Session 21 - More tax-free reorganizations

- §368(a)(1)(B)
  - acquisition of stock in exchange solely for voting stock of acquiring corporation or its parent
- §368(a)(1)(C)
  - acquisition of substantially all of the properties of another corporation in exchange solely for voting stock of acquiring corporation or its parent

Type B: Stock-for-Stock Exchange

- Acquiring corporation exchanges its stock for stock of Target, Target becomes a subsidiary of the acquiring corporation
  - Keeps Target intact and avoids having to transfer title to Target's assets
- Disadvantage is no consideration other than stock is allowed or the transaction will not qualify as a reorganization
  - In tax jargon, "no boot in a B"
- Easy to inadvertently include some unintended compensation (such as the acquiring corporation paying some liability of Target) that causes the deal to become taxable.

Normal “B” Reorganization

- Example:
  - T has assets with a basis of $100 (inside basis) and FMV of $200.
  - A pays T’s shareholders with A shares.
  - T’s shareholders have a basis (outside basis) in T stock = $80.

Normal “B” Reorganization - Results

- T Corp
  - No gain or loss on the exchange
  - T’s basis in its assets remain the same ($100)
  - Tax attributes generally not affected (ability to use in the future may be limited)
- A Corp
  - Basis in T stock = Basis which T’s old shareholders had in stock ($80)
- T’s Shareholders
  - No gain or loss on the exchange of stock
  - Basis in A stock = Basis in old T stock ($80)

Subsidiary "B" Reorganization

- Only a first-tier subsidiary may act as the acquiring corporation
- The subsidiary can subsequently "drop-down" the acquired target to lower level "controlled corporations" with no tax consequences
  - Note: drop-downs to partnerships (even if corporation is the majority owner) is not allowed
- A's basis in S is increased by the carryover basis of T shares in S's hands

"Solely for Voting Stock" Rule

- Exceptions:
  - Redemptions by T -- T may redeem up to 50% of its own stock (e.g., for cash) prior to the "B" without destroying reorganization
    - "50%" limitation is needed to preserve "continuity of shareholder interests" requirement
    - T must use its own resources -- debt which is later repaid by a cash infusion from A will destroy "B"
  - Payments to dissenters -- In cases of forced "B", state laws may provide for dissenters rights.
    - T payoffs will not destroy "B". (treated like redemptions)

“Solely for Voting Stock” Rule, continued

- Exceptions:
  - Cash for fractional shares -- If A pays T shareholders cash instead of issuing fractional shares, it will not violate the “solely for stock” rules
  - A’s acquisition of T debentures -- If A acquires T’s debentures (bonds, etc.) this exchange will normally be viewed as a distinct transaction from the “B” -- A can use any form for payment without nullifying “B”

Step-Transaction Doctrine

- What if A had previously acquired T stock for cash or property -- can it acquire the remaining T stock in a "B" reorganization?
  - Key question: Is the second step a separate transaction from the first step?
    - Based on A's intent (subjective) and partly on the passage of time
    - Periods of 12 months or less are generally not sufficient

Type C: Stock-for-Assets

- Acquiring corporation exchanges its stock for "substantially all" of the assets of Target
  - Target is liquidated
  - Stock of acquiring corporation is distributed to Target's shareholders
- Up to 20% boot allowed as consideration

Normal "C" Reorganization

- "substantially all" of T's assets must be acquired solely in exchange for A voting stock
- An assumption of T's liabilities will generally be disregarded
- T's liquidation as part of the plan of reorganization is a requirement

Normal “C” Reorganization

- Example:
  - T has assets with a basis of $100 (inside basis) and FMV of $200.
  - A pays T with A shares.
  - T’s shareholders have a basis (outside basis) in T stock = $80.

Normal "C" Reorganization - Results

- T Corp
  - No gain or loss on the exchange
- A Corp
  - Carryover basis in T's assets ($100)
  - Acquires T's tax attributes (ability to use in the future may be limited)
- T's Shareholders
  - No gain or loss on the exchange of stock
  - Basis in A stock = Basis in old T stock ($80)

Subsidiary "C" Reorganization

- Only a first-tier subsidiary may act as the acquiring corporation
- The subsidiary can subsequently "drop-down" the acquired target to lower level "controlled corporations" with no tax consequences
  - Note: drop-downs to partnerships (even if corporation is the majority owner) is not allowed
- A's basis in S is increased by the carryover basis of T's assets in S's hands

The “Substantially All” Requirement

- IRS’s position is that “substantially all” of T’s assets means:
  - 90% of the FMV of T’s net assets (gross assets less liabilities) and
  - 70% of the FMV of T’s gross assets
- Redemptions or spin-offs by T shortly before A acquires T’s assets in a “C” reorganization are taken into account in determining whether A acquires substantially all of T’s assets

The Liquidation Requirement

- The general rule states that T must liquidate as part of a plan of reorganization qualifying as a "C"
- Very limited exceptions exist which allow the company to distribute its assets but to retain its corporate charter and the minimum (state) required capital
  - T has a license to operate (bank or insurance company) which was not "sold" in the reorganization

"Boot Permitted"

- Limited use of "boot" is permitted in a "C" reorganization

  Boot *plus*

  T's liabilities transferred *plus*

  the FMV of any of T's assets not transferred to A

  must be less than or equal to

  20% of the FMV of T's total assets

Treatment of goodwill and other intangibles

- Since reorganizations are not "purchases" for tax purposes no goodwill (or other purchased intangibles) is recorded
  - No assets are stepped up in basis, therefore, there are no future tax deductions associated with the purchase price
- Financial accounting treatment
  - Because tax basis is lower than book basis for acquired assets, deferred tax liabilities are also recorded for the tax effect of the book-tax difference
  - These DTLs reflect the fact that future depreciation will be higher for book than tax