More Economic Substance Woes: Part II

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It should be pretty obvious that the IRS doesn't like this sort of thing very much. The IRS found three different reasons why this stunk, and should not fall within the bankruptcy exception provided by Code Sec. 382(l)(5). First, the purchase of the new stock lacked economic substance. After all, Investor (the acquiring company here) should have received more shares for its capital contribution.

If a new share price had been properly fixed, and if the acquiring company had received additional shares to fit the economics, the percentage stock ownership of the historic shareholders would have been just over 10 percent. That meant the bankruptcy exception continuity of ownership requirement would not have been satisfied.

Second, the IRS said the second and third shareholders here should be treated as redeemed out as part of a preexisting plan. After all, the price at which their shares were redeemed was fixed *before* the bankruptcy proceeding under a predetermined plan. The value of the shares presumably was greater on the later events. Yet shareholders 2 and 3 received no more at the advanced stage of the transaction than did the shareholders at the beginning.

The IRS suggests that the only reasons shareholders 2 and 3 were not redeemed out with the other shareholders was the fact that the acquiring company wanted to construct a transaction that—in form at least—would *appear* to meet Code Sec. 382(l)(5) requirements. The IRS said the step transaction doctrine worked well to collapse the redemptions into a single step for tax purposes. That meant continuity of ownership was not satisfied.

Last but not least, the IRS said the acquiring company contributed to the target an amount greater than 16 times the value of the pre-bankruptcy target stock in order to get creditor approval of the plan. The acquiring company went from having a zero-percent interest in the target (at the beginning of the year) to having 100 percent of the target's stock at the end. This 100-percent shift does not qualify (says the IRS) under Code Sec. 382(l)(5). Acquiring was neither an historic shareholder nor an historic creditor of the target.

Greed Is Good

Gordon Gekko's famous phrase sounds a little bit like "let them eat cake" these days. It will be interesting to see it revived in the forthcoming Oliver Stone reprise. As anyone who has ever been involved in a bankruptcy reorganization knows, the relaxed NOL rule Code Sec. 382(l)(5) allows is designed to give extra latitude to NOLs, essentially giving them a kind of get-out-of-jail-free card. But such a card is not a license to commit a felony.

On one hand, you have to admire the creativity of the transaction described in CCA 200915033. Yet upon reflection, it should be no surprise that the IRS would think this simply does not work. In this sense, one has to assume that the acquiring company here ended up with a lousy deal.

After all, it presumably relied on the notion that it was going to get access to the NOLs. On some level, perhaps the professional advisors involved and/or even the bankruptcy court all agreed. The IRS did not agree, as CCA 200915033 makes clear.