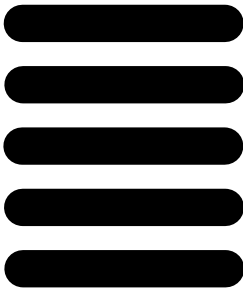




a Wolters Kluwer business



T H E M & A Tax Report

VOLUME 14, NUMBER 10
MAY 2006

THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF

Robert W. Wood
Wood & Porter
San Francisco

ASSOCIATE EDITOR

Joanna Schaller
Tax Institute
San Francisco

ADVISORY BOARD

Dominic L. Daher
University of San Francisco
San Francisco

Paul L. Davies III
The Cambria Group
Menlo Park

Jonathan R. Flora
Lindquist & Venum
Minneapolis

David R. Gerson
Wilson Sonsini
Goodrich & Rosati
San Francisco

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Wood & Porter
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Rejected REIT Reorganization

By Richard C. Morris • Wood & Porter • San Francisco

Don't ask the question if you can't stand the answer. So says an oft-quoted adage. It applies to private letter rulings, and accounts for the fact that you usually don't apply for a ruling unless you are pretty certain you'll get it. Likewise, it accounts for the fact that you rarely see a negative private letter ruling issued, though that has another explanation too: It is customary to withdraw the pending request if the IRS tips you off that it plans to rule against you. But, that brings us to our story.

Recently, the IRS published a private letter ruling in which a complicated transaction failed to qualify as a tax-free reorganization. [LTR 200611007 (Mar. 17, 2006).] The ruling discusses two publicly traded real estate investment trusts (REITs) and a third publicly traded company which is not a REIT. However, before discussing the details of the ruling itself, I'd like to say a few words about the taxpayer failing to achieve its desired results in the ruling. It never ceases to amaze me that such rulings ever get published.

In the typical ruling submission process, there is a fair amount of communication between the taxpayer and the IRS, both formally and informally. The taxpayer generally knows ahead of time if he will receive a favorable or unfavorable ruling. Indeed, in LTR 200611007, after the taxpayer submitted its initial ruling request on October 17, 2005, the taxpayer provided the IRS additional information on six further occasions during the following seven weeks. This heightened level of formal communication suggests that there was even more frequent informal communication by phone and e-mail. With such a constant dialogue, it's hard to imagine that the taxpayer was oblivious to the fact that Washington was not going to rule in its favor.

On the other hand, I suppose it is always possible that the parties were moving forward with their transaction regardless of the tax consequences. Perhaps the ruling was merely a time-saving device in

(continued on page 2)

ALSO IN THIS ISSUE

Becoming One with the Refund:	
California's LLC Fee Is Ruled Unconstitutional	4
Better Luck Next Time:	
Deducting Costs of Failed Business Transactions.....	6

case of a future audit. Yet, taxpayers rarely want to submit a time-consuming and costly ruling without the hope of a current tax benefit.

In any event, it is not clear which party submitted the ruling request. It is safe to assume that all three parties were cognizant of the submission, since it likely delayed (either temporarily or permanently) the undertaking of the transaction. One would think that a publicly traded company entering into a multiple-party transaction would have wanted more than an unfavorable ruling.

In fact, the IRS gives no indication whatsoever about what may have affected the outcome of the ruling. Yet, as we'll see, it is difficult to believe that the taxpayers were seriously trying to achieve tax-free status. After all, like the oft-photographed drive-through tree on California's North Coast, the holes in the trunk of this transaction tree were literally large enough to drive through.

Meet the Parents


The acquirer ("Parent"), a publicly traded REIT, was a holding company, owning an interest in a limited partnership, Parent LP. Parent LP owned several operating subsidiaries. It is not clear from the ruling (and presumably was not relevant) whether Parent owned a general or limited partnership interest in Parent LP. Unrelated third parties owned the remaining interests in Parent LP.

The target ("Company") was also a publicly traded REIT and a holding company. Company owned all of Company GP, which was classified as a wholly owned qualified REIT subsidiary. As part of this transaction, Company GP was going to elect to be treated as a taxable REIT subsidiary. Company GP was the sole general partner of Company LP, and Company was its sole limited partner. Company LP owned several operating subsidiaries.

Foreshadowing

The first step in the integrated transaction was Parent LP's formation of two limited liability companies (LLCs): Merger Sub and LP Merger Sub. (I say "integrated" because the taxpayer represented that all steps were "interrelated and each would not be effectuated without all of the steps being consummated.") This step alone should have tipped off even the casual observer that the transaction might not qualify as a tax-free reorganization. Both Merger Sub and LP Merger Sub were LLCs, not corporations. Although this step otherwise appears as if it could be the start of a typical forward (or possibly reverse) triangular merger, the use of LLCs, while allowed in certain limited circumstances, makes me skeptical that the transaction is going to qualify as a tax-free reorganization. This skepticism is only increased in the following steps, when yet another party ("Buyer") is added to the reorganization mix.

As M&A TAX REPORT readers know, in a forward triangular merger, the acquiring corporation contributes its stock to its subsidiary for use as consideration in the transaction. Typically, the contribution is made in a single step to an immediately controlled corporate subsidiary and is tax-free under Code Sec. 351. Here, the contribution was to occur in two steps, and no corporation received any Parent stock. Although a two-



<p>EDITOR-IN-CHIEF Robert W. Wood</p>	<p>MANAGING EDITOR Kurt Diefenbach</p>
<p>COORDINATING EDITOR Tara Fenske</p>	<p>PRODUCTION EDITOR Laila Gaidulis</p>

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com. ©2006, CCH. All Rights Reserved.

Permissions requests: Requests for permission to reproduce content should be directed to CCH, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

step contribution may be allowed, the lack of a corporate recipient in either step should have given the taxpayer pause.

Parent made its first contribution to a partnership (Parent LP), which presumably would be tax-free under Code Sec. 721. It made its second contribution to a single-member LLC (Merger Sub), and presumably this would be a nonevent for income tax purposes.

Parent stock was not the only property contributed to Merger Sub. Parent LP also planned to contribute money (which originated from borrowings) to Merger Sub. Additionally, Buyer, a wholly owned subsidiary of a publicly traded company not in the real estate business, was to contribute money to Merger Sub in exchange for a membership interest. Buyer's contribution appears significant, since Merger Sub would no longer be a disregarded entity, but rather would now be classified as a partnership. Indeed, the ruling notes that Merger Sub would be classified under the default rules, and no entity classification election would be made.

Merger Numero Uno

In the next step, Company was to be merged with and into Merger Sub. Merger Sub would have been the surviving entity, with Parent LP and Buyer continuing as the members of Merger Sub. Merger Sub was to have received all of Company's assets in the merger: its stock in Company GP and its partnership interest in Company LP. In exchange for their shares, Company's common shareholders would have received cash and publicly traded Parent common shares.

At this point, even those with only the most rudimentary understanding of the tax-free reorganization rules might legitimately question whether the transaction would qualify as a tax-free reorganization. Clearly, subchapter C basics require a tax-free reorganization to be engaged in solely between corporations. Granted, in January 2006, the IRS expanded the A reorganization rules to include certain transactions involving LLCs. [See Morris, "A" Reorganizations Revisited, M&A TAX REPORT, Mar. 2006, at 3.]

Yet, even a cursory review of the new regulations (or even the now obsolete proposed regulations, since the new regulations were not finalized until after the ruling process was substantially completed) should quickly eliminate the possibility that the taxpayers in

LTR 200611007 could rely on them. Generally speaking, these regulations only allow a taxpayer to claim tax-free status in certain reorganizations involving single-member LLCs. Here, Merger Sub clearly had two members.

Merger Redux

Once this first merger was completed, the ruling proposed a second merger. LP Merger Sub was to be merged with and into Company LP, with Company LP surviving. (Prior to this second merger, Merger Sub, Company GP and third parties would have been the owners of Company LP.) In the merger, the third-party owners of Company LP were to exchange their interests in Company LP for Parent LP interests. This second merger was sensible, since the minority interests of Company LP—now a lower-tier entity—would be moved to the Parent LP level, effectively consolidating all third-party interests in Parent LP.

As with the first merger, the second merger should send shivers down the spine of practitioners wondering how the taxpayer could have thought that a merger of a single-member LLC owned by a partnership into a partnership could have qualified as a tax-free reorganization. Perhaps the taxpayer thought that if all of the steps were integrated, then it would not matter that the steps standing alone wouldn't qualify. This step transaction analysis might be right. Yet, the IRS doesn't address whether and/or how the second merger affected its analysis or its ruling.

Cash Me Out

Immediately after the second merger, Buyer planned to cash out, transferring its Merger Sub interest to Company LP in exchange for certain Company LP properties. Because of this step, Company LP now would have had, at least transitorily, a hook-stock type interest in Merger Sub. Even more interesting is the discussion concerning Buyer's "acquisition" of certain properties held by Company LP. The taxpayer represented that Buyer would acquire the properties in an arm's-length transaction. If Buyer were just purchasing property, why bother even including Buyer in this complicated transaction? Buyer does not have an integral part of any step in the transaction, and it probably could have been removed without any change to the steps or the outcome.

In any event, immediately following the cash out, Merger Sub planned to dissolve. Parent LP's interest and Company LP's newly acquired hook-stock type interest would have been eliminated. As a result, Parent LP would have owned 100 percent of the limited partnership interest in Company LP, and Company GP would have owned the general partnership interest in Company LP.

Conclusion

Hopefully, my foreshadowing hasn't spoiled the ending of this story. The IRS's ruling is so brief that it bears quoting in full. "The transaction is not described in section 368(a) of the Code, but will be treated for federal income tax purposes as a taxable sale of Company's assets, followed by a liquidation of Company to its shareholders pursuant to Section 331 of the Code." That statement is telling, in that it confirms that the taxpayer had asked for tax-free treatment under Code Sec. 368(a).

The IRS's brevity in its ruling is only surpassed by its brevity in its analysis. There is none. Perhaps this is the manner in which the IRS reinforces Code Sec. 6110(k)(3), which provides that rulings cannot be used or cited as precedent. When the IRS says taxpayers can't rely on a private letter ruling, they mean every word (or lack thereof).

Still, a few points bear noodling. One issue which deserved attention, but received none, is continuity of interest. To qualify as a forward

triangular merger, the transaction must qualify as an A reorganization as if target merges directly into acquirer. To obtain a favorable ruling, the consideration received by target's shareholders as a group must be at least 50-percent acquirer stock. In other words, the cash consideration must be less than 50 percent of the total consideration. No part of the ruling, including the representations, discussed the relative values of the Parent stock and the cash used as consideration for Company's shareholders. Evidently, continuity of interest was not so important since so many other structural problems existed.

It's always good to try to put a good spin on a bad situation, and hopefully, LTR 200611007 will be a lesson to all practitioners in the do's and don'ts in achieving a successful ruling. Do carefully think through the proposed transaction, and perhaps have another practitioner review it before submission. Second opinions are not just for medical advice anymore. Don't expect a corporate reorganization ruling to provide for a tax-free treatment when no corporation is involved in the merger. Do listen to the IRS during the ruling process—a taxpayer can always withdraw or modify a ruling to prevent an unsuccessful result. Don't represent to an acquisition of property as part of a reorganization.

There are probably a few more do's and don'ts, yet this representative list should provide a lesson (or two). But, here's a last pair I can't resist: "reit" the rules, and before asking the IRS for assurance, "reit" them again.

Death, Taxes and Refunds

Given the proverbial certainty of death and taxes, many clients get spiritual satisfaction from the fact that courts frequently rule state and local taxes to be unconstitutional. Clients and practitioners find it especially satisfying when they learn that the tax that has been struck down as unconstitutional is a tax they have paid. Hot off the presses is news that a California Superior Court has ruled California's annual fee on LLCs to be unconstitutional. [*Northwest Energetic Services, LLC v. California Franchise Tax Board*, CGC-05-437721 (SF Sup. Ct. Mar. 3, 2006).]

This is Not Your Grandfather's Minimum Tax

California imposes an annual "fee" on LLCs doing business in California, or registered with the California Secretary of State. [Cal. Rev. & Tax. Code §17942.] This is not the standard \$800 minimum franchise tax. Like most businesses, LLCs are required to pay the standard California \$800 minimum franchise tax. [Cal. Rev. & Tax. Code §17941.]

However, in addition to the minimum franchise tax, LLCs must pay an annual "fee." California calculates the LLC annual fee based on the LLC's worldwide gross income. Under the newly invalidated statute, it is immaterial whether the LLC earns any portion of its income in California. The LLC still pays the annual fee in full. The LLC annual fee is determined as follows:

- If the LLC's total income is between \$250,000 and \$500,000, the fee is \$900.
- If the LLC's total income is between \$500,000 and \$1,000,000, the fee is \$2,500.
- If the LLC's total income is between \$1 million and \$5 million, the fee is \$6,000.
- If the LLC's total income is more than \$5 million, the tax is \$11,790.

A Tax by Any Other Name

Having annual sales in excess of \$5 million is not difficult for an LLC. Thus, many LLCs doing business in the state (and many not doing business in the state, but registered with the state and subject to the fee) are paying the \$11,790 fee each year. In *Northwest Energetic*, the plaintiff was in fact a Washington State LLC registered in California, but not doing business in the state.

The court in *Northwest Energetic* held that the LLC annual "fee" is really a tax, ignoring the label placed on the tax by the state. Moreover, the court determined that although the fee was a tax, the State did not apportion the LLC annual tax. Apportionment is required for taxes imposed on taxpayers doing business both inside the state and outside the state, based on a taxpayer's business activities within and without the state. [See *Complete Auto Transit, Inc. v. Brady*, 430 US 274 (1977).] Since the tax is not calibrated based on the business' California business activity or operations, the court ruled that the tax violated the Federal Commerce Clause and was unconstitutional.

Did Somebody Say "Refund"?

No doubt the California Franchise Tax Board ("FTB") will appeal the decision. What choice do they have? There is a great deal of money at stake, and California desperately needs it. After all, the state has realized budget shortfalls in recent years. Thus, it is unlikely the state will issue any tax (or fee) refunds while an appeal is pending.

Moreover, the FTB will likely require LLCs to continue paying the tax during the appeal. However, LLCs that have paid the tax may consider filing protective claims for refund for any open refund years. California has a four-year statute of limitations on audit and refund. [Cal. Rev. & Tax. Code §19306.] The statute of limitations for refunds begins on the later of April 15 or the filing of the LLC's state tax return. [*Id.*] Thus, the LLCs may file protective claims for refund for tax year 2001, depending on when the LLC's return was filed in 2002. Therefore, time may be of the essence.

LLCs may also file protective claims for refund for tax years 2002 through 2005. An LLC paying the \$11,790 minimum tax could file protective claims for a total of five years (2001 through 2005), totaling approximately \$59,000. Claims for refund accrue interest. Interest adds up pretty quick and can double the amount of a refund in no time. As *Northwest Energetic* continues to work its way through a series of appeals, LLCs may continue to file protective claims each time the LLC annual fee is paid (for example, in connection with annual fee paid for tax year 2006).