

No. 06-3482

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**IN THE UNITED STATES COURT OF APPEALS  
FOR THE SEVENTH CIRCUIT**

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**TRIBUNE COMPANY, as agent of and successor by merger to  
the former The Times Mirror Company, itself and its consoli-  
dated subsidiaries,**

*Petitioner-Appellant,*

*v.*

**COMMISSIONER OF INTERNAL REVENUE,**

*Respondent-Appellee.*

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Appeal from the United States Tax Court (Cohen, J.)

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**REPLY BRIEF FOR  
APPELLANT TRIBUNE COMPANY**

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# REPLY BRIEF FOR APPELLANT TRIBUNE COMPANY

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## INTRODUCTION

Respondent (“Commissioner”) presents this case as if it were a factual dispute. However, the facts Commissioner emphasizes are legally irrelevant. Commissioner has conceded all of the relevant facts necessary to conclude that the Bender transaction qualifies as a reorganization under §368. Reversal is therefore required as a matter of law.

Based on his theory that Times “cashed out” (CIRBr55) its investment in Bender, Commissioner offers two “alternative” arguments: first, that the MB Parent common stock (“MB Parent Common”) was worthless, and second, that the Bender transaction was in substance a sale. But Commissioner concedes facts that conclusively establish that Times did not own LLC’s assets. Because he cannot show that Times owned the assets, Commissioner points to Times’ management of LLC’s investments, asking this Court to equate investment control with ownership. Only by conflating management and ownership can Commissioner claim that the ability to manage LLC’s investments is an asset

worth more than \$275,000,000 that disqualifies the Bender transaction as a reorganization under §§368(a)(1)(A) and 368(a)(1)(B).

Commissioner contends that the Tax Court's opinion similarly rests on two independent, "alternative" holdings: a factual valuation determination, and a substance-over-form recharacterization of the transaction as a sale. In reality, the court's entire analysis — like Commissioner's — rests on a substance-over-form analysis that is riddled with legal errors. To analyze this case as if it were a straightforward valuation dispute begs the fundamental question: can the court disregard the corporate existence of MB Parent and equate the receipt of its common stock with receipt of its assets?

Undisputed facts establish that MB Parent must be respected under the two controlling tests set forth in *NIPSCO*. TribBr44-58. First, MB Parent engages in substantive business activity. Commissioner concedes that:

- MB Parent has existed in corporate form since 1998 (CIRBr75);
- MB Parent is the sole member of LLC (CIRBr13);

- LLC’s purpose is to invest its assets in its best interests (CIRBr10);
- LLC’s funds have been invested profitably and have appreciated greatly (CIRBr19);
- MB Parent reports and pays taxes on significant income from LLC’s investments (Stip. 330-38; TribBr48); and
- MB Parent owns Bender preferred stock, through which it acquired an interest in Lexis (CIRBr13, 64-65).

Second, Commissioner concedes that the transaction resulted in non-tax changes to the parties’ economic positions. Reed obtained control over, and an interest in, LLC’s assets. MB Parent obtained an interest in Bender’s economic fortunes. And Times (through its wholly owned subsidiary TMD) obtained control over significant Bender corporate actions:

- Reed — not Times — controls MB Parent (CIRBr6, 12);
- Reed controls any MB Parent Common dividends to Times (CIRBr16, 40);
- Times “may not upstream LLC assets to itself” (CIRBr15);

- LLC must distribute funds to MB Parent to pay taxes, preferred-stock dividends to Reed, and general expenses (CIRBr10);
- MB Parent was liable to Reed for the \$68 (later \$109) million value of Reed's MB Parent preferred stock, even if Bender was incapable of redeeming MB Parent's Bender preferred stock (CIRBr67);
- MB Parent owed \$700,000 (later \$900,000) more to Reed in annual preferred dividends than Bender owed to MB Parent, requiring payment of LLC's funds to Reed (CIRBr18); and
- Times had veto power over major corporate actions of Bender, including the Lexis contribution (CIRBr18-19).

Further, Commissioner concedes the key facts that establish that the transaction meets the governing reorganization tests (CIRBr26-67; TribBr32-39, 64-71):

- the transaction was motivated by business purposes (CIRBr3; A110);
- MB Parent controls Bender (CIRBr12);

- the transaction constituted a merger under New York law (CIRBr11; A76);
- the merger agreement states that the merger consideration was MB Parent Common (CIRBr14);
- Times received stock in MB Parent (CIRBr13); and
- the management authority is “economically inseparable” from the MB Parent Common (CIRBr35).

Attempting to divert attention away from these unavoidable concessions, Commissioner misrepresents the Tax Court’s decision and controlling law, focusing instead on legal irrelevancies such as GAAP accounting. He urges this Court to ignore governing Supreme Court precedent and the well-defined reorganization rules and instead to adopt an amorphous, subjective approach to a subject that demands clarity and predictability.

Without a legal or factual predicate, Commissioner is left with the absurd contention that “common sense” shows that the MB Parent Common is of negligible value. CIRBr24, 38. But MB Parent’s existence must be respected under *NIPSCO*. Common sense therefore dictates that the value of the MB Parent Common must equal the value of MB

Parent's assets, less any senior claims. The MB Parent Common conferred full ownership rights in assets worth \$1.375 billion, after subtracting Reed's \$68 million preferred stock interest. The management authority protected the value of the MB Parent Common. As Commissioner's experts recognized, no one would pay anything for the obligation to manage LLC without the stock unless they could "loot" LLC, which would have violated the manager's legal duties.

Even if the management authority could be stripped away from the stock and viewed as a separate asset — contrary to the parties' understanding and common corporate practice — Commissioner could only cause the transaction to fail the 80% test by instructing his experts to make the assumption that the two "assets" would be sold separately to unrelated parties. However, the Tax Court found, Commissioner's experts testified, and Commissioner now concedes, that this would never happen. CIRBr35. Only Tribune presented evidence consistent with *Curry*, under which economically inseparable assets must be valued as if they would be sold together. Commissioner's contrary expert testimony was rejected by the Tax Court and is now abandoned on appeal. As was the case in *Kohler Co. v. United States*, 468 F.3d 1032, 1037 (7th

Cir. 2006), Commissioner has “played all or nothing” and should be left with nothing.

## **ARGUMENT**

### **I. The Commissioner Cannot Overcome The Legal Errors In The Tax Court’s “Substance-Over-Form” Analysis.**

The only way the Tax Court could conclude that the Bender transaction failed the 80% test was to hold that the management authority was a highly valuable asset and that the MB Parent Common had only “negligible” value. A133. In determining that Times received “all incidents of ownership of the \$1.375 billion” (A119), the court equated the management of LLC’s investments with ownership of those investments. It is undisputed, however, that LLC owns the investments, MB Parent owns LLC, and MB Parent is a separate corporation controlled by Reed. Commissioner concedes that Times cannot “upstream” LLC’s assets to itself. CIRBr15. The funds can therefore be treated as belonging to Times only if MB Parent’s corporate existence is ignored, which is exactly what the Tax Court did.

The Tax Court’s substance-over-form analysis is central to both of its “alternative” holdings. First, in order to find that the management authority was a valuable asset, the court disregarded MB Parent’s exis-

tence and attributed ownership of LLC's assets directly to Times. Second, based on that conclusion, the court determined that the “‘true economic effect’ of the Bender transaction was a sale.” A133. Both of these determinations rest on fundamental legal errors.

**A. Because the court’s entire opinion is based on a legally erroneous recharacterization of the transaction, *de novo* review is appropriate.**

Commissioner claims that the determination that the Bender transaction fails the statutory 80% test raises a factual question, subject to deferential review. CIRBr26. However, *only* by ignoring MB Parent — and the law of this Circuit — could the Tax Court conclude that “the consideration received by [Times] ... was not common stock in MB Parent but was control over the cash deposited in the LLC.” A120.

This Court should not be misled by the Commissioner’s attempt to recast this case as a factual dispute. The Tax Court’s analysis is based on a legally erroneous recharacterization of the transaction. As Commissioner concedes (CIRBr54), this Circuit follows the rule that the “general characterization of a transaction for tax purposes is a question

of law” subject to *de novo* review. *Frank Lyon*, 435 U.S. at 581 n.16, followed by *Wellons*, 31 F.3d at 570.<sup>1</sup>

**B. The Commissioner offers no justification for the court’s decision to disregard MB Parent.**

Under *NIPSCO*, MB Parent’s existence and ownership of assets are entitled to respect if it engaged in *bona fide* business activity and the form of the transaction resulted in non-tax changes in the parties’ economic positions. Commissioner has conceded the facts necessary for MB Parent to satisfy both of these tests. *See* pp. 2-4, *supra*; TribBr44-58. Commissioner attempts to avoid *NIPSCO* in three ways, all of which fail.

First, Commissioner denies that the Tax Court disregarded MB Parent, claiming (CIRBr71) that “it is not necessary to disregard MB Parent in order to conclude that the Bender transaction was in substance a sale” and asserting (CIRBr72) that “we are not asking this Court to disregard MB Parent.” But the Tax Court did exactly that,

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<sup>1</sup> Commissioner has recently argued for *de novo* review under *Frank Lyon* in similar circumstances. *Coltec Industries, Inc. v. United States*, S.Ct. Docket No. 06-659, [www.usdoj.gov/osg/briefs/2006/0responses/2006-0659.resp.pdf](http://www.usdoj.gov/osg/briefs/2006/0responses/2006-0659.resp.pdf) at 10-14.

stating that “[t]o disregard the existence of MB Parent is not to ignore any meaningful step in the transfer of Bender from Times Mirror to Reed,” and that “the bare title of MB Parent in the LLC should be disregarded.” A130-31. Commissioner cannot dodge this legally indefensible ruling.

Commissioner next attempts to distinguish *NIPSCO*, incorrectly claiming (CIRBr73) that the *NIPSCO* Court respected Finance *because* Finance (and not the taxpayer) had control over Finance’s investments. The Court did mention investment control, but *NIPSCO*’s holding was clear: that “a corporation *and the form of its transactions* are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in *bona fide* economically-based business transactions.” 115 F.3d at 512 (original emphasis). Commissioner does not dispute that MB Parent’s LLC investments were profitable, earning 10.5-11% per annum, well above the S&P 500’s 2.5% over the same period, and growing to over \$2.4 billion by 2002. SA139; Ex. 1112-J. Nor does he dispute that MB Parent owned valuable preferred stock in and had operational control over Bender, a substantial business enterprise.

Thus, Times' ability to manage — but not own — LLC's investments does not affect the result under *NIPSCO*.

Commissioner argues that this transaction more closely resembles *West Coast Marketing* than *NIPSCO*. CIRBr73. In *West Coast Marketing*, Manatee never carried on *any* activity except holding land designated for sale to Universal, and was liquidated after seven months. 46 T.C. at 33-39. MB Parent, by contrast, has carried on substantial business activity and has been in existence significantly longer than both Manatee and *NIPSCO*'s Finance. TribBr49-52. It is still doing business today. CIRBr75.

In arguing that MB Parent is a conduit under *NIPSCO*, Commissioner claims that “MB Parent (controlled by Reed) has irrevocably passed its assets to LLC (controlled by taxpayer), leaving MB Parent in control of essentially nothing.” CIRBr75. But MB Parent owns LLC and all of its investments. It also owns \$68 million of preferred stock (with 80% vote) in Bender, as Commissioner admits. CIRBr5-6, 12. Commissioner's assertion (CIRBr75) that “taxpayer's agent [Behnia] testifie[d] that MB Parent's only assets are the Bender preferred stocks” is false. Behnia testified that MB Parent transferred cash to LLC, “a limited li-

ability company, in exchange for 100 percent ownership of the interest in [LLC].” SA149. Neither Behnia nor Times ever represented that MB Parent did not own LLC and its investments.

Finally, Commissioner says that the Tax Court’s failure to cite — let alone apply — *NIPSCO* was not legal error because “[t]he Tax Court’s determinations are consistent with *NIPSCO*’s legal standard....” CIRBr74. This claim is meritless. *NIPSCO* makes clear that MB Parent cannot be disregarded. TribBr44-58. Commissioner’s claim (CIRBr74) that Tribune did not bring *NIPSCO* to the Tax Court’s attention is equally baseless. Commissioner claimed for the first time in his post-trial brief that MB Parent should be treated as a conduit. In response, Tribune cited the Tax Court’s opinion in *NIPSCO*, and this Court’s affirmation thereof. Doc. 81 at 44.

Once MB Parent’s separate corporate existence is acknowledged, Times cannot be treated as owning LLC’s assets without confusing the ability to *manage* investments with the *ownership* of those investments. The ability to manage a separate corporation’s “affairs down to the minutest detail” is no basis for attributing ownership of its assets to the manager. *National Carbide*, 167 F.2d at 307 (Hand, J.), *aff’d*, 336 U.S.

422, 431-33 (1949) (quoting lower court with approval). LLC's investments remained in corporate solution. Because the corporate form must be respected, the court's conclusion that the MB Parent Common had negligible value is legal error.

**C. The Commissioner misstates controlling law in arguing that the transaction was in substance a sale.**

The second result of the court's substance-over-form analysis was its conclusion that the Bender transaction was in substance a sale. Commissioner attempts to support this conclusion in three ways. He argues that Tribune's straightforward reading of the regulatory continuity-of-interest ("COI") test is inconsistent with precedent (CIRBr68-70), that the transaction failed the COI test (CIRBr62-68), and that Times "cashed out" or "monetized" its Bender gain (CIRBr55-62). Commissioner misrepresents the COI test and the controlling regulation.

Supreme Court precedent makes clear that the COI test requires only that the taxpayer receive a "definite and substantial proprietary interest" in the reorganized business, even if the taxpayer also receives other economic benefits or advantages through the vehicle of reorganization. *See Minnesota Tea*, 296 U.S. at 385-86 (taxpayer received stock interest as well as cash); *Nelson*, 296 U.S. at 376-77 (taxpayer received

short-term, non-voting preferred stock as well as cash); *Paulsen v. Commissioner*, 469 U.S. 131, 136 (1986) (reaffirming these precedents).

The COI doctrine was originally a judicial creation, which was later “codified in Treas. Reg. §§1.368-1(b), 1.368-2(a).” *Paulsen*, 469 U.S. at 136. In 1998, references to COI in those sections were replaced with the COI provision at issue here, which confirms the role of COI: “The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations.” Treas. Reg. §1.368-1(e)(1). Thus, COI is the standard for determining whether, in substance, a transaction is a sale or a reorganization.

Commissioner attempts to obfuscate the clear text of the regulation, citing (CIRBr63) the single sentence: “All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.” In quoting this language, however, Commissioner omits the crucial operative language that defeats his argument. The regulation specifies three situations in which the required “interest in the target corporation *is* preserved,” one of which is receiving “a proprietary interest” (*i.e.*, stock) in the issuing

corporation (here, MB Parent). Treas. Reg. §1.368-1(e)(1) (emphasis added). When Commissioner's cited language is read in context, it is clear that all facts and circumstances are to be considered in determining *whether* stock was in fact received (as opposed to being received but then immediately redeemed by the issuing company for cash, for example). Application of the rule is therefore straightforward: if Times received stock of MB Parent (which both the Tax Court and Commissioner admit (A74; CIRBr13)), COI "*is* preserved."

Commissioner cites (CIRBr69) this Court's decision in *McDonald's* as support for ignoring the plain language of the regulation. *McDonald's* interpreted the prior judicial test for COI, endorsing a subjective facts-and-circumstances, intent-based approach to COI that subsequently led to confusion and whipsaw potential. TribBr34. Treasury specifically rejected *McDonald's* when it concluded that "the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently." T.D. 8760, 63 Fed. Reg. 4174, 4175 (Jan. 28, 1998). Treasury rejected both the analysis and the outcome of *McDonald's* in adopting the bright-line COI test. This Court should not be misled into adopting another open-

ended inquiry that will reintroduce the same type of uncertainty and inconsistency that existed prior to 1998.

Commissioner also erroneously claims (CIRBr62-68) that the Bender transaction fails the COI test because Times did not maintain a substantial continuing interest *in Bender*. But the COI regulation states that the necessary interest “*is preserved*” if the divested company’s former shareholders receive stock in the acquiring parent. The relevant COI inquiry therefore must address the connection — conceded by Commissioner — between Times and *MB Parent*.

Supreme Court case law supports this conclusion. In *Nelson*, the divested company’s shareholders received nonvoting, nonconvertible, fixed-dividend, redeemable preferred stock of the acquiring company, which represented virtually no economic link to the divested business. The Seventh Circuit found — similar to Commissioner’s argument here — that there was no COI “from the old corporation to the new; that the control of the property conveyed passed to a stranger, in the management of which petitioner retained no voice.” 75 F.2d at 698. The Supreme Court rejected this theory, focusing instead on whether the former shareholders obtained a continuing interest in the *acquiring* corpo-

ration, not in the divested business. The Court found that COI was satisfied because “the seller acquire[d] a definite and substantial interest in the affairs of the purchasing corporation.” 296 U.S. at 377. *See also Minnesota Tea*, 296 U.S. at 386 (“The transaction here was no sale, but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser.”).

*Paulsen* is of no help to Commissioner. *E.g.*, CIRBr56, 63. *Paulsen* reaffirms *Minnesota Tea* and *Nelson*, which refute the Commissioner’s position here. 469 U.S. at 136. Moreover, in *Paulsen*, the issue was whether what was received (passbook savings accounts and time certificates of deposit) in fact constituted an equity interest. Here, Commissioner has never claimed that the MB Parent Common was not stock.

The irrelevance of the magnitude of Times’ continuing interest in Bender is further reflected in the maxim that “a whale can swallow a minnow.” When a small software business merges with a giant company like Microsoft, the transaction qualifies as a reorganization even though the Microsoft stock given in the transaction represents an infinitesimal retained interest in the divested business. *See General Housewares*

*Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980); BITTKER & EUSTICE ¶12.01[2], 12-11.

Commissioner mistakenly focuses on “the link between the ... shareholders and the former ... business assets following the reorganization,” which, as Treasury explained, is “commonly known as *remote continuity of interest*.” T.D. 8760, 63 Fed. Reg. at 4175 (emphasis added). “The IRS and Treasury Department believe that the COBE [continuity of business enterprise] requirements adequately address the issues raised in [the remote continuity of interest cases].... Thus, these final regulations do not separately articulate rules addressing remote continuity of interest.” *Id.* In other words, COBE — not COI — addresses the link between Times and Bender. Commissioner has *conceded* that the transaction “satisfied the continuity of business enterprise requirement for qualification as a tax-free reorganization under I.R.C. § 368.” Stip. 303; A76.

Commissioner’s legally irrelevant arguments about “monetization” and GAAP accounting similarly misconstrue the role of COI. Monetization of a stock interest is not a relevant factor in determining whether a transaction qualifies as a reorganization. A participant in a valid reor-

ganization can borrow against the shares he receives, thereby instantly “monetizing” his original investment. *Stockton Harbor Industrial Co. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954). Similarly, an operating company can be merged with an investment company holding only cash or liquid investments under §368(a)(2)(F). The 1998 COI regulations specifically allow former shareholders to immediately sell their shares obtained in the reorganization to unrelated parties, thus immediately severing *all* interest in the divested business (the opposite result from *McDonald’s*). T.D. 8760 (reflecting promulgation of Treas. Reg. §1.368-1(e)(6), Ex. 3). *See also Paulsen*, 469 U.S. at 141, explaining that *Nelson* upheld reorganization even though 62% of the consideration was cash.

Furthermore, monetization simply did not occur here. LLC’s investments were *managed* by Times, but were *owned* by MB Parent. Commissioner concedes that taxpayer “may not upstream LLC assets to itself.” CIRBr15. Any attempt by Times to abscond with LLC’s funds would have violated its legal duties to both LLC and TMD. Commissioner’s argument (CIRBr60) that Tribune’s reliance on Delaware law is “misplaced” because “the parties agreed that the LLC agreement overrode any contrary provisions in law, including Delaware law” is spe-

cious. The duty of good faith cannot be restricted under Delaware law. TribBr59-62.

There is nothing to Commissioner's rhetorical assertion (*e.g.*, CIRBr40 n.4, 57) that LLC's assets are "gone" or "spent." LLC owns a portfolio of investments, including operating companies, the value of which has grown by more than \$1 billion. To the extent that the assets consisted of Times (now Tribune) stock, those shares too have increased in value (Reply Brief Separate Appendix ("RepSA") 3-4) and receive significant dividends (A103). Commissioner emphasizes that this stock is "restricted." CIRBr40 n.4. This does not mean that the stock does not retain its value. A103. If LLC chose to sell this stock, it could do so if Tribune simply filed a registration statement with the SEC. 15 U.S.C. §77e.

Commissioner's insinuation (CIRBr19, 25, 40-41, 57-58) that the transaction should be treated as a sale because LLC's purchases of Times stock may have increased Times' stock price or otherwise made Times appear in a positive light to the market is similarly without merit. The fact that an affiliate makes investments that benefit its shareholder does not mean that the affiliate's separate legal status can

be ignored. *Moline Properties*, 319 U.S. at 438-39 (“Whether the purpose be to ... serve the creator’s personal or undisclosed convenience, so long as that purpose is ... followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.”) (footnotes omitted). Moreover, any benefit to Times in the financial market as a result of LLC’s share purchases is speculative at best. Many factors influence share price, and a share purchase program can instill both confidence and concern in the market. RepSA5-8. Times’ stock price increase was driven primarily by its improved operating results, not by LLC’s purchase of Times shares. RepSA7. Nothing in the statute, case law, or applicable regulation suggests that benefits of this sort defeat reorganization status. *See* pp. 13-14, *supra*.

Commissioner repeats the Tax Court’s error of referring to Times’ GAAP-based statements to support his argument that Times treated the funds as its own. Although Commissioner relies on *McDonald’s*, he fails to mention that Commissioner in that case similarly “ma[de] much of the differences between the accounting and the tax treatment” of the transaction, only to have the Court summarily reject the argument: “[t]he short answer to this argument is ... [that] such variations are

common and accepted.” 688 F.2d at 522, n.6. *See also Thor Power Tool*, 439 U.S. 522, 538-44.<sup>2</sup>

Even if GAAP-based statements were relevant, Times accurately described the transaction as a reorganization in its SEC filings, specifically stating that the merger consideration was “all of the issued and outstanding common stock of [MB Parent].” SA260. As the record makes clear, MB Parent’s assets appear on the consolidated Times group’s balance sheet because Times consolidates its ownership of MB Parent, not because LLC’s assets belong to Times. TribBr41-42; RepSA21-25. Commissioner’s claim (CIRBr16) that Times’ balance sheet showed an increase in cash is baseless. As Commissioner’s own expert explained, it is impossible to distinguish the receipt of stock from the receipt of assets when examining a consolidated balance sheet. Tr. 740-45. Both Times’ GAAP-based descriptions of the transaction and its financial accounting are entirely consistent with the structure of the transaction as a reorganization.

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<sup>2</sup> *Nelson* and *Minnesota Tea* similarly used the terms “seller” and “purchaser,” despite concluding that the transactions were reorganizations. *See* p. 16, *supra*.

## **II. The Commissioner Cannot Overcome The Legal Errors In The Tax Court's 80% Analysis.**

Not only was the Tax Court's substance-over-form analysis contrary to governing legal principles, but its threshold decision to apply such an analysis to the transaction before applying the statutory and regulatory reorganization tests was also legal error. In form, the Bender transaction was a stock-for-stock exchange in which Times received stock in a company that held assets in corporate solution. Neither Times nor Reed viewed the authority to direct LLC's investments as an asset separate from the MB Parent Common, with independent value. To allow Commissioner to recharacterize it as such ignores the corporate form of the structure, is contrary to common corporate practice, and contradicts governing Seventh Circuit precedent.

### **A. The Commissioner provides no defense of the Court's error in ignoring the stock-for-stock form of the transaction when applying the 80% test.**

The rules under §368 set out precisely the tests for reorganization treatment. As this Court has explained: "When we are dealing with statutory terms of art, the form-substance dichotomy is a false one. 'Substance' can only be derived from forms created by the statute itself. Here substance *is* form and little else; there is no natural law of reverse

triangular mergers.” *Howell*, 775 F.2d at 890 (original emphasis, citation omitted). Thus, the *form* of putative reorganizations must be tested under the rules of §368 and its regulations.

In a similar context, the Tax Court acknowledged: “Congress enacted a transaction under which tax consequences are dictated by form; to avoid those consequences, [Commissioner] must demonstrate that the form chosen ... was a fiction....” *Esmark*, 90 T.C. at 183. This Court affirmed without opinion. 886 F.2d 1318. This is consistent with *Gregory*, 293 U.S. 465, which the Supreme Court has interpreted to mean that “the corporate form may be disregarded where it is a sham or unreal.” *Moline Properties*, 319 U.S. at 439.

Thus, before embarking on an amorphous substance-over-form inquiry, the Tax Court should have determined whether the 100% stock-for-stock transaction as structured met the 80% and COI tests. Instead, the court *first* recast the transaction based on its view of its substance, ignoring MB Parent and artificially extracting a second valuable item of consideration (the management authority) from the MB Parent Common. The court then applied the reorganization rules to those *revised*

facts. This backwards approach is not only directly contrary to *Esmark*, but also renders technical compliance irrelevant.

Commissioner has repeatedly acknowledged that Times “in form” received only stock for Bender. Commissioner’s Notice of Deficiency, the basis for his adjustment, admits that “[i]n form, [Times] exchanged its [Bender] common stock *solely* for qualifying consideration, *i.e.*, common stock of MB Parent.” RepSA28 (emphasis added). *See also* Trial Brief, RepSA32 (“In form, [Times] got back only qualifying consideration....”). To contend that the transaction failed the 80% test, Commissioner had to completely recast it. Answer, RepSA30 (Commissioner “[a]lleges that [Times] also *constructively* received ... the management rights over [LLC].”) (emphasis added); Notice, RepSA28 (“*In substance*, [Times] received ... non-qualifying consideration (‘boot’) in the form of rights ... to manage the assets of [LLC].”) (emphasis added).

Commissioner twice cites *United States v. Hendler*, 303 U.S. 564 (1938), for the proposition that the management authority should be treated as separate property, even though it is economically inseparable from the common stock. CIRBr38, 59. In *Hendler*, the Supreme Court found that the assumption of liabilities in a reorganization should be

treated as separate boot. The Court adopted the Commissioner’s fiction that the transaction should be treated as if the acquiring party had paid cash, which was then used to satisfy the liabilities. Payment of debts has no parallel to the circumstances here, where LLC’s assets have remained in corpus for over eight years and never were conveyed to Times or its creditors.

More importantly, *Hendler* illustrates the dangers of seeking to raise tax revenue by artificially fragmenting a transaction. Commissioner’s Pyrrhic victory survived less than one year. At the Government’s urging, Congress overturned *Hendler* with the predecessor to §357(a) because *Hendler*’s deconstruction of a reorganization’s integrated elements invited extensive manipulation. *See generally* BITTKER & EUSTICE ¶ 3.06[1]. Commissioner ironically relies on *Hendler* — like *McDonald’s* — to urge the Court to return to a fragmented, subjective approach that the Government itself has previously rejected as ill-advised and unworkable.

Commissioner cites a number of Times’ statements that supposedly “touted” the value of the “control rights.” CIRBr38-40. There is no indication anywhere in the record that the appointment of Times as the

LLC manager carries any separate value. The statements instead describe *deal value*, in a consolidated financial accounting sense. These statements are not meaningful in distinguishing “sales” from “reorganizations.” TribBr39-42. Nor do they speak to whether one item of consideration or two was received for Bender’s stock.

Commissioner gets nowhere in arguing (CIRBr20-21, 33) that Tribune conceded that the management agreement was consideration for the transaction, citing Times CFO Thomas Unterman’s testimony. Unterman was asked whether the management authority was “a separate part of the consideration” Times received for Bender. He responded: “*Not at all. It was all one deal.*” RepSA1 (emphasis added).

Shareholder agreements are frequently used to protect the interests of shareholders through veto powers, voting agreements and trusts, and asset management agreements. These agreements are ancillary to the stock ownership and not valuable assets separate from the stock. See LIPTON, 103 J. TAX’N at 270 (under “longstanding practice,” “a managerial right with respect to an LLC usually is viewed by the parties to the transaction as not having significant value”). It is understandable, therefore, why commentators have criticized the Tax Court’s

decision. The court's "explicit assumption that the Service can separate stock from certain underlying rights associated with that stock ... is, on several levels, a radical departure from fundamental assumptions of corporate tax law." RIZZI, 33 J. CORP. TAX'N at 27-28. This approach may lead to "various types of mischief" by the Service and by taxpayers. *Id.* For example, "[t]axpayers could re-run transactions ... to apply the gain recognition result of *Tribune Co.* to obtain a step-up in the basis of corporate stock or assets" and thereby "harvest[] billions of dollars in 'overlooked' tax attributes." *Id.*

Simply put, the Tax Court's use of fictions here threatens to harm future revenue collection efforts:

The fundamental problem confronted by the IRS and the Tax Court in *Tribune Company* is that the form of the Bender transaction was a nontaxable reorganization.... The only way to change this result was to bestow value on control rights, which the parties agreed had no value (and which usually are not ascribed any value by the parties to a transaction). Thus, the IRS has taken a position in this case which may result in significant revenue, but the cost to the fisc in the future could be much greater.

LIPTON, 103 J. TAX'N at 270. Furthermore, "the loss of certainty in tax planning that arises when a structure agreed to by the parties at arm's

length is overturned by the courts may have an even greater adverse impact on the tax system.” *Id.* This is precisely the type of problem that Treasury sought to end with the 1998 COI regulation when it rejected the *McDonald’s* COI approach, which had led to inconsistent results and whipsaw potential “[b]ased on an intensive inquiry into nearly identical facts....” T.D. 8760, 63 Fed. Reg. at 4175.

Commissioner claims that there is no whipsaw effect here because “for both taxpayer and Reed, this transaction is a taxable sale of stock.” CIRBr53. This misstates the result of his opportunistic argument. If the parties had agreed to structure the transaction as a taxable sale of stock, Reed and Times could have contemporaneously elected to treat the transaction as a sale of Bender’s assets. That would have increased Reed’s basis in those assets and entitled it to claim over \$1 billion in additional depreciation and amortization deductions. *See* §338(h)(10). Reed gave up this significant tax advantage and cannot reclaim it now. *Id.*; TribBr28-31; CIRBr8 (conceding that the parties negotiated a stock-for-stock transaction to give the tax benefit to Times, not Reed).

**B. Only Tribune offered proof consistent with *Curry* and the agreed inseparability of the MB Parent Common and management authority.**

Because it was legal error for the Tax Court to create a second asset instead of addressing the 100% stock-for-stock form of the transaction, there should be no valuation dispute in this case. Even if the court's approach were correct, however, only Tribune presented evidence properly valuing those assets.

Commissioner now abandons the position that he has consistently taken throughout this litigation and concedes that the MB Parent Common and the management authority were “economically inseparable.” CIRBr35. This Court's decision in *Curry* therefore mandates that they be valued as if they would be sold together. But Commissioner chose not to present *any* proof of that kind. Instead, Commissioner instructed his experts to assume that they would be sold to unrelated, hostile parties, despite warnings from his experts that this would *never happen*. CIRBr44; TribBr69-70.

Commissioner's assumption is completely at odds with *Curry*, in which this Court rejected a “hypothetical bifurcation of an otherwise integrated bundle of property,” because permitting the “hypothetical sce-

nario of separate disposition of [the two assets] to form the basis of a proposed valuation would defy common sense and the requirements of the ‘fair market value’ standard....” 706 F.2d at 1428.

Commissioner attempts to side-step *Curry* by claiming that his experts’ inconsistency with *Curry* is irrelevant because the Tax Court did not rely on them. CIRBr45. But this leaves him with no valuation evidence whatsoever, and forces him to argue with empty characterizations (CIRBr38-39) that “the record” and “common sense” support the Tax Court’s view that the MB Parent Common had only “negligible” value.

The Tax Court misdescribed Tribune’s position on valuation as an “effective concession that the MB Parent common stock and the management authority over the LLC were inseparable.” A121. Tribune did not “concede” they were inseparable. Tribune *proved* it, and thus established the direct applicability of *Curry*. In line with *Curry*, Tribune presented Bradley’s testimony that valued the MB Parent Common and the management authority as part of an integrated bundle of property.

Commissioner, on the other hand, insisted at trial that the hypothetical willing buyer/willing seller standard required that the experts

value the MB Parent Common and the management authority as though they would be sold separately. CIRBr44; TribBr67-70. Significantly, none of Commissioner's experts was willing to testify that the MB Parent Common would be discounted at all if, consistent with the facts, it were not sold separately from the management authority. Commissioner's counterfactual instruction to his experts was the only way he could assign a value to the management authority sufficient to support his case. However, Commissioner now acknowledges that, even if Times received two assets, *Curry* requires that they be valued as if "both were deemed to be sold to the same buyer" because they are economically inseparable. CIRBr37. Thus, all of Commissioner's valuation proof is contrary to *Curry* and was correctly rejected by the Tax Court.

Even though their bifurcation assumption was squarely rejected by the Tax Court, Commissioner still refers to the testimony of his experts. But they only confirm that Bradley's approach was correct.

Commissioner claims that Barclay's testimony was consistent with *Curry*, because he valued the management authority in the hands of "a seller who owned both the common stock and the control rights." CIRBr42. But Barclay's expert report plainly states:

Why would the owner of both willingly sell the Control Rights separately? ... Economic theory indicates that a separation of the Control Rights from the common stock is inefficient and should not occur. Nevertheless, I have been asked to value the Control Rights under the fair market value concept, which assumes both a hypothetical seller and a hypothetical buyer.

CIRSA164. Barclay's analysis of the value to a hypothetical buyer was predicated on the amount that the buyer could potentially "extract[ ]," "expropriat[e]," or "divert[ ]" from LLC at the expense of "an unrelated common stockholder of MB Parent." RepSA11-12; Ex. 1351-R, p. 25. Thus, Barclay's own report confirms that his testimony was inconsistent with *Curry*.

Commissioner's attempt (CIRBr42) to bolster the Tax Court's valuation determination based on Barclay's use of control premium studies also fails. The studies Barclay cited, like the authorities in Commissioner's brief (CIRBr42), relate to a discount to the value of common stock, not the value of a separate contractual provision. A control discount arises when there is a dissipation of control through ownership by multiple shareholders. This theory does not create a separate "control" asset where none existed before. Furthermore, there was no such diffusion here; Times owned *all* of the MB Parent Common shares.

The only evidence of the value of the MB Parent Common that was not based on the bifurcation hypothesis was Bradley’s testimony. Assuming *arguendo* that it would be proper to value the management authority and the MB Parent Common separately, Bradley used “the net asset value approach” (A121) to value the MB Parent Common at \$1.375 billion. Bradley explained that the MB Parent stock would bear no discount for lack of control because the MB Parent Common and the management authority would never be separated, and hence the holder of the MB Parent Common would always be able to protect its interests. RepSA17-20.<sup>3</sup>

Commissioner’s expert Shapiro confirmed that Bradley’s net asset value approach was correct. As the Tax Court noted, “[l]ike Bradley, Shapiro began with a determination of net asset value.” A122. Under this approach, Shapiro valued the MB Parent Common at \$1.368 million, or just \$7 million less than Bradley’s value. Thus, before any “con-

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<sup>3</sup> Bradley further opined that, “[u]sing an ‘avoided costs approach’, ... the management authority might have a fair market value ranging from \$9.2 million to \$44.1 million.” A122. Thus, contrary to Commissioner’s argument (CIRBr35-38, 45-50), Tribune did not fail to prove the value of the MB Parent Common and the management authority. Consistent with *Curry*, Bradley valued them each as part of the integrated bundle of rights that they are.

trol” discount, Bradley and Shapiro used the same net asset value approach and arrived at virtually identical values for the MB Parent Common.

Shapiro then “concluded that the MB Parent common stock should be discounted substantially for lack of control over the assets.” A122. This was based on his assumption that the MB Parent Common would be “sold to an *unrelated* party.” CIRBr44. Yet, as Shapiro admitted, separation did not occur here and would never be an “economically rational choice.” RepSA14-15. This part of Shapiro’s valuation is therefore inconsistent with *Curry*. All that remains is Shapiro’s conclusion that the MB Parent Common was worth \$1.368 billion.

Once the Tax Court agreed with Tribune about inseparability (A120-21), the court could no longer rely upon Commissioner’s experts and was forced instead to draw what it dubbed a “commonsense conclusion[]” that the MB Parent Common “had a value less than \$1.1 billion....” (A125). But this is the antithesis of common sense. The MB Parent Common conferred full ownership rights in Bender stock worth \$68 million and the assets of an investment company worth \$1.375 billion, with only \$68 million in senior claims. The management authority rein-

forced the MB Parent Common's value by enabling the common stockholder to fully protect its interest in those assets. No one would pay anything for the obligation to manage LLC without the stock unless they could "loot" LLC, which would have violated the manager's legal duties. It defies common sense to allow the tax collector to create, and then value, an asset that was never the subject of negotiations between the two adverse parties to the transaction.

The Tax Court and Commissioner have both conceded that the MB Parent Common and the management authority are economically inseparable. *Curry* — which the Tax Court ignored — therefore mandates that no discount to the MB Parent Common's \$1.375 billion value be applied.

### **III. Reversal Without Remand Is The Appropriate Disposition.**

Once the Tax Court's legal errors are corrected, MB Parent's separate legal status must be recognized. Times' management authority cannot be equated with ownership of LLC's assets and therefore cannot be viewed as a separate valuable asset. Thus, there is no valuation question at issue and reversal is required.

Even if this Court were to accept Commissioner’s invitation to artificially cleave the management right from the MB Parent Common, only Tribune presented proof of the value of the MB Parent Common assuming — as Commissioner now concedes — that it would never be uncoupled from the management authority. The valuation experts — including Commissioner’s — have consistently agreed that economic inseparability was the only premise that made sense, but Commissioner declined to present any proof consistent with that premise.

Under *Kohler*, reversal without remand is the necessary consequence of Commissioner’s position:

To permit the Internal Revenue Service to place an arbitrary value on difficult-to-value property obtained in a transaction and require the taxpayer to prove that it was worth less — and exactly how much less — would place an unreasonable burden on taxpayers. ... The government would have to present *some* evidence in defense of its extravagant assessment before the burden of production and persuasion would shift to the taxpayer. This conclusion is implicit in cases that hold that when the IRS makes a “naked” assessment, which is to say one “without any foundation whatsoever,” the taxpayer does not have to prove what the assessment should have been.

468 F.3d at 1036. Commissioner’s assessment in *Kohler* was “undeniably excessive” because it — like his expert’s testimony — “took no ac-

count” of a key economic reality. *Id.* The Court found that Commissioner “could have justified a more modest estimate, ... but clinging stubbornly to its untenable valuation it suggested no alternative.... It played all or nothing, lost all, so gets nothing.” *Id.*

Here, Commissioner’s adjustment was based on the creation of a separate asset that neither party to the transaction believed existed. Commissioner ascribed to this artificially separated asset an outlandishly large value, and then required Tribune to prove its exact value. Here, as in *Kohler*, Commissioner has played all or nothing and should get nothing.

### CONCLUSION

The judgment of the Tax Court should be reversed, with instructions to enter judgment in Tribune’s favor.

Respectfully submitted.

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## **CERTIFICATE OF COMPLIANCE**

Pursuant to Fed. R. App. P. 32(a)(7)(C), the undersigned hereby certifies that the foregoing reply brief of appellant Tribune Company complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B)(ii) and contains 6,992 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

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One of appellant's attorneys

## **CIRCUIT RULE 31(e)(1) CERTIFICATION**

The undersigned attorney hereby certifies that he has filed electronically, pursuant to Circuit Rule 31(e), a digital version of the foregoing reply brief and all of the appendix items that are available in non-scanned PDF format.

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One of appellant's attorneys

## **CERTIFICATE OF SERVICE**

The undersigned attorney hereby certifies that, on April 17, 2007, he: (i) caused two copies each of this Reply Brief for Appellant Tribune Company, bound together with the accompanying Separate Appendix, to be served on counsel for Commissioner, Commissioner of Internal Revenue, by Express Mail to the following address:

Judith A. Hagley, Esq.  
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and (ii) caused a digital version of the foregoing reply brief and all of the appendix items that are available in non-scanned PDF format to be served on counsel for Commissioner at the email address  
[Judith.A.Hagley@usdoj.gov](mailto:Judith.A.Hagley@usdoj.gov).

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