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Three Topics

Settling a Lawsuit by Merging Plaintiff and Defendant – Tax Issues

ISO Exercise Associated with a Corporate Liquidation – Ninth Circuit's Decision in Brown v. US

Accelerating Taxable Gain in Anticipation of a Future Rate Increase

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I. Settling a Lawsuit by Merging Plaintiff and Defendant – Tax Issues.

A. Litigation Settings Where Merger Discussions Are Useful.

1. Problematic where there are open animosities and customer competition.

2. Hostile takeovers are possible, but rare, if the target corporation is publicly traded.

3. The most common setting for settlement by merger involves disputes over the ownership of intellectual property. This often occurs when the target corporation (typically the plaintiff in an underlying patent or copyright infringement suit) has, as its principal assets, intellectual property that it alleges to have been infringed by the acquiring corporation (typically the defendant in the under suit).

4. Merger settlement is especially attractive if the plaintiff/target is a "non-practicing entity" and privately held, while the defendant/acquirer is a more substantial operating corporation.

B. Tax Objectives of the Settlement.

1. Settlement is normally structured to minimize recognition of gain by the plaintiff/target and its shareholders. This reduces tax burden to the plaintiff/target and may reduce the settlement cost to the defendant/acquirer. A tax-deferred structure, though, reduces the tax benefits to the defendant/acquirer.

2. Corporate Structure.

   a. Some form of triangular merger – normally reverse triangular unless there is a substantial amount of cash to be paid in the deal (then forward triangular).

   b. Need shareholder approval from the plaintiff/target, though this is normally just a matter of majority vote.

   c. The acquisition must qualify as a "reorganization" under Section 368(a) of the Code to achieve tax deferral for the plaintiff/target and its shareholders.

C. Special Issues Tax Issues in Structuring the Reorganization.

1. Normal checklist of statutory and regulatory rules will apply.

2. Continuity of business enterprise.

   a. If the plaintiff/target has no business other than the claims pertaining to the underlying lawsuit, COBE will be a concern.

   b. Current COBE rules require either the continuation of a target business or the continued use of historic business assets. If the plaintiff/target had developed and marketed the underlying IP, the defendant/acquirer's use of that IP in its business following the merger is likely to satisfy COBE requirements. If the plaintiff/target had merely developed the IP without ever engaging in revenue-directed activities, the case for COBE is weakened, though perhaps not fatally. If the plaintiff/target had merely purchased the IP from a third party for cash and then instigated the underlying litigation for IP infringement, the claim for the pre-merger existence of a business is quite weak.

c. Treasury Regulation Section 1.368-1(d), Example 2 is instructive. The acquirer in that Example merges with a target corporation that had been a supplier of computer components. It does not operate the target corporation following the merger, but retains the target's equipment as a backup source of supply. The Example concludes that COBE is satisfied.

3. Cancellation of Debt Associated with Extinguishment of Infringement Claims.

a. The defendant/acquirer, by agreeing to the merger, is indirectly settling the plaintiff/target's claims by issuing its own shares.

b. Under the rule of Section 1032 of the Code, the defendant/acquirer does not recognize gain on the transfer of its (or its parent's) appreciated securities.

c. Under the rule of Section 362 of the Code, the defendant/acquirer takes a carryover basis in the IP it acquires as a result of the merger.

d. Under the rule of Section 361of the Code, the plaintiff/target does not recognize gain on the transfer of assets to the defendant/acquirer.

e. A somewhat unsettled question is whether the defendant/acquirer incurs cancellation-of-debt income by reason of the merger. Any debt or royalty obligations of the defendant/acquirer to the plaintiff/target are eliminated as a result of the merger.

f. Treasury Regulations Section 1.108-2(f)(3) is "reserved" on this issue, and the preamble to that Reg (way back in 1992) warned of forthcoming regulations that would address this topic. If there were no clear debt, or if the debt when paid would have given rise to a deduction, there are solid grounds for arguing that there is no net cancellation-of-debt income.

II. ISO Exercise Associated with a Corporate Liquidation – Ninth Circuit's Decision in *Brown v. US*.

A. Corporate Liquidations When There Are Outstanding Incentive Stock Options.

1. Corporate sale of substantially all assets followed by liquidating distributions of sales proceeds.

2. Winding up at a time when there is a corporate surplus to distribute to shareholders. (This is rare.)

3. Board vote, shareholder vote, notice to optionholders.

B. Holding Period Rules Applicable to ISOs.

1. Two years from the date of ISO grant.

2. One year from the date of ISO exercise.

3. If stock is sold prior to the satisfaction of both holding periods, any gain on the disposition of the ISO shares is ordinary income up to the ISO spread that existed at the time of exercise.

4. Same-day exercise and sale will represent a disqualifying disposition of ISO shares.

C. Ninth Circuit Decision in *Brown v. US*, 427 F.2d 57 (9th Cir. 1970).

1. Taxpayer was Clay Brown, who was also the taxpayer in a famous tax case decided by the US Supreme Court – ***Commissioner v. Clay Brown***, 380 U.S. 563 (1965), involving a sale-leaseback arrangement.

2. Taxpayer exercised a "restricted" stock option (predecessor to current-law statutory stock options such as ISOs) on November 15, 1955. The employer corporation sold substantially all of its assets for cash on August 17, 1956. Taxpayer, in his separate capacity as shareholder, had voted against the asset-sale transaction.

3. Over 96 percent of the shareholders surrendered their stock certificates and received liquidating distributions on August 17, 1956. Taxpayer did not yield his certificates until December 12, 1956. Thereafter, taxpayer received his liquidating distribution and the corporation dissolved.

4. Taxpayer initially reported his gain on the option exercise as ordinary income. Taxpayer then sued for a refund, claiming that he had satisfied the holding period for his shares by refusing to turn over his shares until December of 1956.

5. District Court agreed with the IRS that taxpayer had constructively received his liquidating distribution when that distribution was made available to him in August of 1956. The taxpayer therefore had not satisfied the applicable holding period requirements.

6. The Ninth Circuit reversed, holding that a disqualifying disposition requires a "voluntary" and affirmative action by the taxpayer. So the taxpayer's strategy of voting against the asset sale and then delaying the surrender of his shares was to be respected for tax purposes.

D. Aftermath of the Ninth Circuit Decision.

1. Both the IRS and the Tax Court disagree with the ***Brown*** analysis. See Rev. Rul. 74-267, 1974-1 C.B. 102, and ***Kast v. Comr.***, 78 T.C. 1154 (1982). Neither will require a "voluntary affirmative" act by a taxpayer before finding a disqualifying disposition.

2. BNA portfolio on statutory stock options, at footnote 114, states as follows:

> "Except for cases arising in the Ninth Circuit, an involuntary disposition is a disposition. [citations] In the Ninth Circuit, *Brown v. U.S.*, 427 F.2d 57 (9th Cir. 1970), still has precedential effect. Accordingly, the Tax Court will follow the *Brown* decision for taxpayers in the Ninth Circuit, under the Tax Court's procedural rule of ***Golsen v. Comr.***, 54 T.C. 742, 756–58 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971). **The authors believe that the *Brown* decision is so flawed that we will not discuss it in this Portfolio, and taxpayers and practitioners in the Ninth Circuit should proceed with caution before relying on *Brown*.** *See also* **Schumann v. Comr.**, T.C. Memo. 1983-35, *aff'd*, 857 F.2d 808, 810–12 (D.C. Cir. 1988) (explaining errors in the Ninth Circuit's analysis)." [emphasis supplied]

E. Four Final Notes on the *Golsen* Rule.

1. Under the ***Golsen*** rule, the Tax Court will follow the precedent of the Circuit Court to which appeal lies. Venue for appeal is generally determined by the residence of the taxpayer as of the date the taxpayer files his petition to Tax Court. See Section 7482(b)(1) of the Code (flush language).

2. Section 6662 of the Code imposes a penalty on certain understatements of tax liability where the taxpayer cannot demonstrate that his position is supported by "substantial authority." Section 1.6662-4(d)(3)(iv)(B) of the Regs describes the precedent that may be considered in determining whether "substantial authority" exists. That Section of the Regs acknowledges the ***Golsen*** rule as follows:

> "The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. **Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item**."

3. Section 1.6662-4(d)(3)(iv)(C) of the Regs states that substantial authority must exist either on the final day of the year to which the return relates or on the date the return is filed.

4. Section 1.6694-2(b)(3) of the Proposed Regs, dealing with the new "more likely than not" standard for return preparers, provides that a return preparer may rely on the authorities described in the Section 6662 Regs in reaching a more-likely-than-not conclusion.

III. Accelerating Taxable Gain in Anticipation of a Future Rate Increase.

A. Benefits of Deferral.

1. Time value of money.

2. Matching income recognition and tax liability with receipt of funds.

B. Shifting Political and Tax Policy Environment.

1. Campaign rhetoric.

2. Obama and McCain tax policy and fiscal realities.

3. Precedent – Tax Reform Act of 1986.

   a. Reagan initiative – flatter tax, broader base.

   b. Tax rate on long-term capital gain increased from 20 percent to 28 percent.

C. Judgment Calls.

1. Client surrenders time value of money – current low interest rates.

2. Cash flow – tight credit.

3. Internal Revenue Code's bias against deferral – planning opportunities.

D. Election Out of Installment Method.

1. Section 453(d) -- elect out by reporting full gain on return for year of sale.

2. Election must be made by due date of the return, ***including extensions***.

3. This may increase value of filing extensions to 10-15-09 for the calendar year 2008. There are, of course, uncertainties about the timing and effective dates of future rate increase legislation.

E. Busting a Like-Kind Exchange.

1. Section 1031 compliance requires investment in replacement property within the earlier of (i) 180 days from the date of the initial sale or (ii) the due date (taking into account extensions) for the tax return covering the year of sale.

2. Taxpayers may therefore be able to wait until 2009 to decide whether to comply with Section 1031 timing requirements. If immediate gain recognition would be preferable, simply reinvest on the 181st day.

3. Continual rollovers permitted under Section 1031 may make gain acceleration less attractive if the investor anticipates indefinite participation in real estate projects.

F. Busting a Corporate Reorg.

1. Technical requirements for “reorganization” status often make it easy to design a corporate acquisition to fall outside the rules.

2, Corporate acquisition is either a reorg or not a reorg as of the date of closing – no look-back possibilities as with installment sales or like-kind exchanges – need careful judgment before taking this approach.

G. Corporate Liquidation to a Liquidating Trust.

1. Need to complete liquidating distribution for shareholders to fully recognize gain.

2. If there are still corporate affairs to be wound up, corporation can liquidate to a liquidating trust and the trustee will settle final issues.

3. Be careful about triggering installment obligations of liquidating C corporation.

H. Stockpile Potential Losses.

1. Loss positions in publicly traded securities -- weak stock market in 2008.

2. Consider whether to postpone harvesting 2008 loss positions so as to preserve losses for use against future gains subject to higher rates.

Attachment 1

Article – Alameda County Bar Association Bulletin – Summer 2008

“Would Your Client Ever Want To Pay Taxes Sooner Rather Than Later? Some Tips on Accelerating Taxable Gain in Anticipation of Future Rate Increases.”

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