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Energy Transfer, Williams, and the Circular Ownership of Stock

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INTRODUCTION

In the past year, corporate tax issues, such as inversions and the ''border adjustment tax,'' have frequently made the front pages of business sections of major newspapers. In contrast, it is unusual for a partnership tax issue — especially one which causes a multi-billion dollar corporate transaction to sink or swim — to become front page news. However, last year's attempted merger between Energy Transfer Equity, LP (''ETE'') and The Williams Companies, Inc. (''Williams'') provides a rare exception, where a major deal fell through because of a relatively obscure partnership tax issue.

Much has been written about whether the proposed combination of ETE and Williams would have amounted to a tax-free contribution to the capital of a partnership under §721 or would have instead triggered tax liability under the partnership disguised sale rules of §707.[1] It has been suggested that the transaction could have been restructured in a manner that would have avoided implicating the disguised sale rules (whether the parties were legally obligated to restructure the transaction to salvage the deal, or whether such restructuring would have been respected for U.S. tax purposes, are separate issues).

However, this article will address a different issue: even assuming that a should-level opinion that the proposed combination of Williams and ETE could have been issued with respect to the partnership contribution and disguised sale rules, might the transaction still have been taxable under another set of rules that have not received much recent attention — the ''May Company'' rules? These rules apply and must be analyzed whenever a partnership acquires stock of a corporate partner. This issue becomes important in that, while ETE was not obligated to proceed with the combination with Williams unless its counsel could deliver a tax opinion that the contribution of the Williams assets by Energy Transfer Corp. LP (''ETC'') to ETE should be tax-free under the partnership contribution rules, such requirement may have been meaningless if the proposed combination would have been taxable under non-partnership tax principles. Given the ongoing litigation between ETE and Williams, this raises the issue of whether the Delaware Chancery Court should have allowed ETE to walk away from the proposed transaction when the combination, as structured, might have produced adverse tax consequences even if the contribution of the Williams assets by ETC to ETE was tax-free under the partnership contribution rules.

BACKGROUND OF THE TRANSACTION

On September 28, 2015, Williams and ETE executed an Agreement and Plan of Merger (the ''Merger Agreement''). Williams was carrying on its business as a C corporation. ETE was taxable on a flow-through basis as a publicly-traded limited partnership.[2]

Economically, the parties desired that Williams would transfer its assets to ETE and Williams' shareholders would receive 81% of the equity interests in ETE and $6.05 billion in cash. As an initial matter, this economic goal could not be achieved by simply merging Williams into ETE with ETE surviving because such a transaction would have been characterized as a contribution by Williams of all of its assets to ETE followed by a fully taxable liquidation of Williams.[3]

Therefore, to accomplish the first step of transferring the assets of Williams to ETE on a tax-free basis, ETE formed a limited partnership, ETC, which

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[1] Unless otherwise noted, references to ''Section'' or ''§'' are to the Internal Revenue Code of 1986, as amended (the ''Code''), and references to ''Reg. §'' are to the Treasury regulations issued under the Code.

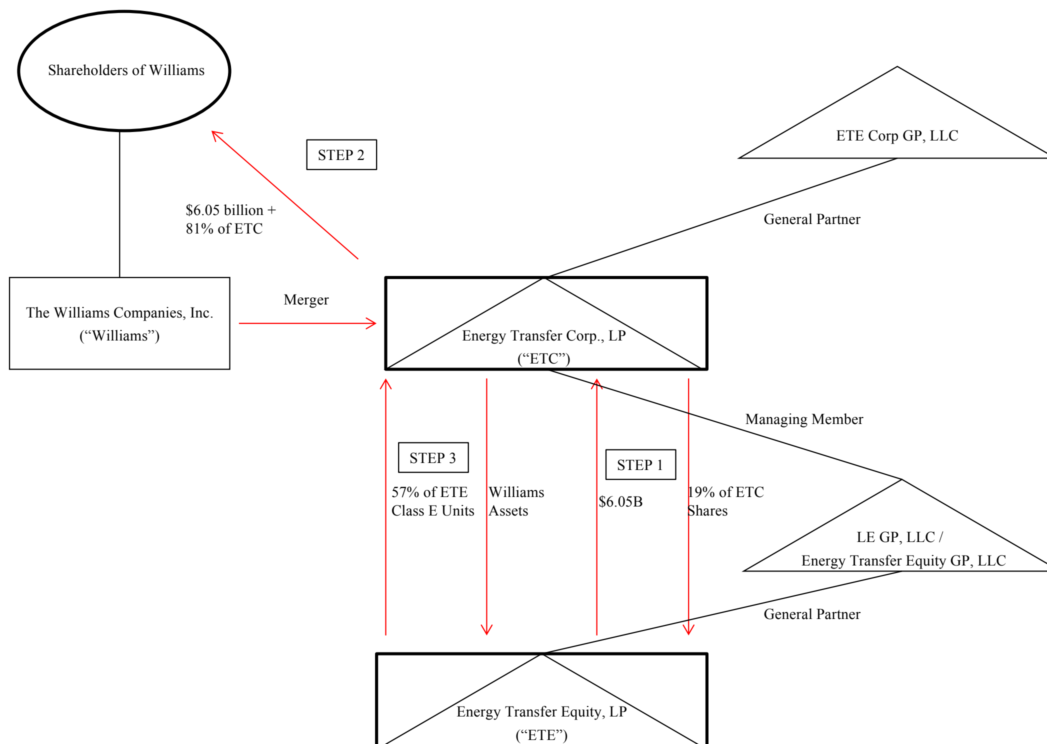
[2] *See* §7704(c).

[3] *See generally* §721, §336; Rev. Rul. 69-6, 1969-1 C.B. 104.

elected to be taxed as corporation under the ''check the box rules.''[4] Subsequently, the parties intended to transfer the Williams assets to ETC by merging Williams into ETC, in what would be a tax-free corporate merger.[5]

Next, the parties desired that Williams's shareholders should receive $6.05 billion of cash. While ETC could have contributed the assets it received from Williams to ETE in exchange for partnership interests of ETE and $6.05 billion of cash (which could be distributed to the former Williams shareholders), as described below, the receipt of the cash would have been taxable to ETC under the Code's disguised sale rules. In order to accomplish this cash distribution, and in order to transfer the Williams assets from ETC to ETE without triggering gain under the disguised sale rules, the parties planned for ETE first to purchase $6.05 billion of ETC stock instead of having ETC contribute assets to ETE in exchange for cash. Following the sale of 19% of its shares to ETE, ETC then would be able to distribute 81% of its shares and $6.05 billion to Williams' shareholders as part of the merger of Williams and ETC. The parties then intended for ETC to contribute the Williams assets that it obtained in the merger with Williams to ETE in exchange for partnership interests in ETE. The parties intended to report the receipt of cash by ETC arising from the purchase of its stock by ETE as a separate transaction from the contribution by ETC of the Williams assets to ETE in exchange for partnership interests in ETE.

Below is a diagram illustrating the general transaction intended between ETE and Williams.



A mutually-agreed upon condition precedent to the closing of the transactions described above under the Merger Agreement was the issuance by ETE's tax counsel of an opinion that the contribution of assets by ETC to ETE should be tax free under §721, which deals with contributions of assets by a partner to a partnership. Interestingly (for reasons to be described below), closing was not conditioned on the receipt of an opinion that the combination generally should be tax-free under all applicable Code provisions.

LITIGATION HISTORY

After the Merger Agreement was signed in September 2015, energy prices fell drastically. In March 2016, before the merger was completed, ETE's Executive Vice President and Head of Tax asked its outside tax counsel to evaluate whether there could be adverse tax consequences related to ETE's payment of $6.05 billion for the ETC shares because the number of ETC shares to be acquired was fixed and the value of those shares was tied to the value of ETE's units prior to their dramatic decline in market value. In other words, ETE would be purchasing for $6.05 billion a fixed number of ETC shares worth substantially less than the amount paid. His concern was that if the stock being purchased was worth less than $6.05 billion, then arguably some of the cash being paid could be allocated to the assets being contributed to ETE in the next step of the transaction. He raised the issue of whether this ''deemed'' cash payment in exchange for

[4] *See* Reg. §301.7701-3.

[5] *See* §368(a).

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the Williams assets might cause part of the assets to be treated as having been sold in a taxable transaction.

Following its evaluation of the transaction, ETE's outside tax counsel determined that it would be unable to issue an opinion that the contribution of assets by ETC to ETE should be tax free under §721. ETE separately consulted with additional and independent outside tax counsel, who advised that even if the ETC stock received by ETE had been worth the $6.05 billion to be paid for it, that they could not issue an opinion that the transaction should be tax free because of the application of the disguised sale rules.

On April 12, 2016, ETE's outside tax counsel advised Williams' primary deal counsel that it would not be able to issue the required tax opinion. Williams filed a complaint in the Delaware Court of Chancery on the grounds that ETE materially breached its contractual obligations by failing to use ''commercially reasonable efforts'' to secure the desired tax opinion and should, therefore, be estopped from terminating the merger. Following a two-day trial on June 20-21, 2016, the Delaware Court of Chancery issued an opinion on June 24, 2016, that ETE would not be enjoined from terminating or otherwise avoiding its obligations under the Merger Agreement. The Supreme Court of Delaware affirmed the lower court's opinion on March 23, 2017. Although the Supreme Court of Delaware suggested that ETE may not have used commercially reasonable efforts to complete the merger, it found that the inability of ETE's outside tax counsel to render the required tax opinion mooted the issue.

MAY COMPANY GUIDANCE

Before the repeal of the *General Utilities*[6] doctrine in 1986, corporations were allowed to distribute appreciated assets to their shareholders without paying corporate-level tax on the appreciation. In connection with the repeal, §337(d) was enacted to authorize the Treasury to prescribe regulations to carry out the repeal of the *General Utilities* doctrine and prevent its circumvention. In 1989, the IRS issued Notice 89-37,[7] in an attempt to curtail certain transactions intended to circumvent the repeal of the *General Utilities* doctrine. The IRS's position in Notice 89-37 was restated in proposed Treasury regulations issued in 1992.[8] The Notice and the proposed regulations have been described as the ''May Company Notice'' or ''May Company Regulations'' based on partnership transactions engaged in at that time by the May Department Stores Company to avoid corporate gain recognition on distributions of appreciated assets (here, the ''May Company rules''). The May Company rules have received scant attention in the intervening years, and the issues addressed by the May Company rules are far less common (or frequently addressed) than the disguised sale rules (which partnership tax practitioners confront much more frequently in practice). However, 23 years after the issuance of the May Company Regulations, the Treasury issued temporary regulations on June 12, 2015, implementing the ''deemed redemption'' rule and applying it to transactions occurring on or after the publication date.[9]

In the original May Company transaction, a corporate partner contributed appreciated assets to a partnership, another partner contributed cash, and the partnership used the contributed cash to purchase stock of the corporate partner contributing the appreciated assets. It was anticipated that after a sufficient amount of time had elapsed, the partnership would be liquidated, with the corporate partner that had contributed its own assets receiving a tax-free distribution of its own stock and the partner contributing cash receiving a tax-free distribution of the appreciated assets under §731(a). From the point of the view of the corporate partner contributing appreciated assets, the corporation had received cash and, in effect, redeemed some of its stock in exchange for appreciated assets (that were now held by the other party), and the corporation had not paid tax on the appreciation of such assets.

In response to the May Company transaction, the IRS issued Notice 89-37, which addressed situations where a partnership acquired stock of a corporate partner (the ''Deemed Redemption Rule'') or where a partnership distributed stock of a corporate partner to such partner (the ''Distribution Rule''). Specifically, where a corporate partner of a partnership contributes appreciated property to such partnership, and relinquishes an interest in the appreciated property in exchange for a distribution of its own stock, Notice 89-37 recharacterizes the transaction from a tax-free distribution under §731(a) to a taxable ''deemed redemption'' of the corporate partner's stock under §311(b).

As an initial matter, it should be noted that whenever a partner contributes appreciated property to a partnership, that partner has economically exchanged an interest in the appreciated property for the other assets owned by the partnership. For example, if Partner X contributes unimproved land with a value of $100 (and an adjusted tax basis of $0) and Partner Y contributes $100 of cash to Partnership XY, and the partnership uses the cash for improvements, then Partner X has effectively exchanged half of its interest in the land for half of the interest in the improvements. Subchapter K of the Internal Revenue Code does not generally attempt to tax this contribution because the inherent gain that Partner X has on its contributed land will be preserved: if Partnership XY subsequently were to distribute a 50% interest in the improved land to Partner X (who originally contributed the unimproved land), then Partner X would have a carryover basis of $0 in the improved land, and would recognize gain attributable to any pre-contribution appreciation upon a subsequent sale or exchange.

There is something fundamentally different that occurs when a corporate partner has contributed appre-

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[6] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1936).

[7] 1989-1 C.B. 679.

[8] *See* REG-208989-90, 57 Fed. Reg. 59,324 (Dec. 15, 1992).

[9] *See* T.D. 9722, 80 Fed. Reg. 33,402 (June 12, 2015).

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ciated property to a partnership that holds or acquires corporate stock of the partner. In this case, the possibility exists that the corporate partner will receive its own stock on liquidation of its interest in the partnership. Property that a partner receives on liquidation of a partnership takes the same basis that the partner had in its partnership interest under §732(b), reduced by any money distributed in the same transaction. However, the basis that a corporate partner has in its own stock is irrelevant because, if the stock becomes ''treasury stock,'' it will never be sold in a transaction in which gain is recognized. Alternatively, even if the stock were sold, no gain would be recognized under §1032.

A numerical illustration demonstrates how the Deemed Redemption rule under Notice 89-37, the May Company Regulations, and the 2015 temporary Treasury Regulations work to close this ''loophole.'' Consider Partnership XY, above, in which Partner X contributes assets with a value of $100 and a basis of $0, and Partner Y contributes $100 of cash. Now assume that Partnership XY takes the $100 of cash and, instead of investing in improvements, purchases $100 of Partner X's corporate stock. Viewing Partnership XY as an aggregate (and not a separate entity), Partner X now effectively owns $50 of appreciated assets and $50 of its own stock through the partnership and has a basis of $0 in its partnership interest. In effect, Partner X has swapped $50 of appreciated assets for $50 of its own stock. However, Partner X's ownership of its own stock is economically a nullity because the stock is effectively treasury stock and will never be sold at a taxable gain despite its basis of $0. In the absence of the ''Deemed Redemption'' rule under Notice 89-37 and the subsequent proposed and temporary Treasury Regulations, this transaction would have allowed Partner X to avoid $50 of gain on the exchange of the appreciated assets for its own stock.

Applying the May Company rules to the aborted transaction between ETE and ETC, ETC would have recognized gain upon the contribution of the Williams assets to ETE to the extent that ETC was deemed to have redeemed a portion of its stock in exchange for an underlying share of the contributed assets. This gain would have arisen independently of the disguised sale rules of §707 and would have existed regardless of whether such rules permit ''cherry picking'' (as described below).

While the discussion in the press has largely focused on the disguised sale rules, it has not been lost on some that the ownership of ETC stock by ETE could, in and of itself, have triggered adverse tax consequences. Indeed, even the expert that testified on behalf of Williams during the litigation noted that the acquisition of ETC stock by ETE economically resulted in a deemed sale of part of ETC's assets.[10] Interestingly, no discussion was made of this point by the trial court judge.

In the ongoing litigation between Williams and ETE, Williams could have argued that the condition precedent of the tax opinion (i.e., that an opinion be received that the contribution by ETC of the Williams assets to ETE should not be taxable under §721) was not relevant because the transaction still would have been taxable under §337(d) and the May Company rules. Thus, it could be argued that the condition precedent should have been ignored and the combination required to be completed. ETE only ''bargained'' for a tax ''escape clause'' if the transaction might have been taxable under the partnership contribution rules of §721. Assuming that the transaction was tax free under the partnership contribution rules of §721 (perhaps if ''cherry picking,'' as discussed below, were permitted), it is not at all clear that a Delaware judge should have allowed ETE to back out of the transaction if it had discovered that another tax rule, such as the May Company rules, caused the transaction to be taxable.

THE STATED REASON THAT THE ''SHOULD'' LEVEL TAX OPINION COULD NOT BE ISSUED — THE PARTNERSHIP DISGUISED SALE RULES

Section 721 generally provides that no gain or loss shall be recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. Regulations issued under §707(a) provide that certain transactions between a partnership and a partner can be recharacterized as a sale of property between the partnership and a party acting in a capacity other than a partner.[11] For instance, if there is a transfer of money or other property by a partner to a partnership followed by a related transfer of money or other property by the partnership to the partner, then the transaction can be recharacterized as a sale or exchange of property by the partner to the partnership. In particular, Reg. §1.707-3(c) presumes that a contribution of assets by a partner to a partnership preceded (or followed) within two years by a transfer of money or other consideration by the partnership to the partner are related transfers that should be treated as a ''disguised sale'' of property to the partnership.

It appears that when the proposed Williams-ETE transaction described above was initially structured, tax counsel believed that the proposed combination could be looked at as two separate transactions: (1) a purchase by ETE of ETC stock; and (2) a contribution of assets by ETC in exchange for ETE partnership interests. Under this formulation, the first step would have been tax free to ETC under §1032 and the second step would have been tax free to ETC under §721.

However, following a subsequent review of the transaction at the request of ETE's Head of Tax, coun-

[10] Plaintiff's Answering Pre-Trial Br., at JX 599, *Williams Cos. v. Energy Transfer Equity, LP*, No. 12168-VCG and 12337 (Del. Ch. June 19, 2016).

[11] *See generally* Reg. §1.707-3.

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sel (under the anti-cherry picking rules) concluded that alternatively characterizing the transactions as a transfer by ETC to ETE of the Williams assets and ETC's stock in exchange for ETE partnership interests and cash might be appropriate. A concern was raised that, unless the cash could be specifically allocated by ETC solely to the stock that it contributed to ETE, allocation of part of the cash to the Williams assets that ETC contributed could be treated as a sale with respect to those assets.

DISGUISED SALE "CHERRY PICKING" RULE

Under certain sections of the Code, when a taxpayer sells multiple assets for multiple classes of consideration, it is permissible to "cherry pick" and specify that one class of consideration is being paid with respect to one asset and another class of consideration is being paid with respect to another asset. For example, installment sales are one area in which this occurs.[12] Cases and rulings have allowed a taxpayer to allocate cash received to high-basis assets and installment notes received to low-basis assets.[13]

In 1991, the Treasury Department issued proposed regulations addressing cherry picking in the disguised sale context.[14] The proposed regulations provide that if a partner transfers multiple items to a partnership pursuant to a plan, the amount realized by the partner from any transfer of money or other consideration by the partnership pursuant to the plan is treated as part of a disguised sale and must be allocated among each item of property transferred pursuant to the plan based on the relative fair market value of the property contributed.[15] However, the final disguised sale regulations issued in 1992 deleted this rule.[16] It is unclear whether the deletion of this rule signified that cherry picking is permitted. The proposed ETE-Williams combination appears to have been structured by assuming that the ETE partnership interests would be treated as having been issued solely for the Williams assets and that the ETC stock was exchange solely for cash. In a transaction where cherry picking was not given full regard, ETC would have been deemed to have contributed the Williams assets and its stock to ETE in exchange for ETE partnership interests and cash. In the absence of cherry picking, part of the cash received would be treated as issued for the contributed Williams assets, thereby implicating the partnership disguised sale rules.

Based on the current state of the disguised sale regulations, and the lack of guidance regarding cherry picking in the disguised sale context, it is easy to see how counsel for ETE could conclude that a should-level opinion could not be issued. Similarly, it is also easy to see how a party that thought cherry picking was permitted (or, at least, not definitively disallowed) under the disguised sale regulations could conclude that a should-level opinion could be issued. This may serve to explain how tax counsel (and experts during the litigation) for each of ETE and Williams reached differing views as to whether the proposed combination constituted a disguised sale (in part). However, differing views over the disguised sale rules do not impact whether tax would have been triggered to ETC under the May Company rules.

CONCLUSION

It is sufficiently rare and confusing when a subsidiary owns an equity interest in its parent. This can arise in both corporate and partnership settings. When this form of circular ownership arises, however, antennae should go up and practitioners should be sure to consider the economic effect of this unusual ownership structure. And, of course, for partnership tax practitioners, if the result is that a partnership ends up owning an equity interest in a corporate partner, the May Company rules should be addressed.

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[12] *See generally* §453, §453A, §453B.

[13] *See, e.g., Collins v. Commissioner*, 48 T.C. 45 (1967) (transaction treated as sale of two properties, including one for cash and the second under the installment method); *Brown v. Commissioner*, 27 T.C. 27 (1956) (contribution of property and installment sale of partnership property to a corporation was respected as two transactions and basis to transferee of assets purchased under installment method equal to cost). *See also* TAM 200540010 (noting that "cherry-picking" high-basis asset sales available under certain circumstances involving part-sales and part-contributions for contributions of multiple properties); TAM 200512020 (same). *But see* TAM 200701032 (revoking TAM 200540010 and reissuing with removal of cherry-picking language from original TAM); TAM 200650017 (revoking TAM 200512020 and reissuing with removal of cherry-picking language from original TAM).

[14] *See* Prop. Reg. §1.707-3(e), 56 Fed. Reg. 19,055, 19,057 (Apr. 25, 1991).

[15] *See id.*

[16] *See* T.D. 8439, 57 Fed. Reg. 44,974 (Sept. 30, 1992).

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