

Michigan Law School
Tax Seminar Problem

By

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1. Just the Facts. American Magic Corp. ("Magicco") is a holding company, a majority of the common stock of which is owned by Mr. Wizard, an American citizen who is 83 years old, and the balance of the common stock of which is publicly traded, listed on the New York Stock Exchange ("NYSE"), and owned largely by institutional investors. It has no other stock outstanding. The sole asset of Magicco is 82% of the common stock of MagicSubOne Corp. ("MS-1"), the balance of the common stock of which is publicly traded, listed on the NYSE, and owned largely by institutional investors. MS-1 owns and operates three facilities engaged in the manufacture of magic wands, under licenses granted to MS-1 by the US DarkArts Agency ("USDA"), which carefully regulates all businesses relating to magic in the United States. Each wand-manufacturing facility is required to have a separate license. MS-1 also owns 55% of the outstanding common stock of MagicSubTwo Corp. ("MS-2"). The balance of the stock of MS-2 is, you guessed it, publicly traded, listed on the NYSE, and owned largely by institutional investors. MS-2 owns and operates five wand-making facilities, also under licenses granted to MS-2 by the USDA.

As a result of the USDA's recent relaxation of limitations on the ownership of multiple wand-making facilities in the same market, as well as the public's renewed fascination with magic and the occult, valuations of such facilities have increased significantly. Magicco and Mr. Wizard have been advised by their investment bankers that an appropriate value for the facilities, assuming they are sold as a group to a buyer able to take advantage of the USDA's new rules, is in the vicinity of \$6 billion. The bankers' valuation reports indicated that, in light of the ancient, well-understood and unpatentable technology involved in the manufacture of magic wands, approximately 95% of the value of each facility owned by MS-1 and MS-2 is allocable to the USDA-granted license to operate the business, and with goodwill and going concern value which is inseparable from the license itself. The licenses are transferable, but only to USDA approved licensees (though momentary ownership as part of an overall transaction designed to comply ultimately with USDA requirements should be permissible).

Mr. Wizard and Magicco authorized their bankers to conduct an auction for all three companies as a group, and as a result have arrived at an agreement in principal with Deutsche Alkemy Korporation, AG ("DAK"), a corporation organized under the laws of foreign country Z, to have DAK acquire all three companies controlled by Mr. Wizard. DAK is a major multi-national conglomerate, at least three times larger (in terms of its fair market value) than Magicco and its subsidiaries, which is engaged in the business, among numerous others the origin and nature of which are best left undisclosed, of the manufacture and sale of magic wands, including a major presence in the U.S., where it is subject to regulation by the USDA. Voting control of DAK is owned by an individual

whose name may not be spoken (or written), and who is generally referred to as The Dark Lord (but whose real name is rumored to begin with the same letters as the enterprise he controls). The balance of the stock of DAK is widely held and traded, among other places, on the NYSE in the form of American Depositary Receipts ("ADRs"). The Dark Lord, whose origins are said to be in the mists of Ruthenia, long ago became a naturalized citizen of the United States, drawn to this country by his unnatural fascination with its revenue laws. He may be assumed to be both very old and, unlike Mr. Wizard, immortal.

DAK operates in the U.S. through its wholly-owned subsidiary, DAK US Holdings, Inc. ("DUH"), a Delaware corporation the sole asset of which is 80% of the stock of United Magic, Inc. ("UM"), a corporation also organized under the laws of Delaware (the balance of the stock being publicly traded on the NYSE). UM conducts many businesses, all of which are related in one way or another to the magic arts, including businesses that derive their success from DAK's worldwide reputation for manufacturing first-rate magic wands. However, because the USDA, and the federal statute which it administers, permit licenses to be held only by U.S. corporations controlled by U.S. citizens, and require that the licensee have ultimate control over the wand-making business, UM's magic wand manufacturing activities are carried out by a separate company, United Magic Levitation Services, Inc. ("UMLS"), a corporation organized under the laws of an obscure state in the American Midwest, all the common stock of which is owned by UM, but in which the Dark Lord personally owns a class of preferred stock which, though it has minimal value, carries all the voting power. Thus, in the DUH organization, UMLS is the USDA's only approved licensee for the manufacture of magic wands (it currently holds seven USDA-granted licenses to manufacture magic wands at locations throughout the United States), and is likely to remain so.

As stated above, DAK and Magicco have an agreement in principle for the acquisition of the Magicco group by DAK for \$6 billion, to be paid to Mr. Wizard, and the public shareholders of Magicco, MS-1 and MS-2. Mr. Wizard, being both old and mortal, wants tax-free reorganization treatment (or its equivalent) for as much of his stock as possible. The Dark Lord, on the other hand, wants neither to unduly dilute his ownership and voting control of DAK nor to deconsolidate UM from DUH. Thus, he is willing to pay not more than 60% of the total purchase price in stock, and insists that it must be nonvoting common stock of DAK, not stock of UM. The balance will be in cash. Mr. Wizard has also insisted, in light of advice given him by his corporate counsel, that all his shareholders, including the public shareholders of MS-1 and MS-2, be given, if not the same mix of consideration, at least the same opportunity to elect the consideration they receive, as he has. He is confident, however, that given the choice, the institutional investors will prefer cash to DAK stock of comparable value, regardless of the tax consequences.

2. The Assignment. Mr. Wizard has come to you, a world renowned tax lawyer, and asked for your advice as to how the transaction should be structured to satisfy all the requirements of himself and his controlled corporations (in particular, tax-free reorganization treatment with maximum deferral for him), The Dark Lord (use of DAK

stock for not more than 60% of the acquisition consideration), and the USDA (UMLS as the licensee of the wand-making business). The only help he is able to give you (other than a fat retainer) is to tell you that after their last meeting, The Dark Lord shuffled out of the room shaking his head and mumbling something that sounded like "continuity of this, continuity of that....."

