were not "collapsed" into an exchange to which section 351 applied with the result that Newco's acquisition of Oldco's stock constituted the presection 338 equivalent of a qualified stock purchase.

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