REVIEW OF RECENT M&A TRANSACTIONS

Bernie J. Pistillo, Jr.
Morrison & Foerster LLP
May 21, 2015
BPistillo@mofo.com
AGENDA

- The Kraft-Heinz Merger
  - Forward Subsidiary Merger with Cash Payout from Buyers
- Yahoo/Alibaba
  - Spinoff of Minority Shareholding
- Burger King/Tim Hortons
  - Inversion with Option to Avoid the Section 367 “Substantiality” Test
- Procter & Gamble/Duracell
  - Cash-Rich Split-Off
KRAFT/HEINZ MERGER
I. BACKGROUND

A. On March 25, 2015, H.J. Heinz Company (“Heinz”) and Kraft Foods Group, Inc. (“Kraft”) announced that they had entered into a definitive merger agreement to create the Kraft Heinz Company.

B. Heinz is privately owned by Berkshire Hathaway and 3G Capital.

C. The merger is structured to ensure that Berkshire and 3G will remain in control of the combined company. Part of the consideration to be paid to Kraft shareholders is a special cash dividend of $10 billion, funded by Berkshire and 3G.
II. THE MERGER

A. Heinz will form Merger Sub I and Merger Sub II. Berkshire Hathaway and 3G each will contribute $5Bn to Heinz in respect of their shareholdings, and Heinz will transfer these funds to Merger Sub I prior to the merger.

B. Prior to the effective time of the merger, Kraft will declare a special dividend of $16.50 in cash per share of Kraft common stock payable to all holders of record as of a date immediately prior to the closing of the merger.

C. At the closing of the merger, Merger Sub I will be merged with and into Kraft, with Kraft surviving as a wholly owned subsidiary of Kraft Heinz. Kraft at this point will pay the special dividend.
II. THE MERGER (CONT’D)

D. Immediately following the effective time of the merger, Kraft will be merged with and into Merger Sub II, with Merger Sub II surviving as a wholly owned subsidiary of Kraft Heinz.

E. Each share of Kraft common stock is to be exchanged for one share of Kraft Heinz stock.
III. DISCUSSION OF TAX ISSUES

A. Note the significant amount of cash paid to Kraft shareholders in the transaction. If all stock consideration had been used, Berkshire and 3G would have lost control of the combined entity.

B. With cash of $10Bn, roughly 30 of the total amount received by Kraft shareholders will be in the form of other than stock.

C. This much cash could not be paid in a reverse subsidiary merger under §368(a)(2)(E): the maximum amount of non-stock consideration payable is 20% (§368(a)(2)(E)(ii)).

D. The share consideration and cash “dividend” will be considered together in determining total consideration paid to Kraft shareholders in the transaction, because the cash was funded by the Heinz shareholders. See, Waterman Steamship Corp., 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971). In other circumstances, a cash payment from the target can be structured so that it will be respected as a dividend (and not treated as merger consideration). Compare, TSN Liquidating Corp., 624 F.2d 1328 (5th Cir. 1980); Litton Inds., 89 T.C. 1086 (1987).
III. DISCUSSION OF TAX ISSUES (CONT'D)

E. With 30% of the consideration paid in the form of cash, it will be necessary to qualify the Kraft acquisition under §368(a)(2)(D) as a forward subsidiary merger: hence the second merger of Kraft into Merger Sub II.

F. This raises the question of why the first Kraft merger (reverse subsidiary) was even used:
- corporate law in Virginia (Kraft’s home jurisdiction);
- debt covenants;
- other consent issues; or
- to preserve historic Kraft’s existence just long enough to pay the $10Bn dividend.
YAHOO SPINOFF OF ALIBABA STAKE
I. BACKGROUND

A. Yahoo Inc. ("Yahoo") announced in January 2015 its intention to spin off its nearly $40Bn of holdings (or 384 million shares) in Alibaba Group Holding Ltd. ("Alibaba") in January 2015.

B. Prior to the Alibaba IPO, a portion of the Yahoo stake had been redeemed for roughly $6.2Bn in cash and redeemable preference shares. Yahoo paid U.S. taxes of around $2.3Bn on the transaction. (The $800M of preference shares were redeemed in 2013.)

C. In September 2014, 140 million Alibaba shares were sold by the Hong Kong subsidiary of Yahoo. This attracted approximately $3.3Bn in U.S. tax.

Today:
I. BACKGROUND (CONT'D)

D. In light of these transactions, Yahoo was criticized by some shareholders for not finding a more “tax-efficient” strategy for monetizing the value of the Alibaba shares. Tax on the outright sale of the remaining stake would be approximately $14Bn. The recently announced Spinoff would distribute the Alibaba shares to the Yahoo shareholders tax-free, but they remain inside corporate solution (as discussed below).

E. The Spinoff is subject to receipt from the Service of a favorable ruling on certain aspects of the transaction. It is not entirely clear what elements of the transaction are to be the subject of the ruling, since today only “significant issues” rulings can be obtained. Rev. Proc. 2013-32, 2013-28 IRB 55.
II. THE SPIN OFF

A. Yahoo will form Spinco.

B. Yahoo will contribute Yahoo Small Business, a business division that sells tools to help small business owners market and sell their goods online, to Spinco (to satisfy the active trade or business requirement of Section 355).

C. Yahoo will contribute its stake in Alibaba to Spinco.
D. Yahoo will distribute the shares of Spinco pro rata to all Yahoo shareholders.
III. DISCUSSION OF TAX ISSUES

A. General Issues Under Section 355

• Active Trade or Business (“ATB”)

  - Yahoo Small Business (annual EBITDA $50M) is a tiny percentage of the value of Alibaba shares (current value $34Bn)

  - Historically, any ATB, regardless of its relative size, has been sufficient to qualify a spinoff: See Rev. Rul. 73-74, 1973-1 C.B. 182: “there is no requirement in section 355(b) that a specific percentage of the corporation’s assets be devoted to the active conduct of a trade or business.”

  - Yahoo sought a ruling on “certain” aspects of the transaction, and this presumably was one.

  - On Tuesday (5/19/15), Isaac Zimbalist, senior technical reviewer at the IRS Office of Associate Chief Counsel (Corporate), observed at a D.C. Bar Association event that spinoff ruling practice may change to require a more substantial ATB in these transactions.
III. DISCUSSION OF TAX ISSUES

- “The issue comes down to whether we’ve dropped a hot-dog stand or a lemonade stand into a business that is primarily publicly traded stocks, cash and other wonderful things that I call appreciated property,” Zimbalist said.

• “Device”: the transaction must not be used “principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both.” §355(a)(1)(B).

- In this regard, Rev. Rul. 73-44, supra, notes that the percentage of a corporation’s assets that in fact are devoted to the active conduct of a trade or business is a relevant factor in determining whether the transaction was in fact used as a “device.”
III. DISCUSSION OF TAX ISSUES (CONT'D)

B. Investment Company Status

- Spinco was registered as an investment company under the Investment Company Act of 1940

- Question the purpose for this election: Spinco does not currently qualify as a RIC under §851 due to overwhelming value of Alibaba shares (§851(b)(3)(B) requires that no more than 25% of the value of a RIC may be invested in the securities of any one issuer).

- Some commentators have suggested that it may bolster ATB by demonstrating an “investment business,” despite Treas. Reg. §1.355-3(b)(2)(iv)(A) statement that ATB does not include the “holding for investment purposes of stock, securities, land, or other property.”

- It may be that the election was intended as a defensive measure: it could make any future takeover attempt more difficult to structure as a tax-free business combination, since any such transaction would be more likely to fall within §351(e) after this election had been made.
III. DISCUSSION OF TAX ISSUES (CONT'D)

C. Subsequent Transactions

• The most likely future buyer for Spinco would be Alibaba, but the acquisition and future ownership would be greatly complicated by a number of US tax rules:
  - §355(e)
  - §367 and Treas. Reg. §1.367(a)-3T
  - §7874 and Notice 2014-52
I. BACKGROUND

A. Burger King announced its plan to acquire Tim Hortons and move the headquarters of the combined group to Canada.

- Press releases stated that the motivations for the transaction were synergies between the groups, planned expansion of Tim Hortons into the US and Burger King into Canada, and of each of the companies worldwide.

- Certain parties even claimed that the overall business was more Canadian than US.

B. Disclosure materials state that §7874 does not apply because the “substantial business activities” test is satisfied in Canada.

C. Nevertheless, the transaction does not satisfy the §367 substantiality test, because Burger King is significantly larger than Tim Hortons. Therefore, the transaction is taxable to US owners of Burger King shares who receive Holdings shares.
II. TRANSACTION STRUCTURE

A. Burger King (in US) and Tim Hortons (in Canada) begin as standalone, publicly traded entities.
II. TRANSACTION STRUCTURE (CONT’D)

B. In order to prepare for the combination, the companies establish a new holdco (Holdings) in Canada, which owns an Ontario Partnership. Holdings will be listed on NYSE and will be the primary vehicle through which the newly combined group is traded. The partnership will issue units (exchangeable for Holdings shares) to certain Burger King shareholders in lieu of Holdings shares. A merger sub (to acquire Burger King) and an amalgamation sub (to acquire Tim Hortons) are owned beneath Holdings and the partnership.
II. TRANSACTION STRUCTURE (CONT’D)

C. Merger Sub merges with and into Burger King, and Amalgamation Sub amalgamates with Tim Hortons.
II. TRANSACTION STRUCTURE (CONT’D)

D. In the exchange, Tim Hortons shareholders receive cash, Holdings shares, or a mixture thereof, subject to proration such that the Tim Hortons shareholders in the aggregate receive 21% of the Holdings shares. Burger King shareholders receive partnership units, or Holdings shares and cash, subject to proration. Financing for the transaction was provided by Berkshire Hathaway, in the form of preferred shares and warrants issued by Holdings.
III. DISCUSSION OF TAX ISSUES

A. Inversion Rules: §7874

- A foreign entity completes the acquisition of substantially all the assets of a domestic corporation;

- At least 60% of the stock of the foreign entity is held by former shareholders of the domestic entity by reason of holding stock in the domestic corporation; and

- The expanded affiliated group of which the acquiring foreign corporation is a member does not have substantial business activities” in its jurisdiction of incorporation.

- “Substantial business activities” requires:
  - at least 25% of group employees (tested both by number and by total compensation) must be located in the jurisdiction;
  - at least 25% of the value of group assets must be located in the jurisdiction; and
  - at least 25% of the group income must be derived from unrelated customers located in the jurisdiction.

Treas. Reg. §1.7874-3T.
III. DISCUSSION OF TAX ISSUES (CONT’D)

• Note that Tim Hortons shareholders received 21% of the equity in Holdings. If Burger King shareholders had received 80% or more of Holdings equity (including through the partnership), the stakes would have been even higher: §7874(b) provides in that case that if the substantial business activities test is not met, Holdings would be taxed as a domestic corporation.

• Commentators suggested that by meeting the less-than-80% ownership test as well as the substantial business activities test, Holdings had greater freedom to pursue a restructuring of the Burger King international operations post-merger whereby subsidiaries would cease to be CFCs and their “trapped cash” could be repatriated.

• The strategies typically used to accomplish these goals may be less accessible in light of Notice 2014-52.
III. DISCUSSION OF TAX ISSUES (CONT’D)

B. Section 367

• In order for a US person to qualify to receive non-US shares tax-free in a transaction otherwise qualifying under §351 (or the reorganization provisions), Treas. Reg. §1.367(a)-3(c) requires that:

  - 50% or less of the vote and value of the foreign corporation be received in the transaction by US transferors;

  - 50% or less of the vote and value of the foreign corporation be owned by US persons who are officers, directors or 5% shareholders;

  - US persons who are 5% shareholders must enter into a GRA; and

  - the active trade or business (ATB) test of -3(c)(3) must be satisfied.
III. DISCUSSION OF TAX ISSUES (CONT’D)

- The active trade or business test generally requires that the transferee be engaged in an ATB outside the US for 36 months before the transfer, that there be no intention to dispose of or cease that business, and that the fair market value of the foreign corporation be at least equal to the value of the transferred US corporation (the “substantiality” test; see, Treas. Reg. §1.367(a)-3(c)(3)(iii)(A)).

- In the current transaction, the element of the §367 regulations that is not satisfied is the “substantiality” test, because Burger King is significantly larger than Tim Hortons. This caused Burger King shareholders who received Holdings shares in the transaction to recognize the full amount of any gain on the exchange.

  - In a typical inversion transaction, it is the 50% of vote and value test that is failed.
IIII. DISCUSSION OF TAX ISSUES (CONT’D)

C. Use of partnership Structure

• Reason: transfers of property to a foreign partnership are not subject to §367

• Shareholders taking partnership units in the transaction would have reported no gain (contrasted with those who received Holdings shares)

• Although units were offered to all shareholders, they would not have been an attractive option to many (and very few took them)
  - lockup provisions
  - redemption: cash or Holdings shares at option of partnership
  - listing on Toronto exchange, but extremely illiquid (virtually no trades)
III. DISCUSSION OF TAX ISSUES (CONT’D)

• Tax Issues Regarding Partnership Units:
  - Demonstrate units not a surrogate for Holdings shares
  - Business purpose for formation and existence of partnership; non-applicability of anti-abuse rule
    o valid use of partnership to complete transaction that 3G would otherwise not complete;
    o impact of repeal of §1491; demonstrates Congressional intent to permit tax-free transfers to foreign partnership (so §367 should not be construed as somehow applicable)
I. BACKGROUND

A. Procter & Gamble had announced plans to dispose of Duracell as part of its strategy to exit non-essential businesses and focus on its core brands.
   • It had proposed a split-off to shareholders whereby it would distribute Duracell to electing shareholders who would surrender Procter & Gamble shares of equivalent value.

B. Instead, it agreed to a transaction with one of its largest shareholders, Berkshire Hathaway, whereby Berkshire would surrender a stake in Procter & Gamble in exchange for Duracell and cash.
II. TRANSACTION

A. Procter & Gamble forms Splitco and contributes to it assets totaling $4.8Bn, including the Duracell business and $1.7Bn of cash.

B. Berkshire Hathaway exchanges Procter & Gamble shares valued at $4.3Bn for all of the shares of Splitco. (Berkshire’s basis in its Procter & Gamble shares is roughly $336M.)
II. TRANSACTION

C. Structure after Split-Off
III. DISCUSSION OF TAX ISSUES

A. ATB: acquired by Splitco in entirely tax-free transaction

B. Non pro rata distribution: §355(a)(2) permits distribution to be non pro rata, and also allows for a requirement that a shareholder receiving Splitco shares must surrender Distributing shares.

C. Disqualified investment corporations: §355(g): distribution is taxable if Splitco assets are more than 2/3 “investment assets,” including cash and stock or securities in a corporation (except for corporations that are at least 20% controlled).

- By this rule, Splitco may hold up to 2/3 cash so long as the other 1/3 of its assets are not considered “investment assets.”
III. DISCUSSION OF TAX ISSUES

D. Device?

E. Benefits of Transaction

- Berkshire: Allows it to swap its appreciated stake (2%, worth $4.7Bn) in Procter & Gamble tax-free for 100% of a consumer products company that can be added to the holding company’s portfolio, plus $1.8Bn in cash.

- Procter & Gamble: Allows it to avoid valuation and other issues associated with a sale (to shareholders or otherwise) of Duracell, including potential shareholder lawsuits. Also allows it to maximize the number of Procter & Gamble shares repurchased in the transaction by combining cash with the Duracell assets.