

## Fox-Disney Transaction Presents Opportunity to Apply Device Regs

by Michael J. Kliegman



Michael J. Kliegman

Michael J. Kliegman is senior counsel at Akin Gump Strauss Hauer & Feld LLP.

In this article, Kliegman discusses the proposed spinoff and merger of Disney and Fox and argues that the transaction is not a device as prohibited by section 355(a)(1)(B).

The views expressed in this article are the author's and do not necessarily reflect those of Akin Gump. The author and Akin Gump do not represent any of the principals in the Disney-Fox transaction discussed in the article.

(With apologies to the late Jim Croce):

*You don't tug on Superman's cape,  
You don't spit into the wind,  
You don't pull the mask off that old Lone  
Ranger,  
And you don't sell stock after a spinoff.*

Good advice, and we have all given it. But what if there is a planned disposition of shares of the distributing or controlled corporation after a putative section 355 distribution that includes cash consideration, and as a tax adviser to a shareholder or as an IRS official, you have to determine whether an otherwise qualifying transaction is disqualified because the transaction is a device to distribute earnings and profits as prohibited by section 355(a)(1)(B)? The recently announced 2.0 version of the proposed merger of the Walt Disney Co. and Twenty-First Century Fox Inc. presents just such a situation and an opportunity to undertake a more thorough

examination of the device test than typically occurs.<sup>1</sup>

The transaction originally entered into between Fox and Disney and announced December 14, 2017, called for Fox to first spin off to its shareholders a new company (New Fox) containing, among other businesses, Fox Broadcasting Co., Fox News Channel, and Fox Business Network. The Fox parent company was to then merge with a Disney subsidiary solely in exchange for Disney stock, bringing to Disney the remaining Fox assets, including its film production businesses, television creative units, regional sports networks, and Fox's interests in Hulu and Sky PLC.<sup>2</sup> In response to a higher, all-cash bid by Comcast Corp., Disney and Fox refashioned their transaction with a higher total consideration and also introduced cash into the mix of merger consideration.

The original transaction was essentially a *Morris Trust* transaction,<sup>3</sup> which, while apparently meeting all of the requirements under section 355 and the reorganization rules, ran afoul of section 355(e), causing the spinoff to be taxable at the corporate level while being tax-free to shareholders. Parenthetically, the parties planned to make a section 336(e) election for New Fox, and both the corporate tax cost and corresponding benefit were written into the economics of the transaction.

<sup>1</sup> See Disney release, "The Walt Disney Company Signs Amended Acquisition Agreement to Acquire Twenty-First Century Fox, Inc., for \$71.3 Billion in Cash and Stock" (June 20, 2018).

<sup>2</sup> See Disney release, "The Walt Disney Company to Acquire Twenty-First Century Fox, Inc., After Spinoff of Certain Businesses, for \$52.4 Billion in Stock" (Dec. 14, 2017).

<sup>3</sup> *Commissioner v. Morris Trust*, 42 T.C. 779 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966).

The new Disney-Fox transaction involves a pro rata distribution of New Fox shares followed by what is now a horizontal double-dummy section 351 transaction in which Fox and Disney shareholders exchange their Fox and Disney stock (through mergers) for shares in New Disney holding company. The consideration is to be solely New Disney stock to the Disney shareholders, while Fox shareholders elect to receive New Disney stock or cash, in approximately a 50-50 aggregate ratio.

We can stipulate that if the merger were solely for cash consideration as in the transaction offered by Comcast, the spinoff would be disqualified in any case for failure to satisfy the specialized continuity of interest requirement in reg. section 1.355-2(c). Ironically, although the acquisitive reorganization rules no longer require post-reorganization continuity,<sup>4</sup> that requirement still exists for spinoffs.<sup>5</sup> Indeed, the IRS's central objection to the transaction in *Morris Trust* involved the issue of continuity, which the court found adequately protected through the subsequent stock-for-stock transaction.

A joint proxy statement-prospectus dated June 28 contained the following tax disclosure regarding the pre-merger distribution of New Fox, Disney, and Fox:

The U.S. federal income tax consequences of the receipt by [Fox] stockholders of New Fox common stock in the distribution are uncertain. A distribution undertaken in connection with an acquisition where cash comprises a substantial portion of the aggregate consideration can prevent the distribution from qualifying as tax-free as a result of the "anti-device" requirement under Section 355 of the Code. The determination of whether the distribution can satisfy the anti-device requirement is complex, inherently factual in nature, and subject to significant uncertainty because the law is unclear. As a result, counsel cannot opine that the distribution will be tax-free to [Fox] stockholders under Section 355 of the Code. Although New

Disney intends to report the distribution as taxable to [Fox] stockholders, [Fox] stockholders will not be prohibited from taking a contrary position. [Fox] stockholders are urged to consult their tax advisors regarding the U.S. federal income tax consequences of the distribution to them.<sup>6</sup>

That's fine: It's a tax disclosure, it's a joint project between the two companies and their law firms, and there's not much incentive to try to tackle an issue on which reasonable minds may differ. Also, as discussed later, the companies and counsel needed to address the tax treatment of the distribution if taxable and proceeded from that assumption. But suppose you are counsel to a shareholder who asks you to pick up the challenge and provide an opinion on whether the distribution of New Disney stock qualifies under section 355.

The following is one of the requirements of section 355:

The transaction was not used principally as a device for the distribution of . . . earnings and profits . . . (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device).<sup>7</sup>

Neither the statute nor the regulations define what a device is, but based on the case law that gave rise to this statutory provision, the central focus is an effort to effect a dividend to shareholders that is ultimately taxed to them as capital gain rather than a dividend. The classic

<sup>4</sup>Reg. section 1.368-1(e)(1).

<sup>5</sup>Reg. section 1.355-2(e).

<sup>6</sup>See joint proxy statement-prospectus (June 28, 2018).

<sup>7</sup>Section 355(a)(1)(B).

transaction would be a tax-free spinoff, especially of investment assets, followed by a sale of the stock to a third party.<sup>8</sup>

The regulations take a facts and circumstances approach to determining whether a spinoff is a proscribed device. They list factors indicative of a device and other factors indicative of a non-device. Among the non-device factors are a strong business purpose for the spinoff and the fact that the distributing corporation is publicly traded and widely held. Chief among the device factors is — no surprise here — a prearranged sale of stock of either the distributing or controlled corporation after the spinoff. A sale that is negotiated or agreed on before the spinoff presents “substantial evidence of device.”<sup>9</sup>

Reg. section 1.355-2(d) directs us to make the device determination based on:

all of the facts and circumstances, including, but not limited to, the presence of the device factors specified in paragraph (d)(2) of this section (“evidence of device”), and the presence of the nondevice factors specified in paragraph (d)(3) of this section (“evidence of nondevice”). However, if a transaction is specified in paragraph (d)(5) of this section, then it is ordinarily considered not to have been used principally as a device.

We will set aside the (d)(5) matter for the moment and pretend that it isn’t present in our facts; we will most certainly come back to it.

Note that there is no statement indicating that a sale of stock is a super device factor, other than, as noted above, a pre-negotiated sale presents “substantial” evidence of device.

In listing the device factors, the regulation notes that their strength “depends on the facts and circumstances.” The relevant ones are:

- The distribution is pro rata.
- There is a post-distribution sale or exchange of the stock, with a pre-negotiated sale

presenting substantial evidence of device. When the sale or exchange is under a plan of reorganization, and either no gain or loss or only an insubstantial amount of gain is recognized, it is not considered evidence of a device. Boot treated as a dividend is also disregarded.<sup>10</sup>

Relevant non-device factors are:

- Corporate business purpose. The regulation indicates that a stronger business purpose is needed to counteract stronger evidence of device.
- Distributing corporation publicly traded and widely held. The important aspect here is that there be “no shareholder who is directly or indirectly the beneficial owner of more than five percent of any class of stock.” Note that in the case of Fox, the Murdoch family interests own substantially more than 5 percent and possess voting control.

The device test is ultimately looking to both motivation and opportunity to engage in the classic E&P bailout. The Fox-Disney transaction presented no real problem of device until Disney came in with a second-generation offer that was structurally the same as the original all-stock transaction but with greater value and a cash-stock mix, subject to a Fox shareholder election procedure.

Generally, when the stock is publicly traded and highly liquid, it should be stipulated that any given shareholder that wishes to sell stock in one company and retain the other is free to do so, and this fact doesn’t present a device issue. Indeed, the fact that a company has publicly traded stock without major shareholders is a non-device factor. So what is different about a prearranged transaction in which cash will be part of the consideration? It’s fairly clear that here, as in most instances of the section 355 rules, it is the closely held corporation that was the central source of concern. And a public company that is controlled by a single person or group may present similar concerns.

The original Fox-Disney *Morris Trust* structure involved solely stock. Cash was introduced by

<sup>8</sup> *Gregory v. Helvering*, 293 U.S. 465 (1935). Recent murmurs that perhaps the device prohibition could be used by the IRS as a basis to challenge an otherwise qualifying transaction that presents corporate-level tax avoidance concerns are, in my view, wholly unfounded. In any case, for Fox and Disney, section 355(e) is doing its job, and there will be full corporate tax imposed on the stock distribution.

<sup>9</sup> Reg. section 1.355-2(d).

<sup>10</sup> Reg. section 1.355-2(d)(2).

Disney in response to a competing offer by Comcast. With this in mind, it seems to me that from a motivation standpoint, the spinoff transaction was not conceived in sin, but with a pure heart. If that is the case, does the introduction of cash into the transaction in response to commercial circumstances replace that clean motive with a soiled one?

Here's an interesting question: Is the device analysis affected by whether the controlling shareholder elects to take stock or cash in the merger? Assuming one thinks that having cash in Disney-Fox 2.0 is a problem even though there was none in version 1.0, it seems to me that the consideration that the controlling shareholder receives is a significant factor. After all, the presumption is that he is the one calling the shots and whose motivation is central, and he is the reason that the "publicly traded and widely held" non-device factor is inapplicable.

I submit that if the Murdoch family elects to receive Disney stock in the merger, this should negate the "substantial evidence of device" indicated by the presence of cash. If they elect to take cash or a mix of stock and cash, the prearranged sale factor still has potency.

Wherever one falls on the device issue based on the above considerations, there is one other consideration, not yet discussed, that should make it quite difficult to argue that the transaction is a device. As mentioned earlier, after introducing the overall facts and circumstances approach for weighing device and non-device factors, the regulation states that "if a transaction is specified in paragraph (d)(5) of this section, then it is ordinarily considered not to have been used principally as a device."

Reg. section 1.355-2(d)(5) sets forth three situations "that ordinarily do not present the potential for tax avoidance described in [reg. section 1.355-2(d)(1)]. Accordingly, such distributions are ordinarily considered not to have been used principally as a device, notwithstanding the presence of any of the device factors." One of these three situations is if, "in the absence of section 355, with respect to each shareholder distributee, the distribution would be a redemption to which section 302(a) applied."

The distribution of New Fox to the Fox shareholders is being accomplished through an

internal merger, and each Fox shareholder will receive New Fox shares in exchange for a proportionate amount of the shareholder's shares in Fox — in other words, a redemption rather than an ordinary distribution. Although the redemption is pro rata among the Fox shareholders, it should be tested by comparing a shareholder's pre-distribution percentage ownership in Fox with its post-merger percentage ownership in New Disney under the well-established *Zenz* doctrine.<sup>11</sup>

That is apparently the analysis adopted by the companies' tax counsel. In the proxy statement discussed earlier, after indicating that the tax treatment of the New Fox distribution is not so clear, the tax disclosure states that the ensuing analysis will assume that the distribution is taxable. It then goes on to state:

A U.S. holder who receives shares of New Fox common stock in the distribution in exchange for a portion of its shares of [Fox] common stock will generally recognize gain or loss equal to the excess of (a) the sum of the fair market value of the New Fox common stock and any cash received in lieu of a fractional share of New Fox common stock over (b) such U.S. holder's adjusted tax basis in the portion of its [Fox] common stock exchanged therefor.<sup>12</sup>

Thus, the distribution of New Fox shares by Fox, subject to reasonable debate on whether it fails the device test under the regular factors — including cash in the Disney merger — is covered by what is very close to a safe harbor for transactions that present no possibility of actually being a device because they do not convert dividend income into capital gain. I, for one, would be much more comfortable arguing that the distribution is not a device than that it is. ■

<sup>11</sup>*Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954). See also Rev. Rul. 77-226, 1977-2 C.B. 90.

<sup>12</sup>See the June 28 joint proxy statement-prospectus, *supra* note 6.