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Those Were the Days: *Times Mirror* and How to Make a Sandwich (Part II of II)

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The first half of this article appeared in the December 2005 issue of the M&A Tax Report.

Post-Merger Events

Several post-merger events suggest that Times Mirror may have known that its tax position was aggressive. For example, Times Mirror did not disclose any information concerning the Bender transaction on its 1998 income tax return, despite the fact that the Code Sec. 368 regulations require disclosure of a tax-free merger. Times Mirror eventually furnished a disclosure statement as part of a delivery of papers relating to the IRS's audit of Times Mirror's 1998 tax year.

Then too, MB Parent's return listed the outstanding preferred stock (owned by Reed) as having a value of $68 million. Yet, it listed no value for its common stock, even though TMD exchanged Bender stock worth over $1.3 billion for this common stock.

Times Mirror was also not so forthcoming to its shareholders. It disclosed the Bender divestiture yet failed to mention in its annual report that Reed had an ownership interest in the cash-laden and investment-rich LLC. It did, however, provide lengthy details of the investments it had made through Liberty and planned to make with its newly "acquired" cash.

IRS Audit

If the complexity of the Domestic Sandwich doesn't shock you, the speed with which the IRS began its audit of Times Mirror should. Times Mirror signed its 1998 return on September 14,

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1999. The IRS audit of Times Mirror's 1998 return began sometime prior to February 18, 2000. A five-month audit cycle probably didn't even allow the dust to settle on the workpapers. When it comes to recovering a billion dollars, perhaps even the IRS thinks there is no time like the present.

The IRS issued Times Mirror a Notice of Deficiency, stating that it realized $1.375 billion in exchange for 100 percent of its Bender stock. The Notice provided five reasons for the determination: (1) TMD cashed out its investment in Bender; (2) TMD failed to exchange its Bender common stock for stock of MB Parent worth at least $1.1 billion (which would be 80 percent of the value); (3) after the merger, post-merger Bender, the surviving corporation, failed to hold substantially all of its properties and the properties of the merged corporation; (4) TMD received consideration other than voting stock; and (5) Code Sec. 269 applies to deny nonrecognition treatment. Ultimately, Times Mirror and the IRS only argued points #2 and #4.

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Reverse Triangular Merger

Times Mirror argued that the Domestic Sandwich structure was intended to qualify as a reverse triangular merger. A reverse triangular merger is a statutory merger in which the merged corporation (*i.e.,* Merger Sub) merges with and into the target (*i.e.,* Bender) in exchange for stock of a corporation (*i.e.,* MB Parent), which, immediately prior to the merger, controlled the merged corporation. Here, MB Parent arguably controlled Merger Sub since it owned preferred stock of Merger Sub that had 80 percent of the vote.

The IRS summarily stated that the merger failed to meet the requirements of a reverse triangular merger. The Code requires TMD, as the former shareholder of Bender, to exchange stock of Bender constituting control, where control is defined as 80 percent of the vote and 80 percent of the total nonvoting shares. The parties agreed that TMD had to receive MB Parent common stock at least equal in value to 80 percent of the Bender stock exchanged to qualify. Since Bender was valued by the parties at $1.375 billion, the 80-percent threshold was $1.1 billion.

What Is Value?

The IRS argued that the consideration Times Mirror received in the exchange of its Bender stock was not only common stock of MB Parent, but also control over the $1.375 billion contained within Liberty. The court concluded that all incidents of ownership of the $1.375 billion had been shifted to Times Mirror. The court looked to the "totality of the contractual arrangements and [was] not limited to the design, characterization and labels put on the arrangement by the Times Mirror tax advisors."

Indeed, the contractual terms, the parties' subsequent conduct and representations made to shareholders and regulatory bodies were all telling. The provisions regarding voting, dividends, redemptions, liquidations and unwinding all confirmed that only Times Mirror had a continuing economic interest in the cash, and only Reed had a continuing economic interest in Bender. For example, any dividends paid to MB Parent from Bender were assured to be received only by Reed as preferred stock dividends.

Once the court decided the easy question (that TMD received both MB Parent stock and control of Liberty in the exchange), it reached the more difficult point: the value of the MB Parent stock *vis a vis* the value of control of Liberty. Although Times Mirror argued that the value of the MB Parent stock was plainly stated in the merger documents as $1.375 billion, the court ignored this testimony, noting it was "merely a recital consistent with the intended tax effect."

In a game of dueling experts, the court heard testimony from one Times Mirror expert and three IRS experts. The Times Mirror expert determined that the value of the MB Parent stock was $1.375 billion, but the court found his testimony to be based on less than all of the relevant facts. Indeed, the court seemed nonplussed with the Times Mirror expert because he gave no consideration to the contractual aspects of the transaction and assumed, against the grain of common sense, that MB Parent, Bender and Liberty would be immediately dissolved.

Meanwhile, the three IRS experts produced a range of values for the MB Parent stock from nil all the way up to $1.1 billion. In fact, two of the three experts produced ranges of values. Taxpayers may think that having a court pick a value after hearing expert testimony produces a result similar to throwing darts at a dart board. But, unlike a charitable contribution or estate tax valuation case, certainty wasn't important here.

The court merely determined that the value of the MB Parent stock was less than $1.1 billion, the 80-percent control threshold. The court did not have to choose a value. Since the MB Parent common received by TMD was worth less than $1.1 billion, the control requirement was not met.

In passing, the court noted that it did not have to decide how the altered fiduciary obligations could be respected under state law: "It is enough to observe that there is uncertainty on that subject, which uncertainty affects value."

B Reorganization

In the alternative, Times Mirror argued that this was a B reorganization, where valuation is not determinative. A B reorganization, of course, is a stock-for-stock exchange. Although in form TMD was the holder of MB Parent common stock and no longer owned any Bender stock, the court found that Times Mirror received more than just stock in consideration for exchanging its Bender stock. It received control over Liberty, which contained $1.375 billion. Thus, there was not a valid B reorganization.

Ultimate Findings of Fact

In a 135-page opinion, the court provided four "ultimate findings of fact":

> The primary consideration received by Times Mirror, through TMD, for transferring control over the operations of Bender to Reed was control over $1.375 billion paid by Reed, through MB Parent, to the LLC.
>
> The agreements and corporate organization documents entered into by Times Mirror and Reed negated any meaningful fiduciary obligations between Times Mirror and Reed with respect to Times Mirror's control over the cash or Reed's operation of Bender.
>
> The MB Parent common stock held by TMD had a value of less than $1.1 billion and less than 80 percent of the $1.375 billion paid by Reed.
>
> The Bender transaction effected a sale of Bender by TMD to Reed. [*Tribune,* at 106.]

Summing It All up

The IRS had asked the court to render a broad decision, applying the spirit of the law, to deter what it saw as abuse. The IRS went back to basics, looking to *Gregory v. Helvering*, SCT, 35-1 USTC ¶9043, 293 US 465, 55 SCt 266 (1935), to support its substance over form argument. It cited several more recent cases and legislative history to augment its argument that Times Mirror had "created an elaborate scheme to no other purpose than to create the form necessary to support a claim for tax-free reorganization treatment." [*Id.,* at 127.] The IRS argued this Domestic Sandwich lacked continuity of proprietary interest, and that the court should apply the step transaction doctrine. [*Id*., at 128–29.]

Although the court reached a decision in favor of the IRS, it refused to do so on any of these grounds. This must irk the IRS tremendously. After all, cases such as *Tribune* can tie up significant IRS resources for years. The payoff is creating IRS favorable precedent, which can operate like a warning shot across the bow of rambunctious taxpayers.

It is noteworthy that the presiding judge was Judge Cohen, who 16 years ago was also the presiding judge in the famous *Esmark* case. [*Esmark, Inc.*, 90 TC 171, Dec. 44,548 (1988), *aff'd*, CA-7 (unpublished opinion), 886 F2d 1318 (1989).] In *Esmark*, form ruled over substance. Hoping for a similar result, and relying on *Esmark,* Times Mirror stridently argued that form should rule here too.

However, the court distinguished *Esmark* on the grounds that in *Esmark*, uncontrolled parties were involved (*i.e.,* the general public) whereas in this case, there was "no uncontrolled participation by persons who [were] not parties to the contractual arrangement … to give substantive economic effect to the existence of MB Parent." [*Id.,* at 130.] In addition, the court noted that Reed was hostage to the form: It "could not acquire the Bender stock without agreeing" to Times Mirror's terms. [*Id.,* at 131.] Even though this seems like strong enough language to support a substance over form finding, all of this language is *dicta.*

Still, the court also noted that the MB Parent common stock could not be separated from the authority of Times Mirror to manage Liberty's cash. The 20-percent voting power of the MB Parent stock held by TMD and the "bare legal title of MB Parent in the LLC should be disregarded." [*Id*., at 131.] Moreover, the court noted that "we deal only with what actually transpired and give effect to the legal documentation." [*Id*., at 132.]

Form and Substance

This *dicta* sure does sound like a substance-over-form analysis. Perhaps even more telling is the court's mention of *Frank Lyon*, the Supreme Court case which lays out substance over form jurisprudence. The court noted that "'the simple expedient of drawing up papers' is not controlling for tax purposes when 'the object of economic realities are to the contrary.'" [*Id*., at 131, quoting *Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561, 573, 98 SCt 1291 (1978).] Ouch.

Only time will tell how the precedent established by Times Mirror will affect taxpayers' behavior and future litigation. Of course, the case could be overturned on appeal. Or, the decision could become one of the legal pillars of the substance-over-form doctrine. In fairness, it is difficult to determine what the case stands for. On the one hand, the court expressly notes that its findings are based principally on the value of the MB Parent common stock being less than $1.1 billion. Yet, the court appears to support this finding by overlooking form and giving legal effect to the substance of the parties' action.

The actions giving rise to this litigation (*i.e.,* the Domestic Sandwich) were complicated, and the opinion is no less complicated. Recall that this was 1998, the heat of the 90's stock market bubble. Perhaps some tax advisors were chanting the mantra, "paying tax is for wimps." Fast forward to 2005 and we're sorting through all types of tax messes from years past, with the Department of Justice rooting around like there is a South American drug cartel in our midst.

In this atmosphere, it seems unlikely that the case will be overturned. Whatever happens, though, we can expect a lot of reading of the tea leaves over this case. Maybe the appellate court opinion will be short, and that would be a blessing. In any event, it does seem likely that PwC will move on to casseroles.