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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, DELAWARE-MARYLAND DISTRICT
CC:SER:DEM:BAL

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Leveraged Buyout Transaction

This Field Service Advice responds to your memorandum dated July 7, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Parent =

Target =

Promoter =

Acquisition =

LP1 =

LP2 =

LP3 =

Sh1 =

Sh2	=
Business	=
Agreement	=
Year1	=
Year2	=
Year3	=
Date1	=
Date2	=
$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
#m	=
#n	=
#p	=

ISSUE:

Whether the temporary existence of transitory corporation Acquisition can be disregarded for tax purposes and result in ignoring Acquisition's liabilities assumed by Target.

CONCLUSION:

The transitory corporation Acquisition can be disregarded in the leveraged buyout transaction at issue. However, disregarding Acquisition does not result in disregarding or ignoring Acquisition's liabilities assumed by Target.

FACTS:

Target was formed in Year1 by Sh1. He and his wife owned all of the outstanding stock equally. Target was engaged in Business.

In Year2, Promoter identified Target as a target for a leveraged buyout. Promoter formed a transitory acquisition corporation, Acquisition. Acquisition purchased from SH1 and Sh2 all but #m shares (retained by Sh1) of the outstanding stock of Target. The purchase price was approximately $aa.

Pursuant to an Agreement dated as of Date1, Acquisition obtained funds to finance the acquisition of Target through the issuance of senior and subordinated notes to three limited partnerships previously formed by Promoter to invest in leveraged buyout transactions. In particular, it issued senior notes in the amount of $bb to LP1, subordinated notes in the amount of $cc to LP2, and subordinated notes in the amount of $dd to LP3. In addition, the limited partnerships purchased a total of 450 shares of Class B common stock in the aggregate amount of $ee. #n managers of Target purchased a total of #p shares of Class A stock in the aggregate amount of $ff.

Immediately after this acquisition, Acquisition merged into Target, with Target surviving and assuming Acquisition's liabilities, including the notes issued to the limited partnerships. At the same time, the shares of Target stock retained by Sh1 were converted to new Class A stock of Target, and shares of Class A and Class B stock were issued in exchange for the Class A and Class B stock of Acquisition. The remaining shares of Target stock previously held by Acquisition were canceled. This essentially resulted in a recapitalization of Target.

In Year3, LP1, LP3, and other investors (unrelated to Target) formed Parent to acquire the assets of four companies engaged in businesses that were related or complementary to Target's business. On Date2, Parent acquired the stock of Target in exchange for newly issued shares of Parent.

LAW AND ANALYSIS

Disregarding Acquisition

The Service generally disregards a transitory corporation that is formed solely for the purpose of acquiring the stock of a target corporation. *See* Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 90-95, 1990-2 C.B. 67. In Rev. Rul. 78-250, for example, individual A owned 65 percent of the stock of Corporation X, and the remaining stock of S was widely held. In order to acquire complete control of X, A formed new corporation Y, receiving all of the Y stock in exchange for his X stock. Y then merged into X under state law, with each share of Y stock converted into a share of X stock and the minority shareholders of X receiving cash for their X stock. The ruling concludes that Y should be disregarded:

> [T]he creation of Y followed by the merger of Y into X with A exchanging X stock for Y stock, with the minority shareholders receiving cash and the conversion of the Y stock into X stock is disregarded for Federal income tax purposes. Rev. Rul. 73-427. The transaction is treated as if A never transferred any X stock, with the net effect that the minority shareholders of X received cash in exchange for their stock. Such cash is treated as received by the minority shareholders as distributions in redemption of their X stock subject to the provisions and limitations of section 302 of the Code.

1978-1 C.B. at 84.

In *Custom Chrome, Inc. v. Commissioner*, T.C. Memo. 1998-317, 76 T.C.M. (CCH) 386, *appeal filed*, No. 98-71378 (9th Cir. November 9, 1998), Jordan Company, an investment firm, formed Custom Chrome Holdings, Inc. ("Holdings"), which entered into an agreement to purchase the stock of Custom Chrome, Inc. ("CCI") from its sole shareholder for $16.75 million. Holdings then formed Custom Chrome Acquisition Corp. ("CCAC") as a wholly owned subsidiary for the purpose of facilitating the purchase of the CCI stock in a leveraged buyout transaction. CCAC obtained a bank loan of $26 million to finance the purchase and provide working capital for CCI after the acquisition. Using the funds borrowed by CCAC, Holdings purchased the CCI stock and immediately caused CCAC to merge into CCI. Under the merger agreement, CCI became liable for the debts of CCAC.

In determining whether CCI properly deducted certain legal and professional expenses incurred in connection with the transaction, the Tax Court determined that CCAC and the steps of the transaction involving CCAC should be disregarded for income tax purposes. "In effect, the transaction is to be treated for Federal income tax purposes as if petitioner received loans directly from [the bank] and then used $16.75 million of the loan proceeds to redeem the shares of stock that were held by [the sole shareholder]." 76 T.C.M. at 393. Based on this view of the transaction, the court held that the fees incurred in connection with CCI's redemption of its stock were nondeductible under I.R.C. § 162(k).[1/]

[1/] Previously, in *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), the court
(continued...)

As discussed by the court in *Custom Chrome* (76 T.C. M. at 392), the conclusion that the target should be treated as having redeemed its shares is supported by applying the step transaction doctrine. The step transaction doctrine has been described as another rule of substance over form "which treats a series of formally separate steps as a single transaction if such steps are in substance integrated, interdependent and focused toward a particular result." *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *see also Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path.").

In *Penrod* the court discussed three alternative tests for invoking the step transaction doctrine: (1) the "binding commitment" test; (2) the "interdependence" test; and (3) the "end-result" test. The application of any these tests to the acquisition of Target shares by Acquisition from the selling shareholders, followed immediately by the merger of Acquisition into Target, results in an integrated transaction properly designated for tax purposes as a redemption.

A series of transactions are collapsed under the "binding commitment" test "if, at the time the first step is entered into, there was a binding commitment to undertake the later step." *Penrod v. Commissioner*, 88 T.C. at 1429. This test is clearly satisfied. Acquisition acquired the shares of Target from the selling shareholders pursuant to an agreement that contemplated the immediate merger of Acquisition into Target.

Since the binding commitment test is the narrowest test and, therefore the most difficult to satisfy, the less restrictive "end-result" and "interdependence" tests described in Penrod, are also satisfied. The "end-result" test is described as applying where a "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result." The "interdependence" test is stated to "focus on whether the steps are so interdependent that the legal relations created by one transaction would have been fruitless without completion of the series." *Penrod v. Commissioner*, 88 T.C. at 1430.

The Agreement provided that Acquisition would merge into Target and that Target would assume responsibility for repayment of the funds borrowed to acquire the selling shareholder's Target stock. Target, not Acquisition, was intended as the

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[1/](...continued)
accepted, without discussion, the Service's treatment of a similarly structured leveraged buyout transaction as a redemption to the extent of the liabilities assumed by the target. 103 T.C. at 351 & n.12.

ultimate owner of the shares and as the obligor on the securities issued to acquire the shares from Sh1 and Sh2. Acquisition's acquisition was merely a transitory step to that end. Viewed in this manner, the end result of the transaction as intended by all of the participants was the acquisition by Target of its own shares. This is the essence of a redemption as defined in section 317(b).

In short, the step transaction doctrine, founded on the principle that substance prevails over form, applies where a transitory corporation purchases target shares from the selling shareholders followed by the merger of the transitory corporation into the target. As a result, the transitory corporation and the series of transactions involving it are disregarded and treated as a redemption for federal income tax purposes to the extent that the target shares were acquired with borrowed funds that target was liable to repay.

This leveraged buyout in this case involves the following steps:

1. The investors (i.e., Target's management and the limited partnerships) formed Acquisition, contributing cash in the amount of $gg in exchange for Class A and Class B common stock.

2. Acquisition raised approximately $hh by issuing senior and subordinated notes to the limited partnerships.

3. Using the proceeds from the loans, Acquisition paid Sh1 and Sh2 approximately $aa for almost all of their stock in Target, with Sh1 retaining #m shares.

4. Immediately after the acquisition, Acquisition merged into Target, with Target surviving the merger and assuming Acquisition's debt obligations to the limited partnerships.

5. In the merger, Target revised its capital structure to have Class A and Class B common stock. Target issued Class A shares to replace the #m shares retained by Sh1, as well as Class A and Class B shares to former shareholders of Acquisition (on a share-for-share basis).

These steps are similar to the transactions in *Custom Chrome*. Acquisition was formed solely to facilitate the purchase of Sh1's and Sh2's Target stock, and the only business it conducted before merging out of existence was related to purchasing the stock and financing the purchase. Accordingly, based on the rationale discussed above, Acquisition should be disregarded.

Effect of disregarding Acquisition

As indicated above in discussing Rev. Rul. 78-250 and the *Custom Chrome* opinion, the effect of disregarding a transitory corporation such as Acquisition is to treat Target as receiving the loan proceeds directly from the lender and using those proceeds to redeem its stock from the selling shareholders. *See* 76 T.C.M. at 383. The rationale for treating the transaction as a redemption is that the target corporation is obligated to repay the borrowed funds that are used to purchase the target stock from the selling shareholders. It is a common characteristic of a leveraged buyout that assets of the target are used to pay for part or all of the cost of acquiring the target's stock. Thus, to the extent that the target is obligated to repay the borrowed funds used to acquire its stock, the transaction is treated as a redemption.[2/]

As relevant to your request, the essential point is that disregarding Acquisition in this case does not mean that Target's assumption of Acquisition's liabilities can be disregarded or ignored. On the contrary, inasmuch as the intent of the parties was that Target would ultimately be liable for the amounts financed, the effect is to treat Target as incurring the assumed liabilities itself. As a result, disregarding Acquisition because it was a transitory corporation would not alter the end result in which Target assumed Acquisition's liabilities.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Although we concluded that disregarding Acquisition would not affect the recapitalization of Target, we note that this does not preclude an inquiry into the question of whether the assumed liabilities constitute bona fide indebtedness. Because the debt is between related parties (i.e., Target and some of its shareholders), such an inquiry is appropriate. *See, e.g., Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968) (in closely held corporation, the form of the transaction may not reflect intrinsic economic nature of the transaction because the parties can mold the transaction at their will); *Calumet Industries, Inc. v. Commissioner*, 95 T.C. 257, 286 (1990) (form and labels may not be significant in related party debt). This is a fact-intensive inquiry, involving a number of factors that the courts have developed. *See Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 494 (1980); *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973). Based on the available information, we do not discern a

[2/] On the other hand, to the extent that the funds used to acquire the target stock purchase are from other sources (e.g., from new investors), the transaction should arguably be treated as an ordinary purchase.

compelling argument for treating the debt at issue as equity. However, we are available to assist if you wish to pursue this line of argument.

Because the purchase of Sh1's and Sh2's stock should be treated as a redemption by Target, I.R.C. § 162(k) would apply to disallow a deduction for any costs incurred by Target in connection with that transaction. The available information does not indicate whether Target claimed deductions for any such expenses, but we raise this point merely to call it to your attention.

If you have any further questions, please call (202) 622-7930.

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