Downstream Mergers, Consolidated Returns and the Step Transaction Doctrine

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Readers of the M&A TAX REPORT know that the corporate reorganization provisions are sufficiently complicated to keep us gainfully employed for the foreseeable future. When practitioners have to layer on top of this complexity the Byzantine consolidated return rules and the capricious application of the step transaction doctrine, most of us probably shudder just thinking about the difficulties involved. The unexplored interaction of these realms surrounds a recently decided case, *The Falconwood Corporation v. United States*, 2005 U.S. App. Lexis 19054 (Sept. 2, 2005).

Not Just Another Reorganization

The Mocatta Group consisted of a parent company, TMC Holdings Corporation ("TMCH"), which owned three companies: The Falconwood Corporation ("Falconwood"), Falconwood Securities Corporation ("FSC") and Rimmon Corporation ("RC"). Falconwood owned Mocatta Futures Corporation ("MFC"), which owned Wallace Commodities Inc. ("WCI"). The Mocatta Group had a fiscal year end of March 31 and filed on a consolidated basis.

In 1986, the Mocatta Group underwent an internal reorganization, to become several S corporations. To avoid the effects of the Tax Reform Act of 1986 (which included the enactment of the S corporation built-in gains tax), the Group had to complete its reorganization before January 1, 1987. With just days to spare, the Mocatta Group reorganized on December 23, 1986. As part of the reorganization, TMCH merged downstream into Falconwood.

This downstream merger was necessitated by Falconwood's unique assets. It held seats on various commodities exchanges and the downstream merger avoided the risk and delay incident to obtaining approval of a transfer of those seats from Falconwood to TMCH. As part of the initial transfers, RC merged into Falconwood and WCI liquidated into MFC. A certificate of merger was filed at 11 a.m. on December 23, 1986, showing Falconwood as the surviving parent corporation. Keeping track of the time of day during a merger is generally not important, but in *Falconwood*, it turned out to be key to the court's decision.

After the initial merger and liquidation, FSC paid a cash dividend and transferred a note to Falconwood at 1:20 p.m. At 2:26 p.m., MFC paid a dividend to Falconwood. At some point after the dividends were distributed, Falconwood sold the stock of MFC and FSC to its shareholders so that the three corporations became brother/sister companies. Then, Falconwood, MFC and FSC each elected S status.

Consolidated Return Enigma

Falconwood filed a consolidated return as the common parent of the Mocatta Group for the period ending March 31, 1987. The return included Falconwood's operations (which included TMCH) for the entire 12 months, and operations of MFC and FSC up to December 23, 1986. MFC and FSC filed separate returns after the reorganization. This approach seems logical. However, practitioners know that when tax worlds collide (such as when mergers interact with consolidated returns), logic can be trampled under obscure and untested rules.

The Falconwood reorganization would be rather hum-drum if it weren't for Falconwood sustaining a $10 million loss after completing the internal reorganization. Ouch. Falconwood took the position that the consolidated group survived the merger and Falconwood's operations from December 23, 1986, through March 31, 1987, were part of the Mocatta Group's consolidated return. Thus, it included the $10 million loss in the consolidated return, and then carried back the loss to the Group's prior tax years. Not surprisingly, the IRS determined that the Mocatta Group terminated on December 23, 1986, with the downstream merger of TMCH into Falconwood and that the final consolidated return should have been filed with such ending date.

Falconwood paid the tax requested by the IRS and brought suit in the Court of Claims. [*See Falconwood Corp.*, 60 FedCl 485 (2004).] Falconwood argued that the Mocatta Group survived the termination of TMCH, the group's former common parent. Under the regulations, the consolidated group survives a downstream merger if the group

succeeds to the assets of the former common parent, and if subsidiaries remain connected to the new common parent. The taxpayer argued that the Mocatta Group succeeded to TMCH's assets and FSC and MFC remained subsidiaries of Falconwood, at least until Falconwood sold each company to its shareholders approximately three hours after the downstream merger.

Interestingly, the IRS did not contest the first part of the test regarding the assets remaining in the group. However, it did argue that the second part of the test had not been met, that there remained a subsidiary after the downstream merger. The IRS thought this requirement should be judged at the conclusion of the reorganization and not in the middle of the day between steps in a larger transaction.

The Claims Court, siding with the IRS on a summary judgment motion, determined the Mocatta Group did not survive the downstream merger. It found that the consolidated return regulations governing whether a group remains in existence despite termination of the common parent implied a "temporal requirement" not satisfied by the short time period of three hours. In the alternative, the court applied the step transaction doctrine, determining that the appropriate time to assess the nature of the transaction is at the conclusion of the transaction.

Not So Fast

In what may seem to the taxpayer as a never-ending 20-year saga (which is ironically twice as long as the 10-year built-in gains tax Falconwood may have been trying to avoid!), on September 2, 2005, the Federal Circuit reversed and remanded the case back to the Court of Claims, disagreeing with the lower court on both rationales for summary judgment. The court noted that the Mocatta Group was required to file a consolidated return since it had done so in previous years. The consolidated return had to include the income of the common parent for that corporation's entire tax year and the income of each subsidiary for the portion of such tax year during which it was a member of the group. (This rule is found within Reg. §1.1501-76(b)(1), and has been slightly modified since 1986. The court noted that it was uncertain if the modification would have affected the outcome, but that issue was not before the court.)

Generally speaking, a consolidated group is considered to remain in existence if the common parent remains as the common parent and at least one subsidiary remains affiliated (whether or not such subsidiary was a member of the group in a prior year and whether or not a corporation has ceased to be a subsidiary at any time after the group was formed). There's an exception, though, where a common parent is no longer in existence, but has transferred all of its assets downstream to a subsidiary. In that case, the group is considered to remain in existence if the members of the affiliated group succeed to and become owners of substantially all of the assets of the former parent, and there remains at least one subsidiary.

The court easily found that the income of all companies up to December 23, 1986, had to be included in the consolidated return. The more difficult inquiry was to identify the income of the common parent for that corporation's entire tax year which had to be included in the Mocatta Group's final consolidated tax return. The determination hinged upon whether Falconwood succeeded to and became the owner of substantially all of the assets of the group and whether there remained at least one subsidiary. Clearly, Falconwood met both requirements, but it only met the latter requirement for three hours.

THE HOURS may have been a popular movie title, but it's rarely relevant in a corporate deal. Still, whether three hours of continuity was sufficient under the consolidated return rules was what the court undertook to analyze.

The stakes were high. If three hours were sufficient, the former common parent, TMCH, would be deemed to continue in existence and TMCH/Falconwood would be regarded as the common parent for the entire tax year, until March 31, 1987. In that case, the post-merger losses would be included in the consolidated return. If three hours were not sufficient, the consolidated group would terminate as of December 23, 1986, and Falconwood's post-merger losses would not be able to be used in the consolidated return.

Continuity

The Claims Court found that three hours was not sufficient to satisfy the requirement of continuity. It based its decision on *Union Electric Co. of Missouri*, CtCls, 62-2 USTC ¶9621, 305 F2d 850 (1962), which determined that the regulations required the continued existence of at least one subsidiary from one year to the next. In *Union Electric*, a common parent was joined by only some subsidiaries in

filing a consolidated return. Other subsidiaries were precluded from joining the consolidated group, based on not being eligible for a particular tax credit.

Later, when the common parent was not eligible for the tax credit, it essentially switched groups. The subsidiaries not eligible for the credit joined the consolidated group, and those using the credits filed separately. Thus, the *Union Electric* court found that there was no continuity. In other words, losses from one "group" could not offset income earned in another year from a different group.

The Federal Circuit held that reliance on *Union Electric* (to determine whether the Mocatta Group remained in existence after the reorganization) was misplaced. *Union Electric* based its analysis on the physical make-up of a consolidated group from one year to the next, and on regulations which did not yet contain a downstream merger exception. Here, the court noted, the issue is the make-up of a consolidated group both prior to and subsequent to a downstream merger of the former common parent into a subsidiary.

Without judicial guidance, the court looked to the plain meaning of the regulation, which only states that "there remains" a subsidiary. This was a legislative regulation with the full force and effect of law. The court found that the phrase "there remain" presupposed no particular passage of time. Thus, the court held that three hours was sufficient. In fact, the court thought that under the rules as written, there was no difference between three hours versus the passage of days or weeks or months.

Step Transaction Shuffle

As M&A Tax Report readers are well aware, the step transaction doctrine is a judicial manifestation of the more general tax law ideal that effect should be given to substance, rather than form, of a transaction, by ignoring for tax purposes steps of an integrated transaction that separately are without substance. Some (though clearly not all) courts believe the step transaction doctrine does not apply "when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purpose." [*Tandy Corp.*, 92 TC 1165, 1173 (1989).]

Although the interaction of the step transaction doctrine with cases where a taxpayer has a clear business purpose may depend on the particular court, the Federal Circuit placed great weight on the existence of an independent business purpose. As such, the court determined that an independent business purpose prevented the application of the step transaction doctrine. The court held that based on the timing of the merger activity (*i.e.*, in the morning and afternoon of December 23, 1986), the Mocatta Group, and the court, was bound to follow the consolidated return regulations.

Indeed, the court found that the express terms of the regulations "belie any notion that compliance by the Mocatta Group was discretionary." Having successfully succeeded to the assets of TMCH, to avoid the cost and delay in transferring various exchange seats, and having remained connected through stock ownership to MFC and FSC prior to the ultimate termination of the Group, the Mocatta Group was required to file a consolidated return for the tax year which includes the income of the common parent through March 31, 1987.

Conclusion

A case like *Falconwood* makes both taxpayer and practitioner look for strength—the taxpayer for surviving a 20-year ordeal (which is still on remand), and the practitioner for getting a glimpse into the obscure reaches of our tax code. It wouldn't surprise me if, prior to the *Falconwood* decision, most practitioners thought three hours between transfers was not sufficient to allow the consolidated group to continue. Three hours seems paltry in the realm of the step transaction doctrine. Nonetheless, the Federal Circuit does make a thoughtful and reasoned analysis in finding for the taxpayer. Perhaps the more interesting question is whether the IRS will acquiesce. I think the smart money is on the IRS amending its regulations to prevent this type of thing from happening.

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