International Taxation

*By Eva Farkas-DiNardo, Kevin Rowe and Edward Tanenbaum**

Examining the Alcatel-Lucent and Daimler-Chrysler Mergers–The Merger of Equals

This column addresses the "merger of equals," examining Alcatel-Lucent and Daimler-Chrysler. Here we specifically examine the Alcatel-Lucent Technologies Agreement and Plan of Merger dated April 2, 2006. The Alcatel-Lucent merger, like the 1998 Daimler-Chrysler merger, involves the foreign company's acquisition of a U.S. corporate icon by in a stock deal billed as a merger of "equals." The Alcatel-Lucent merger appears to be a relatively straightforward reverse subsidiary merger. In contrast, the Daimler-Chrysler merger needed a more complex structure because German law did not permit a reverse subsidiary merger.

The Alcatel-Lucent Merger

Under the Alcatel-Lucent Technologies Agreement, Alcatel's wholly owned U.S. subsidiary, Aura Merger Sub, Inc. ("Aura"), will merge into Lucent pursuant to Delaware law with Lucent as the surviving corporation. Each Lucent share will be converted into 0.1952 of an Alcatel American depositary share, which possesses all rights of a regular share of Alcatel common stock (an "ADS"), and is treated as common stock for U.S. income tax purposes. This Alcatel-Lucent transaction is intended to qualify as a tax-free reverse subsidiary merger described in code Code Sec. 368(a)(2)(E). Since Alcatel is a foreign corporation, Lucent shareholders are deemed to transfer their shares directly to Alcatel for purposes of the outbound stock transfer rules of Code Sec. 367(a).

The Daimler-Chrysler Merger

The 1998 merger of Daimler-Benz AG and Chrysler Corporation involved a significantly more complex structure than did Alcatel-Lucent; German corpo-

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rate law did not permit the acquisition of Chrysler in a tax-free reverse subsidiary merger. First, a new German holding company, Daimler-Chrysler, was formed and it made a share-for-share tender offer for shares of Daimler-Benz, the historic parent company of the Daimler group. Daimler-Chrysler acquired more than 80 percent of the Daimler-Benz shares in the tender. Next, a special purpose subsidiary, Chrysler Merger Sub, merged into Chrysler. Chrysler shareholders exchanged their Chrysler shares for Daimler-Chrysler shares. The taxpayer employed a complex exchange agent structure in this step because of restrictions under German law. Next, Daimler-Benz was merged into Daimler-Chrysler. Shares of Daimler-Benz shareholders who did not participate in the tender were converted into shares in Daimler-Chrysler by operation of law.

Tax Consequences to Daimler-Chrysler Shareholders

The former Chrysler shareholders had three theories for tax-free treatment of the exchange of their Chrysler shares:

1. Notwithstanding German law, the merger of Chrysler Merger Sub into Chrysler was a good reverse subsidiary merger because the requirements under the U.S. reorganization provisions were satisfied in substance.
2. Ignoring Chrysler Merger Sub, Chrysler shareholders transferred their shares directly to Daimler-Chrysler in a good B reorganization (voting stock for control).
3. Ignoring Chrysler Merger Sub, the tender offer for Daimler-Benz shares and the transfer of Chrysler shares are part of a single plan to which Code Sec. 351 applies.

The former Daimler-Benz shareholders exchanged their shares either in the tender offer or in the merger. The tender offer exchange could qualify as part of a Code Sec. 351 transfer if integrated with the exchange by the Chrysler shareholders. If not integrated, it could qualify as a B reorganization because more than 80 percent of the Daimler-Benz shareholders tendered their shares. The exchange pursuant to the merger could qualify as a tax-free C reorganization *i.e.,* substantially all target assets for voting stock. The exchange could not qualify as an A reorganization because, under the rules then in effect, a foreign law merger could not qualify. Alternatively, if the merger is integrated with the tender offer, the transaction could qualify as a tax-free D reorganization.

Outbound Transfers of Stock Under Code Sec. 367(a)

Under Reg. §1.367(a)-3(c), a transfer of stock of a U.S. corporation to a foreign corporation pursuant to a tax-free reorganization or to a Code Sec. 351 transaction will qualify for tax-free treatment only if it satisfies four conditions:

1. U.S. transferors of target stock receive in exchange for their target stock no more than 50 percent of the voting power and value of the stock of the transferee foreign corporation. In a reverse triangular merger, the transferee is deemed to be the foreign parent corporation.
2. U.S. persons that are insiders own no more than 50 percent of the combined voting power and value of the transferee foreign corporation immediately after the transaction, counting all stock held by such persons in the foreign transferee corporation.
3. U.S. persons that transfer target stock and own at least five percent of the transferee foreign corporation after the transaction enter a "gain recognition agreement" which, among other things, requires recognition of gain realized in the transfer of target shares (plus interest at the underpayment rate) if the foreign transferee corporation engages in certain post-reorganization transactions within five years of the transfer.
4. The transferee foreign corporation satisfies the active trade or business test.

The active trade or business test in turn has three parts:

1. The transferee foreign corporation (including any 80 percent owned "qualified subsidiary") must have been engaged in an active trade or business outside the United States for the three-year period ending on the date of the transfer.
2. There must be no plan or intention to discontinue that active trade or business.
3. At the time of the transfer, the fair market value of the foreign transferee corporation must be at least equal to the fair market value of the U.S. target (the "substantiality test"). For purposes of the substantiality test, recently acquired assets are disregarded if they are passive investment type assets, acquired for the purpose of avoiding the substantiality test or acquired from the target and affiliates within the three-year period ending on the date of the transfer. Recognizing the practical difficulty in meeting the active trade or business test, regulations permit a target

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Endnotes

Restricts DISC Profits, 1 DISCUSSION 8 (Nov. 1972).

[9] Feinschreiber, *Related and Subsidiary Services Qualify for DISC Benefits*, 1 DISCUSSION 4 (Nov. 1972); W. Green, *Obtaining DISC Benefits for International Services*, 3 INT'L TAX J. 467 (1977).

[10] Feinschreiber, *Obtaining DISC Benefits for Managerial Services*, 1 DISCUSSION 12 (Nov. 1972).

[11] Feinschreiber, *Proposed Regulations Define Gross Receipts*, 1 DISCUSSION 4 (Oct. 1972); as background for the gross receipts definition, *see* Feinschreiber, *Accounting for Percentage Leases*, 8 MD. CPA J. 11 (Dec. 1968).

[12] For background as to these Code Sec. 482 issues, *see* FEINSCHREIBER, TRANSFER PRICING HANDBOOK, John Wiley & Sons. Inc. (3d ed. 2001.

[13] Feinschreiber, *Inventory Costing Rules Affect DISC Status and Profitability*, 1 INT'L TAX J. 14 (1974); Feinschreiber, *How Extensive Are the Absorption Costing Regulations in the Final Inventory Regs?* 39 J TAX'N 338 (1973).

[14] *Longview Fibre Co.*, 71 TC 357, Dec. 35,570.

[15] Feinschreiber, *Final Regulations for Allocating and Apportioning Deductions*, 3 INT'L TAX J. 344 (1977); Bodner and Feinschreiber, *Introducing the Final Regulations for Allocating and Apportioning Deductions*, U.S. TAXATION OF INTERNATIONAL OPERATIONS, at ¶6002 (1977).

[16] *Dresser Industries, Inc., supra* note 7, upholding Reg. §1.994-1(c)(6)(v); *Int'l Paper Co.*, FedCl, 95-1 USTC ¶50,246, 33 FedCl 384; *General Dynamics Corp.*, 108 TC 107, Dec. 51,961.

[17] Feinschreiber, *Maximizing DISC Profits Through Quantitative Pricing Techniques*, 2 INT'L TAX J. 28, at 28–31 (1975).

[18] Feinschreiber, *The No Loss Rule Restricts DISC Profits*, 1 DISCUSSION 2 (Dec. 1972); DeLap, *Working with the DISC Intercompany Pricing Rules*, 3 INT'L TAX J. 118 (1976).

[19] *Archer-Daniels-Midland Co.*, CA-7, 94-2 USTC ¶50,522, 37 F3d 321, held that Reg. §1.994-1(e)(1)(i) was valid as an interpretive regulation.

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company to obtain a ruling to the effect that it is in substantial compliance with the test.

Transfers of stock in a foreign corporation are subject to a more modest set of requirements under Code Sec. 367(a). Target shareholders that own less than five percent of the transferee foreign corporation qualify for tax-free treatment in all cases, while five-percent shareholders must enter a five-year gain recognition agreement to qualify for tax-free treatment. The 50-percent limitations and the active trade or business requirement do not apply.

Alcatel-Lucent

Since Alcatel is considerably larger than Lucent and it has been in business for at least three years, it should satisfy the active trade or business test. The public record does not suggest that significant Alcatel assets will be disregarded either as passive assets or under the three-year look-back rule for acquisitions from Lucent. Nonetheless, the rules in the active trade or business test are complex and will probably be one of the issues addressed in a legal opinion to be issued under the merger agreement. At the end of the day, Lucent shareholders should have tax-free treatment on the receipt of the Alcatel ADSs. It is assumed that no current Lucent shareholders will be a five-percent Alcatel shareholder after the merger and no gain recognition agreement will be required.

Daimler-Chrysler

Exchanges of Daimler-Benz shares for Daimler-Chrysler shares by U.S. persons qualify for tax-free treatment under the limited Code Sec. 367(a) outbound stock transfer rules applicable to transfers of stock in a foreign company. It appears that none of the shareholders were five-percent shareholders of Daimler-Chrysler. The exchange of Chrysler shares under any of the three theories for tax-free treatment was subject to the full Code Sec. 367(a) rules on outbound transfers of domestic stock. Since the former Chrysler shareholders and Chrysler insiders owned less than 50 percent of Daimler-Chrysler after the transaction and no former Chrysler shareholder was a five-percent Daimler-Chrysler shareholder, tax-free treatment turned on the active trade or business test. To ensure that the business of Daimler-Benz counted for purposes of this test, LTR 9849014[1] was obtained. Apparently, there was concern that, at the time of the exchange of the Chrysler shares, Daimler-Chrysler did not own 80 percent of Daimler-Benz and, as a result, the historic Daimler-Benz business would not count under the active trade or business test. The ruling held that Daimler-Chrysler was in substantial compliance with the active trade or business test even if it did not meet the 80-percent threshold at the time of the exchange.

Planning Considerations

The contrast between these two mergers illustrates the extraordinary difficulties that can result in attempting to mesh foreign corporate law with the requirements of the corporate reorganization provisions.

Endnotes

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[1] LTR 9849014 (Sept. 4, 1998).