REPORT #552

TAX SECTION

New York State Bar Association

Report on Mirror Subsidiaries and A Related Technique

December 9 1986

Table of Contents

Cover Letter: i

Report on Mirror Subsidiaries and A Related Technique 1

I. Principal Recommendations 1

II. Description of Techniques 2

III. Comments 4
- A. Needs for Guidance 4
- B. Investment Basis Adjustment Technique 6
- C. Elective Carryover Basis 7
- D. Techniques Creating Carryover Asset Basis 8

IV. Conclusions 11

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December 9, 1986

The Honorable J. Roger Mentz, Esq.
Assistant Secretary of the Treasury (Tax Policy)
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Mirror Report

Dear Roger:

I enclose the Report of the Tax Section on mirror subsidiary techniques.

The Report recommends (although a substantial minority of the Executive Committee disagrees) that the Treasury promptly announce that mirror subsidiary transactions are not inconsistent with Section 631 of the Tax Reform Act of 1986, will continue to be allowed (to the same extent permitted under current law) after Section 631 become effective, and will be reviewed by the Treasury as part of its pending study of Subchapter C.

The Report also recommends that the Treasury promptly announce that techniques (relying on the investment basis adjustment rules of the Consolidated Return Regulations) that,

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unlike the mirror technique, permit a stepped-up asset basis without a corporate – level tax on gain are inconsistent with Section 631 and will not be available after the effective date of Section 631.

As always, the Tax Section will be pleased to be of help to the Treasury as it studies reform of Subchapter C; and I urge you to involve us in the process.

Sincerely

Richard G. Cohen

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Mirror Subsidiaries and A Related Technique

December 9 1986

This report discusses the use of “mirror subsidiaries” and another technique pursuant which a corporation (“P”) can purchase the stock of another corporation (“T”) and dispose of unwanted assets of T without the recognition of gain. The question is whether those techniques, which may be permissible under pre-1987 law, should continue to remain available to an acquiring corporation following the repeal of the General Utilities doctrine by Section 631 of the Tax Reform Act of 1986 (the “1986 Act”). The need for guidance by the Treasury is particularly urgent because of the considerable effect the answer will have on a large number of transaction currently being planned or in various stages of completion.

I. Principal Recommendations.

For the reasons stated below, the Executive Committee of the Tax Section of the New York State Bar Association recommends that the Treasury promptly announce that:

(1) Mirror subsidiary transaction s are not inconsistent with Section 631, will continue to be allowed (to the same extent permitted under pre-1987 law) after Section 631 becomes effective, and will be reviewed by the Treasury as part of its pending study of Subchapter C; and

(2) Techniques that, unlike the mirror technique, permit a purchaser of assets from P or T to achieve a stepped-up basis in former T assets without the imposition of corporate level tax on appreciation in those assets are inconsistent with Section 631 and will not be available after the effective date of Section 631.

A substantial minority of the Executive Committee disagrees with recommendation (1) above, and believes that those techniques are inconsistent with Section 631 and should not be allowed after the effective date of Section 631 (except as part of a comprehensive reform of Subchapter C).

II. Description of Techniques.

Under the mirror subsidiary technique, (1) P sets up a number of wholly owned subsidiaries (the "mirror subsidiaries"), (2) P funds the mirror subsidiaries entirely with cash, (3) each mirror subsidiary purchases a portion of the stock of T, either directly or by its ownership of a portion of the stock of a shell corporation that either makes a tender offer for T or is merged into T or a combination thereof, (4) no election is made under Section 338(a) and (5) T is liquidated into the subsidiaries under Section 332 (replying on the ownership aggregation rule of Treas. Reg. § 1.1502-34), with each subsidiary acquiring one or more assets of T. [1] P, which has a cost basis in the stock of the mirror subsidiaries, is then free to sell the stock of one or more of the mirror subsidiaries without recognizing the "built-in" gain inherent in the underlying assets formerly held by T and now held by the subsidiaries. The purchaser of the mirror subsidiary will retain the carryover asset basis inside the subsidiary unless

[1] The technique also relies on Rev. Rul. 83-61, 1983-1 C.B. 78, concerning non pro-rata liquidations.

it makes a Section 338 election (in which case corporate-level tax on gain will arise)

under the alternative approach (the "investment basis adjustment technique"), (1) P directly buys the stock of T at fair market value, (2) T distributes wanted and certain unwanted assets to P, creating gain under § 311 which is deferred under treas. Reg. § 1.1502-13, (3) P (within 90 days) sells the unwanted assets, and (4) P then sells the stock of T to a third party, triggering the deferred gain. Because P will obtain a stepped-up basis on the unwanted assets that it sells, P will realize no gain on the sale of such assets.[2] P will take a carryover basis for the wanted assets because it will make a carryover basis election to avoid a deemed Section 338 election. Because of the basis adjustment rules under Treas. Reg. § 1.1502-32, all gain recognized to T on its distribution of assets will be offset in amount by a capital loss to P on its sale of the T stock.[3] Thus, where the gain recognized to T

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[2] In order for the technique to work, P must not make a Section 338 election as to T and must make use of one the exceptions to the consistency rules of Section 338 which permit certain assets acquired from T to take a basis determined without regard to those rules. Assets eligible for those exceptions include stock of target affiliates of T (e.g., subsidiaries owned by T on P's acquisition date – although there is in such case no step-up of underlying assets basis) and any assets sold by P within 90 days of their distribution to P. See Treas. Reg. §1.338-4T(f)(5).

[3] For example, assume T has three nondepreciable assets, each with a basis of $10 and a value (to a buyer that will obtain a carryover basis) of $50. P buys the stock of T for $150, distributes two assets to itself, and then sells one asset and the stock of T, each for $50. The assets distribution, and down by the distribution of $100, leaving a basis of $130. The result is a loss of $80 on the stock sale offsetting the Section 311 gain of $80 on the asset distribution.

As part of step (2), T could also sell some unwanted assets to a third party. If T then distributes the cash proceeds to P, the net result will be a basis decrease in the stock of T equal to the former tax basis of the asset to T (disregarding differences between T's taxable income and earnings and profits on the sale). Because cash equal to the value of the assets has been distributed, the stock basis will then exceed the value of the stock by the amount of gain recognized on the asset sale.

is capital gain, no tax will be payable by the P-T group as a result of the transactions. (There may, of course, be substantial recaptures under Sections 1245, 1248 or 1250, the tax on which will be payable and will diminish the attractiveness of the technique.)

Following the effective date of Section 631 of the 1986 Act, the mirror subsidiary technique will not result in a stepped-up asset basis to a third party purchaser of a mirror subsidiary.[4] However, under the investment basis adjustment technique, a third party acquiring the underlying assets of T can obtain a stepped-up asset basis, although the step-up would not be available to purchaser of the stock of a subsidiary of T (or to the purchaser of the stock of T itself).

III. Comments.

A. Needs for Guidance. We strongly urge the Treasury to provide guidance as possible as to the availability of the mirror subsidiary and investment basis adjustment techniques after the effective date of Section 631 of the 1986 Act.[5] Numerous acquisitions, large and small, friendly and unfriendly, are currently underway or contemplated. Many of

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[4] Under current law, the purchaser could elect under §338 to obtain a stepped-up asset basis at the cost only of recapture taxes. Such an election would generally not be worthwhile for a purchase in 1987 because of full gain recognition arising as a result of the election.

[5] This Report does not consider the validity of those techniques under pre-1987 law. See Letter Ruling 8642051 (July 21, 1986), where the Internal revenue service ruled favorably on the P acquisition aspects of a mirror subsidiary transaction. Questions obviously arise in the situation where P is already committed to the sale of one or more assets or mirror subsidiaries at the time of the T acquisition. See representations (k) (p) in Ltr. 8642051. Even without such prearrangement, Section 269 might arguably apply, although it is very difficult to fit the transactions into the statutory language. Finally, independent of the 1986 Act, the techniques might be regarded as inconsistent with the consistency rules of Section 338 and if so, query whether Section 338 (i) (1) would provide authority for a restriction on the techniques.

those acquisitions may not (or clearly will not) close until after the new provisions are effective. The value of T will in many cases be significantly affected by whether P will be able to dispose of unwanted T assets without the recognition of gain.

Whether the mirror subsidiary and investment basis adjustment techniques are available after the effective date of Section 631 is at present unclear,[6] and the determination as to whether those techniques are to be prohibited because inconsistent with Section 631 has been delegated by Congress to the Treasury.[7] It is most undesirable from a tax policy point-of-view for buyers and sellers to be left in such a state of uncertainty on a major, well-publicized issue, where the Treasury clearly has authority to determine the outcome by regulation.

Finally, given that uncertainty, buyers and sellers may be unable to agree on price due to disagreement among counsel, or the price received by shareholders will be discounted by the risk that the techniques may be unavailable. Moreover, in contested situations perhaps an undue advantage

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[6] See (1) Sept. 25, 1986 Cong. Rec. at H 8358 (floor statement of Representative Rostenkowski preceding House passage of H.R. 3838), (2) Sept. 27, 1986 Cong. Rec. at S 13958 (colloquy between Senators Dole and Packwood preceding Senate passage of H.R. 3838; (3) Oct. 2, 1986 Cong. Rec. at E 3389 (extension of remarks by Representative Rostenkowski), and (4) Oct. 17, 1986 Cong. Rec. at S 17055 (colloquy between Senators Dole and Packwood). More recently, see the letter dated November 8, 1986, from Senators Dole and Bentsen to Treasury Secretary Baker, reprinted in Tax Notes, Nov. 17, 1986, at p. 680.

[7] Section 337 (d), as amended, authorized the Secretary to issue such regulations as may be necessary or appropriate to carry out the purposes of the repeal of the General utilities doctrine, including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations).

may be provided to buyers represented by more aggressive counsel. We see no reason for that burden on the bidding process. Guidance on the issue is essential to place all bidders on an equal basis.

B. Investment Basis Adjustment Technique.

We believe that, where the investment basis adjustment technique gives the ultimate buyer of T assets a cost basis in those assets (as opposed to a cost basis in stock of a T subsidiary without a stepped-up basis for its assets [8])without payment of tax P, T or the buyer, the approach would clearly be inconsistent with the repeal of General Utilities. The most fundamental aspect of repeal is that corporate-level gain recognition is a prerequisite to a stepped-up asset basis. While the investment basis adjustment technique results in gain recognition on the underlying assets, it also creates an offsetting tax loss (which may be of a different character) under the basis adjustment provisions of the consolidated return regulations. Such result is inconsistent with General Utilities repeal, and the Treasury should promptly announce, under the authority Section 337((d), as amended, that the technique will not work.

One logical way to accomplish that objective would be for regulations to provide that gain to T arising from asset sales or distributions (as opposed to gain to T on sales or distributions of the stock of subsidiaries, which is discussed separately below), to the extent of built-in gain at the time of P's acquisition of T, will not be included in T's earnings and profits for purposes of the basis adjustment rules of

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[8] As mentioned in footnote 2, supra, a T subsidiary could be distributed to P, leaving asset basis inside the subsidiary unchanged.

Treas. Reg. §1.1502-32. A narrower, and perhaps easier to enforce, approach would be to retain the present earning and profits adjustments, but disallow a loss to P on a sale of T stock to the extent of prior recognized built-in gain on assets sales, if the T stock is sold within a period of time (such as five years) after its purchase.

C. Elective Carryover Basis. As background to our discussion of the mirror subsidiary technique, and others not producing a stepped-up asset basis, we note that the staff of the Senate Finance Committee, in its 1985 report on proposed revisions to Subchapter C, accompanied its proposed repeal of General Utilities with an elective carryover basis rule. The Treasury has supported that rule.[9] Under that rule, if P bought the stock of T or substantially all the assets of a liquidating T, then unless the parties elected otherwise T would not recognize gain or loss on the sale and P would take a carryover basis in the assets.[10] The carryover basis result could even have been achieved on the purchase of a single asset if T dropped the asset into a subsidiary and sold the stock of the subsidiary.

We strongly support an elective carryover basis approach. If the purchaser of assets in corporate solution does not obtain a stepped-up basis in the assets, and the assets remain in corporate solution, then there is no reason as a matter of tax policy for the seller to be required to recognize gain. The Treasury should support that approach in its

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[9] Reform of Corporate Taxation: Hearing before the Senate Comm. On finance, 98th Cong., 1st Sess. 18 (1983) (testimony of Deputy Assistant Secretary (Tax Policy) Pearlman).

[10] The Subchapter C Revision Act of 1985, S. Print 99-47, 99th Cong., 1st Sess. (Finance Comm. Print 1985) at 50-52 223-28.

forthcoming study of Subchapter C mandated by Section 634 of the 1986 Act.

D. Techniques Creating Carryover Asset Basis. We now turn to the mirror subsidiary technique (and to the investment basis adjustment technique to the extent it does not result in a stepped-up asset basis).

A number of arguments can be made for or against allowing those techniques after the effective date of Section 631 of the 1986 Act. As mentioned below, a majority of the Tax Section Executive Committee believes that the arguments in favor outweigh those against, although a substantial minority is of the opposite view. The arguments are as follows:

(1) The first issue is whether the continued use of the techniques is consistent with the repeal of the General Utilities doctrine generally.

(a) The argument in favor of the techniques is that the purpose of General Utilities repeal income tax by requiring that an increase in the basis of corporate assets (which would provide tax benefits by increased depreciation or amortization deductions, or reduced gain or increased loss upon disposition) would be paid for by a corporate level tax. The techniques in question do not undermine that purpose, in that the historic basis of T's assets is unchanged (and cannot be increased without payment of corporate level tax).[11] Moreover, P, in selling an asset of T's, is fully taxed on its economic gain (or loss) upon the sale. Without the use of the technique, P would be taxed inappropriately and inequitably on an artificial "gain" (i.e., on the difference between asset basis and the fair market value at the time of P's acquisition of T) which P does not realize in economic terms. General Utilities repeal was not intended to require taxation of nonexistent gains.

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[11] Analogously, no corporate level tax is payable upon the liquidation of an 80% or more subsidiary because the assets distributed in the liquidation have a carryover basis. The payment of a corporate level tax on appreciation is preserved until there is a subsequent transaction in which the basis of the distributed assets is changed. See item (1) of footnote 6, supra.

(b) The argument against the techniques is that they should not be available to P merely because the underlying assets do not receive a stepped-up asset basis. Under the new Code provisions, stock in a subsidiary in itself an asset, and corporation selling (or distributing to its no-80% shareholders) stock of a subsidiary must recognize any gain on the stock, even though the underlying assets do not receive a stepped-up basis. Thus, Congress has already rejected the argument that a carryover assets basis should be sufficient to avoid gain recognition to the seller. The 1986 Act ameliorates any perceived unfairness from the combination of recognized gain on stock and carryover basis on assets not by providing the no-gain-recognition/carryover-basis election described above, but instead by expanding the circumstances in which a sale or distribution of subsidiary stock may at the election of the taxpayer be treated as a taxable asset sale. See Code §§ 338(h)(10) and 336(e), as amended.

(2) The second issue is whether congress failure to adopt a carryover basis election system is consistent with the continuation of the techniques and whether Congress otherwise intended to permit or prohibit the techniques.

(a) The argument in favor of the techniques is that the Conference Committee on the 1986 Act never considered a carryover basis regime and was never presented with an elective carryover basis legislative alternative.[12]

Rather, such congressional action (or inaction) evidences an intent to permit the continuation of any techniques that currently achieve the effect of a carryover basis regime – except where otherwise expressly prohibited by the 1986 Act. Since Congress did not consider, and therefore did not adopt, a carryover basis. [13] regime for sellers, the absence of legislation on the point does not compel, or even particularly suggest, that the Treasury should proscribe all transactions that achieve the effect of elective no-gain-recognition/carryover basis. That is particularly so because of the possibility will be adopted in the future pursuant to the Subchapter C Study, it makes no sense to disallow the techniques on an interim basis

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[12] The carryover basis regime was not included in the Senate version of H.R. 3838, and was not the subject of Conference Committee deliberations. Indeed, while the General Utilities repeal had previously been presented (for instance in the 1985 Senate Staff proposal) as part of a comprehensive reform including as its centerpiece an isolated, eleventh-hour revenue raiser.

[13] Support includes the October 17 colloquy between Senators Dole and Packwood (footnote 6, <u>supra</u>), which indicates that there was a considered decision of Congress not to proscribe the mirror subsidiary technique.

only to reinstate them shortly thereafter as part of a broader reform of Subchapter C.

(b) The argument against such techniques is that, given the proposal by the Senate Finance Committee staff for elective carryover basis, Congress' failure to adopt that proposal is an implicit rejection of such an elective approach for anyone pending further study of Subchapter C. So viewed, such failure to include the approach in the 1986 Act is inconsistent with continuing to allow only a limited class of taxpayers (acquiring corporation disposing of assets of acquired corporations) nevertheless to continue to utilize the techniques. The techniques technique should be available to nobody if not to everybody, even if that means a temporary suspension of the techniques to acquiring corporations pending reform of Subchapter C. The October 17 colloquy expressly leaves open to the Treasury the authority to promulgate regulation in the area.

(3) A third issue concerns the effect of the techniques on acquiring and target corporations. The general adoption of a carryover basis election would allow T itself, as a defensive maneuver or otherwise, to sell all or part of its assets without recognizing gain (as long as the buyer accepts a carryover tax basis), thus giving P the same options with respect to T assets as T itself.

(a) The argument in favor of the techniques is that P's use of them it not unfair to T, because the different situation of P and t justify a difference in treatment. T pays t ax because of the economic gain it realizes upon disposition of an asset. P, however, does not realize any economic gain (absent post-acquisition appreciation), since it has paid full value for T's assets (including for the appreciation of such assets while in T's hands), and, accordingly, there is no reason for P to pay tax on dispositions of such assets unless there is additional appreciation. Moreover, the techniques maximize the amount of the consideration passing to T's stockholders in any acquisition (friendly or not) where T has an unwanted business line or where the possibility of divestitures is under consideration. Finally, the effect of the 1986 Act is to eliminate, perhaps unduly, many incentives to corporate acquisitions. Allowing continuation of the mirror subsidiary technique may redress the balance and restore the "level playing field" which, in the absence of elective carryover basis, is lacking.

(b) The arguments against the techniques are that the continued use of the by P, in the absence of the general carryover basis election being available to T, is unfair to T, and that there is no tax policy reason to allow P following an acquisition of T, but not T itself before it is acquired, to sell T assets in that manner.

> The effect would be that T's assets would be more valuable on an after-tax basis to P than to T itself. The tax law should not so tip the scales in favor of P. The argument that P "paid" T's shareholders for the right to sell T assets without recognition gain is essentially an argument for a non-gain-recognition/carryover-basis approach which, as argued before, was rejected by the 1986 Act.

A majority of the members of the Executive Committee finds the arguments in favor of the continued availability of the techniques more persuasive than the arguments against the techniques, and supports the continued availability of the techniques (to the extent allowable under pre-1987 law), at least pending comprehensive reform of Subchapter C. A substantial minority of the members of the Executive Committee finds are opposing arguments more persuasive and believes that those techniques should not be available after Section 631 becomes effective, again pending comprehensive reform of Subchapter C.[14]

IV. Conclusions.

It is essential that the Treasury promptly announce whether the techniques described in this report will be affected by the enactment of Section 631 of the 1986 Act. We urged the Treasury to announce that the techniques will not be allowed to the extent that they result in a stepped-up asset basis without payment of corporate level tax on the gain. We support the general adoption of a carryover basis/no gain recognition election as part of a comprehensive reform of Subchapter C. Pending such reform, a majority of our members support the continued availability of the use of the techniques described herein to the extent that they do not result in a stepped-up asset basis; a substantial minority of our members

[14] For that purpose, the effective date should be the effective date of Section 631, thus, the various provision of Section 633 should apply.

believes the techniques should not be allowed unless and until the carryover basis election becomes generally available.