Contents

I - WHY HAVE A CORPORATE TAX?

DOUBLE TAX REGIME

- corporate profits are first taxed at corporate level, also taxed when distributed to shareholder as dividends

Corporate tax

1. corporation taxed at 21% §11
2. Individual top rate @ 37%

- §1(h)(11)(A) Net capital Gain means NCG (determined without QDI) + QDI
- §(h)(11)(B): Qualifying Dividend Income means dividends received from domestic and qualified foreign corporation (taxed at CG rate of 20%)
- §1411 Obamacare Tax: 3.8% on lessor of net investment income or excess of modified Adjusted Gross Income over threshold amount
- If corporate SH, §243 DRD may apply

§199A Qualified Business Income

- Non-corporate TP can deduct up to 20% of QBI (plus qualified REIT dividend and qualified PTP income) from domestic business (sole proprietorship, partnership, S corp, trust/estate)

JUSTIFICATIONS FOR DOUBLE TAXATION

Avi-Yonah: Curbing Corporate Power

- Three views of corporation:
  - Aggregate: an aggregation of the shareholders
    - Empowers the shareholders
  - Artificial: creature of state law
    - Empowers gov't/regulators
    - Difficult to impose p-ship regime on large organizations
- Real: an actual entity w/ existence separate from shareholders
  - Empowers the board
- Real entity tends to win out
  - Avi-Yonah is concerned w/ corporate power
    - Ways corporations have power
      - Political power
      - Economic power (corporate wealth)
- Corporate income tax: purpose is to curb corporate power
  - Two functions:

        - Regulatory function:
            - Tax incentives and penalties
        - Limiting function:
            - Slows rate at which they grow

Bank: Capital Lock-In Theory

- Reason for corporate tax: capital lock-in
    - Capital lock-in:
        - One of the advantages of corporation is you can be guaranteed that capital will stay in the entity
            - Creditors of shareholders cannot get at corporation's assets
            - Shareholders cannot force liquidation (unlike partnerships)
- Since shareholders cannot unilaterally withdraw their share of profits from corporation, Congress cannot wait for profits to be distributed before taxing them or else the corporation would become a vehicle for indefinite deferral of taxation
    - Capital lock in so valuable: we need it BUT we also need a way to tax corporate profits
- Explains difference in corporate and partnership taxation

PROBLEMS WITH DOUBLE TAXATION

Incidence Of The Corporate Tax

Traditional view: falls on capital (corporate investors) and labor (modern more emphasis on SHs)

- **Auerbach**: corporate tax burdens investors in both corporate and non-corporate entities
    - There are different types of SHs (so different burden)
        - retirement fund → defined benefit fund [formula using length of service and salary] v. contribution plan [based on contribution to fund by employee]
        - Difficult to say who bears tax burden – employer or employee?
    - **Harberger model**: burden is borne by capital, but NOT JUST SHs, also investors in non-corporate enterprises
        - After-tax profits of corporates are lower due to corporate tax, so money shifts to non-corporate sector
        - As money shifts to non-corporate sector, return on investment in that sector decreases, so eventually investment in that sector will decrease and shift back to corporate sector (finally, evening out)
        - Thus, returns on investment in both sectors is reduced
    - Corporate tax aides in progressivity → SHs are disproportionately in higher-tax brackets
- Labor: mobility of capital → jobs move abroad to lower tax JDXs
- Consumers as well?

- Double tax good? Depends on who bears the burden: If SH, problem is SH will just sell
  - So reduced wages for labor, higher cost for consumers, or pay less for supplies
  - Double taxation makes sense if SHs bear it: but not if labor and consumers bear it
  - Often unclear who bears the burden

Problems w/double taxation: distortive effects and impact on efficiency

- Corporations may tried to avoid effects
  - Choice of entity considerations, recharacterization of distributions (compensation in closely-held corps), stock buy backs, write off by purchasing assets and deducting costs
  - Creation of tax-shelters (see BLACK & DECKER where TP formed sub putting in cash (501k) and contingent liabilities w/ nonrecognition treatment and then sold stock for 1k w/ a basis of 500k to generate a big loss
  - Inversions
  - Retaining earnings rather than distributing
- Creates preference for raising money w/ debt over equity b/c of interest deductions
  - Risky if overleveraged
  - Also creates issues for recipient of interest (under 1441, 3.8% tax on lesser of net investment (interest, annuities, royalties, rents) or excess of AGI over threshold amount (Obamacare tax)
- BUT b/c of capital markets, C Corps continue to exist (easier to raise capital in corporate form – more history/familiarity)
  - Also difficulties w/ p-ship arrangements and relatively cheap compared to p-ship formation
  - Offers limited liability (although now have LLPs, LLCs)
  - QD and DRD reduce double tax

I - CHOICE OF FORM AND ENTITY CLASSIFICATION

<u>CHOICE OF FORM</u>

<u>*Nontax factors*</u>

Entity	Liability	Centralized Management	Exit/dissolution
Sole proprietor	personal	No	
General Partnership	personal		Dissolved easily through withdrawal of any partner
Limited partnership	Limited only to LP	LP cannot actively engage in management of biz affairs	
LLP	Limited (not directly responsible/personally involved)		
LLC	Limited	Flexible (can be member or manager)	Somewhere in the middle
S Corporation	Limited	Yes	
C Corporation	Limited	Yes (not directly, can only elect BOD)	Indefinite life

Additionally, corporation provide easier ***access to capital market***, benefit available to employees (deferred comp, options), but high ***cost of formation*** (requires Articles and Bylaws and registration, whereas partnership need not register with state) p23

<u>*Tax Factor*</u>

- **Corporation**:
  - double taxation
  - shareholder cannot deduct corporate loss on individual tax return
- **Pass-through entities**: (partnership, **S corp**, LLC, LLP)
  - single federal income tax (no entity-level tax)
  - Can deduct loss on personal return (though restricted)

<u>*S corporation*</u>

- When elected under Subchapter S, business profit flow to shareholders and taxed on individual-level
  - income/loss computed at entity level (but required to separate state items affect liability of s/h)
  - s/h report ***pro rata*** shares of income/loss on individual return, even without distribution
- Election under only available to:

- Domestic corporation
- Shareholders:
  - No more than 100
    - S corps can be partners – can bypass the 100 shareholders rule by forming multiple S corps in a partnership
    - but family members, including six generations of lineal descendants and spouses of common ancestors, are counted as 1 shareholder
  - cannot be nonresident alien
  - must be individual, tax-exempt corporations or certain trust (NO corp/partnership can be S/H)
- Can only issue 1 class of stock
  - §1361(c)(4) some shareholders may have greater voting rights
  - Reg1.1361-1(l)(1): shares are considered same class as long as they have identical rights to distribution and liquidation proceeds

- §1317(a): Subchapter C applies to S corporation and it shareholder, except otherwise provided
- All s/h is required for the initial Subchapter S election
- Revocation: majority vote or failure to meet the small business corporation definition

<u>CLASSIFICATION OF BUSINESS ENTITY</u>

1. **Is it a separate entity for tax purpose?**
   - Co-ownership of property/sharing of expense doesn't create a separate tax entity
2. **Is it a business entity?**
   - Separate tax entity NOT classified as trust or subject to special treatment (ex: real estate mortgage investment conduit) is a business entity
3. **Is it a *per se* corporation?**
   - Reg§301.7701-2: incorporated business, joint-stock companies, publically traded partnership (partnership interest traded on established securities market or readily tradable on secondary market), certain foreign entities
     - Reg §301.7701-3(a) If per se corporation -> no election can be made

<u>Check-the-Box</u>

- Reg§301.7701-3(a) business entity NOT classified as corporation is an *eligible entity*
- Reg§301.7701-3(b)(1) **default rule**
  - One owner -> default is disregarded separate entity
  - More than one owner -> default is partnership
- Eligible entity can elect to change its classification (once every five years)
  - Note: election to be corporation is actually to be classified as an association (thus a corporation under Reg §301.7701-2(b)(2))

Commissioner v Bollinger: corporation properly incorporated under state law may be disregarded for federal income tax purposes

- Here corporation acting as agent of partnership, who are the true owner of property. Court disregarded corporation, upheld reporting of income/loss on partnership tax returns and income flow to individual partners

II - NONLIQUIDATING DISTRIBUTION

- **§316(a)**: dividend means any distribution of property made by a corporation to its shareholder
  - **(1)** out of its accumulated E&P, or
  - **(2)** out of is current E&P
- **§317(a):** *property* means money, security and other property, <u>except</u> stock in the distributing corporation

<u>TAX CONSEQUENCE TO SHAREHOLDER</u>

- **§301(a)** distributions of *property* by a corporation to shareholder with respect to its stock is provided in §301(c)
- **§301(b)**: (**in-kind distribution**)
  - §301(b)(1) <u>amount of distribution</u> = money received + FMV of property received
    - Then -> §301(c)
  - §301(b)(2) distribution determined under 301(b)(1) *reduced* by
    - (A) amount of *liability* of corporation assumed by shareholder in connection with the distribution, and
    - (B) amount of liability to which the property received by the shareholder is subject, immediately before an immediately after, the distribution
  - §301(b)(3) FMV determined as of the date of the distribution
- **<u>§301(c)</u>**: distribution where §301(a) applies:
  - (1) portion constitutes ***dividend*** included in *gross income*
    - If current EP are sufficient to cover all distributions -> all distributions are dividends
    - If current EP are NOT sufficient -> current EP are apportioned to each distribution (see below formula) + eat into accumulated EP
    - Tax on dividend (corp s/h) = dividend * 21%*0, 35 or 50 % inclusion
    - Tax on dividend (individual s/h) = dividend * 23.8 (assuming threshold met for Obamacare tax)
  - (2) Portion not dividend ***reduce the Adjusted Basis*** of the stock
    - New AB = old AB – reduction in basis
  - (3) portion not dividend, to the extent it exceeds the basis of the stock, is treated as ***gain*** from sale or exchange of property
    - Generally, S/H holds stock as capital asset -> CG @ 20%
- **§301(d)**: <u>Basis</u> for property received in distribution in 301(a) = FMV

<u>Dividend amount?</u>

- **§ 316**: amount of dividend = distribution out of current or accumulated E&P
- **§1.316-2(a):** first use current E&P, then accumulated E&P

- **§1.316-2(b)**: if current E&P insufficient to cover total distribution -> portion of each distribution which the total of the E&P of the year bears to the total distribution during the year shall be regarded as out of the E&P of the year:
  - $\frac{\boldsymbol{distribution\ to\ each\ shareholder}}{\boldsymbol{Total\ distribution}} \times \boldsymbol{current\ E\&P}$
- **Rev. Rul. 69-440:**
  - If distribution on 1 class of share and insufficient E&P to cover dividend => amount of each distribution determined on *pro rata basis* (rather than looking to the actual E&P at the time of each distribution)
  - if distribution on both common and preferred stock, apply E&P to distribution on preferred stock first, then remaining E&P on common (not pro-rated)

1. positive CE&P, positive AE&P -> use current E&P first, then accumulated E&P
2. positive CE&P, deficient AE&P -> use current E&P first, deficient AE&P not considered
   - **Rev. Rul. 74-164** situation 2: if accumulated E&P is in deficit -> consider only current E&P
3. deficient CE&P, positive AE&P -> current E&P eats into Accumulated E&P
   - **Rev. Rul. 74-164** situation 3: <u>prorate</u> current E&P deficient and net against accumulated E&P at time of distribution

4. deficient CE&P, deficient CE&P -> no dividend to distribute -> reduction in basis
   - note if s/h doesn't want dividend treatment, can wait until when both E&P are negative

<u>**Appreciated property**</u>

§311(b): distributing <u>**appreciated property**</u> (FMV>AB)

- treated as if there had been a pretend sale
- amount of distribution received = FMV

<u>***individual or corporation s/h?***</u>

<u>**Individual shareholder**</u>

- §1(h)(11)(A) NCG includes QDI subject to CG rate @20%
  - §1(h)(11)(B): dividend from domestic or qualified foreign corp
  - §1(h)(11)(B)(iii) **holding period**: shareholder must hold the stock for at least 60 days during a 121-day period beginning 60 days before "ex-dividend" date
    - purpose: prevents short-term trader from buying stock few days before ex-dividend date, getting dividend tax rate, then sell stock to realize short-term CL to deduct against short-term CG
- §1411 Obamacare tax @3.8%
- If not QDI -> ordinary income

<u>**Corporate shareholder**</u>

- §243 Dividend Received Deduction (DRD)
  - >= 80% (i.e. distributing corporation and s/h are member of an affiliated group) -> 100% deduction of dividend received/0% inclusion

        - §1504 affiliated group: own 80% voting power and 80% of total value of distributing corp
    - 20%- 79.999% (corporate s/h owning 20% or more of stock of distributing corp) - > 65% deduction of dividend received/35% inclusion
        - Effective rate on dividend distribution: 21% corp tax rate * 35% = 7.35%
    - <20% (corporate s/h own less than 20% of distributing corp) -> 50% inclusion/deduction
        - Effective rate: 21% corp tax rate * 50% = 10.5%
- Purpose: avoid multiple level of tax when dividend move up corporate structure

<u>Timing of inclusion:</u>

- **§1.301-1(b)**: s/h include distribution in gross income when property is unqualifiedly made subject to demand of s/h -> *on date/year received*
    - Where distribution is mailed year-end, but not received until next year -> distribution included in s/h gross income in the next year
        - YR1: E&P calculation to determine dividend treatment
        - YR2: determine TP inclusion of income
- But FMV of property/dividend still determined on date of distribution §301(b)(3)

<u>TAX CONSEQUENCE TO CORPORATION</u>

- §316(a) dividend means distribution out of accumulated and current E&P
- **§1.316-1** E&P *computed as of the close of the taxable year*, without diminution by reason of any distribution made during the year

Timing

- **Rev. Rul**. **62-131**: date of payment (rather than date of declaration) constitutes date of distribution
    - If distribution out of current E&P -> determined by reference to year of payment
        - Current EP calculated at year-end, and pro-rated to distribution throughout the year
    - If distribution out of accumulated E&P -> on date of payment

<u>§312 Earnings & Profits adjustments</u>

- Title to §312(n): adjustments to E&P to *more accurately reflect economic gain or loss*

1. Start with <u>taxable income</u> (gross income – deduction)
    - Doesn't include unrecognized amounts, interest/cost on state/local bonds, but includes deductions for expenses
2. Calculate <u>tax owed</u> = Taxable income * 21% corporate tax (only corp rate) → step 6

Adjustments

3. <u>Upward</u> adjustment:
    a. Items excluded from taxable income (but in E&P) -> add back
        - exempt income: §1.312-(6):
            - state/local bond interest received (those excluded from GI by §103)

- Life insurance proceeds
- Federal tax refund
- §312(n)(5) Gain deferred through installment method under §453. (add back gain in out years `xdeferred through installment method)
- Excess of accelerated method over straight-line depreciation §312(k)(1), Reg §1.312-15(a)

b. Deduction permitted for tax purpose but not reduction for E&P -> add back
   - Dividend Received Deduction (excluded from GI under §243)

4. Downward adjustment:
   a. Items included in taxable income (but not in E&P) -> subtract
      - §312(f), 1.312-7(b)(1): CL in excessive of CG
   b. Deduction not allowed for tax purpose but reduce E&P -> subtract
      - Exempt interest: §265(a)(2)
        - Expense incurred on loan to buy state/local bonds
5. Tax owed (not paid, as corp is accrual TP so reduce EP in the year liability accrues)-> subtract
6. Dividend paid -> subtract

Not included in E&P

- Realized but unrecognized gain (only brought into E&P until recognized, ex §1031 like-kind exchange/§351)
  - Reg §1.312-6(b): gain/loss within purview of §1002 are brought into E&P at the time and to the extent such gain/loss are recognized
- Contribution of capital

In-kind distributions §311

- §311(a): general rule: no gain/loss recognized to the distributing corporation upon distribution of property or stock
  - Cannot recognize loss upon distribution of loss property (but if sold lost property -> lose recognized, can then distribute cash)
  - No gain/loss recognition if distribute cash
- §311(b): distributing **appreciated property** (FMV>AB)
  - Exception to 311(a)
  - Distributing corporation ***recognize gain*** upon distribution of appreciated property (as if the property sold to shareholder at FMV – pretend sale)
  - Gain = FMV- AB Tax = (FMV – AB)*21% After Tax Gain = Gain - Tax
- ***General Utilities*** *v Helvering*
  - GU distributed highly appreciated stock in E corp to S/Hs who sold the stocks.
  - Issue: whether to report a taxable gain on sale of E Corp shares it distributed to S/Hs (difference between FMV and basis). GU did report gain on the sale of shares in E Corp itself retained.

- Held: no taxable gain on distribution of appreciated property to S/H, not a realization event.
- Problem: corporation disposed stock/transferred value to s/h without paying taxes on the gain, escaped double taxation on corporate income. If the corp sold the stock and distributed cash, cor would've paid corporate-level tax
- **Legislative amendment** (repeal *General*): 311(b) gain recognition on distribution of appreciated property
    - Note if both loss and gain are recognized, corp motivated to leave gains unrealized by holding appreciated assets but realize loss by distributing loss assets (still keep loss asset in corp family)
    - P 311(b) by having a deemed sale, ensures double taxation on distribution of appreciating property

Effect on Final E&P (Accumulated E&P for next year)

- **§312(a)**: upon distribution of property, distributing corporation reduced E&P ("to the extent thereof") by sum of:
    - (1) amount of money
    - (2) ***principal amount*** of corporate ***obligations*** (i.e. face amount of debt if there's debt) , and
    - (3) ***AB*** of *other* distributed property (for even and loss property)

    Note: Cannot create deficiency in E&P through distribution ("*to the extent thereof*"). Negative E&P can only result from operation

    No recognition of loss when sell loss property → loss property has no interim gain.

    Final EP = current – basis
- **§312(b)**: **distribution of appreciated property**
    - (1) E&P increased by amount of excess of FMV over AB of property distributed
        - Increase E&P = gain = FMV-AB   Decrease E&P = tax =(FMV-AB)*21%
        - Current E&P + Gain – Tax = Interim E&P
    - (2) E&P decreased by ***FMV*** + amount of money + principal obligations

    Interim EP = current EP + gain – tax on the gain

    Final EP = interim EP – FMV (reduction in EP from the distribution itself)

DISTRIBUTION INVOLVING LIABILITIES

Crane & *Tuft*: acquisition of indebtedness is *included in* both amount realized by distributing corporation and basis of property received by shareholder

1. Calculate §311(b) taxable gain on appreciated property = FMV – AB   tax on gain = gain *21%
        - But NO gain if FMV < AB
    - if liability > FMV => -§311(b) FMV of property be treated no less than amount of liability
        - taxable gain = liability – AB
2. Interim E&P = current E&P + gain – tax

- pro-rate for each s/h (if EP not enough to cover all dividend)

3. S/H consequence
    - **§301(b)(2)**: (**in-kind distribution**) If s/h assumes liability (recourse debt) or take property subject to liability (non-recourse), in connection with an in-kind distribution, amount distribution reduced (but not below zero) by amount of liability
        - Amount of distribution = FMV – amount debt
        - S/H AB = FMV of property received (*Crane*)
    - if liability > FMV
        - Amount of distribution = 0 (cannot reduce below zero)
        - S/H basis = limited to FMV
    - 301(c) calculation and tax consequences -> dividend and tax, AB reduction and new AB, gain

Distributing Corporation Consequence

4. Accumulated E&P = interim E&P – FMV of property distributed + debt (relief of debt is economic benefit to corp)
    - §312(c): "proper adjustment" be made to E&P

<u>CONSTRUCTIVE DIVIDEND</u>

- Salary payment are taxable without regard to E&P, but are deductible as expense
- Constructive dividend is taxable as dividend under 301 only to the extent of E&P, but not deductible as expense
- <u>§1.301-1(j):</u>
    - if property is transferred to S/H for an <u>amount less than FMV</u> -> S/H receive a distribution (to the extent of bargain)
        - Amount of distribution = FMV- amount paid/realized
- <u>§1.61-6(a):</u>
    - Gain = amount realized – basis of property sold
    - When a part of a larger property is sold, the cost of the entire property is equitably apportioned among its parts
        - sell of each part is treated as separate transaction
        - gain/loss computed separately on each part
        - ex: FMV = 100, AB = 60, AR = 75. *Distribution* = FMV-AR = 25 or 25% of 100
            - portion that's sale: AR – AB = 75-60*0.75 = gain = 30
            - portion that's *distribution*: 25-60*0.25 = gain = 10
            - AB for taxpayer = FMV = 100
- <u>Rev. Rul. 58-1</u> Where S/H rents apartment from corporation
    - Distribution = FMV of apartment – rent paid
    - Distribution constitutes dividend to the extent of E&P, which constitutes gross income

TP may attempt to minimize tax through 3 types of structure:

1. make inflow not giving rise to corporate income
    - Assignment of income principal: gross income is taxed to person who earns it or owner of property that generated income, regardless of where the income end up. Taxpayer cannot avid tax by assigning the right to income to another.
    - Ex: instead of paying C corp, G pays $6000 rental to 2 s/h of C Corp → constructive dividend, s/h each get $3000 (tax = 3000*23.8%), C corp pay tax $6000*21%
        - *Contra*: only D&J report income of $6000, corp reports none
2. make outflow deductible
    - Ex: C corp distribute machine to S/H, AB = 2,000, FMV = 10,000 → characterized as distribution
    - corp after tax-gain = 8,000*(1-21%)   for s/h, distribution to the extent of E&P and taxed at 20/23.8%
        - *Contra*: distribution characterized as compensation → 8,000 gain offset by §162(a) 10,000 deduction; TP pay 37% on 10,000 as ordinary income
3. make outflow not resulting in S/H income
    - ex: corp advances $ to s/h and employee: characterize as loan v dividend/salary -> tax consequence different
    - ***Weigel***: loan of wholly owned subsidiary to corporate parent SH was constructive dividend, factors include:
        - TP's degree of control over the corporation
        - Existence of restrictions on the amount of disbursements (i.e. ceiling)
        - Corporate earnings and dividends history
        - Use of customary loan documentation, such as promissory notes, security agreements or mortgages
        - Ability of the s/h to repay
        - Treatment of disbursements on the corporate records and financial statements
        - Creation of legal obligations, such as payment of interest, repayment schedules, and maturity dates
        - Corporation's attempts to enforce repayment
        - s/h's intention or attempts to repay the loan
    - ***Alterman Food***: loan of wholly-owned subsidiary to corporate parent was constructive dividend

§243 DIVIDEND RECEIVED DEDUCTION (DRD)

Only applies to corporate S/H

First consider §243, then §236(c), then §1059

§243 DRD

- >= 80% (i.e. distributing corporation and s/h are member of an affiliated group) -> 100% deduction of dividend received/0% inclusion
    - §1504 affiliated group: own 80% voting power and 80% of total value of distributing corp
- 20%- 79.999% (corporate s/h owning 20% or more of stock of distributing corp) - > 65% deduction of dividend received/35% inclusion

        - Effective rate on dividend distribution: 21% corp tax rate * 35% = 7.35%
    - <20% (corporate s/h own less than 20% of distributing corp) -> 50% inclusion/deduction
        - Effective rate: 21% corp tax rate * 50% = 10.5%
- $\boxed{\text{P}}$: avoid multiple level of tax when dividend move up corporate structure. Without deduction, corporate profits would be taxed first to the corporation that earned them, gain to corporate s/h receiving distribution, yet again to s/h upon receipt of distribution from 2nd corporation.

<u>Conditions of DRD</u>

1. <u>§236(c) **holding period** in the **91-day window**</u> → Stock held for 46 days or more during the 91-day period beginning 45 days before ex-dividend date (and ends 45 days after ex-dividend date)
    - <u>246(c)(3)</u>: do NOT count day of acquisition, DO count day of disposition
    - $\boxed{\text{P}}$: prevent corporations from purchasing stocks immediately and selling immediately after a distribution simply to take advantage of §243 deduction

2. <u>§1059(a): if **extraordinary dividend** </u>issued on common stock held for **≤ 2 YEARS** *before* dividend announcement date, then:
    - <u>1059(a)(1) Basis reduction:</u> corporate s/h must reduce basis in the stock by nontaxed portion of dividend (i.e. DRD amount)

      New AB = current AB – DRD amount (but cannot reduce basis to negative)
    - 1059(a)(2): if nontaxed portion of dividend exceeds basis, such excess is treated as gain from the sale/exchange

    - §1059(c): <u>Extraordinary dividend</u>: *amount* of dividend equals or exceeds **10%** of taxpayer's *AB* in the stock

      if dividend amount/AB ≥ 10% → extraordinary dividend
    - §1059(d)(5): <u>dividend announcement date</u> means the date which the corporation declares, announces or agrees to the amount or payment of such dividend, whichever is the earliest

    - $\boxed{\text{P}}$: prevent dividend stripping by s/h that didn't hold stock for long enough (corporation to take advantage of §243 deduction by buying shares of another corporation immediately before distribution and sell shares shortly after, in order to receive DRD and capital loss) -> effectively denies DRD such that TPs do not profit from dividend stripping

Ex-dividend Date

- Ex-dividend date: first day on which stock can be traded without buyer's dividend entitlement (seller gets dividend)
    - if bought stock before ex-dividend date, buyer entitled to dividend
    - if bought stock on/after ex-dividend date, buyer NOT entitled to dividend

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- Corporate s/h receives dividends on stocks purchased before ex-dividend date but after record date (i.e. date on which seller becomes entitled to dividend) -> buyer is not entitled to DRD, because dividend is taxable to the seller after record-date -> see Reg 1.61-9(c) (seller cannot assign/shift dividend income to purchaser after record date)
- What matter is *record date*

Bootstrap Acquisition

- the seller use its own funds to "bootstrap" the sale (substantial portion of funds for acquisition appear to come from the seller itself rather than from the buyer)
- by converting CG to dividend, take advantage of DRD to reduce corporate s/h potential gain from sale of stock
- Despite *Waterman*, TSN and Litton suggest that it's possible to structure a bootstrap acquisition through a pre-sale dividend distribution of assets by a target subsidiary, deductible by the selling parent under §243. TP need to ensure that:
  - there's some business reason for the distribution (ex. assets unwanted by the buyer).
  - the parent should avoid an immediate sale/exchange of assets received in the pre-sale distribution.
  - TP must take into account the bass reduction in its subsidiary stock, and potential taxable gain that can result if the distribution is treated as extraordinary dividend under §1059.

Waterman Steamship

- Fact: WS received $3.5MM cash offer for stocks in 2 subs. WS basis in sub was $700,000, the sale would result in 2.8MM CG for WS. Instead, deal was structured to have stock sold for $700,000 after its subsidiaries declared and paid dividends of $2.8MM in form of promissory note. The note was paid by the funds injected by purchaser in the sub. The result was designed to have 0 gain on sale of stock (700,000-700,000) and 100% DRD for 2.8MM dividend, zero tax if it worked.
- 5th Circuit: *entire $3.5MM was amount realized on sale, no dividend is respected (cannot claim DRD)*
  - TP had binding pre-dividend commitment to sell sub stock
  - the sale and dividend was one transfer the promissory note was "one transitory step in a total, pre-arranged plan to sell the stock"
  - Seller WS received 0.7MM+2.8MM = $3.5MM, all purchase price came from the buyer
  - Transaction occurred over a short period of time, no business purpose for structure of the transaction
  - No business purpose for the distribution

Litton Industries

- Fact: before any negotiation, Litton dividend up $30MM in form of promissory note to sub. Then, Litton entered into discussion and sold stock 6 months later. Buyer infused cash and paid off P/N.
- Court: form of transaction respected: both dividend and sale
  - Distinguish from *Waterman*, in this case, a 6-months gap between when dividend was declared and when stock was sold. There was no "buyer waiting in the wings" at the time dividend was declared -> sale of stock was not prearranged
  - Business purpose exists to structure the transaction: value of sub stock was mostly based on past earnings in public market and not based on sub's assets, so TP can increase its return on the investment in sub by receiving dividend and still get approximately the same value to sell the stock
  - No binding pre-dividend commitment to sell

TSN Liquidating Corporation

- Fact: TSN arranged for in-kind distribution $1.8MM of assets from target sub immediately prior to selling the sub stock to purchaser for $800,000. Immediately after the sale, the purchaser contributed substantial capital to target sub. TSN claimed §243 DRD.
- 5th circuit: dividend is respected
  - *Business purpose* that TSN distributed *assets unwanted* by the buyer to itself
  - No suggestion that TSN had tax avoidance motive

RR 74-493

- Seller paid cash dividend to sub immediately before sell of sub stock. But funds came from sub, not buyer -> divided respected (not part of amount realized)

III - REDEMPTION DISTRIBUTION

Redemption: corporation acquires stock from a s/h in exchange for property

§317(b): stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a SH in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock

- Property" = money, securities, indebtedness, and any other property, except stock in the distributing corporation (stock dividend) or rights to acquire such stock. §317(a); Reg. 1.317-2.

If treated as sale/exchange under §302(a): ➔ see below

- SH's Gain/loss = AR – AB of redeemed stock   Assume taxed as LTCG @ 20%
- Individual s/h wants sale/exchange treatment:
  - 1) Basis recovery
  - 2) offset CG on the redemption against CL from other transactions
  - 3) sale of stock is generally taxed at CG rate, but it's less attractive now since QRI is taxed @ 20%

If treated as distribution -> §301 applies ➔ see below

- Individual SH share get QDI, same rate as LTCG rate
- NO basis recovery
- BUT corporate s/h wants this, wants DRD

§302(A),(B)

General Rule

- If §302(b) applies (only needs to meet one of the tests (safe harbors) in §302(b)(1), (2), (3), or (4)) →redemption is treated as a sale/exchange, pursuant to §302(a); Reg. 1.302-1(a).
- If §302(b) does not apply → redemption is treated as a §301 distribution, pursuant to §302(d); Reg. 1.302-1(a).

Steps: Go through objective tests of §302(b)(2), (3) & (4) first. Then, if required, subjective test of §302(b)(1):

(1) Redemption Not Essentially Equivalent to a Dividend*. §302(b)(1); Reg. 1.302-2.*

- Meaningful reduction Test →if redemption resulted in a "***meaningful reduction***" of the SH's proportionate interest in the corporation -> sale/exchange treatment [*Davis*]
  - Fact that §302(b)(2), (3), or (4) isn't met is irrelevant. §302(b)(6); Reg. 1.302-2(a).

- *Davis*: TP redeemed non-voting preferred shares in closely held corp owned by TP and family members-> deemed to still own 100% of shares after redemption due to attribution rule -> dividend treatment (here, absence of tax avoidance purpose or existence of business purpose - doesn't matter)

Application

- *Davis*: Redemption of a sole SH, actual or constructive, will never qualify for sale treatment (always equivalent to a dividend)

- *Himmel*: ownership of stock involve 3 rights (1) to vote and exercise control, (2) participate in current and accumulated E&P and (3) to share in net assets on liquidation
    - Dividend is pro-rata distribution of E&P with no change in basic SH relationship

Redemption from majority s/h (meaningful reduction only if losing majority)

- *Rev. Rul. 78-401*: Reduction from 90% to 60% is NOT meaningful reduction since SH still has control.
    - Losing supermajority (while maintain managerial control) is not meaningful reduction, if no action requiring a 2/3 vote was contemplated at the time of reduction
    - *Wright* (Reduction from 85% to 61.7% where 2/3 vote is required for certain corporate actions held to be meaningful reduction.) – but IRS focused on losing of majority control
- *Rev. Rul. 75-502*: Reduction from 57% to **50%** (remaining 50% held by 1 SH) is meaningful reduction since majority voting control is lost (went from majority to potential of deadlock) -> meaningful reduction -> sale/exchange
    - But if reduction less than 7% -> still has *majority voting control-> not qualify under 301(b)(1)*
    - But if remaining 50% held by many s/h -> redeemed s/h still has dominate voting rights -> not meaningful reduction

Redemption from minority s/h (even small reduction qualifies meaningful reduction if no block control)

- *Rev. Rul. 76-364*: Reduction from 27% to 22% of voting power resulting in loss of concerted control, other 3 SH each had 24.33% (i.e., redeemed SH and another SH can have control before redemption, but not after) is meaningful reduction
- *Rev. Rul. 76-385*: Reduction from 0.0001118% to 0.0001081% is meaningful reduction. (minority s/h with minimal stock interest and exercise no control. Basically, minimal reduction in shares held in a <u>public corp</u> is sufficient)
- *Rev. Rul. 85-106*
    - Reduction in <u>voting power is most important factor</u> re meaningful reduction. Other factors include right to participate in current EP surplus, and right to participate in net assets on liquidation.
        - Redemption of nonvoting stock of a minority SH holding both voting and nonvoting stock is NOT a meaningful reduction since no loss of voting power; important fact was that SH had potential to participate in control group (by acting in concert with 2 other SH); ruling would have probably gone the other way had corporation's stock been widely held so that SH had no potential to gain control through block voting.
- *Rev. Rul. 81-289:* Redeemed SH's remained at 0.2% before and after redemption held NOT a meaningful redemption since no reduction of SH's *proportionate* interest (no reduction in rights to vote/participate in earnings distributions/net assets upon liquidations)
-

Redemption of only non-voting stocks

- RR 77-426: redemption of any non-voting, non-convertible stock is a meaningful reduction of SH proportionate interest under 302(b)(1), if SH owns only that class of non-voting stock, directly or indirectly
    - $\boxed{\text{P}}$: P/S SH giving up right to first call on E&P on liquidation

- Note: <u>Attribution rules</u> in §318(a) apply. §302(c)(1).
- This is the provision of last resort for most TPs.

- **Step-transaction**: while there appear to be separate transactions, these transactions are steps of a single transaction
  - Conditions:
    - Binding commitment: if two steps, the two sales should be steps in overall transaction, if at the time of the first transaction, there was a binding commitment to engage in the second
    - Mutual interdependence: if step 1 is meaningless without step 2 – would TP have engaged in step 1 if TP knew that step 2 was not going to happen?
    - End result: was the intention of the transaction to get to the end result?

(2) Substantially Disproportionate Redemption §302(b)(2); Reg. 1.302-3.

Test → immediately *after the redemption*:

- (1) 50% threshold test:
  - SH owns <50% of total combined voting power of all classes of voting stocks. §302(b)(2)(B)
    - $\boxed{P}$ reduction in ownership isn't significant if SH still has deadlock voting power.
- (2) 80% disproportionate distribution tests
  - (a) SH owns <80% of voting stock he held immediately before the redemption. §302(b)(2)(C)
    - In effect, this requires a >20% reduction of SH's voting power.
    - For test to be met $\frac{\%\text{ voting } after \text{ redemption}}{\%\text{ voting } before \text{ redemption}} < 80\%$, AND
  - (b) SH owns <80% of common stock (voting or nonvoting) held immediately before the redemption. §302(b)(2)(C)
    - For test to be met $\frac{\%\text{ value of common stock } after \text{ redemption}}{\%\text{ value of common stock } before \text{ redemption}} < 80\%$
- $\boxed{P}$ Provides certainty of sale treatment to TPs (safe harbor).
- Reg. 1.302-3(a)
  - Test is applied to each SH separately.
  - §302(b)(2) applies only to:
    - Redemption of only voting preferred stock can qualify (even if the SH owns no common stock).
    - Redemption of only **non**voting stock (common or preferred) cannot qualify under 302(b)(2) (since does not reduce voting rights).
    - Redemption of **non**voting stock ("piggyback" –this can also be exchange)AND voting stock can qualify, if the voting stock is sufficiently reduced to meet 302(b)(2)
      - PS can piggyback, same tax treatment as CS
  - 302(b)(2)(D): if series redemption is made pursuant to a plan that result in not S/D -> redemption is not S/D

- Series of redemption
  - **§302(b)(2)(D)**: If redemption forms part of series of redemptions pursuant to a plan with a result (in the aggregate) that's NOT is not substantially disproportionate (i.e. result not <50%) → Redemption is not substantially disproportionate (i.e. 302(b)(2) test fails, but 302(b)(1) may still apply)
    - Statutory form of step-transaction
  - ***Rev Rul 85-14***: 302(b)(2) does not apply to a redemption of stock from a majority SH A, where a second redemption from another SH B was designed to restore the majority SH A's control – A temporarily yields control to B (A held majority, redeemed shares held 49.96%, then B resigned and redeemed all shares, A's majority restored)
    - No K is needed for a plan
    - When do you test sub/dis? After all the transactions

- **Even if 302(b)(2)(D) not met?** -> IRS/courts can apply common law step-transaction doctrine to determine whether there was a meaningful reduction in shareholder's interest upon a redemption

Note:
- Attribution rules in §318(a) apply. §302(c)(1).

(3) Complete termination of a S/H's Interest*. §302(b)(3); Reg. 1.302-4.*
- Test → Redemption of all the stock held by a SH.
- $\boxed{\text{P}}$ parallels tax treatment of sale of all the SH's stock to a third party.
- A series of redemptions may be considered part of a complete termination of interest, if the individual redemptions constitute, in substance, the *component parts* of a single sale/exchange of the entire stock interest and if the redemptions are pursuant to a firm and fixed *plan* to eliminate the SH from the corporation [*Bleily & Collishaw*]

- Note: Attribution rules in §318(a) apply. §302(c)(1).
  - But waiver for family attribution. §302(c)(2).

(4) Redemption of Noncorporate SH in Partial Liquidation §302(b)(4)
- §302(b)(4): 302(a) shall apply to a distribution if distribution is:
  - in redemption to a **non**corporate SH
  - in partial liquidation of the distributing corporation

- distribution is "partial liquidation" if it is:
  - (1) pursuant to a plan and occurs within the taxable year where plan is adopted or within the next taxable year §302(e)(1)(B), and
  - (2) not essentially equivalent to a dividend (determined at corporate level rather than SH level). §302(e)(1)(A)
    - Facts and circumstances test → requires a *contraction of corporate business*. See (old) Reg. 1.346-1(a)(2).
    - Safe harbor under §302(e)(2) → distribution is partial liquidation if:
      - (1) distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business §302(e)(2)(A), and
      - (2) immediately after the distribution, the distributing corporation is actively engaged in the conduct of a *qualified trade or business* §302(e)(2)(B).
        - "qualified trade or business" = any trade or business:
          - (1) actively conducted throughout the 5-year period before redemption §302(e)(3)(A), and
          - (2) NOT acquired by the distributing corporation in such 5-year period in a transaction in which gain or loss was recognized in whole or in part to the seller. §302(e)(3)(B).
          - $\boxed{\text{P}}$ limits the safe harbor to corporate contraction easily distinguishable from ordinary dividend and that would thus have had no problem qualifying under facts and circumstances test.
          - Note: safe harbor is not exclusive, the corporate contraction test is still available.

- Note: §302(4) differs from other §302(b) tests in 2 respects:

- (1) it's available only to noncorporate SHs, and
- (2) it focuses on the contraction of the distributing corporation, rather than the effect on SH's proportionate interests.
  - Pro rata distributions may qualify (i.e., not limited to non-pro rata distributions). §302(e)(4).

ATTRIBUTION RULES §318

- §301(c)(1): attribution rules apply only for the purposes of testing the redeemed SH's proportionate interest in the corporation immediately before and immediately after the redemption and then applying the §302(b) tests.
  - P SHs are presumed to exercise control over shares held by certain unrelated parties. Ex: husband who redeemed all shares still exercise control over corporation to the extent of wife's interest

Family Attribution §318(a)(1)

- Individual shall be considered as owning stock owned directly or indirectly by *spouse, parents, children, and grandchildren* (lineal relationship)
  - No attribution for siblings
  - Cannot apply family attribution rule twice to make another constructive owner -> see below 318(a)(5)(B)
  - Attribution from grandchildren to grandparents, but NOT from grandparents to grandchildren. Reg. 1.318-2(b).
  - *Metzger* Trust: family discord cannot be used to avoid family attribution (maybe only relevant under 301(b)(1) meaningful reduction)

Attribution from Entities (upstream) §318(a)(2) ***proportion***

- Partnerships → Stock owned directly or indirectly by a partnership shall be considered as owned *proportionately* by its partners. §318(a)(2)(A).
- Corporations → a person (include corporation) who owns 50% or more *in value* of the stock in a corporation will be considered to own stock owned by the corporation in proportion to the value of stock owned §318(a)(2)(C).
  - In determining this ≥50% requirement, count stocks actually and constructively owned. Reg. 1.318-1(b)(3); Reg. 1.318-2(a) Ex. 2
  - P reason for ≥50% threshold: SH has very limited control over the corporation with <50% of stock, whereas a partner has control proportionate to his interest in the partnership.

Attribution to Entities (downstream) §318(a)(3) ***all the stock, no proportion***

- Partnership → All the stock owned directly or indirectly by a partner shall be considered as owned by the partnership. §318(a)(3)(A).
- Corporations → Where SH owns 50% or more by value of a corporation, then corporation shall be considered to own all of the stocks owned by the SH. §318(a)(3)(C).
  - In determining this ≥50% requirement, count stocks actually and constructively owned. Reg. 1.318-1(b)(3); Reg. 1.318-2(a) Ex. 2.

- Cannot apply 318(a)(3) then (a)(2) to make another SH/partner constructive owner -> see below §318(a)(5)(C)
- Corporation shall not be attributed its own stock by §318(a)(3)(C). Reg. 1.318-1(b)(1); Reg. 1.318-2(a) Ex. 1
- Note: All the stock owned are attributed (not proportionally as in upstream rules).

Option treated as stock §318(a)(4)

- Where a person has an option to acquire stock, such stock shall be considered as owned by such option holder. §318(a)(4).
  - This rule applies to option to acquire an option, and each one of a series of such options. §318(a)(4).
  - e.g., if A has option to acquire 25 shares, and option to acquire another 25 shares → then A is deemed to own 50 shares. Reg. 1.318-3(c).
- <u>multiple attribution:</u> option rule under 318(a)(4) take precedent over 318(a)(1) family attribution rule (i.e. can combine option and family attribution rules) §318(a)(5)(D)
- Rev. Rul. 68-601 (warrant or convertible security is treated as an option if it provides the holder with a right to obtain stock at his election and there is no contingencies with respect to the election.)
- Rev. Rul. 89-64 (an option only exercisable after a period of time has elapsed is still treated as an option.)

Multiple attribution

- General rule – **deemed actual o/s -** stock constructively owned shall be considered actually owned for purposes of applying the attribution rules. §318(a)(5)(A).
- **<u>EXCEPTIONS</u>**
- I) para(1)/para(1) family attribution cut-off:
  - Stock constructively owned by individual under family attribution rules shall not be considered as owned by him for purposes of again applying the family attribution rules in order to make another the constructive owner of such stock. §318(a)(5)(B).
  - $\boxed{\text{P}}$ prevents multiple application of the family attribution rules that could result in constructive ownership of stock to family members not included in the family attribution rules directly (e.g., siblings).
- II) para(3)/para(2) entity attribution cut-off:
  - Stock constructively owned by a partnership or corporation by reason of application of para (3) [the downstream attribution rules] shall not be considered as owned by it for purposes of applying para(2) [the upstream attribution rules] in order to make another the constructive owner of such stock. §318(a)(5)(C).
  - $\boxed{\text{P}}$ prevents attribution from one partner/SH to another partner/SH. Because a partnership/corp may have many partners/SHs, one partner/SH cannot know the shareholdings of the other partners. No reason to assume that one partner/SH has control over a corporation in which an unrelated partner/SH happens to hold stock

  - Note: While there is cut-off re downstream to upstream, no such cut-off re upstream to downstream (i.e., stock constructively owned by reason of upstream rules may be reattributed by reason of downstream rule). Reg. 1.318-4(c)(1).
  - Note: Stock constructively owned by reason of downstream rules is subject to upstream rules if also constructively owned by reason of option attribution rule (i.e., if upstream rule applies on top of option rule it's fine, regardless of whether downstream rule applied or not). Reg. 3.318-4(c)(2).

- Note <u>option</u>
  - For purposes of the special rules (i.e., §318(a)(5)), if both the option attribution rule and the family attribution rule apply, the option rule takes precedence. §318(a)(5)(D)
  - $\boxed{\text{P}}$ permits a reattribution of the optioned stock to another member of the option holder's family (e.g., if a parent has an option to purchase stock owned by one child, the stock the parent owns constructively through the option can be reattributed to another children).

WAIVER of Family Attribution Rules. §302(c)(2)

- In the case of a §302(b)(3) complete termination of interest distribution, the family attribution rules in §318(a)(1) can be waived if:
  - (1) immediately after the redemption, the redeemed SH had no interest in the corporation (including an interest as officer, director, or employee), other than an interest as creditor; **§302(c)(2)(A)(i)**
    - To qualify as creditor (1) the SH's rights must not be greater than necessary to enforce the claim, (2) the ***debt must not be subordinate*** to general creditors 1.302-4(d), (3) principal payments must ***not be contingent*** on ***earnings***, and (4) acquisition of corporation's assets through enforcement of creditor rights upon default is alright unless the stock is reacquired. Reg. 1.302-4(d), (e).
      - Debt instrument cannot be too long (>15 years), otherwise it looks like equity interest -> debt holder is considered to have continuing interest in the corporation
      - ***Lynch***: TP who provides post-redemption *services*, either as an employee or independent contractor → holds a prohibited interest in corporation because he's not a creditor → family attribution rule applies → redemption NOT sale/exchange
      - *RR77-467/Hurst*: Arm's length leasehold interest retained by the redeemed SH is not prohibited under the waiver rules as long as the rental payments to the redeemed SH are not subordinated to general creditor or dependent upon corporate earnings
        - *Hurst*: employee was the wife of the redeemed SH (but didn't own stock of corp); redeemed SH and wife personally owned corporation's headquarters, and continued to lease it to corp after redemption; retired SH received promissory note for his redeemed shares, which were secured by redeemed shares and were subordinate to bank debt → notes were not subordinate to *general* creditors, and neither the amount or certainty of payment on notes was contingent on corporation earnings
      - *Dunn*: installment agreement with retiring SH (provided for postponement of installment payment that would cause the corporation to fall below the net working capital requirement or to violate the 50% net profit retention clause under the corporation's franchise agreement with third party – GM). held -> only timing of payment, rather than amount of payment was contingent on corporation's earnings. General creator have not greater rights than the retiring SH if the corp were to liquidate -> meet 302(c)(2)(A)(i)
  - (2) redeemed SH doesn't acquire such interest (other than by bequest or inheritance) within 10 years following date of redemption §302(c)(2)(A)(ii), and
  - (3) redeemed SH files an agreement to notify the Secretary of any such acquisition within the 10-year period and retains adequate records. §302(c)(2)(A)(iii); Reg. 1.302-4(a), (b).
- If redeeming SH reacquires interest within the 10-year period, assessment period by IRS will be extend for 1 year after she notifies IRS (if never notifies IRS, assessment period remains open forever) and taxes for the year of redemption will be recomputed to treat the redemption as a §301 distribution rather than a sale. §302(c)(2)(A) flush language.
  - Doesn't apply if §302(b)(1), (2), or (4) applies as well. §302(b)(6).
- $\boxed{\text{P}}$ without the wavier rules, a shareholder in a family business can never get sale/exchange treatment under complete termination due to attribution rules. The waiver rule allows sale treatment to family member SH to retire from the family business, where the retire family member no longer has any interest in the corporation other than a creditor.

Exception (10-year look-back rule)

- **§302(c)(2)(B)** Waiver of family attribution does NOT apply if: (so family attribution apply)
  - §302(c)(2)(B)(i) (i.e. *family member sold shares to redeeming SH in past 10 years*)

Redeemed SH *acquired any part* of the redeemed stock within the *10 years preceding* the redemption, directly or indirectly, from a *person* whose *stock is attributable* to the redeemed SH under §318(a), OR
  - e.g., father A owns all of Xco's stock and wants to give cash to son B. Absent 10-year look-back rule, A could give stock to B, B redeems shares. B would get sale treatment provided he complies with the waiver (instead of A getting dividend then gives cash to B) prevent convert dividend to gain.

- §302(c)(2)(B)(ii) (i.e. redeemed SH (father) redeems stock, buyer (son) does not redeem) At the time of redemption, any person who owns stock attributable to redeemed SH under §318(a) and acquired from the redeemed SH, directly or indirectly, within the *10 years preceding* the redemption, <u>unless</u> the stock so acquired is redeemed in the same transaction.
  - e.g., parent A owns all of Xco's stock and wants to retire and relinquish the business to son B. Absent 10-year look-back rule, A could, after extracting some cash from Xco, give most of the stock to B and cause Xco to redeem A's remaining shares, a plan that is substantially identical in economic effect to an ordinary dividend to A followed by a gift of all of the stock to B.

- **<u>But exception does NOT apply</u>** (i.e., waiver applies) if the acquisition in (i) or deposition in (ii) (stock transfer to or from the redeemed SH) **does NOT have as one of its <u>principal</u> purposes the avoidance of tax**. §302(c)(2)(B) flush language.
  - A tax avoidance purpose is not inferred merely because the transferee is in a lower income tax bracket than the transferor. Reg. 1.302-4(g).
  - Note: if the purpose of transfer to son is to have father retire and leave biz to son, it's principle purpose is not tax avoidance -> exception doesn't apply -> no family attribution

- P prevents pre-redemption stock shuffling enabling one family member to receive sale treatment (e.g., sole SH who otherwise wouldn't have gotten sale treatment could transfer shares to family member (transferor would get sale treatment since this is a sale) who would then be immediately redeemed and then get sale treatment with no gain since step up in basis when acquired shares.)

302(c)(2)(C) WAIVER OF FAMILY ATTRIBUTION BY ENTITIES: permits an entity to waive family attribution rules

- Why take waiver?
  - May be useful when redemption terminates partnership/corp actual stock ownership but entity still owns stock that is attribute from one family members to another 'related person' and is then reattributed to the entity (DOES NOT WAIVE direct beneficiary/owner to entity attribution under 318(a)(3)
- Requirements:
  - 302(c)(2)(C)(i): can waive family attribution rule if:
    - Both partnership/corp and the partner/SH meet the 302(c)(2)(A) requirements of family attribution;
    - AND each related partner/SH agrees to be jointly and severally liable for any deficiency resulting from acquisition of redeemed stock within 10 years after redemption
  - 302(c)(2)(C)(ii) Definitions
    - Entity: means a partnership/corporation
    - Related person: any person to whom ownership of stock in corp is (at time of distribution) attributable under family attribution rules if the stock is further attributable to entity
- e.g., Xco is owned equally by A and P, a partnership of which A's daughter is the sole partner. Absent waiver by entity, a redemption of stock owned by P would not terminate its interest cuz stock owned by A is attributed to A's daughter (family attribution), which are then attributed to P (downstream attribution). With the waiver by entity, the redemption would qualify cuz A's daughter (and thus P) would not be attributed stock owned by A.
  - If A owned 50%, P 25% and A's daughter 25%, the redemption would qualify cuz waiver by entity would only apply to stock owned by A, leaving intact the attribution of stock owned by A's daughter to P (downstream attribution).
    - Note: Would also fail under §302(b)(2) which doesn't recognize waiver of attribution.
    - However, a redemption of both P and A's daughter would work.

REDEMPTION RELATED TO INTER-SH TRANSFERS & BOOTSTRAP ACQUISITION

- Bootstrap acquisition: one SH want so sell her interests in the corporation, the remaining shareholders use corporate assets to fund acquisition of that interest
  - When selling SH is individual -> want redemption as part of the plan, in order to get $302(b) sale/exchange and lowering the purchase price to buyer
  - When selling SH is corporation -> does not include redemption, because corporate seller wants §243 DRD
- General rule:
  - The increase in the remaining SH's proportionate interest resulting from the redemption of another SH is not taxable.
  - Primary and unconditional obligation (Exception)
    - ***RR: 69-608***: when the continuing SH is subject to a "primary and unconditional obligation" to purchase the redeeming SH's stock -> increase in proportionate interest is a constructive §301 distribution to the continuing SH (in the amt of amt redeemed/paid for shares)
      - Primary and unconditional obligation arises when the obligor's *duty to perform becomes unconditional.* Thus, if continuing SH assigns his K to redeeming corp before the time when he incurs a primary and unconditional obligation to pay for the shares -> no §301 distribution
      - Ex: B is under contractual obligation to purchase A's shares when he *retires*, but instead corp buys A shares -> redemption is constructive dividend to B
      - Note: an option to purchase by continuing SH is NOT a primary and unconditional obligation
    - P: This is a bootstrap acquisition as the continuing SH increased his proportionate interest using corporate assets. The redemption by the corporation discharged the continuing SH's obligation (akin to a debt). Recall *Old Colony Trust*: corp pays income tax liability for executives – it's payment of obligation that give rise to income on executives.

- ***Zenz***: sequence of redemption/sale doesn't matter if end-result meet 302(b)(2) or 302(b)(3)
  - "zenz-like" bootstrap acquisition will qualify as a §302(b)(3) complete termination and sale/exchange treatment to the redeemed SH, whether the redemption is before or after the sale of shares to other SHs, as long as both steps are part of an overall integrated plan to dispose of the SH's entire interest in the corporation (i.e. look at end-result)
  - Fact: step (1) selling SH sell a small % of shares to buyer, step (2) seller redeems the remaining shares completely and get sales treatment under §302(b)(3)
  - This is beneficial for buyer: (1) require less cash, (2) reduce E&P (thus later taxable dividend)
- Rev. Rul. 75-447: *Zens* applies to transactions that do not completely terminate the redeeming SH's interest for purpose of §302(b)(2), if they are part of an integrated plan to reduce the SH's interest

    - i.e. order of sale and redemption doesn't matter for substantially disproportionate distribution test

TAX CONSEQUENCE TO REDEEMING S/H

- If **sale/exchange**:
    - Gain = AR-AB, assuming shares are capital assets, held for more than 1 year -> taxed at LTCG of 20% + 3.8% under §1411
- If **dividend treatment:**
    - §301(c)(1): dividend to extent of EP
    - §301(c)(2): reduce basis
        - Reg 1.302-2(c): <u>proper adjustment to the basis</u> of the remaining stock will be made with respect to the stock redeemed
            - Add back basis to remaining shares
                - Ex: sole SH had $100 basis in all shares, redeemed half for $150 as dividend, remaining stock has basis of $100
            - If attribution rule *applies* -> basis flips/transfers to the other SH
                - Ex: husband and wife each own 50% of X, each had basis of $50. H redeemed stock for $150 as dividend. After redemption, W has basis of $100
                - Ex: H and W each own 500 shares, with AB of $50k each. H redeemed all but 10 shares. After redemption, H holds 10 shares with AB of $50k, W holds 500 shares with AB of $50k.
    - ***If corporate s/h***
        - 301(c)(1): dividend to extent of E&P -- taxed @ DRD rate (0/35/50% * 21% rate)
            - Stock ownership (i.e. percentage held) is determined after redemption
            - Income = inclusion rate * $ distributed
        - 301(c)(2) reduction of basis – see above
        - Also, 1059(e)(1)(A) reduction of basis
            - In case of redemption of a corporate SH that's a :
                - partial liquidation §1059(e)(1)(A)(i),
                - *not pro-rata to all SHs* §1059(e)(1)(A)(ii),
                - treated as a dividend because of the §318(a)(4) option attribution §1059(e)(1)(A)(iii)(I), or
                - treated as a dividend because of the application of §304 §1059(e)(1)(A)(iii)(II)
            - → redemption treated as an *extraordinary dividend* under §1059, without regard to holding period and size of dividend
            - If 1059(e)(1)(A) applies:
                - reduce basis of stocks redeemed (ex: pretend shares) by non-tax portion of dividend (i.e. DRD amount) – note: see DRD above
        - 301(c)(3) gain = portion of DRD exceeding basis, from step above
        - P: For i*ndividual SH*, reduction in dividend tax rate (QDI) makes dividend and exchange treatment less significant. For *corporate SH*, prefer §301 dividend treatment due to DRD
            - concern of manipulation of controlling SH with non-pro rata distribution. So in case of extraordinary dividend, corporate SH reduce basis by nontaxed portion of dividend

TAX CONSEQUENCE TO THE OTHER S/H

- generally, no tax consequence to the other s/h (only if stock dividend, then tax consequence), unless basis flips over to him
- Zenz: continuing SH receives constructive §301 distribution

TAX CONSEQUENCE TO CORPORATION

- if a corp distributes property (other than case) in redemption of stock, the distributing corp recognizes gain (but not loss), whether SH is treated under §301 or 302(a):
  - **gain = FMV of distributed property – AB of distributed property in corp's hands**
- §312(b): **E&P increased = gain**
  - Gain triggers a **tax** (@ tax rate) which decreases E&P

- If redemption is treated as dividend -> §301

- If distribution is treated as sale/exchange under §302(a) -> Reduce E&P by lesser of (1) amount redeemed, (2) amount capped under §312(n)(7)
  - **§312(n)(7)**: for redemption under §302(a), reduction of E&P *cannot exceed* ratable share of E&P attributable to the stock redeemed
  - Ex: if 50% of shares redeemed (# shares redeemed ÷ total share before redemption), E&P reduced by 50% at the most
  - P: limit/cap on E&P reduction, because to qualify for sale/exchange treatment, needs to have substantial reduction in proportionate interest. Reduction in E&P to the full extent of redemption would reduce the amount of dividend income on subsequent distribution of remaining SH, might make future distribution not getting dividend treatment.

§304 REDEMPTIONS BY RELATED CORPORATIONS

- P: address concern that SH controls the corporation from which is he is receiving the sales proceeds. In effect, he's taking property out of acquiring corporation in exchange for stock in a related corporation over which he also control. This transaction looks like a redemption and §304 requires that it be tested under the redemption rules.
- §304 prevents SH from extracting property from corporation as capital gain rather than ordinary income, and from offsetting the amount of the distribution by their stock basis for distribution that resemble dividend distributions.
- This primarily applies to individual SH, who prefer sale treatment (CG), though mitigated by QDI
- Corporate SH may prefer a §301 dividend distribution

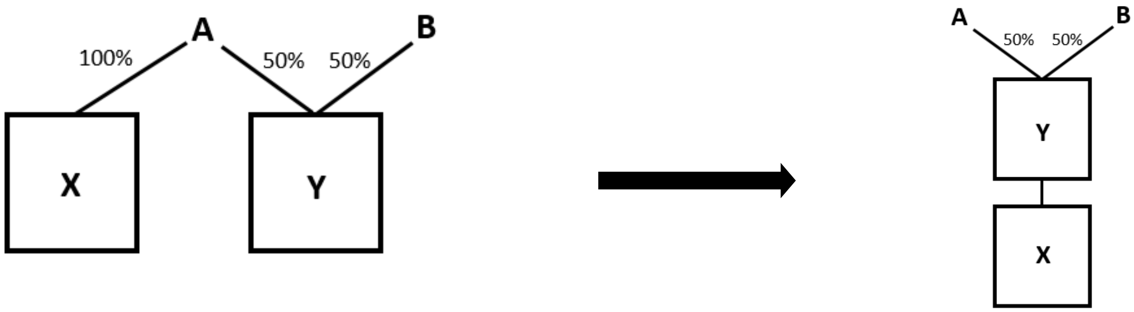
Steps:

- Does §304 apply?
- If so, is it §302(b) sale/exchange (compare SH constructive and actual o/s in issuing corp before/after transaction) or §301?
- If not, regular sale/exchange under §1001
- Determine other tax consequences
  - Test diminution of A's interest in X after the sale
  - Pretend X stock has been exchanged for Y stock, then pretend the Y stocks are redeemed by Y

§304(a)(1) BROTHER-SISTER CORPORATIONS (i.e. commonly controlled corporations)

- Property transferred by acquiring corporation to controlling SH is treated as §302 redemption of the acquiring corporation's stock if:
  - (1) ≥1 SHs (controlling SH) is in **control** of each of the 2 corporations,

- (2) one of the corporations (acquiring corporation) acquires stock in the other corporation (issuing corporation) from the controlling SH, AND
- (3) in exchange for property.
  - "Property" doesn't include the issuing corporation's own stock or right to acquire such stock. §317(a).



1. Does §304 apply?
   §304(a)(1) Property transferred by acquiring corporation to controlling SH is treated as redemption of the <u>acquiring corporation's</u> stock if:
   - (1) ≥1 SHs (controlling SH, A) is in **control** of each of the 2 corporations,
   - (2) one of the corporations (acquiring corporation, y) acquires stock in the other corporation (issuing corporation, x) from the controlling SH, AND
   - (3) in exchange for property.
     - "Property" excludes acquiring corp's own stock or right to buy it. §317(a).

   <u>Special rules re "**control**"</u> (for *before* transfer purposes)
   - "control" = ≥50% by vote OR value. §304(c)(1).
     - If a person controls a corporation which in turn owns ≥50% by voting power or value of another corporation's stock (of all classes), then such person controls such other corporation. §304(c)(1).
     - Reg 1.304-5(b): for control test, 301(4)(1) only considers person that:
       - (i) controls the issuing corp (X) before the transaction,
       - (ii) transfers issuing corp (X) stock to acquiring corp (Y) for property, and
       - (iii) <u>controls the acquiring corp (Y) thereafter</u> (so if A doesn't control Y after the transaction, 304 doesn't apply to A)

     Note: Any stock in acquiring corp (Y) that A get from the transaction (as part of consideration) is considered when determining whether A controls Y

- $\boxed{\text{P}}$ ensures that lower tier corporations are caught (i.e., can't avoid §304 by interposing another corporation)

2. If §304 applies, is it §302(b) sale/exchange (compare SH constructive and actual o/s in issuing corp before/after transaction) or §301?
   - §304(b)(1): run the 302(b) tests by reference to the stock of issuing corp (i.e. test diminution of A's interest in X corp – did A sufficient reduce her interest in X?)
     - see 302(b) tests
     - 304(b)(1) attribution rule: 318(a) attribution rules apply with modifications (without regard to 50% limitation in 318(a)(2)(C) and 318(a)(3)(C))

- Modified §318(a) attribution rules:
  - **Upstream attribution**: if SH owns ≥5% of value in stock (substitute for 50% in 318(a)(2)(C)) of a corporation -> SH deems to own *proportionately* the stock owned by that corporation §304(c)(3)(A), (B)(i).

  - **Downstream attribution**: §304(c)(3)(A), (B)(ii)(I).
    - if SH owns ≥5% of value in stock (substitute for 50% in 318(a)(3)(C)) -> corporation deemed to owns *all* the stock the SH owns in another corporation
    - If SH owns ≥5% but <50% → corporation deemed to own *proportionately* the stock SH owns in another corporation. §304(c)(3)(B)(ii)(II)

3. If §302(b)->302(a) applies -> sales/exchange treatement:
   - **Redeemed SH:**
     - gain = AR (sales proceeds)-AB (of transferred stock/issuing corp stock) Prop. Reg. 1.304-2(a)(5).
     - basis of the acquiring corp stock (y) owned by him = unchanged Prop. Reg. 1.304-2(c) Ex. 1; Reg. 1.304-2(c) Ex. 3 (pre-1997 law but correct result).
     - Holding period is by reference to issuing corporation's stock. Prop. Reg. 1.304-2(a)(5).
   - **acquiring corp:**
     - Acquiring corp takes cost basis in issuing corp's stock §1012 Prop. Reg. 1.304-2(a)(5).
     - E&P reduction limited to amount not in excess of redeemed stock's ratable share of accumulated E&P -> unclear which corp's E&P will be affected

4. If §301 applies (i.e. fails §302(b) tests -> §302(d) sends you to §301):
   - **§304(a)(1) deemed 351 transaction**: SH treated as if she transferred issuing corp (x) stock to acquiring corp (y) in exchange for acquiring corp (y) stock in a nontaxable 351 transaction. Then, acquiring corp (y) pretends to redeem the its own (y) stock
     - §351: when TP (transferor) transfers *property* into a controlled corp in exchange for stock only, TP no gain/loss recognition
   - **Acquiring corporation:**
     - §362: acquiring corp (y) basis in transferred stock (x stock) = basis of stock when held by redeeming SH (i.e. = x's old basis, which rolls over)
     - Non-recognition of gain/loss §351(a)
   - **Redeemed SH** (basis roll-over):
     - §358(a)(1), §1.304-2(a) ex. 1: Basis in acquiring corp shares (y) = basis in issuing corp (x) transferred to acquiring corp (y)
       - figure out w/ deemed basis how many acquiring corp shares that would be: if 50 acquiring corp shares have 100 basis → then 200 basis in issuing corp shares would create 100 deemed acquiring corp shares
       - Basis gets added to stock that SH already held in acquiring corp (Y)
     - §351(a) Non-recognition of gain/loss

     Run **§301 distributions**
     - §301(c)(1): dividend= extent of E&P (first reduce acquiring corp, then issuing corp)
       - §1(h)(11) rate for individuals
       - §243 DRD for corporation, and §1059(e)(1)(A)(iii): 1059(a) applies -> basis of deemed stock reduced by DRD amount, excess of DRD over basis = gain
         - In the case of corporate shareholders where 1059 has reduced basis in deemed stock down to zero, then after-dividend amount of distribution allocated to deemed stock will produce taxable gain under 301(c)(3) (see below)

     - §301(c)(2): reduction of basis on both actual and pretend stock

- Proposed Regs. 1.304-2(a)(4): remaining distribution after 301(c)(1) reduces basis of actual shares and pretend shares on a pro rata basis
- ex: If SH actually owns 50 shares with AB=100 and is deemed/pretend to own 100 shares with AB=200. 301 amount =$500. EP=$200 so 301(c)(1) = $200. The remaining $300 is allocated pro rata to on 2:1 ratio (i.e. 50+100=150. 50/150=1/3, 100/150=2/3): 2/3 or $200 to pretend Y stock (reduce basis to 0) and 1/3 or $100 to actual Y stock (reduce basis to 0)
- Basis reduction under §301(c)(2) is on a pro rata, share-by-share basis. Prop. Reg. 1.304-2(a)(4); (c) Ex. 2.
- e.g., A owns 200 shares (100% of the stock) of Xco (basis of $100) and 200 shares (100% of the stock) of Yco (basis of $30). Xco has $40 of EP and Yco has $20 of EP. Xco and Yco are worth the same (relevant for allocation of basis). A transfers all of his Xco's stock to Yco for $150. It's §301 treatment cuz A still owns (through upstream attribution) 100% of Yco. A takes basis of $100 in the notional shares issued by Yco. Amount of distribution is $150. A has dividend of $60 ($20 Yco's EP + $40 Xco's EP). Remaining $90 of the distribution is applied against the basis of both actual and deemed shares of Yco under Prop. Reg. 1.302-5, so reduction of $45 for each bock of shares (notional and actual). Basis in notional Yco's stock is reduced to $55 ($100 - $45), and there is no gain. Basis in actual Yco's stock is reduced to 0 ($30 - $45), and there is gain of $15. The remaining $55 basis attaches to half of the actual Yco's stock, and the other half has a basis of 0 (cuz of deemed §368(a)(1)(E) recapitalization pursuant to Prop. Reg. 1.302-5(a), so basis allocated pursuant to Reg. 1.358-2(a) → treated as if surrendered multiple blocks of shares) [SEE BELOW]. Prop. Reg. 1.304-2(c) Ex. 2.

- §301(c)(3): gain from sale/exchange of property

- 5. DEEMED RECAPITALIZATION: There is a deemed recapitalization of SH's shares in which SH exchanges all shares (both actual and deemed) and in return gets back her original number of shares that have the same basis (on a pro rata basis) as the actual and deemed shares [confirm whether this is correct]
  - Ex: If SH actually owns 45 shares w/ 90 basis and is deemed to own 90 shares w/ 180 basis and there is a 250 after-dividend amount. The 250 gets allocated 1/3 to actual and 2/3 to deemed, reducing the basis in actual to 7 (90 – 83) and the basis in the deemed to 13 (180 – 167). Then, because of the deemed recapitalization, A is deemed to own only 45 shares, 1/3 of which have 7 basis and 2/3 of which have 13 basis.
- 6. EFFECT ON E&P:
  - First, reduce acquiring corp's E&P
  - Then, reduce issuing corp's E&P

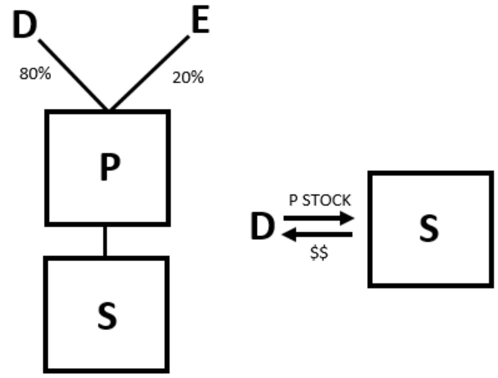
<u>ALTERNATIVE: TRANSACTION WHERE SH RECEIVES PROPERTY + ACQUIRING CORP STOCK</u>

SITUATION: SH sells issuing corp stock for property + acquiring corp stock.

FIRST STEP: Determine whether 304 applies

1. <u>CONTROL REQUIREMENT</u>:
   a. **304(c)(2)(A):** take into account acquiring corp stock transferred to SH in determining control
   b. If met, then go to <u>PROPERTY REQUIREMENT</u> section
   c. If not met, ask whether 351 applies
      i. If not 351, then regular S/E treatment under 1001
2. <u>PROPERTY REQUIREMENT</u>
   a. **304(a)(1)(B):** requires that acquiring corp acquire issuing corp stock in return for property and property under 317 does <u>not include</u> acquiring corp stock
   b. Thus, transaction must be bifurcated into:
      i. Portion for stock
      ii. Portion for property
         1. Based on ratio of value of property to value acquiring corp stock transferred
            a. EXAMPLE: If issuing corp stock is sold in exchange for 450 cash and 10 shares of acquiring corp stock. Then, 90% of transaction is treated as 304 transaction and 10% is treated as a regulation sale.
   c. Portion for stock
      i. Treat as a S/E under 1001
      ii. Unclear what the E&P adjustments are
   d. Portion for property
      i. Treat under 304

§304(a)(2) ACQUISITIONS BY SUBSIDIARY



- Sub (acquiring corp S) acquires parent (issuing corp P) stock from a SH of parent in return for property -> the property is treated as a distribution in redemption of parent's stock.

FIRST STEP: Determine if 304 applies

1. §304(a)(2) applies if:
   a) Control Requirement: issuing corp controls acquiring corp (i.e. parent and sub)
      - **304(c):** 50% voting or 50% value of all shares
   b) Acquiring corp (sub) acquires issuing corp (parent)'s stock from SH of ParentCo
   c) Property Requirement: same as above, SH must be given property as defined in 317 (i.e. not sub stock), and
2. If §304(a)(2) NOT apply → regular Sale/exchange treatment

SECOND STEP: If §304 applies → test under §302: complete termination, substantially disproportionate, essentially equivalent to a dividend

- **304(b)(1):** Test 302(b) by reference to stock of issuing corp (X)
- **304(b)(1)** 318(a) attribution rules apply
  - EXCEPTION: ignore 50% limitation in 318(a)(2)(C) and 318(a)(3)(C)

THIRD STEP: If fails §302(b) tests → §301 distribution rules apply (see above in BROTHER-SISTER ACQUISITIONS)

- Redeeming SH A's basis in X shares retained = basis of old X shares (including AB of shares sold)
- Acquiring Sub's basis in Parent share = §1012 cost basis

FOURTH STEP: If one of 302(b) applies, then regular sale/exchange treatment (see above in BROTHER-SISTER ACQUISITIONS)

- SH gain = AR (amount received from Y Corp) – AB (X shares transferred)

Overlap between §304(a)(1) brother-sister & §304(a)(2) parent-sub acquisitions

- Applying constructive ownership rules, a parent-sub relationship could be viewed as a brother-sister relationship
  - ex: A and B each control parent X, which controls sub Y -> under §318 attribution rule, A and B also controls Y-> A and B controls both X and Y -> seems like §304(a)(1)
- §304(a)(1): §304(a)(2) parent-sub rule trumps brother-sister rule §304(a)(1)
- BUT 1.304-2(c) ex1: *actual ownership takes precedent over constructive ownership*

➔ Direct brother-sister relationship prevail over constructive parent-sub relationship

IV - STOCK DIVIDENDS. §305

- Note: PS holders get <u>first call</u> on dividend and assets on liquidation. CS holder get residual (increase in value above what PS have the first call on) of earnings and assets on liquidation
- Stock dividend is a distribution by a corporation of its own stock to SH. Under §305(a), a stock dividend is *generally tax free* to recipient, unless it falls within one of §305(b) exceptions. If §305(b) applies, the distribution is taxed under §301 as non-liquidating distribution and may be eligible for 20% rate to QDI.

<u>§305(A) GENERAL RULE: STOCK DISTRIBUTION IS NON-TAXABLE</u>

§305(a): gross income doesn't include stock distributed by corp to SH with respect to its own stock, except as otherwise provided

- "stock" includes rights to acquire such stock. §305(d)
- codification of *Eisner v. Macomber*
- Distribution has to be made with respect to the corporation's own stock -> so only distribution to SH *qua* SH (not as compensation for services/satisfaction of corp debt) will be covered by §305

Basis Adjustment

- §307(a): If §305(a) applies → allocation of old stock's basis between new stock (stock dividend) and old stock, in proportion to their FMV immediately after distribution.
- Reg. 1.307-1(a):
  - $\text{New stock's basis} = \text{old stock's basis} \times \frac{\text{FMV on distribution of new stock}}{\text{FMV on distribution of all stock owned (new+old)}}$
  - $\text{Old stock's basis} = \text{old stock's basis} \times \frac{\text{FMV on distribution of old stock}}{\text{FMV on distribution of all stock owned (new+old)}}$
  - Ex (1 class): 50 shares of CS with AB=24/share, total AB=1200. if receives 10 more shares of CS as tax-free stock dividend, AB1200/(50+10 shares)=20/share
  - Ex (>1 class): FMV of CS=10K before distribution. A receives 10 shares of PS with FMV=1K. CS FMV becomes 9K. AB1200*(1/10)=120 AB allocated to PS, 1200*(9/10) = 1080 AB to CS

Holding period

- §1223(4); Reg. 1.1223-1(e): Tacked holding period (new stock are deemed to have the same holding period as old stock)
  - Gain = probably LTCG

No reduction in E&P

- No reduction of EP on nontaxable stock dividend under §305(a). §312(d)(1)(B); Reg. 1.312-1(d).

Eisner v. Macomber (common on common is not taxable distribution)

- Corporation issued 50% stock dividend of <u>common shares to common SH</u>. SH owned 2,200 shares, received additional 1,000 shares. At the time, the *Revenue Act* explicitly provided for the taxation of stock dividend.
- SH: stock dividend wasn't income under the Sixteenth Amendment.
- Gov't: SH receiving a stock dividend could be taxed under the Sixteenth Amendment on the accretion (because of accumulated profits) in the value of the shareholder's interest in the corporation
- Supreme Court:
  - after stock dividend of CS on CS, proportional interest of SHs remain the same. The only change is in the evidence which represents the interest
  - stock dividend shows that the company's accumulated profit have been capitalized, instead of distributed to SH or retained as surplus available for distribution. This defers realization of profits of SH

- Mere appreciation of value is not taxed
- ***Stock dividend that doesn't alter SH proportionate interests is not a taxable event (no realization of gain)***
- Taxation of stock dividend is unconstitutional because it's capital, not income; and 16th amendment applies to income only (only tax realized and recognized gain/loss) – Note: constitutional issue wrongly decided

Koshland v. Helvering (common on preferred is taxable distribution)
- Distribution of common stock on preferred stock without a similar distribution on common stock, results in an increase of the preferred SH's proportionate interest in the corporation (to earnings and assets on liquidation) at the expense of common SHs.
- *Eisner v. Macomber* doesn't apply if the stock dividend alters the proportionate interests of SH, with the result that a common stock dividend on preferred stock, without a similar distribution on common stock, is taxable.

- Stock dividends are excluded from the definition of "property." §317(a).

§305(B) FIVE EXCEPTION TO GENERAL RULES IN §305(A)
- P The exceptions target distributions that change or may change the proportionate interests of SHs. It's akin to a codification of the "change in proportional interest" test developed in *Koshland*

- If one of the §305(b) exceptions applies -> the stock dividend will be treated as a §301 distribution (SH recognize ordinary income @20% to extent of E&P, then basis recovery and CG)
  - Amount of distribution is FMV of stock distributed. §301(b)(1); Reg. 1.305-1(b).
  - SH's basis in stock received will be its FMV (i.e., §307 doesn't apply here). §301(d).
  - Reduction of E&P by the FMV of taxable portion of stock dividend under §305(b). Reg. 1.312-1(d).

- Note: For both §305(b) and (c), "SH" includes a holder of convertible securities or of rights to acquire stock. §305(d)(2).

§305(b)(1) Election to Take Other Property
- §305(b)(1): if any of the SHs **can** elect to have the distribution payable either in stock or property other than stock (i.e. cash) > taxable stock distribution -> §301 treatment to all SH receiving the stock (SH who receive cash is taxed under §301)
- P: if some SH receive stock and some receive cash/other property, the stock recipient increase proportionate interest in the corporation at the expense of other SHs
- This exception applies:
  - even if all SHs actually elected to take stock (i.e. no SH actually took other property) Reg. 1.305-2(a)(1).
    - P: why so broad to also include *potentially* disproportionate distribution? The mere option to take property other than stock suggest that the SH first received cash and simply chose to reinvest the cash in corporation
  - This exception applies whether all or part of the shareholders have the election (ex: 1 SH can elect, the other 9 SHs cannot) Reg. 1.305-2(a)(5)
  - Whether the election is exercisable before or after the declaration of the dividend is irrelevant. Reg. 1.305-2(a)(2).
- Note: debt is property under §317(a), so the right (election) to receive debt/equity is within 305(b)(1)

§305(b)(2) Disproportionate Distribution (heart of exceptions)

- 305(b)(2): if stock distribution results in (1) the receipt of property by some SHs, and (2) an increase in the proportionate interests of other SHs in the corporation's assets or E&P -> taxable stock distribution -> §301 treatment
  - Assets: participation in the residual on liquidation.
  - EP: participation in dividends
  - Voting rights are irrelevant.
- Property include preferred shares because cash dividend will be paid on PS

- **Reg 1.305-3(b)(2)**: §305(b)(2) also applies to series of distributions which results in receipt of property by some and increase in proportionate interests of other, whether or not the stock dividend and the distribution of property are steps in an overall plan or are independent and unrelated.
- **Reg 1.305-3(b)(4)**: If the stock dividend and the distribution of property are more than 36 months apart, the stock dividend and the distribution of property must be made pursuant to a plan, otherwise §305(b)(2) is presumed NOT to apply.
  - Ex: pursuant to plan, Aco pays cash to some SH on 1971/01/01 and increase proportionate interest of other SHs on 1974/03/01 -> such increase in proportionate interest are distribution to which §301 applies
  - Ex: PS convertible to CS, CS distributed on CS -> no plan needed to link dividend paid by PS to increase in proportionate interest on CS, unless 36 months apart
- **Reg 1.305-3(b)(3)**: Property distribution does NOT need to come from corp itself (i.e. no requirement that the SHs receiving property acquire such property by way of corporate distribution wrt to their shares) , so long as they receive such property in the capacity as SH and must be a distribution governed by §301, 356(a)(2) or enumerated provisions in this Reg
- **Reg 1.305-3(b)(6)**: analyze proportionality class by class
  - If there's more than 1 class of stock outstanding, each class is considered separately in determining whether a SH has increased his proportionate interest (i.e. proportionality within that class)
  - if the class of stock as a whole has an increased interest in the corp (i.e. in relation to other class) → the individual SH of a class will be deemed to be increase interest
- **1.305-3(d)(1)(i) Adjustment in Conversion Ratio**: If corp has convertible stock outstanding and distributes stock dividend wrt stock into which convertible stock are convertible, an increase in proportionate interest in assets or E&P of corp by reason of such stock dividend is considered to have occurred, unless a full adjustment in conversion ratio/conversion price to reflect such stock dividend is made.
  - **1.305-3(e)**, EX #4: analyze the transaction on an as-converted basis
  - Conversion Ratio: rate at which a security may be converted into a security of another class; most convertible securities have an anti-dilution provision which prevents the dilution that otherwise would result from stock dividends/splits on the security into which the convertible security may be converted
- Rights to acquire stock is treated as stock. §305(d)(1).
  - Means that distribution of common on common when convertible (into common) preferred is outstanding would result in a proportionate increase for common SHs unless the conversion feature provided anti-dilution protection. Reg. 1.305-3(b)(5).
    - Annual dividend on preferred is sufficient to constitute receipt of property. Reg. 1.305-3(d)(1), (e)(3) Ex. 4.

- EXAMPLES:
  - **TAXABLE CLASS A CASH, CLASS B STOCK:** X Corp has Class A and B common stock w/ equal rights. X pays cash dividend of 10/share on A stock and dividend on B stock payable in additional B stock w/ value of 10/share. Stock distribution is taxable b/c B SHs increase their proportionate interest in earnings/assets of X while A SHs receive cash.

- **NONTAXABLE COMMON ON COMMON, CASH ON PREFERRED:** X Corp has common and preferred stock and declares a dividend on common payable in additional common stock and pays cash dividend on preferred. Cash dividend is taxable, but common stock dividend is <u>not</u> b/c it doesn't increase proportionate interest of common SHs.
- **TAXABLE PREFERRED ON COMMON, W/ PREFERRED OUTSTANDNG:** Same as (b) except that X Corp declares dividend on common payable in shares of preferred. Since interests of common SHs in assets/earnings have increased, preferred stock dividend is taxable UNLESS preferred stock distributed is subordinate to old preferred.
- **TAXABLE COMMON ON COMMON, W/ CONVERTIBLE PREFERRED & NO ANTI-DILUTION:** W corp has 100 shares common and 50 shares convertible preferred. Preferred entitled to noncumulative dividend of 6/year and converts to common 2:1 ratio. W distributes 1 share common on common. Preferred is not protected by anti-dilution feature:
  - Before stock distribution: if preferred converted, then 100 and common SHs have 100 shares
  - After stock distribution: if preferred converted, then 100 and common SHs have 200 shares
  - Proportionate interest of common SHs went from ½ to 2/3
  - Thus, 305(b)(2) applies

Distribution of Cash in Lieu Of Fractional Shares – Exception to 305(b)(2)

- §1.305-3(c)(1): 305(b)(2) doesn't apply if:
  - (i) corp declares dividend payable in its stock and distributes cash in lieu of fractional shares, or
  - (ii) upon a conversion of convertible stock/securities, a corporation distributes cash in lieu of fractional shares,
  - <u>provided that:</u>
    - <u>Purpose</u> of distribution of cash is to save corporation the <u>trouble, expense or inconvenience</u> of issuing and transferring fractional shares, or issuing full shares representing the sum of fractional shares, and not to give any particular group of SHs an increased interest in assets or E&P of the corporation
    - For (c)(1)(i), amount of cash distributed in lieu of fractional shares <u>5% or less of FMV</u> of distributed stock -> distribution considered to have such valid purpose -> 305(b)(2) doesn't apply -> the <u>stocks distributed is non-taxable</u>
      - If presumption not met, then corp must prove there's admin purpose
  - §1.305-3(c)(2): if §1.305-3(c)(1) applies:
    - <u>cash paid</u> in lieu are treated as fractional shares distributed,
    - then, pretend corporation redeem the fractional shares under <u>§302</u>
    - allocate basis of old shares amongst the stock distributed (including fractional share)
    - Rev Rul 76-385: any reduction of minority SH is meaningful reduction -> §302 sales/exchange treatment on fractional shares

<u>***§305(b)(3) Distribution of Common and Preferred Stock (on Common Stock)***</u>

- §305(b)(3) if distribution or series of distribution results in (1) some <u>common</u> SHs receiving <u>common</u> stocks, and (2) <u>other</u> <u>common</u> SHs receiving <u>preferred</u> stock -> <u>both</u> PS and CS distributed are taxable stock distribution -> §301 treatment
- Reg 1.305-4(b) Ex 1

- $\boxed{\text{P:}}$ common SH rights wrt to voting, earnings and assets upon liquidation are different from rights of preferred SH. If a stock distribution results in some common SH receiving additional shares and other receiving only PS, a shift in proportionate interest has occurred. Common SH get larger participating interests while PS received can be reviewed as similar to cash

§305(b)(4) Distribution on Preferred Stock

- §305(b)(4): if any stock distribution **on** preferred stock -> taxable stock distribution -> §301 treatment
  - Unlike other §305(b) exception, this provision applies even to pro rata distribution of PS (to all preferred SH)
  - Exception: distributions to convertible preferred shareholder
    - 305(b)(4) doesn't apply to distributions on convertible preferred shareholder in order to increase the conversion ratio solely to take into account a stock dividend or stock split with respect to stock into which the stock may be converted (i.e. change in conversion ratio is brought by CS on CS -> change in conversation ratio is protected from tax) Reg. 1.305-5(a).
- Is a stock really a preferred stock? (i.e. PS has preference wrt to dividends/liquidation but CS has all the residual. Is the stock really PS or is it CS?)
  - **1.305-5(a)** preferred stock: has limited right to participate in corporate growth (i.e. earnings and assets on liquidation) & limited rights and privileges
    - Taking into account of facts and circumstances (ex: earnings/share, cash dividend/share, extent of participation) at *time a distribution is made*, there's little to no likelihood of PS participating current or anticipated earnings and upon liquidation beyond its preferred interest
    - right to convert is irrelevant for this analysis
  - See 1.305-5(d) example #9&10: (ex of participation in corporate growth and non-participation)
- $\boxed{\text{P}}$ the other 305(b) exceptions are based on changes in proportionate interest. 305(b)(4) notes that PS generally pays specific cash dividends. Stock dividend on preferred stock can be viewed as substitute for cash dividend, thus such stock dividend should be taxed
  - If CS is issued on PS, PS increase proportionate interest in residual of corp at expense of CS

  Where you have convertible PS
  - 1) cash distribution on PS and decrease of conversion ratio in PS -> increase in proportional interest of common SH -> may trigger deemed distribution to common SH (residual holder)
  - 2) cash distribution on CS, increase of conversion ratio of PS to reflect cash distribution on CS > increase in proportional interest of preferred SH -> may trigger deemed distribution to preferred SH
  - See Reg 1.305-3(d) Ex 6&7

§305(b)(5) Distribution of Convertible Preferred Stock

- §305(b)(5): if convertible preferred stock distribution will likely result in (1) the receipt of property by some SHs, and (2) an increase in the proportionate interests of other SHs in the corporation's assets or EP (i.e., disproportionate distribution of §305(b)(2)) -> taxable stock distribution -> §301 treatment
  - i.e. if all SH convert or all not convert – distribution is pro rata -> §305(a) non-taxable
- Reg. 1.305-6(a)(2):
  - Distribution is likely to result disproportionate distribution where (1) conversion right must be exercised within a short period, and (2) factors such as dividend rate, redemption provisions, marketability, and conversion price suggests that some SHs will convert and other SHs won't.
    - e.g., some SHs converts and others sell it to third party and got cash

- where (1) SHs have long period to convert, and (2) dividend rate is consistent with market condition at time of distribution -> no basis to predicate what time and extent to which the stock will be converted and it's unlikely that a disproportionate distribution will result

Reduction of EP
- if nontaxable stock dividend under §305(a) -> No reduction of EP §312(d)(1)(B); Reg. 1.312-1(d).
- if 305(b) applies -> reduction of EP by the FMV of taxable portion of stock dividend under §305(b). Reg. 1.312-1(d).
    - o No reduction of the corporation's economic income *per se*, but makes sense to reduced EP since the SH gets taxed on it.

No gain/loss recognition
- Corporation doesn't recognize gain/loss on distribution of *its own stock*. §311(a)(1).
    - §317(a) says property doesn't include stock in distributing corporation (for purpose of §311), so §311(b) doesn't apply (it's for appreciate *property*)
        - Note that corp's own stock is property for purpose of §301
    - §311(a)(1) deals with *distribution* of its own stock, whereas §1032 deals with issuance of its owns stock in *exchange* for money or property.

§305(C) DEEMED STOCK DISTRIBUTION
- P prevents transaction that may have the effect of a stock dividend (increase proportionate interest of any SH in assets/earnings of the corp) even though no stock is actually distributed, by creating pretend distribution of stock so that the transaction can be analyzed. §305(c) protects the integrity of 305(b)

- **Reg. 1.305-7(a)**: §305(c) deems 5 types of transactions as constructive stock dividend to any SH (i.e. look at individual SH interest, not class by class) whose proportionate interest in E&P or assets of the corporation increase -> taxable distribution §301 (to non-redeemed SH) if it has the result described by one of 5 §305(b) exceptions

  Steps:
    - (1) whether the transaction is a deemed stock dividend that increases the proportionate interest of any SH?
    - (2) whether it's taxable under one of the §305(b) exceptions (and subject to §301 treatment)?
        - Practically speaking only §305(b)(2) and (4) may apply.

  If met both steps:
    - SH whose proportional interest has increased (non-redeemed SH) get taxable constructive stock dividend under §301 treatment (i.e. §305(c) deems the increase in proportional interest as stock distribution)
    - SH's basis in the stock distributed =FMV of stock ~~§301(d).~~
    - The redeemed SH get §301 distribution on the actual redemption

Type 1: Change In Conversion Ratio
- RULE: Under 305(c), changes in conversion ratio to prevent dilution are not deemed stock distributions, BUT a conversion ratio adjustment that has the effect of increasing the proportionate interest of a class of SHs will be treated as a taxable stock distribution

- Where one class of stock is convertible into another:
    - change in conversion ratio that results in an increase in proportionate interest of any SH (note: look at SH, not share class)-> taxable distribution §301

- But if change in conversion ratio is to <u>prevent dilution</u> -> not deemed stock distribution

1. ISSUE: how do we calculate value of the deemed distribution of stock to SHs that increased their proportionate interest
    a. **PROPOSED REG. 1.305-7:** value is the difference in rights before and after the change in conversion ratio
2. **1.305-(e), EX #7:** 305(c) also applies where there is a distribution of cash on convertible stock and an adjustment downward of conversion ratio
    a. Property distributed to convertible stock holders
    b. Conversion ratio is reduced
    c. No actual distribution of stock BUT increase in proportionate interest of SHs who hold stock into which stock is convertible
3. **PROPOSED REG. 1.305-7:** Deemed distributions w/ adjustments of conversion ratio
    a. A decrease in conversion ratio can create deemed distribution to residual (common) SHs
    b. An increase in conversion ratio can create deemed distribution to convertible stockholders (preferred)
    c. These regs. suggest how to value these deemed distributions

- Example: X Corp has Class A and B common outstanding. Each share of B stock is convertible into 1 share of A stock. If cash dividends are paid on A shares, and increased conversion ratio of B shares to 1.5 A shares -> increase in conversion ratio reflects an increase in Class B SH's proportionate interest at the expense of Class A SH -> constructive stock dividend treated as disproportionate distribution under §305(b)(2) -> Class B SH are deemed under §305(c) to have received a stock dividend in the amount of FMV of ½ share per class B previously owned

<u>Type 2: Dividend Equivalent Periodic Redemption "Plans"</u>

1.305-7(a) RULE: If a redemption pursuant to an ongoing plan is treated as a § 301 distribution and has the effect of increasing the proportionate interests of other shareholders (not redeemed), the corporation is deemed to have made a stock distribution to the shareholders whose interests have been increased.

<u>Exception</u>: if "<u>isolated" redemption</u> (in connection with retirement, death, etc. i.e. cash out exit) → § 305 does NOT apply to non-redeemed SH who have increased their proportionate interests (i.e.. no constructive stock distribution -> no taxable distribution). 1.305-3(b)(3); 1.305-3(e), EX #10-11

   a. See 36 months presumption above

2. Requirements:
    a. Need a redemption treated as 301 distribution to one SH
        i. Must have receipt of property by SHs
        ii. 302 redemption does not count as a receipt of property for these purposes
    b. AND a proportionate increase in another SH's ownership interest
        i. Concerned with change in participation in E&P

- Treatment of non-redeemed SH if requirements are met:
    - SH does not actually receive stock → pretend that SH's interest increased via actual taxable stock distribution (see 1.305-3(e), EX #8, 9)
    - 1) *How many shares would've been distributed to non-redeemed SH to interest her interest to after-redemption proportion?*
        - (SH's after-redemption shares + X)/(total after-redemption shares + X) = after-redemption ownership % (= SH's share after redemption share/total after redemption share)
        - Solve for X. X is the number of shares corp needed to use in order to SH to increase proportionate increase from pre-redemption % to after-redemption %
    - *2) determine FMV of the pretend shares distributed*

- FMV of each pretend distributed share = (FMV of actual shares outstanding post-redemption)/(total shares deemed outstanding after-redemption)

3. EXAMPLES:
   a. X corp has common stock, owned by 5 equal and related SHs. X adopts an annual redemption plan that enables SHs to sell limited amount of stock back to company. Pursuant to plan, X distributes cash in redemption of portion of stock held by 2 SHs. Redemptions are treated as 301 distributions. The 3 SHs whose stock is not redeemed increase their proportionate interests in X as a result of redemptions of others. Nonredeemed SHs are treated as having received distributions to which 305(b)(2) and 301 apply.
   b. Same as (a), except the redemptions are not pursuant to a periodic plan but rather are made to shift control from old to younger SHs. This is an isolated redemption, thus 305(b)(2) does not apply to SHs whose proportionate interests have increased.
   c. **1.305-3(e), EX #8:** T corp has 1000 outstanding stock. C owns 100 shares. 9 others own 100 shares each. Pursuant to periodic redemption plan, T redeemed up to 5% of each SH's stock each year. During the year, each of 9 SHs has 5 stock redeemed for cash. Thus, C's proportionate interest in assets and E&P of T is increased. Assuming that cash received by 9 other SHs is taxable under 301, C is deemed under 305(c) to have received a distribution under 305(b)(2) of 5.25 T shares to which 301 applies.
      i. The amount of C's distribution is measured by the FMV of # of shares which would have been distributed to C had corp sought to increase his interest by .47% (C owned 10% of T stock immediately before redemption and 10.47% thereafter) and other SHs continued to hold 900 shares.
         1. AFTER REDEMPTION: 100/955 = 10.47%
         2. DEEMED DISTRIBUTION: (100 + x)/(1000 + x) = 10.47%
            a. X = 5.25 additional shares considered to be distributed to C
      ii. Because in computing amount of additional shares deemed to be distributed to C is disregarded, the redemption of shares will be similarly disregarded in determining the value of the stock of corp which is deemed distributed.
         1. Thus, 1005.25 of shares are considered outstanding after redemption.
         2. Value of each share deemed to be distributed to C is then determined by dividing aggregate FMV of actual shares outstanding (955) after redemption by the deemed total shares of 1005.25 .

Type 4: Redemption treated as a distribution to which §301 applies (i.e., non-pro rata redemption).

- where a redemption is treated as a §301 distribution (i.e. fails 302(b) via proportionate redemption) to the redeemed SH:
  - the remaining SH (who are not redeemed) whose proportionate interest in the corporation is increased by the redemption -> treated to have received a deemed/constructive stock dividend under §301
- Exception: an isolated redemption from one SH resulting in an increase to other SH's proportionate interest -> not constructive stock dividend to the SH whose interests are increase. Reg. 1.305-3(e) Ex. 10.
  - But a redemption plan where one SH's stocks are periodically redeemed, while the proportionate interests of the other SH increases -> constructive dividend to SH whose interests increased. Reg. 1.305-3(e) Ex. 8
- Redemption resulting in §301 distribution will be treated as a §301 distribution to any shareholder whose proportionate interest in the corporation's assets or EP is increased by the redemption (i.e., other SHs who were not redeemed).

PREFERRED STOCK BAILOUT. §306

- $\boxed{\text{P:}}$ If a stock dividend is nontaxable under §305(a), it may still be classified as §306 stock. §306 prevents preferred stock bailout.
- The concern is that SHs holding common stock will be issued preferred stock dividend and such preferred stock will then be sold or redeemed, thereby *bailing out corporate E&P as CG rather than Ordinary income* (so called "preferred stock bailout"). The effect is that the SH sells preferred stock for cash but nonetheless retains control (vote) and residual growth (dividend and distribution on liquidation) of the corporation.
  - *Prevents TP to enjoy preferred stock bail out without reduce its participation interest*
- As a result of *Chamberlin*, where such a preferred stock bailout was blessed by the Court, Congress enacted §306 to characterize certain tax-free stock dividend as §306 stock and taxes some/all of the proceeds from sale of these stock as ordinary income
  - *§306 achieve same effect as if same amount of cash was distributed and treated under §301(c)*
- Impact of qualified dividend: Prior to qualified dividend, preferred stock bailout allowed SH to (1) reduced taxable amount through recovery of basis, and (2) change character of income from OI to CG. Now with qualified dividend received by no corporate SHs, it's less important because they are taxed as same preferential rates as LTC. But reducing the taxable amount through recovery of basis is still relevant.

CHAMBERLAIN: Corporation is profitable and makes tax-free distribution of preferred stock to common stock shareholders. Shareholders then sold preferred stock to insurance companies. Shareholders report LTCG, offsetting A/R with A/B allocable to preferred stock (from common shares) and using holding period of common. Then, corp redeems stock so that shareholder's proportionate interest remains unchanged.

IRS: *Transaction allows shareholders to receive cash (from corp's E&P) without reducing their proportionate interest in corporation.* IRS thus argues that this is essentially a dividend and should be taxed as such.

HOLDING: nontaxable stock distribution; respect transaction

1. Look at time of distribution of stock and not at what happens after to determine whether the distribution resulted in a change in SH's proportional interest
   a. Doesn't matter that the stock was immediately sold after distribution for purposes of this determination
2. Taxability of stock distribution does not depend on business purpose of distribution
   a. And no question of legality of stock distribution
3. No question as to legitimacy of the sale to insurance companies → title passed
4. Nontaxable stock distribution does not become a taxable cash distribution upon sale by recipient
   a. Sale of stock is a sale of a capital asset
   b. Nontaxability determination is made based on whether there is a change in proportionate interest and NOT on disposition of stock after or how long it's held for
5. No money came from corporation to shareholder upon sale (it was from investment company)
6. Not a sham transaction even though redeemed:
   a. Here, redemption taking place over time; insurance companies holding stock for investment; some of stock in hands of the public;
   b. insurance companies have real interest in corp stock (bona fide investment)
   c. arm's length transaction w/ big insurance companies that actually assessed whether these were good investments
   d. while sale was prearranged, there was no *binding* deal

Note: §305 deals with issuance of stock. §306 deals with disposition of stock

DEFINITION OF 306 STOCK

- §306(c)(1)(A): "§306 stock" is stock (other than CS issued on CS) any part of the distribution of which to SHs was nontaxable under §305(a).
- Basically: <u>any stock received tax-free under 305(a)</u> is §306 stock (exclude CS on CS)

- principal category is **PS** distributed to SH in §305(a) tax-free stock dividend

§306(c); 1.306-3(a): 306 stock means: stock that is:

- **Tax free under §305(a)**:
  - stock distributed to SH as a tax-free dividend under 305(a);
- **Distributing corp needs to have some E&P** (i.e. $1 E&P is sufficient):
  - §306(c)(2), Reg 1.306-3(a): not 306 stock can be distributed by a corp with no current or accumulated E&P at time of distribution
  - Test: whether no part of a tax-free stock distribution would have been a dividend, if cash had been distributed instead of stock (at the time of the distribution)
    - If even a small part of cash distribution would have been a dividend, then all the stock is §306 stock
    - Ex: X Corp, calendar year taxpayer, makes tax-free distribution of preferred stock with value of 25k to its common SHs on July 1. X has no E&P. On July 1, X has 10k current E&P, but by the end of the year it has a 1k current E&P deficit. Preferred stock is not 306 stock b/c a distribution of cash in lieu of stock would not have been a dividend. If X had ended with 20 of current E&P, all of the preferred stock would be 306 stock.
  - $\boxed{P}$ No bailout potential if the distribution would not have been taxable as dividend had cash been issued instead of stock.
- **NOT Common stock (i.e. typically §306 stock is PS)**
  - Distribution of CS on CS is not §306
    - $\boxed{P:}$ because subsequent sale of CS would diminish SH interest in corp, no bailout potentail
  - **CS** is stock that has unrestricted rights in growth of corporation
    - not common stock: a class of stock that has limited rights to assets on liquidation or limited dividend rights
  - §351(g)(3)(A): **PS** means stock does not participate in a significant extent in corporate growth
    - Rev Rul. 81-91: class not limited in its participation in corporate growth → CS
    - Rev Rul. 76-386: to be §306 stock, must be redeemable (not just subject to right of first refusal)
      - $\boxed{P:}$ redemption undo the reduction in SH proportionate interest as result of earlier issuance
    - Rev. Rul. 76-387: nonvoting common shares that had unlimited rights in dividends and distributions on liquidation is common stock and not preferred stock for purposes of §306(c)(1)
      - because on disposition SH loses unrestricted residual growth of the corporation; participation in growth is enough to qualify as common stock
    - Rev. Rul. 57-132: stock with unlimited distribution rights is §306 stock if the corporation can discretionarily redeem it at fixed price, since that imposes a cap on growth potential
  -
  - Common stock that is convertible into preferred stock or other property is not treated as common stock. §306(e)(2).

Dispositions of 306 Stock under §306(a)

- **306(a) General Rule**: treatment of gain/loss from 306 stock depends on how SH disposes of it:
  - Dispositions other than redemptions → 306(a)(1)
  - Redemptions → 306(a)(2)
  - Exceptions to general 306(a) rule:
    - Terminations of SH's interest → 306(b)(1)
    - Liquidations → 306(b(2)
    - Where gain or loss isn't recognized → 306(b)(3)
    - Transactions not in avoidance → 306(b)(4)

§306(A)(1): DISPOSITIONS OTHER THAN REDEMPTIONS (I.E SALE)

- §306(a)(1)(A) = Amount Realized is treated as Ordinary Income to the extent of SH's ratable share of E&P at the time of distribution of §306 stock
  - Use year-end E&P = accumulated + current for the year
  - P reflects amount that would have been a dividend had the corporation distributed cash instead of stock (i.e. treat as if cash in amt of FMV of stock was distributed)

- Individual SH (parallel to §301 waterfall):
  - §306(a)(1)(D) treats ordinary income as dividend taxed at max 20% tax under §1(h)(11)(B)
  - §306(a)(1)(B): remainder of AR is treated as basis recovery (limited to AB of stock actually sold), then as CG (@ 20% tax)
    - 1.306-1(b)(2), EX #2 if after treating AR as ordinary income and basis recovery, TP still have unrecovered AB in that PS, that unrecovered portion is added to AB of remaining (common) stock
- §306(a)(1)(C): **no loss recognition**

- 1.312-1(e): No reduction in corp's E&P from any disposition of stock of §306 stock, unless it's a redemption
  - From corp perspective, no distribution - no earnings/assets have come out of corporate solution

- Ex: XCo issues PS as tax-free stock dividend wrt to CS. X E&P=100K. PS is §306 stock. SH A owns 10% of X stock, receives 10 shares of PS. AB in PS = 90K. A sells PS for $92K. A recognizes ordinary income (treated as dividend for §1(h)(11) purpose) to extent of ratable share of E&P at time of distribution (100K*10%=10K). Remainder of sales price (92-10-82K) is retreated as basis recovery, leaving A with 90-82=8K of unrecovered basis in stock sold, which is added back to AB of remaining CS.
  - If A sold PS for $102K, still have dividend of 10K @ 20% tax, cost recovery = 90K, realize CG = 92-90=2K @ 20% tax

§306(A)(2): DISPOSITION BY REDEMPTION

- §306(a)(2): if §306 stock is redeemed, the entire AR is treated as a §301 distribution.
- AR is treated as dividend (taxed at max 20%) to extent of E&P at time of redemption, excess is treated as basis recovery or CG under §301(c)

- Apply §301(c):
  - (c)(1): treated as dividend to extent of E&P at time of redemption
    - Relevant E&P is the year of redemption (current + accumulated), not when §306 stock was distributed
    - All E&P taken into account, not just ratable share (unlike disposition by sales above)
  - (c)(2): basis recovery
  - (c)(3): (capital) gain from sale/exchange of property

- Reg. 1.306-1(e): E&P: reduce corp E&P by amount of distribution
  As a result, corporate SHs might be entitled to DRD, but subject to §1059

- Ex: X Corp makes tax-free distribution of preferred stock w/ value of 20k to its sole common SH A. X has 5k E&P at time of distribution. A's allocable basis in preferred stock (306 stock) is 10k. Two years later, X redeems A's preferred stock for 20k, at a time when X has 30k of E&P. A continues to own 100% of X's common stock. The entire 20k A/R on redemption is a dividend (given 30k E&P at time of redemption). A's basis in preferred stock is added back to basis of A's common stock.

- If X had no E&P at time of redemption, the entire 20k would be a return of capital under 301(c)(2).
- A probably could reduce his basis in both the preferred and common stock before recognizing any gain under 301(c)(3).

§306(B) EXCEPTIONS

- 4 types of dispositions are excepted from punitive general rule of 306(a) b/c *no bailout potential* → regular S/E treatment under §1001

- §306(a) doesn't apply if:
  - (1) Termination of SH interest
  - (2) Liquidation
  - (3) Non-recognition transactions, or
  - (4) Transaction not in avoidance

306(b)(1) Termination of Shareholder's Interest:

- §306(b)(1)(A): §306(a) doesn't apply, if the disposition:
  - is not a redemption
  - is not, directly or indirectly, to a person the ownership of whose stock would be attributable to the SH under §318(a) (i.e. both actual and constructive interest has to be terminated) ; AND
    - i.e. not sold to a related party
  - terminates the entire stock interest (CS and PS) of the shareholder in corp (*taking into account §318(a)*)
    - may not waive family attribution

- §306(b)(1)(B): if SH's §306 stock is **redeemed** in a (transaction that qualifies for exchange treatment under) complete termination of SH's interest under §302(b)(3) or a partial liquidation under §302(b)(4) -> §306(a) doesn't apply
  - In case of **redemption** in complete termination under§302(b)(3) → SH may waive attribution family rules under §302(c).
    - But family attribution may not be waived, if in a non-redemption transaction that completely terminates SH's actual interest but not constructive o/s (eg sale to related family member). In such case, TP needs to *apply §306(b)(4)*

- P: purpose of §306 is to prevent SH to have preferred stock bailout without losing participation interest in corp. but if SH terminates entire interest, it shouldn't be caught by §306
- Ex: X Corp stock, A owns 500 common and 250 preferred, which is § 306 stock. She owns no X stock constructively. A sells all of her common and preferred stock to an unrelated person. A's sale of the preferred stock is not subject to § 306(a) because she completely terminates her interest in the corporation.

§306(b)(2) Complete Liquidations:

- §306(b)(2): §306(a) does not apply, if SH's §306 stock is redeemed in a complete liquidation
  - Since §331 allows CG treatment to SH whose stock is redeemed in complete liquidation, no reason to treat §306 stock differently

306(B)(3) Non-recognition Transactions

- §306(b)(3): If SH transfers his §306 stock in a <u>non-recognition transaction</u> -> §306(a) doesn't apply to the transfer
  - Include: §<u>351 transfers</u>, gifts under §1015, contributions to capital and tax-free exchanges of stock under §1036

- BUT 306(c)(1)(C): <u>§306 taint carries over</u> to any stock <u>received</u> by the SH in the non-recognition transaction
  - any stock received becomes §306 stock, because basis of stock received in tax-free exchange is determined by reference to basis in §306 stock
- 1.306-3(e): stock in the hands of <u>transferee</u> (i.e. corporation in §351 transaction) is <u>also tainted</u> §306 stock
  - Ex: A transfers 100 X Corp preferred stock, which is 306 stock, in exchange for 100 Y Corp common in 351 transaction. X Corp preferred stock (which has 362 transfer basis) and Y Corp common stock (which has substitute basis under 358) are 306 stock.
- §306 taint is removed on death of SH → stock takes date-of-death basis under §1014
  - Ex: Parent gives 100 shares of X Corp preferred stock, which is 306 stock to Child. Stock remains 306 stock in C's hands. If P were to die and bequeath stock to C, it would no longer be 306 stock.

<u>306(b)(4) Transactions not in Avoidance of Tax:</u>

- §306(b)(4): §Section 306(a) does not apply if the TP show:
  - (b)(4)(A): the <u>distribution</u> and the subsequent <u>disposition</u>/<u>redemption</u> of §306 stock, OR
  - (b)(4)(B): in the case of a prior or simultaneous disposition (or redemption) of the <u>underlying stock</u> wrt which the §306 stock was issued, that the <u>disposition</u> <u>or redemption</u> of the §306 stock

  was <u>NOT</u> made pursuant to a plan having <u>tax avoidance</u> as one of its principal purposes.

- RR 89-63: §306(b)(4) relief may apply to disposition PS of widely held corp, but is not automatically available

- Difference between 306(b)(4)(A) and 306(b)(4)(B):
  - (A): looks at two points -> TP needs to show **<u>both</u> the initial distribution and later disposition/redemption had non-tax-avoidance purpose**
    - Ex: stock dividend and isolated deposition by Minority SH (no control) may be ok
      - Idea: TP is controlling SH (there's unity of control) suggests tax avoidance?
  - (B): looks at one point -> TP **<u>only</u> show the disposition/redemption had non-tax-avoidance purpose** Reg. 1.306-2(b)(3)
    - (B) Required disposition of CS, whereas (A) doesn't
    - ***Fireoved***: if TP sells the underlying CS but *retains control of corp* (didn't sell all of its stock) -> §306(b)(4)(B)exception does not apply (if you are willing to give your interest in corp)

- Difference between 306(b)(1)(A) and 306(b)(4)(A):
  - 306(1)(A): disposition of §306 stock: attribution rules apply
  - 306(4)(A): disposition of underlying common stock - attribution rules do not apply (Rev. Rul. 77-455)
    - Rev Rul 77-455: SH wants to cash out in order to retire by his selling shares to Son under 318(a) so Son can maintain control of corp and also he sold some shares to unrelated party. A may waive constructive o/s of B stock, to have complete termination under §302(b)(3). Retirement is not tax avoidance purpose

- ***Pescosolido*** – under §170(e)(1)(A), TP charitable deduction is limited to FMV of §306 stock, reduced by amt of gain that would've been LTCG on a taxable sale (had the stock been sold)
  - 306 backstops 170(e) limitation on deduction for certain charitable contribution of ordinary-income property

TP donates 306 stock to charity and claims he is entitled to deduction = FMV of the stock under 170. IRS argues that under 170(e) applies and prevents TP from taking deduction.

1. IRS argument is that 170(e) reduced charitable deduction by amount of gain which would not have been LTCG if property had been sold at FMV
   a. b/c stock here is 306 stock, if it were sold at FMV, TP wouldn't recognize LTCG, but would get ordinary income treatment
2. TP argues that 306(b)(4)(A) should apply

HOLDING: 306(b)(4) does <u>not</u> apply and TP is not entitled to deduction under 170(e)

1. Factors court weighed
   a. *TP was controlling SH (unity of control)*
   b. Substantial tax savings
   c. Bailout potential of 306 stock
2. Typical scenario to which 306(b)(4) applies:
   a. Stock dividend + isolated disposition of stock by minority SHs
3. Evidence clearly has to negate tax avoidance plan

NOTES: Could we construct argument w/ 306 today that 306 couldn't apply

1. 306(a)(1)(D): For purposes of 1(h)(11), any amount treated as ordinary income under this paragraph, it will be treated as divided received from corp
   a. Got 306 stock, can't get out of 306 by using P's arguments, but could you argue that sale of such stock would produce ordinary income BUT treated as LTCG under 1(h)(11)
   b. Had it been sold at FMV by TP, that income produced would have been taxed at LTCG rates
   c. THEREFORE, argument might be made that 170(e)(1) wouldn't apply

Today, P might have had a decent argument that contribution amount would not have been reduced

V - GENERAL LIQUIDATIONS. §331, §336

- Corp can liquidate in 2 ways:
  - (1) corporation pays off creditors and then distributes remaining assets (in-kind) to SHs, or
  - (2) corporation sells all its assets for cash/notes, pays off its creditors, then distributes remaining cash to SHs

- Since liquidation distribution terminates SH interest in corporation, such liquidation distribution (whether in-kind or cash) are treated as taxable events as if SH sold their stock back to corporation in return for in-kind assets or cash §331
- From corporation's perspective, in-kind liquidating distribution is also a taxable event under §336

§ 346: DEFINTION OF LIQUIDATION

- **346(a) Complete Liquidation Definition**: a distribution is a complete liquidation if distribution (or is one of a series of distributions) in redemption of all of the stock of corporation pursuant to a plan
  - PLAN: board/SH resolution stating intent to liquidate or where SHs/directors manifest intent to liquidate
  - **1.332-2(c):** occurs when corp creases to be a going concern and its activities are limited to winding up its affairs, paying off its debts and distributing remaining balance to SH
    - Corp distributes all its assets to its SHs in exchange for stock
    - *Legal dissolution is not required*
    - Even if corp retains nominal amount of money to pay debts and preserve corporate status under state law, it still may be deemed to be liquidated under tax law (look at tax law defn, not state law)
    - Do NOT need to liquidate for state law purposes to be liquidating for tax purposes
      - Why not liquidate under state law? Might want to keep company name

- Historically: Corp and SHs wanted to achieve liquidation w/ only a single level of tax
  - Was possible depending on how transaction was structured
    - Not difficult given holding in *General Utilities*
  - Then, *Court Holding* was decided: held that gain on sale by SH taxable to corp. following liquidation b/c in substance, it was corp. who was really selling (SHs acting as corp agent)

§331 TAX CONSEQUENCES TO INDIVIUDAL SH

- **331(a)** General Rule: Amounts distributed to SH in a complete liquidation are treated as in full payment in exchange for SH's stock (i.e. get sales/exchange treatment)
  - §331(c), §1.331-1(b): gain/loss will be computed in the same manner as other sale/exchange under §1001.

- §331(b): §301 doesn't apply to complete liquidation

  §331(c); Reg. 1.331-1(b):
- §1001 applies -> **Gain**/loss recognized by SH on liquidation distribution = AR – AB = (FMV of cash + other property rec'd – liabilities assumed by SH or encumbering the distributed property) – basis of shares held by SH
  - **Tax** = gain * 21%
  - Usually CG/CL since stock usually capital asset
  - SH takes property subject to liability, reduces amt received -> so need to reduce AR by liab
  - Liabilities assumed by SH include corporate tax liability (if corp can't pay it) but doesn't include contigent/uncertain liability

- If liability is contingent or uncertain at time of distribution (and not taken on by SH in initial liquidation exchange)-> SH who *later* pays the debt will then be entitled to a deduction, treated as CL
  - ***Arrowsmith****:* after liquidation, SH reported payment on corporate debt as ordinary business loss, Supreme Court held it to be CL because it relates to capital transaction and would've reduced CG so that character should be preserved

- If SH has blocks of shares acquired at different times
  - Reg. 1.331-1(e): AR is allocated to various blocks proportionally, determine gain/loss and whether long-term CG/CL separately for each block
    - i.e. if 2/3 shares bought 2 yrs ago, 1/3 bought 2 months ago -> only 1st block is LTCG
    - e.g., SH acquired 10 shares for $10 on date A and another 10 shares for $20 on date B, Xco distributes $50 in complete liquidation, SH has gain of $25 – $10 = $15 for shares acquired on date A, and gain of $25 – $20 = $5 for shares acquired on date B
    - Means that SH can have gain on one block and loss on another block.

- Series of liquidation payment (in multiple years): SHs permitted to recover basis first, then recognize gain later (as long as pursuant to a plan, otherwise danger of being subject to 301 classification)

Loss allowed in complete liquidation
- §267(a)(1): §267 loss disallowance rule doesn't apply to complete liquidation → SHs' loss will be allowed (even if SH is in prohibited relationship with liquidating corp under §267(a)(2)) if permitted under §165

331(B) non-application of 301:
- Section 301 generally does NOT apply to any distribution of property in complete liquidation (i.e. no dividend treatment for liquidating distributions)

§334(a) Basis of Distributed Property
- if SH receives in-kind distribution and report gain/loss under §331:
  - basis of property received = gross FMV property at time of distribution (without reduction for liabilities)
    - i.e. *Crane* rule: keeps liability in basis

Note:
- Basis in the stock disappears
- E&P of orporation disappears

§336: TAX CONSEQUENCES TO THE LIQUIDATING CORPORATION

Historic Rule
- *General Utilities*: If a corp sells its asset and distributes cash, corp is taxable. If the corp distributes the asset, the corp is not taxable. Incentive: Use liquidation to avoid corp level taxes
- Subsequent developments:
  - *Court Holding*: CH had one asset and negotiated a sale of it. To avoid taxes, it distributed the asset to its SH who then sold the asset. HELD: Gain on sale by SH taxable to corp. following liquidation b/c in substance, it was corp. who was really selling
    - Step Transaction: Corp. did everything but sign it.
    - To Avoid Application of Step Transaction: Keep time in b/t negotiation and distribution so that corp. could argue they abandoned negotiation

- *Cumberland Public Service (Sup. Ct.)*: SHs wanted to sell stock but the buyer didn't want to buy the stock but rather the equipment directly. CPS refused and instead distributed the property to the SHs who then sold it.
  - Held:: Corp. not taxable even though this is exactly like *Court Holding*
  - Led to passing of §336(a) – Anti-*Cumberland* Rule
    - Old §337(a) – Anti-Cumberland Rule: Corp. can sell property without tax so long as in context of liquidation.
      - There is a tax if corp. sells an asset not in complete liquidation

CURRENT RULE

- **§336(a) General Rule**: liquidating corporation generally recognizes gain/loss on liquidating distributions as if distributed property were sold to SH at FMV
  - **Gain/loss** = AR- AB = FMV of property (includes liab) – AB
    - Gain or loss determined separately on each asset
  - Tax = gain * 21% or gain*35%
  - Liab attached to property is transferred to SH –> so AR includes liab
- **§336(b):** If distributed property is subject to liability or SH assumes corporate liability in connection with distribution → FMV of property is treated as not less than the amount of the liability (i.e. MIN(FMV of property) = liab. So if liab > FMV, then gain = liab - AB)
  - This is consistent with *Tuft/Crane*, which says AR includes debt (AR from sale where price paid is buyer's assumption of liability to which property is subject includes full amount of liability even if the liability exceeds FMV of the property).
- EX: X Corp distributes land (A/B 40k, FMV 80k, subject to 100k liabilities) to A in complete liquidation. For 336(a), land is treated as having FMV no less than 100k. Thus, X recognizes 60k gain on distribution of land in complete liquidation (100k – 40k).

Losses – General and limitations

§336(a) general rule: recognition of loss (and gain) in liquidating distribution as if distributed property was sold to SH at FMV

- Unlike §311(a) which does not recognize losses on non-liquidating distributions

Loss Limitations - 2 Rules

(1) Related Persons §336(d)(1)

- §336(d)(1)(A).**Non-recognition** of the entire (not only built-in) loss on distribution to a related person, if
  - (i) The distribution is not pro rata, OR
    - *Pro rata* means each asset must be distributed proportionately to each SH (as oppose to in the aggregate)
    - P: prevents cherry picking of loss assets that go to related person and the gain assets to the other SHs
  - (ii) The distributed property is disqualified property
    - §336(d)(1)(B): "*disqualified property*" = property acquired by liquidating corporation within 5 years prior to the distribution in complete liquidation in a §351 contribution/contribution of capital, including property which its AB is determined by reference to the AB of acquired property (i.e. covers property acquired in §351, and the property later exchanged in §1031)
    - P: Anti-Loss-Stuffing, prevent duplication of loss to SH and liquidating corp, by SH contributing loss property to corp under §351

- Ex: SH contribute property AB=50, FMV=10 under §351 prevents recognition of loss of 40. §358: SH hold stock with AB=50. Without §362(e)(2) corp also have AB=50. If FMV =10 when liquidated 4 yrs later, SH recognize loss = 40 under §331. Absent loss limitation rules, corp also recognize 40 loss under §336. But §336(d)(1) disallows loss from distribution of disqualified property
- "*related person*" (within the meaning of §267(b)(2)): individual owning, directly or indirectly >50% of shares by value (i.e. a controlling SH)

362(e)(2) vs 336(d)(1) **336(e) not covered**

- Note: §362(e)(2) addresses built-in loss problem up front, at time of §351 contribution (by having corp take basis in asset = FMV), such that there's no realized loss when property is distributed in complete liquidation.
  - Ex: if apply §362(e)(2) to §351 exchange, the corporation basis = FMV of 10 (instead of 50 under §362(a)). When property distributed in liquidation, if property FMV is still 10 -> no gain/loss
- Then, what's the continued function of §336(d)(1)?
  - §336(1) disallows loss when property is distributed to SH on liquidation. Further, it disallows the entire loss when disqualified property is distributed to a related party, so even subsequent post-contribution loss will not be recognized under §336(d)(1).
  - Ex: if disqualified property value = 8, when distributed in liquidation to related party. §362(e)(2) already disallows 40 BIL (i.e. 10-50). The addition 2 loss is disallowed under §362(d)(1)
- §362(e)(2) does NOT apply to contribution of appreciated property. 336(d)(1) applies to loss from post-contribution distribution of disqualified property to related party even if there's no BIL
  - Ex: basis of property contributed under §351 = 50, FMV =70. §362(a) substitute base = 50. Contribution of appreciated property -> §362(e)(2) does not apply. If property declines to 10 and distributed to related party 4 years later, §336(d)(1) still disallows the loss.
- §362(e)(2) applies to aggregate AB – if property distributed has no loss (or net gain) in the aggregate, then the rule does not apply
  - Ex: asset A: AB = 3, FMV = 1, BIL=2. Asset B: AB = 1, FMV ≥ 3 has BIG ≥ 2 -> 362(e)(2) doesn't apply (and basis of loss property A remains 3 at initial contribution), but 336(d)(2) still applies to asset A

(2) Anti-Stuffing §336(d)(2) -- *If 336(d)(1) doesn't apply*

- §336(d)(2)(B)(i): IF:
- (I) distributed property was acquired by the corporation in a §351 transaction/contribution of capital, AND
- (II) the corporation received the property pursuant to a plan a *principal purpose* of which was to *recognize loss* on such property on liquidation.
  - §336(d)(2)(B)(ii): Presumption that any §351 contribution or contribution of capital made within 2 years before the adoption of liquidation plan was pursuant to such a plan the principal purpose of which was to recognize loss
    - TP can rebut the presumption: by showing that the contributed property was an integral part of or substantially related to the business of the corp (i.e. property used for biz purpose)
- ➔ §336(d)(2)(A): corporation's AB in the distributed (or sold) property is reduced by excess of AB over FMV of contributed property, *immediately after its acquisition by the corporation* (i.e. reduce AB to FMV)
  - Ex: AB property = 50, FMV=10. Under §336(d)(2): corp reduce §362 basis by AB-FMV = 40. For purpose of gain/loss under §336(a), AB = 10. No loss (FMV- AB=10-10=0). If property declines to 8, AB remains at 10. Of the overall 42 decline in value, 40 BIL is disallowed and 2 loss is permitted.

<u>§336(d)(2) vs §336(e)(2)</u>

- 362(e)(2) limits BIL upfront at the time when property was received in initial §351 exchange, which renders §336(d)(2) moot for most cases
- Under both rules, corp can recognize post-contribution loss
- Because §336(e)(2) uses aggregate basis while §336(d)(2) works on individual asset basis, it can lead to inconstant result
    - Ex: asset A: AB = 3, FMV = 1, BIL=2. Asset B: AB = 1, FMV ≥ 3 has BIG ≥ 2 -> 362(e)(2) doesn't apply. Asset A basis =3. If corp distributes asset in liquidation within 2 years, §336(d)(2) will presume a plan to recognize the BIL by the liquidating corp for Asset A. (i.e. loss = 2) under this scenario, the results is a harsher BIL limitation.

<u>§336(d)(1) vs §336(d)(2)</u>

- **Tie-breaker Rule**: if both §336(d)(1) and (2) apply, then **§336(d)(1) prevails**
- §336(2) is both narrower and broader than 336(d)(1):
    - Unlike §336(d)(1) which disallows the entire loss, §336(d)(2) only disallows the BIL at the time of contribution but allows loss post-contribution (recognized to the corporation).
    - Unlike §336(d)(1) which applies only to distribution, §336(d)(2) applies to both distribution and <u>sale/exchange</u> of previously contributed property
        - i.e. instead of distribution property to SH, corp sold property and distributed cash to SH in liquidation, the BIL is still disallowed under §336(d)(2)

§332, §337 PARENT-SUBSIDIARY LIQUIDATIONS

- $\boxed{\text{P}}$ liquidation of subsidiary corp is generally not taxable because: (1) prevents multi-tiered taxation up the corporate chain, collect only 1 SH level tax and 1 corp level tax, and (2) encourages simplification of the corporate structure by permitting elimination of subsidiary without immediate tax consequence (assets stay in corporate solution)
- Also consistent with §243, entails 100% DRD when distribution from sub to parent

TO QUALIFY UNDER §332(A): CONTROL + ONE-SHOT/3 YR PLAN

- (1) distribution is in complete cancellation or redemption of all the subsidiary's stock
- (2) 80% control test
    - §332(b)(1): must meet requirement under §1504(a)(2): Parent owns **≥80%** of subsidiary's stock by vote and by value, *from the adoption of the plan of liquidation* and at all times *until the receipt of the property* in liquidation, **AND**
        - Date of adoption of plan: adoption of formal plan of liquidation by SH or directors' resolution (mere intention to liquidate is NOT sufficient) *Riggs*
- (3) subsidiary must either:
    - **§332(b)(2): (one-shot distribution)** distribute all of its property within the taxable year (no need for plan to specify when liquidation will be completed, SH resolution authorizing distribution is OK), **OR**
        - Year of distribution can be different than year of adoption of plan
    - **§332(b)(3): (for distribution spans > 1 year)** make a series of distribution in accordance with a *plan of liquidation* under which all of the property is distributed within 3-year period (from close of year of the first distribution in the series)
        - Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan and that such status continue until the liquidation is completed. Reg. 1.332-2(c).
        - Status of liquidation exists when the corporation ceases to be a going concern (i.e, conduct business) and its activities are merely for the purposes of winding up its affairs. Reg. 1.332-2(c).

- Note: if distribution lasts more than 3 years -> those later liquidation can be disqualified retroactively
    - Ex: actual distribution happen within 6 years, SOL run out. But gov't can disqualifies this NOT as §332 and recognize a gain

- §1.332-(b): §332 does NOT apply to liquidation of an insolvent corporation (that's unable to make partial payment for stock)

§332 TAX CONSEQUENCES TO THE PARENT CORPORATION

- §332(a): Non-recognition of gain or loss if parent (SH) received property distributed in complete liquidation of subsidiary
    - (Can be viewed as exception to general recognition rule in §331)

- Basis & Holding Period
    - ***Parent steps in the shoes of sub***
    - §334(b)(1): basis in the distributed property held by parent = basis of property held by sub (i.e., transferred basis)
        - And parent tacks holding period in property received
    - Parent basis in stock of sub ➔ disappear
    - $\boxed{\text{P:}}$BIG/BIL in the subsidiary's assets is recognized when parent later sell/distribute those assets Parent's basis in sub's stock disappears

- <u>Other tax attributes</u>
    - Subsidiary's <u>tax attributes</u> <u>carryover</u> to parent (E&P, net operating loss, recapture potential etc). §381(a), (c)(1), (c)(2).
        - If parent owns <100% of the stock, then inherits EP properly applicable thereto. Reg. 1.381(c)(2)-1(c)(2).
        - i.e., subsidiary's EP, immediately before its assets are transferred to its parent in complete liquidation, are reduced by the amount properly applicable to distributions to minority SHs.

- <u>Effect of §332: outside basis disappears, inside basis transferred/retained</u>
    - outside basis: parent's basis in sub stock
    - inside basis: sub's basis in its assets
    - after liquidation:
        - parent's outside basis in sub stock disappears and any unrealized gain/loss will never be taxed
        - parent takes transferred basis in old sub's assets, thus retaining the inside basis

<u>Exception: distribution to satisfy debt:</u>

- If subsidiary transfers property to parent in satisfaction of the subsidiary's debt (i.e., transferred to parent *qua* creditor) and the subsidiary was indebted to parent on the date of adoption of the plan of liquidation:
    - §337(b)(1): recognition of gain or loss to parent (e.g., purchased bond at discount, but received payment for face value, gain is recognized). Reg. 1.332-7.
        - Parent takes transferred basis nonetheless. §334(b)(1).
    - Non-recognition of gain or loss to subsidiary. §337(b)(1).

<u>TAX CONSEQUENCES TO MINORITY SHS</u> (≤20% OF STOCK BY VOTE OR VALUE)

- §331 applies (since §332 doesn't apply to minority SH because failed 80% test) so: Reg. 1.332-5.
    - <u>Recognition</u> of gain or loss under §331(a)
        - AR= (FMV of property – liabilities assumed by SH – corp tax liability on gain recognized by corp)*minority SH ownership %
        - AB = minority SH basis in the stock
        - Gain = AR – AB
    - <u>Basis in property received = FMV</u> under §334(a).

<u>§337/336 TAX CONSEQUENCES TO LIQUIDATING SUBSIDIARY</u>

<u>Distribution to Parent Corp</u>

- §337(a): in a §332 liquidation of subsidiary, <u>non-recognition of gain/loss</u> to liquidating subsidiary on distribution of property to parent (≥80% SH)
    - (Can be viewed as exception to general recognition rule in §336)

<u>Distribution to Minority SH:</u>

- Since §337 doesn't apply to in-kind distribution to minority SH, §336 general rules apply. Reg. 1.332-5:
    - §336(a): <u>Recognition of</u> <u>gain</u>
    - §336(d)(3): <u>Non-recognition of loss</u>

- $\boxed{\text{P}}$ why double standard (recognize gain but not loss)? prevents liquidating subsidiary from distributing appreciated property to parent (so no gain under §332) and *loss property to minority SH* (where loss would be recognized absent §336(d)(3)). So better to transfer loss property to parent (takes transfer basis), instead of transferring to minority SH (takes FMV basis so loss evaporate)

<u>ELECTIVITY OF §§332 AND 337</u>

- *Riggs, Granite Trust*:
  - §332 is elective in the sense that TP can dispose or acquire stock to fall below or meet 80% control test
  - §332 is a mechanical rule that set out steps to be followed, TP can elect to be either in §332 or out of §332

- If subsidiary has depreciated property, TP might want to recognize that loss.
- Ways for TPs to avoid §332 (and by implication §337, since it hinges §332):
  - (1) Subsidiary could sell its assets to a third party and then liquidate.
  - (2) Parent could adopt a plan of liquidation at a time when parent owns <80%.
    - *Riggs* (where parent increases its stockholding over time, going from <80% to ≥80%, parent can "waive the wand" and decide when the plan of liquidation starts so that it meets §332(b); underscore electivity of §332, in this case the Court held for TP which wanted to meet §332.)
  - (3) Parent could sell enough subsidiary's stock to get <80% and then liquidate the subsidiary.
    - *Granite Trust; Day & Zimmerman* (preliquidation sale of shares for the sole purpose of failing §332 is OK; underscore electivity of §332).
  - (4) If parent's basis in subsidiary's stock is high, parent could sell stock to a third party and repurchase the assets.
    - BUT *Associated Wholesale* (losses on sale of all of subsidiary's stock were not recognizable, because parent immediately bought back almost all the assets pursuant to prearranged plan; Court held that is wasn't a sale but rather a complete liquidation and that §332 applied.)
      - Distinguishing factor vs. *Riggs, Granite Trust, Day & Zimmerman* appears to be that parent (1) had ≥80% of stock, and (2) ended up with almost all of subsidiary's assets through the planned repurchase.

RIGGS: whether plan of liquidation was adopted after parent had 80% control OR was plan of liquidation adopted before 80% control requirement was met

- Jan: BOD voted to redeem shares
- February: redeemed PS/CS of parent
- April: sub's board authorized liquidation and tender offer for redemption of all common by other taxpayers
  - Indicated consideration of liquidation
  - Redemption – eliminate minority shareholders (by tender offer)
  - At this time, parent owned at least 80%
- June: board and shareholders adopted formal plan of liquidation

Court: *plan of liquidation was adopted in JUNE when sub had 80% control*

- Earlier dates plan was not adopted – mere intention to liquidate is not a formal adoption of plan of liquidation

- §332 is elective in that TP can plan to fit under 332 (i.e. engage in sales/redemptions of stock to achieve 80% control and then adopt plan of liquidation to satisfy 332 requirements)

GRANITE TRUST: Parent Co owns Target Co that owns land and building, rented to Johnson Co. Parent Co wants to buy land from Target and liquidate; but stock FMV declined to 65 and cost basis was 100. FMV<AB ➔ loss. Thus, Parent wanted to recognize loss and avoid §332 non recognition. Thus, Parent engaged in several transactions to divest itself of Target ownership. First, it sold 20% CS to Johnson Co and on same day had Target redeem another 20% of CS and reissued to Johnson Co. Then SH approval to sell real estate to Parent and adopt plan of complete liquidation. At the time, Parent owned 79.5% of Target stock. Then, Parent sold 10 CS to Johnson (individual) and 1 to Richmond and donated two CS to United War Fund which were then surrenders in liquidation. Then, real estate is purchased by Parent for 500k and shortly after Target redeems stock.

ISSUE: whether to respect sales/gift or whether to treat as part of larger liquidation transaction

IRS: apply step transaction (end-result test) → looks like complete liquidation and TP just trying to circumvent 332; no valid sales/gift because only done for tax purposes (parent retained beneficial ownership)

HOLDING: TP wins – respect sales and gift so that 332 doesn't apply and TP can recognize losses

- Not an end result provision
- Parent can elect to avoid application of 332 by disposing of some of its interest before liquidation
- Although tax motivation, there are legal transactions that are not fictitious. Title actually passed in sales.

ASSOCIATED WHOLESALE GROCERS: Parent Co (Super Market Developers) wanted to sell Target Co (Weston Market) to another Buyer Co (Elder). First agreement, Agreement and Plan of Merger, provided that Target Co would merge into Buyer Co with Buyer Co exchanging 300k cash and 9M promissory note. Minority SHs entitled to receive 83/share. Second agreement, Agreement and Plan of Reorganization, provided that after merger, *Parent Co would buy back all assets acquired by Buyer Co except for Target Co stock* in exchange for an amount equal to principal of promissory note plus cash received by minority SHs.

TP: treated as sale of Target's assets and declared tax loss under 1001 because transaction brought Parent Co 2M less than its cost basis in Target stock

- Transaction doesn't meet 332 requirements; step transaction doctrine does not apply; business purpose; harsh result of permanent denial of tax loss
- *332 inapplicable b/c 80% requirement not met at all times*; all Target's assets were not transferred to Parent; and TP didn't adopt liquidation plan

IRS: constitutes complete liquidation of Target under 332, so no recognition of loss

- *Temporary loss of 80% control is transitory, didn't break up 80% control and that step should be ignored*

HOLDING: *§332 applies to this transaction (i.e. non–recognition) under step transaction doctrine (interdependence test)*

Parent had all assets of sub except the Target – this is a sale of one asset and liquidation of all other assets

- Continuous 80% ownership requirement met until Parent acquired Target's assets?
    - Adoption of plan: first agreement of merger → 99.97% ownership
    - Step transaction doctrine application?
        - Not entirely inapplicable in 332 context
        - Valid business purpose does not bar application of step transaction doctrine
            - And business purpose here – cashing out minority SHs – is dubious at best
            - Step transaction *GRANITE TRUST* held that end-result version is not applicable to 332 (but didn't rule on interdependence test); also held that courts could look at substance over form
    - applied: interdependence test
        - whether steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?
        - *Would TP enter into step 1 if step 2 would not be done?*
            - Here:
                - Agreements referred to each other (depended on completion of both)
                - Didn't separately list assets in second agreement
                - Timing of the transactions – immediately following (virtually no time b/w the two)
                - Obvious substance:
                    - Buyer bought Target for 300k and Target was liquidated
                    - Parent got Target's assets, Buyer got back value of note, and Buyer reimbursed for cashing out minority SHs
    - Not all assets acquired by parent? Merger plan v. liquidation plan?
        - BUT resolution authorizing distribution of Target's assets in complete cancellation/redemption of its stock – Target SHs approved merger plan by majority vote
        - Both minority SHs and Parent received distribution of Target's assets

What can TP do better? Wait longer [Waterman Steamship & Litton Industry] and have better documents

338 ELECTIONS: STOCK SALES TREATED AS ASSET SALES

STOCK SALES V ASSETS SALES - COMPARISON

- Asset sales (buyer wants)
    - acquisition itself is taxable, seller report gain/loss on disposition of assets (problematic when there's BIG)
    - Acquiring corporation get cost basis, have step up in basis for assets with BIG
    - can buy specific assets
    - buyer does not assume corporation's liabilities
    - asset sale is better when deduction can be accelerated or can use NOL to reduce target's tax
- Stock sales (Seller wants)
    - Non recognition of tax on target
    - Carryover basis of assets for acquiring corp – BIG/BIL retained
    - But buyer assumes liabilities
    - Overall lower tax liability
    - Stock sale is better (more valuable to have lower tax liability now and less future deduction than more present deduction and more present tax liability)
- Adjust purchase price to account for inherent gain in corporate assets: buyer would want to reduce purchase price by debt liabilities on the assets and tax liability on the gain

§338(G) ELECTION

Background:

- *Kimbell-Diamond*: when P bought T's stock in order to obtain T's assets through a prompt liquidation (purchaser's cost basis in target stock was lower than substituted basis in target asset, P should be treated as having made a direct purchase of the assets with cost basis (equal to amt paid by P for the stock), rather than a substituted basis for the target
- But there were problems:TPs used Kimbell-Diamond to their advantage as a way to increase target's basis in its assets after the acquisition when that outside basis was lower than the purchasing corporation's basis in target's stock.
- So Congress enacted §338.
- §338 election allows purchaser corporation to treat a stock purchase of controlling interest in target corporation as an asset purchase. The goal is to have same tax result on sell of target stock as it would've been if there had been a sale of assets followed by liquidation

Requirements for §338(g) Election:

- (1) Qualified stock purchase, AND
- (2) Election by purchasing corporation.
- Also, purchaser must be a corporation (i.e., can't be an individual). Reg. 1.338-3(b)(1).

- <u>§338(d)(3) "QUALIFIED STOCK PURCHASE"</u> = transaction or series of transaction in which **≥80%** of a corporation's stock by <u>vote and value</u> (§1504(a)(2)) is purchased by another corporation during a <u>12-month acquisition period</u>..
    - §338(h)(3) <u>"PURCHASE"</u> means only if stock has NOT been acquired (i.e. <u>taxable transaction</u>):
        - (i) in a transaction in which the purchasing corporation takes a transferred basis from transferor,
        - (ii) in a (tax-free) exchange to which §§351, 354. 355, or 356 applies, AND
        - (iii) from a person the ownership of whose stock would be attributed to the purchasing corporation under §318(a) (excluding option attribution).
            - $\boxed{\text{P}}$ <u>ensures that §338 applies only to taxable acquisitions.</u>

- §338(h)(3)(1), (2) <u>"12-MONTH ACQUISITION PERIOD:</u> the ≥80% of stock by vote and value must be acquired during a 12-month period beginning with the date 1st acquisition by purchase of stock included in a qualified stock purchase
    - Ex: one-shot acquisition of ≥80% shares is QSP within 12 months period
    - Ex: Oct YR1: 5% acquired, Jan Y2: 40%, Apr YR2: 25%, June YR2 5%, Dec YR2 10%. 12-month period can start in Jan YR2. Acquisition Date = Dec YR2

- §338(g)(1): <u>ELECTION</u> must be made <u>not later than the 15th of the 9th month (i.e., within 8.5 months)</u> beginning after the month in which acquisition date occurs
    - "acquisition date" = date on which purchasing corporation first met the ≥80% test. §338(h)(2).

    - Purchasing corporation makes the election §§338(a), 338(g)(2)
        - The election is irrevocable. §338(g)(3).
        - Election is made by filing Form 8023. §338(d)(3); Reg. 1.338-2(d)
        - $\boxed{\text{P}}$ Rationale is that only the purchaser bears the tax triggered by the deemed sale of assets.

Consequences of the §338(g) Election:
- (1) (Actual) <u>sale of stock</u> by target SH to purchasing corporation:
    - **Target SH** gain/loss on sell of T shares = AR – AB tax = gain*35%
        - Recognition of gain or loss to selling corporation. §1001
    - **Purchasing corp**
        - Cost basis to purchasing corporation. §1012.

- (2) <u>Deemed sale of *all* of old target</u>'s assets at FMV (approximated by ADSP) at the close of the acquisition date while owned by purchasing corporation, §338(a)(1).
    - **Old T corp**
        - Recognition of gain/loss on deemed sale (ultimately borne by Pcorp)
        - <u>Gain/loss</u>= AR(ADSP) – AB of old Target assets
        - <u>Tax on gain</u> = gain * 35% tax

    Reg. 1.338-4(a), (b):
    <u>ADSP</u> (grossed aggregate deemed sales price) = grossed up AR (on sale to purchase corp of its recently purchased target stock) + old Target's liability + tax liabilities from deemed share * (ADSP – AB of asset)
    ADSP = GUAR + L + T *(ADSP-AB) = GUAR+L + 0.35ADSP – 0.35AB
    ADSP = (GUAR + L – 0.35AB)/0.65

    <u>Grossed-up AR</u>
    - If ALL stock purchased within 12 months period → GUAR = actual AR for the stock
    - If old stock purchased before 12 months period → GUAR = actual AR/% QSP
        - Ex: bought 20% years ago, paid $80 for 80% shares, $80/80% = ADSP is $100

    - Selling corporation's or purchasing corporation's gain or loss CANNOT be offset against target's gain or loss on deemed sale. §338(h)(9).
        - The tax liability, if any, is indirectly born by the purchasing corporation.
    - Gain/loss is determined asset-by-asset
        - Old target must allocate overall ADSP price amongst its assets
        - Character of old target's gain or loss depends on character of each asset sold

- (3) <u>Deemed repurchase of</u> all of old target's assets by <u>new target</u> the following day. §338(a)(2).

- §338(b)(1) Reg. 1.338-5(a), (b) Adjusted grossed-up basis
  AGUB = deemed repurchase price = gross-up basis (in purchasing corp's recently purchased target stock) + basis of purchasing corp's non-recently purchased stock + liabilities of new target (including tax liab)

- §338(b)(4) gross up basis (in recently purchased stock) =

$$\text{basis of stock purchased in 12 month period } \times \frac{100\% - \%\, non\ rerecently\ purcahsed\ stock}{\%\, QSP}$$

- If 100% stock was purchased @ once -> AGUB = ADSP
- If some stock held by minority SH, those shares are presumed to be purchased at sme avg price as recently purchased stock-> AGUB = ADSP

- Old target tax attributes (EP, NOLs, etc.) disappear (new target no longer has old target's tax attributes). Reg. 1.338-1(b)(1)
  - But new target remains liable for old target's tax liabilities. Reg. 1.338-1(b)(3)

Example:

1. T has 1000 shares of common. T's only asset is Greenacre (A/B 50k; FMV 300k). P buys all of T stock for 212,500 and makes 338 election. All T stock acquired by P is recently purchased, and thus grossed-up A/R = 212,500. ADSP is 212,500 plus T's tax liability on deemed sale. Under regs
   a. ADSP = G + L + T * (ADSP – B)
   b. ADSP = 212,500 + 0 + .35 * (ADSP – 50)
   c. ADSP = 212,500 + .35 * ADSP – 17,500
   d. .65 * ADSP = 195,000
   e. ADSP = 300,000
   f. Thus, T recognizes 250k gain (300 – 50) on sale of Greenacre, and T's tax liability is 87,500 (35% * 250k)
   g. New T's AGUB = 212,500 + 87,500 = 300k, all of which is allocated to Greenacre
2. Same as above, except P buys only 900 shares of T stock for 191,250. Remaining 100 owned by individual (I). T's gross-up A/R is 191,250/.90 (% of total T stock attributable to recently purchased stock), or 212,500. Then, same as above.
3. Same as first example, except P purchased 100 shares of T 5 years ago for 10k and 900 shares in the current year for 191,250. Grossed-up A/R on 900 shares of recently purchased T stock is 212,500, P's ADSP is 300k, and gain on deemed sale of Greenacre is 250k, resulting in 87,500 tax liability. New T's AGUB is sum of
   a. Cost basis to P of 900 shares of recently purchased stock (191,250), which is not grossed-up in this case since P owns 100% of T
   b. PLUS basis of P's nonrecently purchased stock (10k)
   c. PLUS T's tax liability on deemed sale (87,500)
   d. For a total ABUG = 287,250
   e. T can increase basis to 300k if it elected to recognize gain under 338(b)(3) on a hypo sale of non-recently purchased stock for average price paid for recently purchased stock (212.50), causing P to recognize 11,250 gain (21,250 less 10k)

Whether to make §338 election:

- Purchasing corporation get step-up basis in target assets, But old T will trigger recognition of gain/loss (generally not attractive for Purchaser corp to make §338 election, however it's not as costly under current law, due to lower corp tax rate @ 21%)
  - If Purchaser plans to make §338 election, the purchase price will increase
- But if Target assets are depreciable, step-up basis of Targets' appreciated assets may be attractive to Purchaser
- Weight taxable gain from deemed sale by target against value of step-up basis to Purchaser
  - Ex: if discounted present value of additional depreciation allowances provided by higher basis will exceed taxable gain to target under §338(a)(1), or there's NOL that will is wipe out tax -> make election
- Also, if target's asset is gain/loss property and target has other loss/gain → then gain/loss on deemed sale can be used to offset the other gain.
- If target is foreign corporation and would not recognize gain on sale of property in any event, then making §338(g) election is not a problem. That is usually where the §338(g) election is made. Only place where Prof. saw this §338(g) election being made in practice
- 4 choices of Purchaser Corp buy Target corp:
  - No election, no liquidation: stock sale, T stays with the same historical basis
  - No election, liquidation: parent retains assets with historical basis
  - 338(g) election, old T deemed to sell assets @ FMV, new T acquiring assets @ FMV (step-up basis but tax on gain) old T tax attributes disappears
  - 338(g) election, 332 liquidation: above consequences + sub liquidates

<u>§338(H)(10) ELECTION</u>

Background

- When target (T) is wholly owned by a corporate seller (CS) and Purchaser buys all T stocks, target group may be subject to multiple levels of tax: on old T (*if P makes 338 election*, T report gain/loss from deemed sale under §338(a)(1)), CS (on sale of T stock) and CS shareholder (§301 distribution or §331 liquidation)
- Can avoid multiple level of taxation if:
  - (1) CS liquidates T under §332/337 non-recognition (no tax), then sold T's assets to P in taxable asset sale, or
  - (2) T had sold its assets directly to P in a taxable asset sale, then liquidating distribution to CS under §332 non recognition (no tax)
- Recognizing this, Congress enacted the §338(h)(10) election.
- §338(h) avoids 2 levels taxation (only tax on fictitious asset sale) and desire where:
  - CS outside gain in T stock > T's inside gain on asset (338(h) eliminates outside gain)
  - CS' consolidated group has losses that can be used to offset any gain recognized by T on deemed §338(a)(1) sale of its assets
    - T general not considered to be member of consolidated group wrt to §338(a)(1) deemed asset sale
- §338(h) is more common than 338(g) elections

<u>§338(h)(10) Election for Consolidated Group</u>:

- CS (parent) and T (sub) can achieve this result by making joint election with P under §338 and §338(h)(10) to treat T as if it sold all of its assets for FMV to 'new T' while a member of S consolidated group, and then T distributed the sale proceeds to CS in a tax-free 332 liquidation.

<u>Requirements for §338(h)(10) Election</u>

- CS and T sub are part of a consolidated group & selling corporation owns ≥ 80% of target's stock by vote and value §§338(h)(10)(A)(i); 1504(a)(2); Reg. 1.338(h)(10)-1(b)(3), (c)(1)
    - Meet req't as long as CS and T are affiliated, no need to file consolidated return
- Purchaser makes QSP of target stock, §338(h)(10)(A)(ii)
- Both §338(g) election & 338(h)(10) election §338(h)(10)(A)(ii), Reg. 1.338(h)(10)-1(c)(3).
- Target is a domestic corporation. §338(h)(1)(B); Reg. 1.338(h)(10)-1(b)(3).

Who makes election?
- The election is made jointly by selling consolidate group/selling affiliate/selling corp and purchasing corporation. Reg. 1.338(h)(10)-1(c)(3).
- The election is irrevocable. Reg. 1.338(h)(10)-1(c)(4).
- Election is made by filing Form 8023. Reg. 1.338(h)(10)-1(c)(3).

Tax Consequence 1.338(h)(10)-1(d)
- **Tax consequence to Corporate Seller**
    - 1.338(h)(10)-1(d)(5)(iii): Non-recognition of gain/loss on sale of its stock
    - CS inherits T's tax attributes (E&P)
- **Tax consequence to Purchaser corp**
    - Takes cost basis on stock purchased §1012
    - AB = purchase price

    - **Tax consequence to old T**
        - Deemed sale of all of old T's asset for FMV -> recognition of gain/loss on deemed sale
        - AR = amount received by CS for old T stock + old T liab (NO inclusion of tax liab)
            - Tax liab on the sale is indirectly borne by seller
        - Gain/loss = AR – AB in assets
            - Gain/loss included on consolidated tax return, can be used to offset CS' gain/loss

    - **Tax Consequence to New T**
        - New T deemed repurchase of all of old T's assets (the next day while owned by purchaser) §338(a)(2)
        - AB = AGUB, determined under same rule as §338(g)
            a.

Example: CS owns all 100 shares of T stock and has 20k basis in T stock. CS and T file consolidated return. T's only asset is Greenacre (AB 40k; FMV 100k). P purchased T stock for 100k cash and parties make joint 338 and 338(h)(10) elections. T is treated as having sold Greenacre for 100k and recognizes 60k gain, which is includible on CS and T's consolidated return. CS recognizes no gain on the sale of its T stock. P takes a 100k basis in the T stock, and "new T" takes a 100k basis in Greenacre

VI - CORPORATE FORMATIONS

351 Transactions: Consequences to Transferor-Shareholders

	Nonrecognition	Basis	Holding
Transferor	351; 357	358	1223(1)
Corporation	1032	362	1223(2)

- Gain/Loss Recognition Analysis:
  - Is there a realization event?
    - Exchange of property for cash or exchange of legally-distinct entitlements (see COTTAGE SAVINGS)
  - If so, does a nonrecognition provision apply? Such as 351

§351: GENERAL REQUIREMENTS FOR NONRECOGNITION

§351(a): non-recognition of gain/loss if: (1) transfer of **property**, (2) **solely** in exchange for **stock**, (3) contributing SHs must **control** the corporation immediately after the exchange

(1) Transfer of property

(a) Transfer requirement
- Transfer is defined broadly to include complete conveyance of property, lease and nonexclusive license to use certain patents
- Excludes limited licenses of property (nonexclusive license)

(b) Property definition:
- Expansively defined to include:
  - Cash
  - tangible assets: equipment, building etc.
  - intangible property
  - Account receivable (other than those owned by the corp)
    - *Hempt Brothers*: property includes accounts receivable
      - corp will have income upon receipt of receivables → 351 overrides assignment of income principle (earner of income is taxed on it, even if the right to receive it is transferred out)
  - the transferor corporation's own stock or corporate or individual transferor's note
  - the transferee corporation's previously-issued debt obligation
    - Transferee corporation's debt obligation is considered property as long as it is evidenced by a security.
    - If not so evidenced, then not considered property for §351 purposes. §351(d)(2).
    - The debtholder who exchanges it for stock will NOT recognize gain or loss on principal, but WILL recognize gain or loss on accrued interest. §351(d)(3).
  - Note: §317 property definition does not apply here to §351
- 351(d) exceptions: excludes contribution of services
  - Transfer of services for stock -> taxable as ordinary income & do not count as part of control group
    - Service only SH should never receive more than 20% stock, o/w everyone fails control test
  - If part-property/part-services → only stock in return for property has non-recognition
  - §83: transferor who receives stock in exchange for services must include in ordinary income the excess of FMV of the stock over its cost (if any)

    Ordinary income = FMV of stock received – cost of stock (usually 0)
  - Reg. 1.351-1(a)(1)(ii) accommodation transfer (property must be >10% of contribution, o/w excluded) see below

(2) Property is contributed **SOLELY in exchange for stock**

- Idea: SH must have continued interest in the contributed assets
- Debt securities, stock warrants and stock rights are not stock -> counted as boot
- Additional contribution to capital
    - Subsequent SH contribution for no additional shares -> it's just contribution to capital, §351 non-recognition of gain
    - *Lessinger* Sole Shareholder Rule: A shareholder who owns 100% of a corp may, on transferring additional property to that entity, be deemed to have engaged in a 351 exchange even w/o receiving additional stock in exchange b/c in substance nothing is different, just the number of shares have increased.
- 351(b**) BOOT RULE**: If 351(a) would apply but for receipt of other property or money, SH receiving boot from the corporation will be taxed on realized gain to the extent of boot
    - Lesser of Rule: transferor-SH recognizes gain in amount equal to the LESSER OF
        1. Gain realized, OR
        2. amount of boot (cash + FMV of other property)
    - Analysis:
        - FIRST: calculate gain realized under §1001
            - AR = FMV of (stock + boot) rec'd
            - Gain realized = AR – AB
        - SECOND: recognize lesser of: gain realized or amount of boot under 351(b)
        - THIRD: character of gain is determined by property being transferred (usually capital gain treatment)
            - BUT: §1245 property → ordinary
        - CHECK: how much realized? How much recognized? How much not recognized?
            - What amount of basis is needed to preserve unrecognized gain? (FMV stock – AB ~ unrealized gain, except when realized gain < boot)
- 351(b)(2) **LOSS** RULE: loss is not recognized if other property and stock are received

- 351(g) Nonqualified preferred stock exception:
    - (1) Is it preferred stock as defined in §351(g)(3)?
        - *Preferred Stock*: stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.
            - if there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation -> participating in growth
            - PS eligible for §351(a) non-recognition cannot have debt-like features
                - if convertible preferred stock → is there a real and meaningful likelihood that SH will participate in earnings and growth of the corp?
            - If it meets PS defn, and it's not NQPS → then PS is stock for 351(a), non-recognition applies
    - (2) Is it nonqualified preferred stock under §351(g)(2)?
        - Nonqualified preferred stock is PS likely or required to be redeemed by company -> see below
            - P: concern that preferred stock was being used to disguise what is in substance the distribution of debt instruments (which are boot in a 351)
        - 351(g)(2): PS is **classified as NQPS under any of 4 circumstances**:
            - (i) If stockholder has the *right to require* the issuer (i.e. issuing corp) or a related person to *redeem or purchase* such stock within 20 years of issue;
            - (ii) The issuer or a related person is *required* to *redeem* or purchase such stock within 20 years of issue;
            - (iii) The issuer or a related person has the *right to redeem or purchase* the stock within 20 years, and as of the issue date, it is more likely than not that such right will be exercised, or

        - (iv) dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices
    - **Result**: If NQPS is issued in exchange for property:
        - NQPS is treated as boot under §351(b), to the transferor who receives NQPS
        - but NQPS will be treated as stock for purpose of control test under §351(a) & 368(c) (i.e. so SH who doesn't get NQPS is still entitled to §351(a) non-recognition)
- NQPS is treated as boot under §351(b), but is treated as stock for purposes of control test
    - 351(a) does not apply to SH who receives NQPS
    - 351(b) applies only if person who receives NQPS + other stock and NQPS will be treated as boot (because SH needs to get some stock)
- Loss property in exchange for NQPS
    - §351(g)(1)(B): if transferor transfers a loss property (AB>FMV) and receives only NQPS → can recognize loss = FMV-AB
        - i.e. when transferor receives no permitted (i.e. non-recognition) property in the exchange (i.e. only got other property), the loss disallowance rule of §351(b)(2) does not apply

- P: Prevent offering debt-like PS or PS with built-in redemption features to avoid §351(b) boot gain
    - Focus of first 3 cases: share are likely to be redeemed and converted to cash by shareholder, shouldn't get non-recognition treatment
    - Last case: where dividends on stock is tied to market factors, rather then E&P, the PS resembles debt. Since securities are now treated as boot under §351(b), the debt-like PS should be treated as well

(3) transferors must be "in control" of corporation immediately after the exchange
CONTROL
- 368(c): control = 80% of total combined voting power of all voting classes and 80% of the number of shares of all other classes of stock (ex: non-voting shares)
    - Test all voting share together (doesn't matter whether PS and CS)
    - Test non-voting shares class-by-class (to each class of non-voting shares)
- Control is tested in aggregate for simultaneous transferors (i.e. as a group):
    - Transferors counted cumulatively provided that they transfer property "concurrently"
- 1.351-1(a)(1)(ii) Accommodation Transfer: Stock is not treated as issued for property if:
        - (1) it's issued for property of *relatively small value (RR 77-37: <10% of stock value)* compare to stock already owned by the transferor or FMV of services contributed is < 10% of value of stock issued for service, AND
        - (2) the primary purpose of the transfer is to qualify under §351 the exchanges of property by other transferors.
    - Ex: where existing SH contribute a small amount of property together with new shareholder to have control group meet 80% control requirement OR where transferor is a service provider and contributes a small amount of property to meet 80% control requirement
    - Remember: services provider will still have compensation income under §82. Basis in shares exchanged for property take §358 transferred basis. Basis in shares exchanged for services take tax cost basis (equal to income included under §83)

IMMEDIATELY AFTER the exchange:
- 1.351-1(a)(1): does not require simultaneous exchanges by all parties, but rights of parties must have been previously defined
    - If transaction can be viewed as part of an integrated plan of incorporation -> contributing SH under plan will be considered part of "control group" even if all the exchanges did not take place simultaneously
        - test control @ the completion of such series of events

- 1.351-1(a)(3)(i): Purchasing public is part of control group, underwriter is not part of control group
- If member of control group <u>transfers stock to third party</u>, whether or not take into account transfer to third party depends on a number of factors:
  - *International Lumber & American Bantam*: when member of transferor control group disposes of stock shortly after an incorporation exchange pursuant to a <u>binding agreement</u>, that transferor is NOT in control immediately after exchange
  - <u>Step Transaction Doctrine</u>: used to determine whether two steps separated in time (exchange of property for stock and disposition of stock needed to meet the control test) will be treated as part of a plan/same transaction
    - *binding-commitment test*: is there binding commitment (before/at the time shares was received) to sell shares to outside party to bring the transferor SH below 80% threshold? If so, no requisite control immediately after the exchange (Used For 351 Transactions)
    - *Interdependence/mutual interdependence test*: were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series
    - *End/ultimate result test*: separate steps are only integrated if they were taken in furtherance and for the purpose of reaching the end result (looser than binding agreement)

American Bantum Car: assets were transferred by parties to ABC Corp for 300,000 shares of ABC voting common stock (only outstanding stock). Thereafter, SHs sought to generate cash thru sale of voting preferred stock to general public. SHs hired investment bankers to sell voting preferred and agreed to pay bankers with up to 100,000 of the common stock that they had received for contribution of property if bankers sold preferred stock. Eventually, some common transferred to bankers.

- June 3, 1936: contribution of property for 300k CS from Bantum
- June 8, 1936: agreement with underwriters to sell voting PS for cash in exchange for as many as 100k common shares
- October, 1936: 83,600 PS had been sold to general public for cash by underwriters and underwriters were paid 87,900 CS

ISSUE: is this transaction a 351 transaction?

- ABC argued not a §351 transaction → wanted cost (FMV) basis in assets received for 300k common shares (rather than reduced transferor basis) for depreciation purposes → apply step transaction doctrine (all steps of the same transaction)
- If you look at initial date, that's not the end of the transaction, need to take into account subsequent events → control not met b/c underwriters not part of transferor group (so SHs only owned 212,100/300,000 or 70%)

HOLDING: 351 transaction

- SHs had 100% control after contribution of property
- "Immediately after" is around June 8
- In determining when transaction was over, court used mutual interdependence test
  - Deal was *not contingent on performance by underwriters*
  - Only got common stock if sold off sufficient preferred
  - Deal would happen whether or not underwriters sold preferred

PUSHBACK: Even if test after all three steps, TPs still would have lost – why?

- Who are transferors of property?
- Include general public that transferred cash in exchange for preferred stock
- Each share of preferred stock was entitled to three votes
- Thus, if we take TPs argument that all steps in one transaction, after smoke clears → the original transferors of property has 212,100 votes
  - Public owned 83,600 of voting preferred w/ three votes → 250,800 votes
  - Total voting power of transferors of property (SHs + public) = 462,900/550,800 = 84%

SECTION 357: ASSUMPTION OF A LIABILITY

357(a) general rule: Assumption of transferor's liabilities is generally not treated as boot and does not prevent the exchange being with §351

- Remember §1001 AR includes liabilities assumed
- SH basis → See 358(d)
- Ex: A owns property: FMV 100; AB 60; subject to 40 liabilities. A contributes property in exchange for 60 stock. Under general rule, debt relief is not recognized as boot (and thus no recognition of 40 realized gain, absent boot) and A gets 60 stock (and corp assumes 40 liab) with AB= Ab in transferred property – liab = 60-40 (boot for purpose of basis) =20.
- The tax on the gain attributable to the assumption of the liability by the corporation is not forgiven, but is deferred through a reduction in the transferor's basis in the stock received in the exchange

357(b) Tax Avoidance Exception: assumption of a liability is treated as boot if TP's principal purpose in transferring the liability was:

1) Avoidance of income tax OR
2) NOT a bona fide corporate business purpose.

If exception applies:

- Entire liabilities assumed (not just abusive debts) are treated as boot (look for liabilities incurred right before transaction. Doesn't matter if debt> AB or not)

- When debt is borrowed is not determinative:
  - just because debt is new (borrowed right before transaction) doesn't necessarily make it avoidance purpose/no bona fide, but it's more suspicious
  - just because debt is old and cold does not necessarily make it good for 357(b)
  - 1.357-1(c): strong burden on TP to prove absence of improper purpose by "clear preponderance of the evidence" (i.e. unmistakable proof)
    - *Encumbering property for personal reasons* shortly before 351 transaction or causing corp. to assume a transferor's personal debts are examples of improper/tax avoidance purposes
    - Looks like transferor-SH is trying to cash out on appreciation in assets
- ex: If on the eve of a transaction A borrows 40 against property which A then transfers in exchange for stock/cash, then 40 liabilities will be treated as boot and 40 gain will be recognized. Basis is 60 (basis of land), less 40 (debt relief), plus 40 (gain recognized), or 60

357(c) Liabilities in Excess of Basis Exception: If the sum of the liabilities assumed by transferee corp in 351 transaction exceed total AB of the property transferred by a particular transferor, the excess is treated as gain from the sale or exchange of property

- i.e. debt assumed > transferor's AB of property transferred → gain recognized = liab – AB
- 358: The transferor's basis in Newco stock is always zero if 357(c) applies

- Ex: On formation of Newco, A transfers land (AB 30; FMV 100; 55 debt) in exchange for Newco 45 stock. A must recognize 25 gain (excess of 55 debt over AB 30). A's basis in stock is 30 (AB land), less 55 (debt relief), plus 25 (gain recognized), or zero
- Ex: property: AB=20, FMV=200, debt=10, depreciation deduction =15 → AB = 20-15=5 (§1016(a)(2) deprecation reduces AB as it's advance recovery of capital)
    - Gain realized = 200-5=195, gain recognized =debt-AB = 10-5=5.
    - §358: SH basis in stock = AB of property 5 – liab 10 + gain recognized 5 = 0

- Applied separately to each transferor (on aggregate basis) → prevention of negative basis in Newco stock
- To avoid §357(c): pay-off debt before contribution using own fund or borrowed funds
- P: §357(c) is necessary where liab > AB, if doesn't add excess of liab over AB as gain recognized provided by §357(c), may result in negative AB. Because AB is less than liab, even if reduce basis to 0, only part of the realized, but unrecognized gain from assumption of liab is preserved. However, §357(c) forces SH to recognize excess of liab over AB at time of her transfer (i.e $5), so the entire gain gets taxed (gain on subsequent sale = 190, plus 5000 gain already taxed = 195 taxable gain)

- ***If both §357(b) and §357(c) apply -> §357(b) prevails***
- Compare §357(b) vs §357(c):
    - §357(b) recognize entire assumption of liab as boot gain, where §357(c) only recognizes the excess of liab over basis
    - P Congress imposes harsher tax in case involving tax avoidance or lack of bona fide business purposes, whereas in case of §357(c) Congress only impose tax necessary to avoid negative basis problem and ensure entire realized gain at time of transfer is deferred through the use of substituted basis in §358

<u>Deductible, capex and contingent liab excluded</u>
- **357(c)(3) exception**: if in §351 transaction TP transfers liabilities, the payment of which would give rise to a deduction under §162 (interest deductions, service contracts, accounts payable, any payment that biz might have to make in the future that it has not yet made) is excluded for purposes of determining whether liabilities assumed > basis
    - *Rev. Rul. 95-75*: IRS extended this rule to include liabilities the payment of which would <u>give rise to a capital expenditure or deductible expenses</u> (see contingent liabilities below)
- P: transferor is being relieved of liability, BUT is also losing a deduction (to transferee); want to facilitate corporate formation
    - When corporation pays off liability, it can take §162 deduction or capitalize under §263 under corp's method of accounting

BOTH LESSINGER AND PERACCHI ARE CRITICIZED BY COMMENTATORS. DON'T KNOW IF TP'S OWN NOTE WILL AVOID §357(C) OUTSIDE OF 2ND AND 9TH CIRCUIT

Lessinger: (2nd circuit)

- TP transferred property where liab > AB, TP tried to use promissory note to increase AB of property transferred to reduce §357(c) gain
- TP has no basis in his own obligation to pay i.e. AB of TP's own promissory note = 0
- But court found that TP obligation increased AB of asset for purpose of §357(c), and eliminated gain from excess of liab over basis

Peracchi: (9th circuit)

- P transferred 2 properties into X Corp. Liab > AB or FMV of property (so 357(c) is lurking). P also executed a promissory note covering the liabilities in order to ensure that liabilities do not exceed basis. TP argued that AB in note = face amount/FMV
- Held: Where note is worth face amount, TP can issue promissory note to prevent §357(c) --
- Economic reality:
  - Corporation's creditor can enforce TP's note in case of bankruptcy.
  - TP had increased his risk exposure and was entitled to step-up in basis to extent he will be subjected to economic loss if underlying investment turns unprofitable.

  Economic Equivalent Theory:

  - P could've borrowed from bank and put cash into X corp (equal to difference in debt and basis), Then, X Corp could have purchased debt. there would be no §357(c) problem.

Rev. Rul. 95-74:

- Once assumed by corp, how will the contingent liabilities be treated?
  - Contingent liabilities assumed by corp are deductible as business expenses under §162 or are capitalized under §263 under corp' method of accounting

- <u>Contingent liabilities is not counted</u> in determining whether liabilities exceed basis pursuant to §357(c) and it shouldn't reduce SH basis under §358(d)
  - b/c for contingent liabilities, corporate transferor had not yet taken any deductions nor had it resulted in increase/creation of basis in any property
- transfer of deductible expenses or expenses to be capitalized –> both don't trigger §357(c)
  - because transferor haven't gotten benefit of deduction or capitalization, so transferee will get benefit
- 358: these liabilities also excluded for purposes of determining basis in stock (i.e. not treated as money)

<u>CONSEQUENCES TO TRANSFEROR SH</u>

<u>*§351: General Non-recognition Rule for Transferor-Shareholders*</u>

- §351(a): SHs do <u>not recognize gain or loss</u> on certain transfers of property to a controlled (80% control test) corp.
  - P: transaction is mere change in form of SHs' investment, not in substance. SH still have continued interest in the assets (reflected in stock) and continue to control the assets through controlling interest in corporation.
  - congress doesn't want to inhibit corporate formations by requiring recognition of gain on contribution
  - Interaction w/ other code sections:
    - <u>§83 services income:</u> transferor who receives stock in exchange for services must include in ordinary income the excess of FMV of the stock over its cost (if any)
      Ordinary income = FMV of stock received – cost of stock (usually 0)
    - <u>§1245 depreciation recapture</u>: if SH contributes §1245 property with potential for depreciation recapture in a §351 transaction, §1245 will not pick up gain unless SH recognizes gain under §351(b) boot rule

- 1245(b)(3): If transferor contributes §1245 property and 351(b) boot rule applies, then gain recognized attributable to §1245 property will be ordinary gain (*to extent of depreciation deduction* taken)
- Any gain not recaptured (i.e. amt of gain realized but not recognized) will be recaptured when the transferee corporation sells the asset (i.e. §1245 taint is retained by transferee corp, not SH)
  - §1245(a)(2)(A): recomputed basis takes account of deprecation deduction taken by transferor SH
- §267 Related Party Loss:
  - §267(b)(2): between individual and corp, where >50% in value of stock of the corp is owned directly or indirectly by such individual → disallow loss on transfer to related person
    - i.e. if in prohibited relationship of controlling SH & corp ->contributing transfer (SH) loss disallowed
      - Can look to ownership before OR after contribution transaction
    - Transferee takes AB = FMV of loss property transferred
  - §267(c)(4): family attribution rules apply → individual is deemed to own stock owned by family (here, includes spouse, brothers and sisters, lineal descendants and ancestors)
    - Effect: individual can become controlling SH by attribution, leading to loss disallowance
  - 267(d): If loss disallowed on contribution to corporation, then when corporation sells that contributed property, corp's gain on the sale is reduced by amount of loss previously disallowed wrt contributing transferor
  - §267 P: SH and corp is in a community of economic interest, where a disposition by one member of the community (SH) to another member of the community (corp) stays in the community and it's not really a loss, it's only a loss when property is disposed of outside the community

- §1239 Gain from Sale of Depreciable Property between Related Parties:
  - Re-characterizes gain from *sale of depreciable property as* ordinary income if related parties control corporation (>50%)
    - Related Parties: SH + controlled entities
    - Controlled Entities: SH (after *constructive ownership* rules) owns more than 50% of value of stock of corporation, directly or indirectly
      - 1.1239-1(c)(3)(i): If individual to entity transfer: look for control before OR after
      - 1.1239-1(c)(3)(ii): If entity to entity transfer: look for control after
  - 351: may apply where transferor-SH contributes depreciable property in exchange for shares + boot and other transferor-SHs were related to transferor-SH
  - If 1245 and 1239 both apply → apply §1245 first (so transferee corp won't pick up §1245 taint)
  - P: §1239 provides toll charge (ordinary and capital) when basis of depreciable property is refreshed, related transferee corp can depreciate assets again at cost of LTCG.
    - All of the recapture taint in the transferred property taken by transferor B is removed. When property later gets disposed of by corp, §1245 will not apply except to recapture any depreciation taken by the corporation itself

- Note: If transferor contributes cash → just a cash purchase of stock (so doesn't care whether 351 transaction or not)

- If contributing SHs contribute multiple properties: Rev. Rul. 68-55; Prop. Reg. 1.362-4(h) ex

- Realized gain and recognition of gain is computed on asset-by-asset basis
- stock & boot is allocated based on proportion of FMV (Asset FMV/total FMV)
- boot gain is recognized wrt to each gain asset transferred (cuz non-rec for loss asset)
- Character of gain is determined on a property-by-property basis (ordinary, STCG, LTCG, recapture income)
  - e.g., A contributes asset I (FMV of $220, basis of $400), asset II (FMV of $330, basis of 200), and asset III (FMV of $550, basis of 250) to Xco in exchange for $100 and 100 shares. Based on FMV, asset I is 20%, asset II is 30%, and asset is 50%. So A received $20 and 20 shares for asset I (realized loss of $180, nonrecognition cuz loss), $30 and 30 shares for asset II (realized gain of $130, recognition of $30), and $50 and 50 shares for asset III (realized gain of $300, recognition of $50)
  - P: asset-by-asset allocation ensures loss cannot offset gain such that no loss recognition even if there's boot

§358: Basis to Transferor SHs in Transferee Corp Stock

358(a)(1) Substituted Basis Stock:

- **Basis in stock received** = basis of transferred property LESS boot (cash & FMV of any other property received & §358(d): debt treated as boot) LESS loss recognized PLUS gain recognized & amount treated as dividend
  - Note: whatever gain/loss is not recognized, BIG/BIL is preserved in the stock basis for future recognition until disposition of the shares (function like deferral)
  - ex: cash method SH transferred account receivable, basis of shares = AB of account receivable (not FMV)

- 358(a)(2) FMV Basis for Other Property: Basis of any other property received by taxpayer is FMV
  - NQPS: assumed to be "other property" for purposes of 358 (although not explicit in the Code)

- 358(d) Treat Debt as Boot for Basis Purposes: When SH transfers property subject to debt, the debt is treated as boot for purpose of computing basis (only for basis, but NOT considered boot for §351 non-recognition)
  - Why have this special treatment for debt?
    - SH gains from discharge of indebtedness. §358 basis rule preserves the discharge of indebtedness type gain from later tax by treating the liability as money received for purposes of computing basis, reducing SH stock basis by the amount of liability
    - Most biz have debt and have assets that are secured liabilities
      - If all debt on assets triggered gain, almost every incorporation would trigger gain
    - Liquidity concerns – not having enough cash to pay gain (but this also true of other property that is not cash)
- 358(d)(2): 357(c)(3) liabilities not treated as money for determining transferor basis in stock (thus not subtracted in computing AB)

358(h) where AB > FMV ➔ reduce AB of the transferor in stock by the amount of the liability but not below FMV (i.e. AB = FMV)

- P: Because assumed liab is not subject general basis reduction rule of §358(d)(1) so §358(h) reduces AB to FMV. Enacted to prevent tax shelter transaction in Black & Decker, where assumed liab are stripped out and transferred separately from underlying biz.
- Notice 2001-17 Situation: A transfers Asset 1 (AB 800; FMV 800) to XCo in exchange for X stock FMV 700 and assumption of 100 contingent liabilities associated w/ Asset 1 that have not yet been taken into account by A (as either a deduction or capital expenditure). Under REV. RUL. 95-74, the

liabilities are not taken into account as liabilities for purposes of 357(c)(3) and thus for purposes of determining A's basis in stock under 358(d). Thus, under 358(a), A has 800 substitute basis. If A sold the stock after the transaction, A would recognize a 100 loss (AB 800; A/R 700). When corporation paid off liabilities, it would be entitled to either deduction or would capitalize expense. Absent any business purpose, the transaction seems to be set up to duplicate deductions.

a. IRS hasn't found any legitimate business purpose for such a transaction
   i. IRS may disallow loss on subsequent sale that generates loss for A
   ii. AND/OR may disallow deduction to corporation upon paying liability
   iii. TPs also subject to penalties under 6662, 6694, 6700 or 6701

- §358(h)(1): where basis > FMV, reduce basis of the transferor in stock by the amount of the liability but not below FMV
  - Reduce AB to FMV (Ex: AB = 700)
- 358(h)(2) EXCEPTION: 358(h)(1) does Not apply, if transferor transfers trade/business with with the assumed liab is associated to the transferee-corp OR where substantially all the assets with which the liabilities are associated are transferred to the transferee-corp

§1223(1): SH's Holding Period in Transferee Corp Stock

- <u>1223(1) tacked holding period:</u> transferor's holding period for Newco stock received in a 351 transaction in exchange for <u>capital asset or §1231 asset</u> *includes the holding period of the transferred property*
  - The holding period of stock received in exchange for an <u>**ordinary** asset</u> (or for services rendered) begins on the date of the exchange (**NOT** tacked!)
    - P: since stock is capital asset, ordinary assets in exchange for stock cannot have tacked holding period because it would be too much conversion opportunity to convert ordinary asset (generating ordinary income) into long-term capital assets (that generate LTCG)
  - §1231 assets = depreciable and real property (ex: build and equipment)
- ex: A transfers land (1231 asset) held long-term (60 FMV; 10 AB) and inventory (40 FMV; 30 AB) in exchange for 100 common stock. B/c A received stock in exchange for 1231 asset and an ordinary income asset, each share takes a split holding period: 60% includes period in the land and 40% commences as of the date of exchange. If A were to sell next day for 100, then A would recognize 36 long-term capital gain and 24 short-term capital gain.

<u>CONSEQUENCES TO TRANSFEREE-CORP</u>

§1032: Non-recognition of gain/loss

- §1032(a): transferee corp does <u>not recognize gain/loss</u> when it receives money or property in exchange for stock
  - This is an exception to §1001(c) general rule (gain is recognized when realized)
  - even if §351 fails -> §1032 still applies and no recognition of gain/loss
- P: TP has continuing investment in corporation, only the form changed, no change in substance

- §83(h) If <u>services</u> was in exchange for stock -> corp take deduction= compensation paid to service provider

§362: Transferee Corp's Basis in Transferred Assets

General Rule - Transferred Basis Rule for Transferred Property

- 362(a): transferor corp's <u>basis in property received</u> = transferor SH basis in property + gain recognized by transferor SH
  - $\boxed{\text{P:}}$ Transferred basis preserves SH level gain/loss in corporation's hands, adjusted up by gain recognized b/c it reflects the portion of SH realized gain that's already recognized
  - $\boxed{\text{P:}}$ §§358 & 362 transferred basis the effect of double tax/duplicating gains and losses
    - Duplication of gain: same BIG taxed twice on a sale of transferred property by corporation and on sale of stock by shareholder
      - This prevents transferor to accomplish indirectly what it could not do directly (i.e. X Corp to sell property received without tax - if property has step-up basis to FMV, X sell at FMV, no tax)
    - By its nature, subchapter C creates double tax, §§358, 362 just extends the double tax to pre-contribution appreciation

<u>Basis Limitations & Synthetic Losses</u>

362(d)(2) **Limitation On Transferred Basis**: response to 357(c) & 362 planning opportunities for basis increase

- Situation: ForCo has securities (AB 150; FMV 150) that is purchased with 25 cash and 125 debt. If ForCo sells securities, it will not recognize any gain as AB = FMV. ForCo organizes 3 US subs (X,Y, Z) and contributes 1/3 securities to each sub, each sub get $50 of securities. Debt is cross-collateralized, each sub subject to $125 debt (each sub is responsible for all debt)
  - Under Former Rules:
    - §357(c): debt 125 > AB 50, excess = 75 → recognize $75 gain for each of X, Y, Z
      - FCo is not US TP, doesn't pay tax on gain
    - §362(a) AB of securities held by each sub = 50 AB + 75 gain = 125
    - Each sub can then sell securities with AB 125 and FMV 50 to generate 75 loss per sub -> total loss = 75*3 =225
    - FCo multiplied basis: basis went from 125 to 125*3 = 375
    - If each parcel secures 1/3 of the debt, then no 357(c) b/c secured debt is less than 50 AB. BUT if each parcel secures entire 125 debt, then on contribution of each parcel to US entities, ForCo should recognize 75 gain (extent to which 125 debt exceeds 50 AB). However, b/c ForCo is not a US taxpayer, there is no tax paid.

1. 362(d)(2) (before 362(e) was enacted)**:** Basis will not be increased above FMV by reason of gain recognized to transferor as a result of assumption of liability
   a. Addresses issue that arises from cross-collateralization of debt (that generated basis in excess of 125 debt)
   b. <u>REQUIREMENTS</u>: applies where multiple assets are cross-collateralizing debt, but no party is paying any tax on gain recognized
   c. <u>EFFECT</u>: limits amount of gain recognized as if transferee corp's assumed a ratable portion of the debt
      i. Thus, in example above, XYZ would be allocated a ratable portion of the original 125 debt (rather than allowing them a basis increase for entire 125)
         - 1.3 of debt (125/3=41.6) is deemed to have been transferred to each sub: X, Y Z
         - 41.6<AB 50 → no multiplication of loss and basis

Limitation on transfer of BIL (AB > FMV) & 362(e)(2)(c) election

- 362(e)(2)(A): If in a §351 transaction the transferee corp's aggregate AB in transferred property exceeds aggregate FMV of property immediately after the transaction, then aggregate AB of transferred property cannot exceed FMV of property after transaction
  - 1.362-4(b) *Loss Duplication Transaction*: compare aggregate bases of assets transferred by a single transferor-SH (on a <u>transferor-by-transferor basis</u>) with aggregate FMV of assets

  - If aggregate AB < aggregate FMV (i.e. net aggregate BIG) → 362(e)(2) rule does not apply

- <u>If aggregate AB > aggregate FMV (i.e. net aggregate BIL) ➔</u> corp's <u>AB of transferred property = FMV</u>
  - i.e. if loss duplication transaction as defined in 1.362-4(g)(i) & (ii) → 362(e)(2) applies

- Test aggregate basis at time after increase in basis by gain recognition due to boot, if any
- $\boxed{\text{P:}}$ where there's a loss duplication transaction such that the transferred property basis is greater than FMV, this provision denies the duplication of loss (to extent of BIL) and limits corp's AB in transferred property to FMV, so that the loss is preserved only once in the SH's hands

- (1) *Identify Loss Duplication Property*: if 362(e)(2) applies because there is a net aggregate BIL in assets transferred in a 351 transaction, then determine which of the assets is loss duplication property
  - 1.362-4(g) Loss Duplication Property: basis that transferee corp would take in asset under 362(a) (absent 362(e)) would exceed FMV of asset
- (2) <u>Reduction in loss = Net</u> <u>BIL * (BIL for loss property/aggregate BIL)</u>
- (3) *Allocate Net Built-In Loss to Basis of Loss Duplication Property*: take basis of loss duplication property as calculated under 362(a) and reduce by net built-in loss
  - If more than one loss duplication property, then allocate net built-in loss based on relative built-in losses
- (4) Basis Of Big Property: takes AB under 362(a)

- How to avoid §362(e)(2)? Lard up the transaction by contributing appreciated property with depreciated property to either eliminate/reduce its application

- **<u>362(e)(2)(C) Election</u>**: If 362(e)(2)(A) applies, transferor-SH and transferee Corp may jointly elect to reduce SHs' basis in stock received by BIL rather than the corporation's:
- Transferee corp's basis in transferred assets = AB, and
- Transferor SH's basis in the stock is reduced by amount of BIL (generally limited to FMV of transferred property immediately after transfer)

- If basis has been adjusted due to boot/recognition of gain:
  - 1.362-4(d)(2): reduction in AB = BIL that would've been, had the election not been made (can be different than the difference between FMV and original basis)

- Why take the election?
  - If the asset is depreciable property, higher basis (cost basis) at corporate level will result in higher depreciation allowance than transferred basis

<u>Examples</u>
- Ex: T transfers three properties: 1) A (FMV 500, AB 200); 2) B (FMV 200, AB 500); 3) C (FMV 100, AB 400). Aggregate FMV is 800 and aggregate AB is 1,100. Net built-in loss is 300. There will thus be a 300 reduction in the corporation's basis that would be allocated among the three properties in proportion to their respective built-in losses. Corporation's bases in B and C (each had a built-in loss of 300 before transfer) would each be reduced by 150 (300*300/600) to 350 and 250 respectively. None of the 300 reduction would be allocated to A which had a built-in gain before transfer.

- 1.362-4(h) Ex #1: A owns Asset 1 (AB 90; FMV 60) and Asset 2 (AB 110; FMV 120). In 351 transaction, A transfers assets to X in exchange for all of X stock. A's transfer of assets is a 362(a) transaction. But for 362(e), X's aggregate basis immediately after transaction would be

200 (90 + 110), which would exceed FMV 180 (60 + 120). Thus, the transfer is a loss duplication transaction and A has a net built-in loss of 20 (200 – 180).

- But for 362(e), X's basis in Asset 1 would be 90, which exceeds 60 FMV after transaction. Thus, it is loss duplication property.
- But for 362(e), X's basis in Asset 2 would be 110, which does not exceed 120 FMV after transaction. Thus is not loss duplication property.
- Under 362(e), X's basis in Asset 1 is 70, computed as 90 basis under 362(a) reduced by 20 net built-in loss.
- Under 362(a), X's basis in Asset 2 is 110.
- Under 358, A has exchanged basis in X stock of 200.
- If 362(e)(2) election, then A reduced basis by net built-in loss to 180 (200 – 20) and X has basis in Asset 1 of 90 and 110 in Asset 2.

VARIATION: LOSS DUPLICATION TRANSACTION W/ BOOT:

a. FIRST: Determine basis under 362(a) as if no 362(e)(2)
    i. 362(a): carryover basis + gain (but not loss) recognized by transferor under 351(b)
b. SECOND: Under 351(b), gain (but not loss) recognized to extent of boot
    i. Determine gain/loss realized for each asset
    ii. Consideration received (boot + stock) is allocated proportionately among assets transferred based on relative FMV of the assets transferred
    iii. Add bases of assets together to determine aggregate basis of assets immediately after transfer
c. THIRD: Compare aggregate basis as computed above w/ aggregate FMV immediately after transfer to determine if there is a loss duplication transaction
    i. Net built-in loss: aggregate basis > aggregate FMV
d. FOURTH: Identify loss duplication property
    i. But for 362(e)(2): 362(a) basis v. FMV
e. FIFTH: Reduce basis of loss duplication property by net built-in loss
f. SIXTH: Determine transferor's basis under 358
g. SEVENTH: Apply 362(e)(2)(C) election to determine alternative.
h. 1.362-4(h) EX #6: A owns Asset (AB 80; FMV 100) and Asset 2 (AB 30; FMV 25). In a 351 transaction, A transfers Asset 1 and Asset 2 to X in exchange for 10 shares of X stock and 25 cash. A's transfer of assets is a 362(a) transaction. But for 362(e)(2), X's aggregate basis in those assets would be 130:
    i. Under 362(a), X's basis in property acquired in 351 transaction is same as property in hands of transferor, increased by any gain recognized to transferor on transfer.
    ii. Under 351(b), gain (but not loss) is recognized to extent a transferor in 351 exchange receives boot in addition to stock. Under 351(b), consideration is allocated proportionately (by value) among transferred assets.
        1. Asset 1: 80% of value (100/125)
            a. Thus, 80% of stock (8 shares) and 80% of cash (20) are treated as being received in exchange for Asset 1.
            b. Therefore, A recognized 20 of gain for cash received in exchange for Asset 1.
        2. Asset 2: 20% of value (25/125)
            a. Thus, 20% of stock (2 shares) and 20% of cash (5) are treated as being received in exchange for Asset 2.
            b. BUT, A recognized no loss for amount received for Asset 2.
        3. Thus, X has a basis of 100 in asset 1 (80 carryover + 20 gain recognized by A) and a basis of 30 in asset 2 (30 carryover).
    iii. Therefore, b/c X's aggregate basis in assets is 130 (100 + 30), which exceeds the aggregate 125 value of the assets transferred by A, the transfer is a loss duplication transaction and A has a net built-in loss of 5 (130 – 125).
    iv. But for 362(e)(2), X's basis in Asset 1 would be 100 (80 + 20), which would not exceed Asset 1's 100 value immediately after transaction → not loss duplication property.
        1. Under 362(a), X's basis in Asset 1 is 100.
    v. But for 362(e)(2), X's basis in Asset 2 would be 30, which would exceed Asset 2's 25 value immediately after transaction → loss duplication property.

1. Thus, X's basis in Asset 2 is 25, computed as its 30 basis under 362(a) reduced by A's 5 net built-in loss.

vi. Under 358, A's basis in the X stock is 105 (sum of its 80 basis in Asset 1, 30 basis in Asset 2, and its 20 gain recognized, reduced by 25 cash received in exchange)

vii. If 362(e)(2)(C) election, then A reduces basis by net built-in loss (5) to 100 and X's basis in Asset 2 is 30.

§1223(2): Corporation's Holding Period in Transferred Assets

- §1223(2) Tacked holding period: Newco's holding period for transferred property received includes the transferor's holding period, without regard to whether the property was a capital asset or 1231 asset in the transferor's hands
  - ex: A transfers land (1231 asset) held long-term (60 FMV; 10 AB) and inventory (40 FMV; 30 AB) in exchange for 100 common stock. Newco takes tacked holding period in each asset.

FAILED 351 TRANSACTIONS

Consequences to Transferor-Shareholders

- recognize gain/**loss** in transferred property under general §1001 principles
  - If stock/securities received → A/R = FMV of stock/securities received
  - If services provider → recognize compensation income under §83 (and corp takes deduction under 162)
- Transferor takes cost basis in shares received

- Holding Period: new holding period

Consequences to Transferee-Corp

- §1032 non-recognition of gain/loss on receipt of money or property in exchange for stock
  - §83(h) If services was in exchange for stock, then corp can take deduction in the amount of compensation income received by service provider (i.e. deduction= compensation paid to service provider)
- §1012 corp takes cost basis in property received
- Holding Period: no tacking; new holding period

VII - TAX-FREE REORGANIZATIONS

INTRODUCTION

Policy & Types Of Reorgs

- In order to qualify as a reorg, a transaction must fall within one of the categories in §368(a)(1)
- §368: transactions that qualify as reorgs under 368 are wholly or partially tax free to corps and their SHs
- 1.368-1(b): reorg is merely a readjustment of a continuing corp enterprise, resulting in a continuity of investment
- Gain/loss of corp parties to a reorg is deferred thru transferred and exchanged bases for corp assets and SH stock

Acquisitive Reorgs

- Acquisitive reorgs are transactions where one corp (acquiring corp, P) acquires assets or stock of another corp (target corp, T), includes:
  - Type A: Statutory mergers or consolidations
  - Type B: stock-for-stock acquisitions
  - Type C: stock-for-asset acquisitions
  - Triangular reorgs: involve use of sub
  - Nondivisive Type D: transfers of substantially all of the assets of one corp to another commonly controlled corp followed by a liquidation of the first corp
- Divisive Reorgs: divisions of a single corp into two or more separate corp entities

ANALYZING A REORG

- 1): determine if transaction qualifies as a reorg
  - Does transaction satisfy both literal *statutory requirements* and *regulatory requirements (*continuity of proprietary interest, continuity of business enterprise, and business purpose, plan of reorg) derived from case law that are incorporated in regs. (1.368-1(b))
  - 1.368-1(a): Other judicial doctrines, like step-transaction doctrine, may apply
- 2): If transaction qualifies as reorg, the specific tax consequences to parties are determined by *operative* provisions that govern recognition gain or loss, treatment of liabilities, basis, and carryover of tax attributes (i.e. E&P and NOLs)
- 3): If transaction fails to qualify as a reorg, tax consequences are determined under general Subchapter C principles

REGULATORY REQUIREMENTS

- A good reorg must meet requirements as follows:

Plan of reorganization

- 1.368-1(c): transaction *must be pursuant to a plan of reorganization*
- 1.368-2(g) plan of reorganization refers to a consummated transaction specifically defined as a reorg under 368(a). the term is not designed to broaden the definition of reorg, but rather to *limit* it to transactions specified in the plan
- 1.368-3(a): plan of reorg must be *adopted* by each corporation that are parties to reorg

Continuity of shareholder proprietary interest

- 1.368-1(e)(1): requires that a substantial part of proprietary interest in T be preserved through an equity interest in P
  - Purpose: prevent transactions that resemble sales from qualifying as tax-free reorgs

    - 1.368-1(e)(1)(i): P must acquire T by using consideration that represents a proprietary interest in P's affairs (i.e. P stock) and that stock must be a substantial part of the value of the consideration used in reorg
        - Debt instruments, including convertible debt, do not confer the requisite proprietary interest

Continuity of business enterprise

- 1.368-1(b): requires continuity of business enterprise under modified corporate form
- 1.368-1(d)(1): P either must continue T's historic business OR continue to use a 'significant portion' of T's historic business assets in any business
    - The facts that P and T are in the same line of business tends to establish the requisite continuity but is not alone sufficient
    - 1.368-1(d)(3)(ii) historic business assets means: assets T used in its historic business
- 1.368-1(d)(3): P use of target's intangibles assets counts for purposes of COBE
- 1.368-1(d)(2)(ii): If T has more than one business, P only must continue at least one 'significant' line of T's business
    - 1.368-1(d)(3)(iii) significant: all facts and circumstances are considered in evaluating whether business line is significant
    - In general, portion of those assets that are considered significant is based on relative importance to the operation of the business
    - P has to continue T's most recent business, not just a business T enter into for sake of reorg
- 1.368-1(d)(5), EX #1: T conducts 3 separate lines of business which are of equal value. T disposes of 2 of the businesses for cash and, six months later, T merges into P, with T shareholders receiving P stock. If P continues T's remaining business, the continuity of business enterprise test is met because P is continuing a "significant line" of T's business.
- 1.368-1(d)(5), EX #5: T is manufacturer and P operates a lumber mill. T merges into P, which disposes of T's assets immediately after the merger and does not continue T's manufacturing business. Continuity of business enterprise is lacking because T neither continues T's historic business nor uses its historic business assets.
- Rev. Rul. 81-25: Same as EX #5, except after the merger P sells its lumber mill and uses the proceeds to expand the manufacturing business formerly conducted by T. The continuity of business enterprise requirement is met because P continues T's historic business. It is irrelevant that P sold the business it conducted prior to merger.

- Note: focus is on continuity of T's enterprise, don't care if P sells its own assets
- P: it should only be change in form of T business but not change in substance. T SH continues to have proprietary interest in the business, in a different form

Business Purpose

- 1.368-1(c): reorg requires transactions be motivated by a business purpose (apart from tax avoidance)

VII - ACQUISITIVE REORGS: TYPE A (STATUTORY MERGERS)

MERGER AND CONSOLIDATION DEFINED

- Definition: 368(a)(1)(A): Type A reorg means a statutory merger or consolidation (under state law)
    - Ex of typical statutory merger: P corp acquires the asset of T corp, in exchange for assumption of T's liabilities and for stock of the P corporation (and possibly additional consideration)
    - Note: Acquiring corp cannot use its Parent stock as consideration (no parenthetical language)

- Merger: assets and liabilities of T are transferred to P and T dissolves by operation of law
    - Consideration received by T shareholders is determined by merger agreement
    - Don't need third party consent (i.e. lessors, creditors), but do need shareholder consent and there are dissenters' rights

- Consolidate: transfer of assets and liabilities of two or more existing corporations to a newly created corp
  - Transferor corps dissolve by operation of law and their SHs own stock of the new company
- Divisive Merger: transaction that is a merger under state law where a corp's assets are divided among two or more corps
  - A divisive merger where only some of T's assets are transferred and T remains in existence does not qualify as a Type A reorg
  - 1.368-2(b)(1)(iii), EX #3: T's transfer of assets and liabilities to 2 acquiring corps followed by T's dissolution, with T SHs receiving stock of both acquiring corps does not qualify as a Type A reorg

CONTINUITY OF SHAREHOLDER PROPRIETARY INTEREST REQUIREMENT

- 368(a)(1)(A) has no express restriction on permissible consideration received in type A reorg,
- BUT 1.368-1(e): SH of Target must maintain sufficient continuity of interest, failing which results in taxable sale
  - P: purpose of COI is to prevent transaction that would be sales from qualifying for non-recognition of gain/loss in tax free reorg

- COI REQUIREMENTS:
  - (1) **equity requirement**: 1.368-1(e)(1)(i): T's SH must receive equity interest in P:
    - **Only stock** (of any class: CS/PS, voting or nonvoting, including NQPS) counts towards COI
      - *Southwest Consolidated*: stock warrants/options do NOT provide COI – they only become stock upon conversion
      - *John Nelson*: preferred stock (even if nonvoting & redeemable) qualifies as stock
    - **debt** (ex. Long-term bonds which is securities), debt convertible into equity, or cash/cash equivalents (ex. Short-term notes) do not count toward COI
  - (2) **40% stock received requirement**: §1.368-1(e)(2)(v), ex #1: SH of Target in the aggregate must receive stock of Purchaser corp at least 40% of Target's stock in value
    - focus on % (by value) of equity consideration received by SH of T relative to total consideration received
    - *Minnesota Tea*: in exchange for their T shares, equity must be a material part of consideration received by T SHs. Focus on stock as % to consideration received, don't focus on equity paid as % of P corp
    - P: focus is on consideration received, not P outstanding shares. Because otherwise, it's impossible for small biz to be bough t by larger biz

    - 1.368-1(e)(2)(v), ex #1: 40% continuity (i.e. consideration is 40% stock) satisfies requirement
    - *John A. Nelson*: requirement met by lesser % (only 38% was nonvoting preferred stock)

    - T shareholders must acquire a definite and material interest in P Corp that must be a substantial part of the value of consideration transferred
    - *Rev. Rul. 66-224*: COI test is met even if some T SHs receive only cash or P debt, as long as **T SHs as a group maintain COI→** *in the aggregate* must be 40% equity consideration (but only SH who receive stock will be entitled to non-recognition)
      - COI test applies to aggregate
      - Ex: Same as Ex. 1, except SHs owning 60% of T stock receive P preferred stock and remaining T SHs receive cash. SHs as a group have 60% continuity, thus transaction qualifies as Type A reorg. Those who receive cash must recognize gain.
    - Rev. Proc. 77-37: IRS **historically** required at least 50% of consideration paid by P must consist of P stock, which may be common or preferred and need not be voting stock

Measuring Continuity of Interest

- 1.368-1(e)(2)(i), (ii)(A) signing day rule: in determining whether requisite COI is met for a transaction where consideration is "fixed", the measuring date is the last business day before the first date that the merger contract is "binding" (i.e. when it is enforceable under applicable law)
  - *i.e. to pass COI: need fixe consideration and pass 40% test on signing day*
  - 1.368-1(e)(2)(iii): consideration is fixed if contract provides the number of shares of P stock and the amount of nonstock consideration to be received by T SHs
  - K is does not provide fixed consideration if it provides contingent adjustments to consideration that prevent T SHs from being subject to economic benefits and burdens of ownership of P's stock after signing date
    - Ex: if K provides contingent adjustment to # of shares from P to T SH computed using value of P shares AFTER the signing date -> not fixed consideration
  - 1.368-1(e)(2)(v), EX. #1: On January 3 of Year 1, when the value of publicly traded P stock is $1 per share, P and T sign a binding contract pursuant to which T will merge into P on June 1 of the same year. The contract provides that T shareholders will receive 50 P shares and $50 cash in exchange for all the outstanding stock of T. On June 1, when the merger is consummated, the value of P stock is 25 cents per share. Because the transaction provides for fixed consideration pursuant to a binding contract, the determination of whether the continuity of interest requirement is met is made as of January 2, the last business day before the first date that the merger contract is binding. As a result, the merger qualifies as a Type A reorganization even though the consideration received by the T shareholders on June 1 is $12.50 in P stock and $50 cash.

- If consideration is not fixed -> COI is tested as of closing date

POST-ACQUISITION CONTINUITY

- 1.368-1(e)(1)(i)/1.368-1(e)(8), Ex#1 & Ex#3: post-reorg sales of P stock by former T SHs (to unrelated party) generally are not considered in determining whether COI requirement is met, even if dispositions are pursuant to a preexisting binding contract
  - *(i.e. T SHs can sell P stock after reorg, if they don't sell back to P or money didn't come from P)*
  - 1.368-1(e)(1)(ii), (e)(2) Exception: If T SHs sell P stock for cash to P or a related party (P sub), the sale is counted in determining COI (*i.e. may fail COI if too much stock sold for cash*)
    - 1.368-1(e)(4): related parties include affiliated group under §1504 (i.e. parent owns 80% of votes and value of sub), also a corp not related to T is treated as related to P if the relationship is created in connection with potential reorg
    - 1.368-1(e)(8) Ex 4(iii): shortly after merger T SHs sell P stock to wholly-owned sub of P Corp in exchange for cash generated by wholly-owned P Sub→ COI not met because TSH didn't preserve their equity interest in T

- 1.368-1(e)(8) Ex 3: P helps T SH obtain registration rights so they can sell their stock in public market. The sale of P stock owned by the T SH is disregarded and does not affect COI
  - *i.e. post-reorg market transaction will not break COI*
  - same applies if P agreed to help T's SH to sell their P stock to unrelated parties -> does not ruin COI

- ***Rev Rul. 99-58***
  - open market buyback (i.e. redemption) of P shares through a broker does NOT affect COI and does not ruin a good reorg, if there was no agreement between T SHs and P that T SH's ownership would be transitory
    - the buyback is NOT viewed in connection with the merger
    - In open market, P doesn't know who the sellers are and T SHs don't know who are the buyers, and buyback program doesn't favor former T SHs
    - Even if some stock bought by P are from T SHs, they are merely coincidental (and viewed as market transaction)

  - But if there was an agreement that P would buyback T SHs' shares – may break COI
  - Reason why P purchase in open market is that it doesn't want to dilute existing SH o/s, so it buyback # shares equal to # shares issued in reorg, resulting in same # of outstanding SH before and after reorg

- P: IRS effectively took snapshot view to test COI at time when the deal is signed, why did IRS not require parties to keep track of stocks after transaction?
  - Answer: administrative difficulty to track all the stocks post-reorg. Also, shouldn't' hold minority SH hostage for what significant SH does
    - ex: A has 40% of shares issued in reorg, 1000 other SH has 60%. When A sells share post-reorg (as long as not sell back to P or money came from P), the other 1000 SHs who may not have cash shouldn't be forced to pay tax

PRE-ACQUISITION CONTINUITY

- ***Seagram Corp***: COI was preserved notwithstanding significant pre-merger sales of T stock to 3rd parties.
  - For COI, the existence of a continuing equity interest, not the identity of historic SHs, was determinative
- 1.368-1(e)(1)(i): mere disposition of T stock prior to a potential reorg to buyers unrelated to T or P is disregarded in applying the continuity of interest doctrine (i.e. pre-reorg sale to unrelated party is ok for COI)
  - Continuity is adversely affected only if T stock is bought by P (or related person) pursuant to reorg
  - Historic shareholder concept is not relevant in acquisitive reorgs (focus on COI, nature of consideration paid by P)
- 1.368-1(e)(1)(ii):
  - redemption money paid by T is NOT part of consideration received, unless money is paid by P
    - i.e. if money paid by T can be traced to money paid by P, the money received by T SH will count for COI test (as boot, not as equity) (i.e. SH receipt of cash viewed as part of reorg)
    - if T uses its own money to redeem SH, it's not viewed as payment by P & that cash is NOT taken into account for COI test (i.e. SH receipt of cash is NOT viewed as part of reorg)
  - pre-reorg redemptions of T stock generally do not count/disregarded against COI unless treated as boot in the reorg
- 1.368-1(e)(8), EX #1(ii): A owns 100% of the stock of T, Inc. (value– $100,000), which has negotiated a merger with P. Shortly before the merger is consummated, B, who is unrelated to T or P, purchases all of A's T stock for $100,000. Then, in the merger, B receives $50,000 cash and $50,000 P stock in exchange for her T stock. Continuity of interest is satisfied because B's T stock was exchanged for a sufficient amount of P stock (50% of total consideration) to preserve a substantial part of the value of the proprietary interest in T. The fact that B was not a "historic" T shareholder is irrelevant.
- 1.368-1(e)(8), EX #9: A owns 60% and B owns 40% of the stock of T, which has negotiated a merger with P. Because A does not wish to own P stock, T redeems all of A's T shares in exchange for cash, none of which is provided by P. T then merges into P, and B receives solely P stock. T's pre-reorg redemption is not considered in determining if continuity of interest is preserved. The merger qualifies as a Type A reorganization because B's proprietary interest is preserved.

VII - ACQUISITIVE REORG: TYPE C (STOCK-FOR-ASSET ACQUISITION)

BASIC DEFINITION

- §368(a)(1)(C): P acquires substantially all of T's assets solely in exchange for **P**'s voting stock (or voting stock of **P's parent**).

- Differs from a merger in that:
  - T's assets and liabilities are not automatically transferred to P by operation of law
  - T does not immediately dissolve but must distribute the consideration it receives from P (and any assets it retains to its SHs in a complete liquidation)
  - T doesn't necessarily transfer liabilities to P

Voting Stock Requirement:

- qualitative requirement: Like a Type A, requires equity consideration (cash, notes, convertible bonds will not qualify as equity - Southwest Consolidated)
  - BUT Type C is stricter than a Type A → voting stock required for Type C
  - nonvoting PS will NOT count as "voting stock"
- Quantitative Requirement: focuses on % consideration that is voting stock and not % ownership in P stock (*Minnesota Tea*)
  - Don't have to worry about quantitative requirement being satisfied b/c requirement is embedded in statutory definition of a Type C reorg (voting stock required)

FAILED TYPE C:

- Treat as taxable asset acquisition, followed by taxable liquidation (see later)
  - 1.368-2(k)(3): A transaction otherwise qualifying as a Type C reorg is not disqualified if P transfers all or part of the T assets it acquires to a controlled sub of P. Also allowed to drop down to lower-tier P subs.

"SUBSTANTIALLY ALL" REQUIREMENT

- §368(a)(1)(C) requires P to acquire substantially all of T's assets
- ***Rev. Proc. 77-37***: Service requires T transfers its assets representing at least 90% of the FMV of T's net assets and at least 70% of the FMV of gross assets held by T immediately prior to the transfer
  - Assets distributed by T to *redeem* stock held by dissenting and other minority SHs AND *unwanted assets* sold by T to other buyers are considered as assets held by T if the distributions are part of a *reorg plan*
  - Net asset = gross asset – liabilities (note: compare net asset transferred (which subtracts for liab transferred)/T's net asset)
- P: purpose of substantially all requirement is to ensure that divisive transaction will not qualify as C reorg

- ***Rev. Rul. 88-48***: If T sells 50% of its *historic assets* to unrelated parties for cash, and then transfers all its assets (including sales proceeds) to P, the "substantially all" requirement is met, because T transfers all its assets and the effect of the transaction was not divisive (i.e. former business was sold to unrelated party and sale proceeds were not retained by T or its SHs)

- Note: If T Corp does retain assets to distribute to creditors, it might be required under §361(c) to recognize gain if the assets distributed are non-qualified property and have appreciated in value. SH receiving such retained assets in exchange for T stock will receive boot (gain recognition) – not smart
- Note: the 90%/70% is IRS position, not the law. You can have good C reorg based on case law

"SOLELY VOTING STOCK"/BOOT RELAXATION RULE

- §368(a)(1)(C) requires consideration for T's assets consists solely of voting stock of P (or P's parent)
  - P: voting stock requirement ensures there will be COI

- §1.368-2(d)(1): S cannot use both S voting stock and P voting stock, otherwise it will disqualify the reorg

- 2 <u>exceptions</u> to voting stock requirement:
  - (1) boot relaxation rule §368(a)(2)(B)
  - (2) P can assume liabilities of T (or property subject to liabilities) in any amount, if the other consideration consists exclusively of voting stock of P §367(a)(1)(C)

- <u>§368(a)(2)(B) Boot Relaxation Rule</u>: P's use of cash or other boot (consideration other than P's voting stock) will not disqualify Type C reorg treatment, provided that P <u>acquires</u> **<u>at least 80%</u>** of the FMV of all of <u>T's assets solely for voting stock</u>
  - Flush language: For purpose of applying the 80% requirement, *liabilities assumed are treated as cash consideration* IF there is other boot (i.e. money or other property) in the transaction

- §368(a)(1)(C): for purpose of determining "solely for stock" requirement, P's <u>assumption of **liabilities** is **disregarded** if it's the **only** consideration</u> other than voting stock (implying solely req't will be met)
  - But if P also pays cash/other boot (& assumes liab) → liab is not disregarded and is treated as boot, and 20% permissible boot is reduced by liab assumed

  - *RR 73*-102: liab created in reorg and assumed by P (e.g. obligation to pay cash to dissenting SHs of T, this is different than assumption of T's liab) is treated as boot for §368(a)(2)(B)

  - Thus, under §368(a)(2)(B): the sum of:
    - (i) liabilities assumed (if boot paid),
    - (ii) FMV of other boot consideration, and
    - (iii) FMV of assets retained by T,
    - cannot exceed 20% of gross FMV of T's assets.
  - i.e. total boot (non-voting stock consideration) cannot exceed 20% of consideration/T's property (permissible boot is reduced by liab assumed or less than all of T's assets are transferred)

- Ex: T has 100k of assets and no liabilities. P acquires all of T's assets in exchange for 80k P voting stock and 20k cash. Transaction qualifies because P has acquired at least 80% of T's assets solely for P voting stock.
  - Same as above, except P acquires 90k of T's assets for 75k of P voting stock and 15k cash, and T retains 10k of its assets. Transaction does not satisfy boot relaxation rule b/c P only acquires 75% of T's assets for P voting stock. (asset retained + cash = 25% > 20%)
  - Same as first example, except that T has 100k of assets and 20k liabilities. P acquires all of T's assets in exchange for 79k of P voting stock, 1k cash and assumption of T's liabilities. This transaction does not satisfy the boot relaxation rule b/c the liability assumption is treated as cash consideration and thus P only acquires 79% of T's assets for P voting stock.
- Ex: P buys 100%/100K T's assets and assumes 25K of T's liab (25% of T assets FMV), it's C reorg because liab is disregarded §368(a)(2)(C) because the other consideration is solely voting stock.
  - Same fact, except T has 15 liab. Under §368(a)(2)(B), P may issue 80K voting stock, assume the 15K liab and pay up to 5K cash.
  - But if T retains 1K of assets, and Y issues only 79K voting stock (+ 15K liab assumed + 5 K cash) → not good C reorg because assume of liab assumed (15K) and asset retained (6K) exceeds 20% FMV of T's assets (20K)

- *RR 73-54*: payment by P of T's share of reorganization expenses (e.g. legal and accounting fees) is not boot if such expenses were directly and solely related to the reorg. But payment of unrelated expenses (e.g. investment and estate planning advice to SH) is treated as boot

LIQUIDATION REQUIREMENT

- 368(a)(2)(G) liquidation requirement: In Type C reorg, T must distribute all of the stock, securities or other properties received from P and any retained assets pursuant to reorg plan, unless IRS agrees to waive this requirement
  - If T fails to distribute/continue in existence -> fails C reorg, the transaction will be treated as a taxable exchange

  - As a practical matter, this means that T must completely liquidate after its exchange w/ P.
    - In rare case where IRS waives distribution requirement, T is treated for tax purposes as if it had distributed its assets and recontributed them to the capital of a new corp.

  - $\boxed{\text{P}}$: why liquidation requirement?
    - Type C is meant to have merger equivalence, where T disappears
    - If T distributed stock received in asset acquisition by P to T shareholders, but did not liquidate:
      - Transaction seems like a 351 transaction without the 80% control requirement (T shareholders able to receive P stock in tax-free exchange)
    - By staying in existence, T corp could also retain boot property to avoid shareholder-level gain

PRIOR STOCK OWNERSHIP

- 1.368-2(d)(4)(i): P's prior ownership of some T stock does not by itself prevent the 'solely for voting stock' requirement from being met

  1. THEORY: a transaction in which P converts an indirect interest in T's assets (thru ownership of T stock) to a direct interest does not necessarily resemble a taxable sale of T's assets
  2. **EXCEPTION:** If 368(a)(2)(B) boot relaxation rule applies to the final step of a creeping C reorg, the sum of 1) boot distributed to T's SHs other than P and to T's creditors and 2) the liabilities of T assumed by P, may not exceed 20% of the value of all of T's assets
     a. Finally, if in connection w/ potential C reorg, P acquires T *stock* for cash or other boot from a T SH or T itself, that consideration is treated as boot exchanged by P for T's assets
  3. 1.368-2(d)(4)(ii), EX #1: Several years ago in an unrelated transaction, P acquired 60% of T's stock for cash. The other 40% of T stock is owned by A. T has assets w/ FMV 110k and 10k liability. T transfers all of its assets to P in exchange for 30k of P voting stock and 10k cash. T then distributes the P voting stock and cash to A and liquidates. Applying boot relaxation rule, transaction qualifies as Type C reorg b/c 10k cash and 10k liability does not exceed 22,000 (20% of value of T's assets). P's prior ownership of 60% does not adversely affect qualification.
     a. 1.368-2(d)(4)(ii), EX #2: Same as above except P purchased its 60% stock interest in T for 60k cash as the first step in an overall plan to acquire T's assets—i.e. 60% stock acquisition was not "unrelated" to subsequent asset acquisition. Asset acquisition does not qualify as Type C reorg b/c P is treated as having acquired all of T's assets for consideration of 70k cash (60k for T stock and 10k in the later asset acquisition), 10k liability assumption, and 30k of P voting stock

VII - ACQUISITIVE REORG: TYPE B (STOCK-FOR-STOCK ACQUISITION)

BASIC DEFN

- §368(a)(1)(B): P's acquisition of T stock solely in exchange for P voting stock (or voting stock of P's parent) provided that P is in control of T immediately after the acquisition

- 368(c) **Control Requirement**: ownership of 80% or more of T's combined voting power of all classes voting stock, and 80% or more of the total shares of each class of T's nonvoting stock

- Previous transaction to buy T stock doesn't matter, as long as P has 80% of T immediately after the reorg
  - Ex: P owned 79% of T previously, may acquire additional 1% in "creeping B" reorganization
- Looks similar to a 351, but 351 requires that T shareholders have 80% control of P after exchange (also, 351 allows boot consideration, but Type B does not)

- T remains alive as a subsidiary of P after a Type B reorg
- Advantages:
  - No need for P SH approval of acquisition (tho different type of SH approval need for stock issuance)
  - No dissenters' rights (those who don't want to participate don't have to sell their shares)
  - No need for third party consent re: transfer of assets (ex: license, mortgage, contracts)
  - Less complex than an asset sale (no transfer of assets)
  - No liquidation requirement
- Disadvantage:
  - Stricter prohibition on boot, consideration is limited to P stock
  - 80% control requirement

SOLELY FOR VOTING STOCK REQUIREMENT

- ***§368(a)(1)(B)***: voting stock is the <u>only permissible</u> consideration paid by P in type B reorg, any boot will disqualify the reorg
  - Voting stock can be in either P or P's parent, but not a combination thereof
  - Where P uses its parent's stock as consideration (referred to as "parenthetical B") is a triangular reorg
  - ***1.302-3(a)*** voting stock cannot be contingent/convertible: To qualify as voting stock, SHs must have an unconditional right to vote on routine corporate matters, not merely extraordinary events such as mergers and liquidations
    - Ex: if a class of CS/PS can only vote fraction of board (ex: elect 3 out of 8 directors) -> still voting stock
  - ***Southwest Consolidated***: options and warrants of voting stock are not voting stock until exercised
    - Contingent rights to vote (i.e. cumulative preferred stock that only has voting right if the dividend on the stock is in arrears) → only voting stock when contingence occurs
- **<u>NO boot</u>**
  - ***Rev. Rul. 75-123***: In determining whether solely for voting stock requirement is satisfied, all of the <u>consideration received</u> by T SHs in the exchange have to be voting stock of P. Thus, parties cannot argue that requirement is satisfied where 80% of T shareholders receive P voting stock and 20% receive boot. However, if exchange for voting stock and exchange for cash are separate transactions, then the exchange for voting stock may qualify as a good Type B reorg (see below, Creeping Acquisitions)

- **<u>Voting NQPS will not ruin B reorg (but treated as boot for gain purpose)</u>** :
  - **351(g):** while NQPS is not treated as stock for purposes of §351, it is nevertheless treated as stock for all other Code sections unless the regulations state otherwise
    - <u>NQPS with voting rights</u> will <u>qualify</u> as voting <u>stock</u> for purposes of 368(a)(1)**(B)**, because there are no regulations stating otherwise

  - BUT, **354(a)(2)(C)(i)**: NQPS will be treated as boot for purposes of §354 gain recognition (unless NQPS is received in exchange for NQPS)
    - Ex: SH X exchanges Y NQPS $100 (AB=70) for Z CS $50 and Z NQPS $50. X received only non-recognition property: receipt of Z CS in exchange for NY NQPS is outside of

§354(a)(2)(C)(i), Z NQPS received is not treated as boot under §354(a)(2)(C)(i), since it's not received in exchange for stock other than NQPS. NQPS received qualifies as stock for §354 and §356(e), exchange is tax free under §354.

- §356 issue: If T SH receives only NQPS and transaction qualifies as a good Type B, but T SH realizes a loss on the exchange, then should T shareholder be allowed to recognize loss?
  - §356: applies where SH receives permitted (non-recognition) property under §354 and non-permitted property; but doesn't apply where SH receives only non-permitted property under 354 (i.e. only NQPS)
  - For T SH receiving only NPQS, §356(c) loss denial rule doesn't apply
  - → SH can recognize loss on receipt of only NQPS (no receipt of stock)
  - But if SH receives both boot and stock -> non-recognition of loss under §356(c)

    - Note: voting NQPS has to be given with CS, cannot be by itself: if exchange of NQPS for NQPS only -> just non-permitted property. CS exchange NQPS -> transaction not covered by §354, it's a §302

- **Cash**
  - RR 66-365/81-81: P can pay cash in lieu of issuing fractional shares without violating the solely for voting stock requirement, if such cash is *incidental to exchange* and not separately bargained for
  - P can also pay cash to T's SH (*other than in their capacity as SHs*) in a separate transaction without disqualifying B reorg
    - Ex: simultaneously with B reorg, P may pay cash to minority SH for non-compete in a separate transaction, provided cash is not a reality paid as additional consideration for stock acquired in B reorg

- **P debt exchange for T debt does not violate "solely"**
  - *Rev Rul 98-10*: The separate exchange of T bonds for P bonds is an exchange of "securities" pursuant to *plan of reorganization*, eligible for B reorg. Thus, any gain or loss realized by the debenture holders of T as a result of their exchange of their T debentures for an equal principal amount of debentures of P will not be recognized under § 354(a)(1).
  - Note: for purposes of "solely for voting stock" requirement, *focus on what is being paid for T stock* → this consideration can only be P voting stock (or voting stock of its parent)
    - P Corp can use other consideration in exchange for T debt (i.e. P notes for T notes *or pay cash*) without disqualifying Type B reorg
    - For P debt to T debt exchange, 354(a)(1) non-recognition applies as an exchange of "securities pursuant to reorg, unless amounts are unequal
    - SH who's also debtholder?
      - If debt is held by SH, problem: stock paid by P needs to be sufficient in value to exchange T stock from TSHs. Debt paid by P cannot be disguised payment for stock
      - If debtholder is different persons than SHs -> P can pay debt in exchange for its debt
  - NOTE: If P Corp (or its sub) purchases T bonds from debtholders, it does not ruin B reorg (because cash is not paid for T stock) and there is a taxable transaction to the debtholders if AR>AB

- **Pre-reorg redemption of some SH for cash/buyouts of dissenting minority SH**
  - REV. RUL. 55-440: If T SHs object to a stock-for-stock exchange, T may redeem their shares for cash prior to exchange w/ P w/o violating the solely for voting stock requirement provided that the consideration is not provided by P.

- Alternatively, other T SHs may purchase shares from dissenters for cash prior to Type B reorg
- **§1.368-1(e)(8) Ex 9**: Pre-reorganization redemptions of T SHs' stock by T does not count against continuity, provided that T use its own funds for the redemption
  - Thus, even if T redeems more than 20% of SHs before Type B reorg, the transaction can still satisfy 80% control requirement and COI
  - But if P furnishes funds for a pre-reorg redemption of T stock, the subsequent stock-for-stock exchange violates "solely" requirement of §368(a)(1)(B)
  - Note: this reg is for A reorg and COI thereunder, but it should apply to B and issue of "solely" in the sense that it *doesn't affect subsequent stock-for-stock exchange*
- ***Rev Rul. 75-360***: where T corp redeems stock of T SHs and funds for redeemed stock is partially provided by P corp (cash consideration for redeemed shares was acquired via loan, then after transaction P paid off loan via contribution of capital to T (now a sub of P) and T paid off the loan) -> solely for voting stock requirement NOT met
  - If SH participates in reorg exchange, then her new P voting stock is redeemed by P for cash, the post-exchange redemption may disqualify the entire transaction if P *had obligation* to redeem the stock from the outset (i.e. not separate steps)
- ***Rev Rul. 68-285***: before P acquired T shares, T Corp established an escrow account to pay dissenting SH and even made some payment after the subsequent stock-for-stock exchange, this does not preclude Type B reorg.
  - No cash was paid by P to T or TSH, no reimbursement by P to T
    - If cash to redeem T SH came from P -> no good B reorg
  - When those SHs' shares were redeemed, they ceased to have any SH rights except the right to demand payment for the fair market value of their shares, and cannot partake in the exchange by P for voting stock.

- **Infusion of cash into T by P**
  - ***Rev Rul. 72-522***: cash payment is made by P to T for unissued stock is not part of the reorg transaction between P and T SH, and P did not pay any cash to former T SHs for their shares. Solely for voting stock requirement is not violated.
    - Even if P simply made a cash contribution to T, the solely for voting stock requirement would not be violated, provided that the cash was not distributed to former T SH.

- **Dividend distribution by T to former T SHs**
  - ***Rev Rul. 68-435***: The 'solely for voting stock' requirement is not violated where T, prior to a nontaxable merger, pays a dividend based on the dividend T SH would have received from the acquiring corporation if the closing date had not been delayed – does not ruin B reorg
  - ***Rev Rul. 69-443***: The 'solely for voting stock' requirement is not violated where T declares a dividend prior to nontaxable merger and then pays out the dividend to the former TSH after – money paid for dividend is not viewed as part of reorg
  - ***Rev Rul. 70-172***: The 'solely for voting stock' requirement is not violated where T distributes property to its SHs prior to the nontaxable merger.

- **P's payment of expenses**
  - ***Rev Rul. 73-54 Solely & Directly Related Expenses:*** P may pay T's expenses (legal and accounting fees, registration fees) solely and directly related to reorg without violating the solely for voting stock requirement (it's cost attributable to the exchange, so not counted as consideration to T)

- But payment by P to T/T SHs of expenses NOT directly related to reorg and are for their personal benefits (such as TSH's personal legal, accounting fee, transfer tax) -> violates "solely for voting stock" requirement – fails B or C reorg
- If P transfers property other than voting stock to T or TSH with intention that *T/TSH will pay their own expenses* -> fails B or C reorg, even though they are solely and directly related to reorg
- *Rev Rul. 73-54* ***Transfer Taxes:*** BUT where the obligation to pay an applicable state transfer tax is solely that of T SH (i.e. personal benefit), payment or assumption of such tax by the P will violate the solely for voting stock requirement

- ***Rev Rul. 67-275:*** 'Solely for voting stock' requirement is not violated where P paid costs necessary to register stock issued to SHs in reorg. It's expenses attributable to P in promoting orderly marketing of P's stock

CREEPING ACQUISITIONS

- Even if P earlier bought T stock using cash boot, the solely for voting stock requirement may be met, if earlier cash acquisition of voting stock is unrelated and sufficient remote in time (old and cold)
  - Factual question whether earlier purchase of T stock is old and cold
- If P's earlier cash purchase of T stock is related to later exchange, they will be viewed as a single transaction -> cash boot will disqualify the entire transaction as B reorg (even if P bought 80% of T stock solely for voting stock, since *solely requirement applies to total consideration received in exchange*)

- P is not required to buy 80% of T's stock in the exchange -> *P just needs to have 80% or more votes/shares after the exchange*
- 1.368-2(c): series of transaction taking place over a relatively short period of time (12 months) may be viewed together, qualifying as a B reorg, BUT not viewed together if they are separated by long interval (16 years is old and cold)
  - Ex: P acquires 20% of T stock, then buys 60% 6 months later solely for voting stock, the exchanges will be viewed together as a single B reorg
  - Between >1 yr to <16 years -> grey area

- ***Rev. Rul**. **72-354***: where P sold 10% of T stock to an unrelated 3rd party and then acquired 100% of T stock solely for P voting stock, provided that earlier sale to 3rd party buyer was unconditional (buyer has no obligation to sell stock back to P) and not dependent on later reorg -> later transaction is good Type B reorg
  - NOTE: P's risk: may not be able to acquire control of T if unrelated party fails to sell back
- ***Rev. Rul. 68-562:*** Good Type B reorg, where individual owns 90% of P (controlling SH of P) and purchases 50% of T Co with his own cash for his own account; and then two months later, P acquires 100% of T stock (including from the controlling SH)in exchange for P voting stock.
  - P's controlling SH didn't use P stock to purchase T stock initially, he *had no obligation* to exchange T stock it acquired earlier
- ***Rev Rul**. **85-139***: not a good Type B reorg, where P co has its wholly-owned sub S purchase 10% of T stock with its own cash while P exchanges its own voting stock for 90% T stock.
  - *Irrelevant that P did not provide the funds* to S to purchase the T stock or that S retained ownership of the 10% of stock

- P controls its Sub - Sub buying stock with cash is no different as if P bought stock with cash (as if P bought 90% with stock and 10% with cash)
- No good Type B where P uses voting stock + cash to acquire T; thus, shouldn't make a difference that P engages in the same transaction using wholly-owned sub

CONTINGENT CONSIDERATION

REV. PROC. 84-42: Type B reorg will not lose tax-free status if, as part of plan, P agrees to transfer additional P voting stock to former T SHs based on future earnings or other subsequent events. Contingent consideration will not disqualify the transaction if the additional stock is not evidenced by a negotiable instrument and certain other detailed requirements are met.

Alternatively, P may place some of its stock in escrow on the condition that it be transferred to T SHs only if certain conditions (i.e. T attaining specified earnings) are met

SUBSEQUENT LIQUIDATION OF T

REV. RUL. 67-274: If P acquires T stock in stock-for-stock acquisition that qualifies as a Type B reorg and then liquidates T pursuant to same plan, the transaction is treated as an asset acquisition and is tested under Type C reorg rules

VII - ACQUISITIVE REORG: TRIANGULAR REORGANIZATIONS

368(A)(2)(C): C REORG WITH DROP DOWN

- **§368(a)(2)(C) Drop Down Rule**: A transaction otherwise qualifying as a Type A, Type B or Type C reorg is not disqualified, if P (first acquires stock of T in exchange for its own stock, then) transfers (drop-down) all or part of T Corp assets to P's controlled Sub (S)
- **368(b) Parties to Reorg** Definition: Flush language (second sentence) provides that in a transaction that qualifies as a Type A, B or C reorg and is followed by a drop down of T assets to P's controlled sub, *P is a party to the reorganization*.
- 1.368-2(k)(1), (3): successive post-reorg transfers to lower-tier controlled subs and other controlled entities of P are allowed provided that the continuity of business enterprise requirement is met
- §1.368-2(d)(1): S cannot use both S voting stock and P voting stock, otherwise it will disqualify the reorg
  - Some boot permissible
- P: PCo might want to keep T alive after acquisition. Can buy stock of T but req't is strict in B reorg. Another issue 80% control, need to buy shares from minority SHs who might want cash for consideration – is this viewed as part of stock-for-stock detail. Can address these in triangular reorg

Tax Consequences of Type C with Drop Down:

- **Step 1 (C reorg)**: T transfers assets to P in exchange for P voting stock. Then, T liquidates and distributes P voting stock to T SH (and security holders) and T SH transfers T stock back to T
  - T SH/securities holders (who receive P stock on liquidation of T):
    - General non-recognition: §354(a) applies
      - Boot: recognition: §365
    - §358(a) Basis in P stock received = A's previous basis in T shares given up (transfer basis)
    - Character of gain determined under §356(a)(2) & *Clark*: see dividend equivalency test below

  - T Corporation
    - 1) T transfers asset to P in exchange for P voting stock
      - 361(a): non-recognition of gain/loss
      - 357(a): non-recognition on assumption of liab

        - 2) T liquidates and distributes P voting stock to T SH, T SHs transfers T stock back to T
            - 361(c): distribution of property to TSH non-taxable, unless non-qualified appreciated property
            - Distribution of boot not taxable to T: 361(c)
    - P corp
        - §1032 Non-recognition on issuance of shares:
        - §362(b) P's basis in T assets received = T basis in those assets + gain recognized by T
- **Step 2 (drop-down):** P transfers T assets to S for S stock in a tax-free §351 exchange
    - P Corporation - receives S stock for asset drop down
        - §351General non-recognition of gain/loss
        - §358(a)(1): P's basis in S stock received = basis of T assets transferred LESS boot (cash & FMV of any other property received & §358(d)(1): debt assumed treated as boot) + gain recognized + P's basis in S shares
            - If assets transferred to S are subject to liabilities, then 358(d) applies to treat debt assume as boot
    - S (sub) Corporation – issue own stock to P as consideration for T assets
        - §1032: Non-recognition upon issuance of S stock & receipt of assets:
        - §362(a) S basis in T assets = P's basis in T asset
            - This preserves BIG if any

- Tax attributes of T
    - §1.381(a)-1(b)(2)(i)&(ii): P has T's attributes including T's E&P (even tho S has the assets)

- Note: the end result is as if S acquires T assets with stock as consideration

368(A)(1)(C): TRIANGULAR C REORG

368(a)(1)(C) Triangular C: the acquisition by S of substantially all of the properties of T in exchange solely for all or a part of the voting stock of P which is in control of S

- Same requirements as a Type C reorg, except presence of S sub
- Similar to Type C drop down, but assets go directly from T to S without P first acquiring them
- §1.368-2(d)(1): S cannot use both S voting stock and P voting stock, otherwise it will disqualify the reorg
    - Some boot permissible

Party: P, T, S

TAX CONSEQUENCES

- T Corp:
    - 1) transfers assets to S in exchange for P voting stock
        - **361(a)**: non-recognition of gain/loss
        - **357(a)**: non-recognition on assumption of liab
    - 2) T liquidates and distributes P voting stock to T SH, T SHs transfers T stock back to T
        - **361(c):** distribution of property to TSH non-taxable, unless non-qualified appreciated property
- T SH/securities holders (who receive P stock on liquidation of T):
    - General non-recognition: **§354(a)** applies
        - Boot: recognition: **§365**

- **§358(a)** Basis in P stock received = A's previous basis in T shares given up (transfer basis)
- Character of gain determined under §356(a)(2) & *Clark*: see dividend equivalency test below

- S Corp:
  - **§1032:** S's has non-recognition on gain/loss on transfer of P stock in exchange for T assets
    - **§1.1032-2** non-recognition for S: §1032 usually isolate a corp from recognition when it's issuing its own stock. In triangular C, S transfers P stock to T, this is treated as if P disposed its own stock for T assets or stock, such as §1032 will apply
      - Result: S recognize no gain/loss on receipt of T assets in exchange for T stock
    - P: problem in triangular C reorg:
      - 1. S is not issuing own stock but use P stock – this is a problem because §1032 usually isolate issuing corp from gain loss upon issuance of *own* stock
      - 2. S's basis when S uses P stock as consideration for T assets, S may have basis = 0 or less than FMV
      - Reg 1.1032-2 solves the non-recognition by making §1032 applicable to this case, and the problem of S' basis in P stock because S now has non-recognition on the exchange with T
  - §362(b): S's basis in T assets = T basis in those assets
- P Corp:
  - Basis in S stock under §358
    - **1.358-6(c)(1)(i) over-the-top Regs**: P's basis in S stock is adjusted as if we pretend: P acquired T assets and liab (in a direct C reorg) directly from T in a transaction in which P's basis in the T assets was determined under §362(b), and P transferred the T assets (and liabilities) to S in a §351 transaction in which P's basis in S stock was determined under §358
    - Analysis:
      - Step 1: pretend P acquires T's assets from T with carryover basis under 362(b)
      - Step 2: pretend P drops those assets down into S and takes §358 carryover basis in stock with any liab relieved
        - Add this basis to original basis in S stock
      - **P's basis in S stock received = basis in T's asset transferred – liab assumed under §358(d) + P's basis in S shares already held**
    - 1.358-6(c)(1)(i)(ii) Limitation: If in applying 358, the amount of T liabilities assumed by S or to which T assets acquired by S are subject equals or exceeds T's aggregate adjusted basis in its assets, the amount of the adjustment under (c)(1)(i) is zero. P recognizes no gain under 357(c) as a result of a triangular merger.
    - 1.358-6(d) consideration from S: to the extent any of the consideration in the transaction is furnished by S, we reduce basis adjustment
  - P: over-the-top Regs address the problem that P didn't acquire T's asset in a triangular C (or forward subsidiary D merger), P's tax consequence should be the same as if P bought the assets then dropped them down to S

TRIANGULAR C – *BUT* P TRANSFERS ITS STOCK DIRECTLY TO T, T TRANSFERS ASSETS TO S

- This transaction does not fit into 368(a)(1)(C) triangular C reorg (because S didn't use P stock nor is there contribution of P stock to S) or 368(a)(2)(C) C reorg with dropdown
- Older RR: P is treated as acquired asset and dropdown to S under §368(a)(2)(C)

- **1.1032-2(b):** In the case of…a triangular C reorg…(as described in § 1.358-6(b)), P stock provided by P to S, or directly to T or T's shareholders *on behalf of S*, pursuant to the plan of reorganization *is treated as a disposition by P of shares of its own stock for T's assets…* (so no §1032 problem, easier for S)
  - Rule also applies in context of forward triangular or triangular B
- **1.1032-2(c):** <u>S must recognize gain or loss</u> <u>on its exchange of P stock</u> as consideration in a…<u>triangular C reorg</u>… (as described in § 1.358-6(b)), if S *did not receive the P stock from P pursuant to the plan of reorganization.*
- **Same tax consequences as C dropdown**

<u>368(A)(1)(B): TRIANGULAR B REORG</u>

- 368(a)(1)(B) Triangular B(allowed in parenthetical language): acquisition by <u>S</u>, using <u>solely</u> all or part of <u>**P's voting stock** to exchange stock of T from T SH</u>, and immediately after the acquisition, S has control of T
  - Same requirements as a Type B reorg, except presence of sub
    - As in B Reorg, only P's voting stock can be used
  - Could've achieve the same result as Type B with drop down (P buys directly T stock and drop them down to S), but assets go directly to S corp without P first acquiring them

- §1.368-2(c): S <u>cannot use both voting stock of P and S</u> as consideration, this results in taxable acquisition
  - Apply 1001 to T shareholders' disposition of T stock and allocated cost b/w basis in P and S stock under 1012
  - If P and S issue their own shares → 1032 nonrecognition
    - If P drops its stock into S to use w/ other S stock as consideration for T stock → 1.1032-3 insulates S from recognizing gain on transaction (see 1.1032-3(e) EX #1)
    - S holds T stock at FMV
    - P gets step up in basis of S stock = cost of T stock

TAX CONSEQUENCES (same as B reorg – see later for more)

- T Corp
  - Treatment of the exchange of T stock for P voting stock
    - 361(a)(1): T has non-recognition
  - Treatment of the distribution to T SHs the P voting stock:
    - 361(c)(1): non-recognition

- T SHs/Securities holders
  - 354(a): General non-recognition
  - 358: Basis of P voting stock received = basis of T stock/securities surrendered
  - Character of gain determined under §356(a)(2) & *Clark*: see dividend equivalency test below

- S Corp (ends with T stock)
  - §1032: S's has <u>non-recognition</u> on gain/loss on transfer of P stock for T stock, <u>except</u> to the extent that S uses P stock that it did not receive from P under the reorg plan
    - §1.1032-2: extends the application of §1032 non-recognition to S when using P stock, by treating as if P disposed of its own stock for T stock
  - §362(b): S's basis in T stock = T SH basis in those stock (transferred basis)

- P Corp
  - On exchange of P stock by S with T for T stock (tho P not directly involved)
    - 1.1032-2(b) treats the transfer of P shares by S as a disposition by P of its own stock for T stock, thus §1032 applies, and P has *non-recognition* upon the exchange
  - Basis in S stock:
    - **1.358-6(c)(1)(i) over-the-top Regs**: P's basis in S stock is adjusted as if we pretend: P acquired T stock directly from T SHs in a transaction in which P's basis in the T stock was determined under §362(b), and P transferred the T stock to S in a §351 transaction in which P's basis in S stock was determined under §358
    - Analysis:
      - Step 1: pretend P acquires T's stock from T SHs with carryover basis under 362(b)
      - Step 2: pretend P drops those stocks down into S and takes §358 carryover basis in stock
        - Add this basis adjustment to original basis in S stock
      - **P's basis in S stock received = T SH's basis in T's stock transferred + P's basis in S shares already held**

368(A)(2)(D): FORWARD SUBSIDARY MERGER

- Situation: If P wishes to acquire T assets in a tax-free acquisitive reorg, it may be unwilling to incur risk of T's unknown or contingent liabilities. This risk might continue even if P drops down T's assets and liabilities to a P sub after a merger of T into P. P also may not wish to incur the expense and delay of securing formal approval of its SH to a merger or direct asset acquisition. Forward triangular merger solves these nontax problems.
- Why more popular than Reverse Sub Merger or Type C?
  - Fwd Sub Merger allows you to: keep assets in Sub, and don't need voting stock (for COI)

- Forward subsidiary/triangular merger includes the following steps:
  - 1) P forms sub S by transferring P stock (and maybe other consideration) for S stock in a tax-free §351 exchange.
  - 2) ***T is merged into S*** under state law
  - 3) ***T SH receives P stock and any other consideration*** provided by merger agreement.
  - 4) P ordinarily does not need to secure approval from its SH because S is the party to the merger and P is the only SH of S
  - 5) ***All of T's assets and liabilities are transferred to S***, which remains a wholly owned sub of P

Qualifying Requirements

§368(a)(2)(D): forward triangular merger qualifies as tax-free if following requirements are met:
- **Substantially All**: S acquires substantially all of T's assets
  - same as requirement for Type C reorg: 90% of T's net asset + 70% of T's gross asset – see above
  - Compare with type A: "Substantially all" is not required under Type A reorg. A doesn't have the parenthetical language of using P stock
  - Forward sub merger looks like a hybrid of Type A and C reorgs
  - P: this requirement prevents using acquisitive reorg to achieve divisive goal
- 368(a)(2)(D)(i): **No stock of S may be used** as consideration in the merger – **can only use P stock** (can be voting or non-voting);
  - Exception: 1.362-2(b)(2): S can use its **debt** or other boot as consideration. P can also provide boot as consideration
  - 1.362-2(b)(2): either P or S can assume T liab
  - P: no S stock ensures COI
- 368(a)(2)(D)(ii) **Type A Merger**: The transaction would have qualified as a Type A reorganization if it had been a merger of T directly into P

- transaction must meet regulatory requirements of Type A if transaction was T merged into P:
  - continuity of business enterprise,
  - business purpose
  - plan of reorg and
  - continuity of proprietary interest (see thresholds in type A merger above)
- §1.368-2(b)(2): it's not necessary to test merger into P under state law

Subsequent Transfer of S Stock to Another P Sub: If, after a valid forward triangular merger in which T mergers into S (a P sub), P transfers its S stock to S2 as part of an overall reorg plan, the transfer will not cause P to be treated as not in 'control' of S for purposes of 368(a)(2)(D), and thus the transaction continues to qualify as a reorg

- S can also subsequently transfer to its sub without disqualifying forward triangular reorg §368(a)(2)(C)

<u>TAX CONSEQUENCES</u>

- **T SHs -** end up with P stock
  - **§354:** general non-recognition upon receipt of P stock
    - If **boot**: §356 recognize lesser of realized gain or boot
      - For debt, long-term debt is boot
      - §356(d)(2)(B): amt of boot = FMV securities received – FMV of T SH securities surrendered (i.e. non-recognition to the extent debt is changed for debt)
    - **Character of gain** determined under §356(a)(2) & *Clark*: see dividend equivalency test below
      - if public company, gain is probably LTCG
  - **§358**: basis in P stock received = T SH's old basis in T stock – boot (including debt assumed treated as boot under §358(d)(1)) + gain recognized
    - Basis in debt received = FMV

- **T Corp -** Merges into S and disappears
  - Deemed two-step transaction:
    - (1) T transfers T assets with S in exchange for P stock,
      - **§361(a):** non-recognition gain/loss
      - **§357(a):** non-recognition of liab assumption
        - 1.368-2(b)(2): for purposes of 357(a), S is treated as party to reorg
    - (2) then, pretend liquidation of T distributes P stock to former T SH (note: S survives)
      - **361(c):** distribution is non-taxable, unless non-qualified appreciated property
  - *Generally, T has non-recognition*

- **S Corp -** surviving corporation in the merger & end up with T assets and liab
  - **§1032:** S's has <u>non-recognition</u> on gain/loss on transfer of P stock, <u>except</u> to the extent that S uses P stock that it did not receive from P under the reorg plan
    - **§1.1032-2** §1032 usually isolate a corp from recognition when it's issuing its own stock. In this reorg where S transfers P stock to T, this is treated as if P disposed its own stock for T assets or stock, such as §1032 will apply
    - $\boxed{\text{P:}}$ Reg 1.1032-2 solves the non-recognition by making §1032 applicable, and solve the problem of S' basis in P stock because S now has non-recognition on the exchange with T
  - If S issues own debt as consideration -> no gain/loss
  - **§362(b):** S's basis in T assets received = T's basis in those assets
  - §381: S get T's <u>tax attributes</u>

- **P Corp**
  - Ends up owning S stock (with T merged into S)
  - P's basis in S stock: <u>over-the-top method</u>
    - **1.358-6(c)(1)(i)**: P's basis in S stock is adjusted as if we pretend: P acquired T assets (and liabilities) directly from T in a transaction in which P's basis in the T assets was determined under §362(b), and P transferred the T assets (and liabilities) to S in a §351 transaction in which P's basis in S stock was determined under §358
    - Analysis:
      - Step 1: pretend P acquires T's assets from T with carryover basis under 362(b)
      - Step 2: pretend P drops those assets down into S and takes §358 carryover basis in stock with any liab relieved
        - Add this basis to original basis in S stock
      - **P's basis in S stock received = P's basis in S shares already held + basis in T's asset transferred – liab assumed under §358(d)– consideration furnished by S, if any**
    - 1.358-6(c)(1)(i)(ii) Limitation: If in applying 358, the amount of T liabilities assumed by S or to which T assets acquired by S are subject equals or exceeds T's aggregate adjusted basis in its assets, the amount of the adjustment under (c)(1)(i) is zero. P recognizes no gain under 357(c) as a result of a triangular merger.
    - **1.358-6(d) consideration from S**: to the extent any of the consideration in the transaction is furnished by S, we reduce basis adjustment

- Failed forward sub merger:
  - If both P stock and S stock used, cannot be fwd sub merger, but potentially a Type C or Triangular C
  - If nonvoting P stock and voting S stock, cannot be fwd sub merger, but potentially a Type A reorg or a Type C/triangular C

<u>368(A)(2)(E): REVERSE SUBSIDARY MERGER</u>

- Situation: P may wish to acquire T stock in a tax-free reorg and keep T alive as a sub in order to preserve certain rights under state law or valuable assets (e.g. lease/franchise) that might be lost if T is liquidated. Type B reorg may not be feasible if P wishes to use consideration other than voting stock. Reverse triangular merger accommodates these goals.
- Compare with Type B reorg: (1) in B reorg, P only required 80% control of T, so potential for minority SHs. Whereas in Reverse Sub Merger, minority/dissenting SHs can be squeezed out due to state merger law. (2) B only permits voting stock as consideration, whereas Reverse Sub Merger permits boot as well (more flexible)

- In §368(a)(2)(E) reverse subsidiary merger, S is merged directly into T, T survives the merger and S disappears. T SH exchange their T stock for P stock.
- Steps:
  - 1) P forms a new sub S by transferring P voting stock and other consideration for S stock in tax-free §351 exchange
    - Alternatively, P could make a transfer to existing sub
  - 2) S merges into T under state law
    - P exchanges its owned S stock for T stock (by operation of law)
    - All of S assets (and liabilities) are transferred to T
    - S dissolves
    - T SH exchange their T stock for P voting stock (and any other consideration) received by T on the merger of S into T

5) T survives as a wholly owned sub of P (end result: similar to Type B reorg)

S AS TRANSITORY ENTITY

REV. RUL. 67-448: If S is formed for sole purpose of the transaction, it will be viewed as a transitory entity, and transaction can be analyzed under 368(a)(1)(B)

1. BUT REMEMBER: in a Type B reorg, very restrictive as to consideration (no boot in a B)
    a. Also, in a B, acquiring corp could end up w/ less than 100% of shares of target
    b. In a merger under state law, minority shareholders are cut out
    c. In merger, need SHs to agree (usually 2/3 agree); in a Type B, need at least 80% of shareholders to agree
2. 1.368-2(j)(6) EX #4 for good transitory example

Qualifying Requirements

368(a)(2)(E): reverse triangular merger qualifies as tax-free if following 2 requirements are met:

- **(a)(2)(E)(i) Substantially All**: After the merger, T must hold substantially all of T's own properties and the properties of S (other than the stock of P distributed in the transaction and any boot used by S to acquire shares of minority shareholders)
    - ***Rev. Proc. 77-37***: Service requires T transfers its assets representing at least 90% of the FMV of T's net assets and at least 70% of the FMV of gross assets held by T immediately prior to the transfer
    - Likely that S is a transitory sub, in which case it will not have any properties other than the consideration used to acquire T
- 1.368-2(j)(3)(iii): cash and property contributed by P to S, used to redeem stock of dissenting T SH does not count towards "substantially all" test and should not be a problem that T no longer holds those assets (but if T redeems with its own fund, still counts for this test)
    - Also, assets (stock, cash/boot) transferred to S by P pursuant to reorg plan is not taken into account for "substantially all" -> so P stock/cash dropped down by P to S *doesn't have to remain in T/S* (can later transferred to T SH), if it's pursuant to reorg plan
- **Rev. Rul. 2001-25** *Subsequent sale of T assets does not fail "substantially all"*
    - If, following a qualified reverse triangular merger and as part of an overall acquisition plan, T sells 50% of its operating assets to an unrelated buyer and retains the cash proceeds, the asset sale will not cause the transaction to fail the 368(a)(2)(E) requirement that the surviving corporation "holds" substantially all of its properties, *as long as T holds the cash proceeds*

- **(a)(2)(E)(ii) 80% Control Requirement**: in the merger transaction, P must acquire 80% voting power of voting stock and 80% of number of shares of non-voting stock of T *in exchange for P voting stock*
    - The remaining 20% of T may be acquired for boot (cash/other property)
    - **Bulk Transfer Requirement**: 80% of T stock must be acquired by P for its voting stock in a single merger transaction
        - Prior stock held by P will not meet the bulk requirement
            - precludes creeping reverse sub mergers (you can creep up to 20%), unless pursuant to a plan as one single transaction
        - 1.368-2(j)(6) EX #2: Impossible to have a good reverse triangular merger if P owns > 20% of T before transaction (i.e. up to 20% of T stock can be acquired for cash/boot)
            - BUT Dissenting SHs paid in cash (can be with P's funds) are disregarded for purposes of the 80% control test.
                - Dissenting SH is NOT P (so cannot get around Bulk requirement by redemption of P previously held shares) -> see below
            - Ex: T has 1,000 shares, dissenting SHs who own 100 shares are paid in cash, then 720 shares are acquired in exchange for P's voting, 80% control test is met (720/900 = 80%).

Wouldn't have been met if shares of dissenting SH were included (720/1000 = 72%), but they are disregarded for the 80% control test purposes.

- Note: Consideration paid to dissenting SH by T is taken into account for "substantially all" requirement, but consideration paid by S previously contributed by P is NOT taken into account for "substantially all" requirement. (Bottom line is that it's better to do it through S.)

- BUT 1.368-2(j)(6) EX # 4&5: If S is transitory, transaction may meet requirements of a Type B and depending on how P acquired prior T stock (apply creeping B rules above)
- BUT 1.368-2(j)(3)(i): T <u>cannot</u> redeemed T stock previously held by <u>**P**</u> in order to "<u>cleanse</u>" transaction → will still be considered as outstanding for determining whether P acquired at least 80% of T stock for voting stock
    - i.e. cannot get rid of P's holding of T shares by redeeming P, because shares redeemed by P counts towards outstanding (but shares redeemed by SHs A and B do not count)
    - Thus, permissive consideration in a reverse triangular merger is more restrictive than in a forward triangular merger and creeping acquisitions will not qualify
- 1.368-2(j)(3)(i): for purposes of control requirement, T stock that is redeemed for cash or T property prior to a reverse merger is not treated as outstanding prior to the reorg even if the redemption is related to the merger
    - i.e. redemption of <u>dissenting T SHs</u> shares do not count for control, and no longer viewed as outstanding (so generally T can redeem dissenting T SHs, but not P's)

- **Rev Rul 2001-26**: *creepy reorg*: if <u>earlier purchase</u> of stock and later purchase of stock are <u>pursuant to a plan</u> of reorg and intended as part of the same transaction, both stock purchases count and the transaction may qualify as §368(a)(2)(E)

Rev. Rul. 2001-26: P Corp wants T Corp stock by means of tender offer. Makes a tender offer (offers to buy stock) conditioned on obtaining at least 51% of T stock solely for P voting stock. In fact, as a result of tender offer, P does in fact get at least 51% of T stock from T SHs. P then forms sub and has sub merge under T under state law. Then, 49% of T stock is exchanged for 2/3 P stock and 1/3 cash.
Issue: Does 368(a)(2)(E) apply? Is the control requirement met?
Held: *If tender offer transaction and merger transaction are an integrated transaction, then 51% of T shares received in the merger will count for purposes of the control requirement* and it will be satisfied.

- For purposes of applying the control test, the tender offer and merger should view as part of and intended as part of the same transaction. Thus, stock acquired in the merger should be counted for purposes of the control requirement in (a)(2)(E).
- Thus, as a result of tender 51% + merger 33%, T SHs have surrendered more than 80% control to P in exchange for P voting stock.

Is the IRS allowing a creeping reverse merger?

- No, b/c IRS views the tender + merger as part of a single transaction.

TAX CONSEQUENCES

- T SHs
    - **354(a):** general non-recognition on exchange of T stock for P stock
        - 368(b): P is a party to reorg (so stock is covered by 354)
    - If **boot**: §356 recognize lesser of realized gain or boot
        - For debt, long-term debt is boot
        - §356(d)(2)(B): amt of boot = FMV securities received – FMV of T SH securities surrendered (i.e. non-recognition to the extent debt is changed for debt)
    - **Character of gain** determined under §356(a)(2) & *Clark*: see dividend equivalency test below
        - if public company, gain is probably LTCG

- **§358**: basis in P stock received = T SH's old basis in T stock – boot (including debt assumed treated as boot under §358(d)(1)) + gain recognized
    - Basis in debt received = FMV

- T Corp
  - Exchange of T stock for P stock
    - 361(a): non-recognition on exchange of T stock for P stock
    - 361(b)(1) Boot: If T receives boot, it must recognize its realized gain (but may not recognize loss) to the extent of cash and FMV of any boot that T does not distribute to its SHs pursuant to reorg plan
  - (deemed) distribution of property to T SHs
    - 361(c)(1) Generally, T does NOT recognize gain/loss when it distributes property to its SH pursuant to reorg plan
    - 361(c)(2): If T distributes property *other than qualified property* that has *appreciated* in value, then T recognizes gain as if property were sold to SH at FMV (gain=FMV less AB)
      - Since usually the only consideration is P voting stock (qualified property because P is party to reorg) -> *T will have non-recognition on distribution of qualified property to T SHs*

- P Corp
  - §351 transaction (for drop down of P stock and other consideration to S):
    - §351: non-recognition on exchange of property (P stock + boot, if any) for S stock
    - §358: basis in S stock
      - If transfers both P's own stock and cash to S -> basis = FMV of cash (no basis in its own stock)
  - Exchange of S stock for T Stock
    - §354(a): non-recognition on exchange of P stock for T stock
    - 1.358-6(c)(2)(i)(A) Basis Adjustment in T Stock (over the top): P's basis in T stock is P's basis in S stock adjusted as if the transaction were a forward triangular merger (i.e. as if P had merged into S)
    - Analysis:
      - P initial basis in S stock = basis from 351 transaction
      - Step 1: pretend P acquires T's assets from T with carryover basis under 362(b)
      - Step 2: pretend P drops those assets down into S and takes §358 carryover basis in stock with any liab relieved (except here, S is dissolved and T is the surviving corp)
      - Add this basis to initial basis in S stock
      - **P's basis in T stock received = P's basis in S shares already held + basis in T's asset transferred – liab assumed under §358(d)**
    - 1.358-6(c)(2)(i)(B) ALLOCABLE SHARE: If P acquires less than all of T stock, basis adjustment above is reduced in proportion to % of T stock not acquired in transaction. The % of T stock not acquired in transaction is determined by taking into account the FMV of all classes of T stock.
    - 1.358-6(c)(2)(i)(C) IF P OWNS T STOCK BEFORE TRANSACTION: If P owns T stock before transaction, P may treat that stock as acquired in the transaction for purposes of determining basis.
      - REMEMBER: only applies if P had < 20% ownership → otherwise bulk transfer requirement won't be met
    - 1.358-6(c)(2)(ii) REV. SUB MERGER THAT ALSO QUALIFIES AS 351 OR TYPE B: if reverse triangular merger also qualifies as a 351 transfer or both as a reverse triangular merger and a Type B reorg (transitory sub), then P can
      - Determine basis in T stock as if (c)(2)(i) applies OR determine as if P acquired such stock from former T shareholders in transaction in which basis in T stock was determined under 362(b)
  - S Corp
    - *if transitory sub, tax consequence is ignored – no need to compute*
    - §1032: non-recognition when receives contribution of property from P

- Also, no tax consequence when S mergers into T

VII - TREATMENT OF PARTIES TO AN ACQUISITIVE REORG

368(B): PARTIES TO A REORGANIZATION

- RULE: To enjoy benefits of reorg treatment, an individual/entity must be a party to the reorganization
- §368(b), §1.368-2(f): Parties to a reorganization include:
  - A corporation resulting from a reorganization
  - Both corporations, in the case of a reorg resulting from the acquisition by one corporation of stock or properties of another (Acquiring Corp (P) & Target Corp (T), or S & T)

- §368(b) Flush Language: parties to a reorganization also include:
  - First Sentence: In a Type B or C reorg, the corporation controlling the acquiring corporation (i.e. P that controls S)
  - Second Sentence: In a Type A triangular, Type B triangular or Type C triangular or dropdown, the corporation controlling the corporation to which the acquired assets or stock are transferred
  - Third Sentence: In a forward subsidiary merger, the controlling corporation **(P)**
  - Last sentence: In a reverse triangular merger, the controlling corporation **(P)**

CONSEQUENCES TO T CORP

Type A/C and forward triangular rules: apply to T's transfer of its assets in a Type A or Type C reorg or a forward triangular merger and to T's distribution to SHs of consideration it receives from P along with any assets that it retains, in a complete liquidation pursuant to a reorg plan

Type B Reorg: T doesn't exchange anything, remains in existence and retains assets after reorg → no tax consequences (just has a new controlling SH P)

§361/357 Treatment of reorganization exchange

- 361(a) Non-recognition: T recognizes no gain/loss on an exchange of property, pursuant to a reorg plan, solely for stock or securities of P
  - Here, stock includes both CS and PS (PS is also permitted property for this purpose)
- 361(b)(1) Boot Rule: If T receives boot, it must recognize its realized gain (but may not recognize loss) to the extent of cash and FMV of any boot that T does not distribute to its SHs pursuant to reorg plan
  - Note: since any boot passes directly to T shareholders in a merger and must be distributed to T SHs in a Type C reorg, T will rarely recognize gain/loss on reorg exchange
- 361(b)(3) Creditor Rule: transfers of boot by T Corp to creditors in connection with reorg is treated as a distribution in pursuance of plan of reorg

- **Debt:**
  - **Long-Term Bonds**: 10 years or more; *generally* qualify as securities → generally non-boot: Nonrecognition
  - **Short-Term Notes**: 5 years or less; *generally* do not qualify as securities → BOOT
    - still may not result in recognition if distributed immediately to T SHs (see below)
  - §1.368-1(b) short-term purchase money note is not a securities, hence boot

- 357(a) Assumption of Liabilities: P's assumption of T liabilities is NOT treated as boot, and does not prevent the exchange from non-recognition/qualifying as non-taxable to T under §361(this holds even if debt assumed > basis, which is only an issue in §351)

- 357(b) Tax Avoidance Exception: except in case where liability assumption is motivated by tax avoidance or lacks a business purpose -> see 351/357

§361(c) Treatment of distributions by T to its SH

- 361(c)(1) Generally, T does NOT recognize gain/loss when it distributes property to its SH pursuant to reorg plan
- 361(c)(2): If T distributes property ***other than qualified property*** that has ***appreciated*** in value, then T recognizes gain as if property were sold to SH at FMV (gain=FMV less AB)
  - 361(c)(2)(B) Qualified Property: includes T's *stock or obligations* OR stock or debt obligations of any party to the reorg (e.g. P) received by T in reorg exchange
    - NOTE: cash is not qualified property, but it won't trigger recognition b/c cannot appreciate
- 361(c)(3) Distributions to Creditors: T transfer of qualified property to creditors in connection with the reorg (i.e. to satisfy T liabilities) is treated as a distribution to SH (i.e. non-taxable distribution)

SALE PRIOR TO LIQUIDATION OF T

SITUATION: After a reorg w/ P but prior to liquidation, T may sell some of P stock/securities it receives to 3Ps.

1. Fully taxable events even if necessary to raise funds to pay off creditors
2. HOWEVER, if T transfers stock/securities directly to creditors → nonrecognition b/c transfer is treated as a 'distribution' of 'qualified property' under 361(c)

Basis &Holding Period

- AB: T unconcerned with basis
  - b/c P stock/securities received in acquisitive reorg will be distributed tax-free under 361(c) to T SHs who will determine basis/holding period by reference to former T stock under 358 and 1223
  - Even in Type C: T deemed to have distributed assets to SHs who are then treated as having recontributed property to a 'new' corp which takes over SH's basis and holding period.
- 358(a)(2) boot: T takes FMV basis in any boot received from P

CONSEQUENCES TO T SHAREHOLDER AND SECURITY HOLDERS

§354/356 Recognition of Gain/ Loss

FIRST: Calculate gain realized

- **§354(a)(1) General Non-recognition Rule**: Non-recognition for T shareholders and security holders if stock or securities in T Corp are, in pursuance of a plan of reorg, exchanged solely for stock or securities in such corp or in another corp that is party to the reorg (i.e. P corp or S corp)
  - Here, stock includes both CS and PS (PS is also permitted property for this purpose)
- **§356(a) Boot Exception**: recognize realized gain to the extent that a T SH receives boot (money or FMV of other property)
  - **Lesser of Rule**: recognize gain in an amount equal to lesser of gain realized or boot
- 354(c)(2): **NQPS** is treated as boot for purpose of determining gain

  - DEBT
    - Long-Term Bonds: 10 years or more; generally qualify as **securities** → may NOT be boot, look at 354(a)(2), 356(d)(2)(B)
    - Short-Term Notes: 5 years or less; generally do **not** qualify as securities → BOOT
  - **§354(a)(2) Security Limitation**: §354(a)(1) doesn't apply (i.e. recognize gain) if
    - Principal amount of securities received is greater than principal amount of securities surrendered

        - OR if securities are received but <u>none are surrendered</u>
    since 354(a)(2) is triggered, we look at 356(D)(2)(B)
    - **<u>§356(d)(2)(B)</u>:** securities (i.e. long-term debt) is NOT BOOT if T's securities are exchanged for P's securities. <u>Boot = FMV of securities received (from P) – FMV of T SHs' securities surrendered</u>
        - i.e. non-recognition to the extent securities (debt) are exchanged for securities
          Ex: SH exchanges 1000 securities of T with 1000 securities of P -> no boot/recognition
          Ex: SH exchanges 1000 securities of T with 1200 securities of P -> boot= FMV of 200 securities

- **1.354-1(a) debtholder rule**: clarifies that T debtholders who receive P stock in satisfaction of T's liabilities are <u>not taxed</u> (non-recognition) on receipt of stock in exchange for T's debt
    - Basis for permitted property received = carryover basis

- **356(c) No Loss Recognition:** T SH or security holder who *receives boot* may not recognize any realized loss (i.e. loss never recognized), if T SH receives both stock and boot
    - If T SH only receives boot (ex: NQPS) -> §356(c) doesn't apply and can recognize loss
    - For NQPS see 354(a)(2)(C)(i) above in B Reorg

<u>§356 Character of gain & boot-dividend rule</u>
- 356(a)(2) Dividend within Gain:
    - Gain recognized by T SH on acquisitive reorg is treated as a dividend, *if the exchange has the effect of a dividend distribution* to the extent of SH's ratable share of accumulated E&P of corp; any <u>remaining gain</u> treated as (capital) gain from sale/exchange
        - Test for dividend equivalency is based on 302 and §318 attribution rules apply
- *Clark*: test for <u>dividend equivalency</u>
    - First, each T SH is treated as initially having received only P stock on reorg exchange, then a portion of those stock is considered to be *redeemed by P for an amount equal to boot received*
        - If hypothetical redemption <u>meets any of the 302(b) tests</u> for exchange treatment → the receipt of boot does not have the effect of a dividend and <u>SH recognizes CG</u>
        - If hypothetical redemption does <u>not</u> qualify for exchange treatment, the amount of recognized gain is a <u>dividend</u> to extent of SH's <u>ratable share of T corp's accumulated E&P</u> and any <u>remaining gain is CG</u>
    - Ex: Individual A is sole shareholder of T Corp, which has 150k accumulated E&P. A has 60k basis in T stock. P Corp has 100k common shares outstanding with FMV of 10/share. T merges into P in Type A reorg. A receives 20k shares of P stock (FMV 200k) and 100k cash. A realizes 240k gain (300k A/R less 60k basis). A must recognize 100k of gain under 356(a)(1).
        - In determining dividend equivalency, A is treated as having received 30k shares of P stock (FMV 300k – same as A/R), of which 10k shares are redeemed by P in exchange for 100k cash.
        - Before hypo redemption, A is treated as owning 30k of 130k outstanding P shares (i.e. 23.1%).
        - After redemption, A actually owns 20k of 120k outstanding P share (16.67%).
        - Thus, redemption qualifies as substantially disproportionate under 302(b)(2) (as A's % ownership after redemption is less than 80% of her ownership before) and A's 100k gain is capital gain b/c it's sale/exchange, not dividend
    - Note: as long as dividend is same rate as LTCG, "boot-dividend" does not matter for individual SHs. But because §243 DRD, corporate SH may prefer boot-dividend.

Exchange for §306 stock
- §356(f): if §306 stock is received by T SHs, FMV of those stock is treated under §301 distribution

Clark:

- Facts: sole SH of B Corp. B Corp merged into sub of acquiring corp (triangular merger). SH exchange of his shares and received 300 shares of acquiring corp + cash boot of 3.25MM. 300 shares = 0.92% of outstanding shares of acquiring corp
  - SH wanted some cash. The original deal was share only deal: 425 shares of acquiring corp (thus, implied 125 shares of acquiring corp had value of 3.25m) which is 1.3% of acquiring corp.
- How do we test for dividend equivalency? Two approaches:
  - 1): What if right before merger the target had redeemed some stock for cash and then followed by a stock-for-stock reorg?
  - 2): Treat SH as if he had in first instance only P stock and then had requisite shares redeemed for cash by P corp
- Here: court chooses second approach:
  - Pretend SH received 425 shares (1.3%)
  - Then, P corp redeems 125 shares for cash
  - Thus, after redemption 300 shares (ownership down to 0.92%) -> substantially disproportionate reduction under §302(b)(2) -> CG treatment
- Why is first approach incorrect?
  - First redemption by target and then transfer of remaining stock to acquiring corp
  - If this approach, then in many cases, SH will always have dividend treatment and never CG
    - As in *Clark*, where SH was sole SH - redemption of any amount of stock of sole SH will always be dividend because there's no meaningful reduction in SH interest
    - Similarly, pro rata redemption of all SHs → dividend treatment

Allocation of boot

Situation: T SHs receive boot in reorg and surrenders more than one block of stock (i.e. shares acquired at different times for different prices) or more than one class of stock/securities

- **1.356-1(b) receipt of boot does not have dividend effect**: parties may specify how boot is to be allocated among multiple blocks or different classes of stock if specification is "economically reasonable"
  - **Default Rule**: absent allocation agreement, consideration received by T SHs must be allocated pro rata to shares/securities surrendered based on relative FMV at time of exchange
- Ex: T SH has 2 blocks of shares, block 1 has AB=50, FMV=300, black 2 has AB = 200, FMV = 300. P pays 300 stock and 300 cash. Absent specific allocation, 150 P stock and 150 cash allocated to each block. A recognize gain on block 1=150 (lesser of 150 and 250), block 2 = 100 (lesser of 100 and 150) for total realized gain = 250.
  - But parties can allocate boot entirely to block 2. A realize no gain on block 1 (because no boot allocated to it) and realize 100 gain on block 2, for total realized gain = 100.
  - Strategy: allocate boot to blocks of stocks with higher per-share basis

RECEIPT OF BOOT HAS DIVIDEND EFFECT: SHs holding different classes of stock may specify the class to which the boot should be allocated, but a pro rata application must be made among shares of the same class

<u>TAX STAKES</u>

INDIVIDUALS: B/c dividend treatment under 356(a)(2) is limited to SH's recognized gain, noncorporate SHs suffer little/no tax disadvantage if boot is characterized as a dividend as long as dividends and long-term capital gains are taxed at same preferential rates

CORPORATIONS: Corporate shareholders generally prefer to characterize boot received in reorg as a dividend b/c of DRD and absence of any preferential rate on corp capital gains

§358 Basis and Holding Period

- §358(a)(1) carryover basis in Non-recognition Property:
  - basis of non-recognition property (i.e. *stock received* or non-boot securities received by former T SHs or security holders in an exchange to which §354 applies) = basis of T stock/securities surrendered LESS boot (cash and FMV of any other property received & 358(d)(1) debt assumed treated as boot) PLUS gain recognized & amount treated as a dividend
  - NOTE: Basis taken in consideration received should preserve gain or loss not recognized
- §358(b)(1): If different types of non-recognition property are received (i.e. two classes of P stock: CS and PS), the aggregate 358(a)(1) exchanged basis is allocated in proportion to their FMV on date of exchange
- §1223(1): non-recognition property takes a tacked holding period

Boot received

- 358(a)(2) basis takes FMV basis and holding period begins as of date of Exchange
- P: Basis rule preserves for future recognition gain realized but unrecognized due to §354

CONSEQUENCES TO P CORP

§1032 Recognition of Gain or Loss

- **§1032(a) Non-recognition Rule**: P does not recognize gain/loss on issuance of stock (or stock of parent) in an acquisitive reorg
  - 1.61-12(c)(1): if P issues its own securities -> recognizes NO gain/loss
    - i.e. issuance of promise to pay/when borrow money via debt -> borrower has no gain/loss
- **Boot**: If P transfers boot property (property other than stock/securities) → it recognizes gain/loss under general tax principles §1001
  - If P issues cash as consideration -> NOT taxable event, no recognition
- Triangular Merger Rule: In triangular reorg, sub does not recognize gain on acquisition of property in exchange for stock of its parent

§362(b)/1223(2): Basis and Holding Period of T Assets Received

- **§362(b) Carryover Basis**: P's basis in T assets received in Type A or C reorg or forward triangular merger generally is the same as T's basis in those assets PLUS any gain recognized by ***T Corp*** on reorg exchange
  - Effect: since T rarely recognizes any gain, P almost always takes a transferred basis
  - Type B Reorg: basis in T assets are unaffected by a Type B reorg
- **§1223(2):** P takes tacked holding period for capital and 1231 assets that it receives from T
- NOTE: §357(c) debt assumed > liab rule - doesn't apply to reorgs UNLESS 368(a)(1)(D) and 355 apply

§362(b) Basis in Stock Received in Type B Reorg

- §362(b) in a Type B reorg, P's basis in T stock = aggregate bases of former T SHs
  - If T is widely held, and too many SHs such that you cannot determine basis of former T sh in stock received, then you can:
    - Best way is to get survey from SHs, or
    - Statistical sampling
    - If sampling unavailable, can use other mechanism such as estimation

§381 Tax attribute

  - §381: P inherits tax attributes of T

VII - FAILED REORGANIZATION

- RULE: If acquisition fails §368 requirements for reorg treatment → then treat as a taxable acquisition of T's assets or stock

- Type A or C or forward triangular merger failure:
  - T recognizes gain or loss on transfer of its assets
  - T SHs are treated as receiving a distribution in complete liquidation that is taxable under 331
  - P obtains a cost basis in T assets (step-up in basis)

- Type B or reverse triangular merger failure -> taxable exchange:
  - T's shareholders recognize gain or loss on the sale of their stock
  - T doesn't recognize gain and retains its same asset bases unless P makes a 338 election
  - P gets cost basis in T stock acquired
- Note: if P paid consideration in cash, the transaction is a sale, not a merger under §368(a)(1)
  - SH recognize taxable gain/loss under §1001
  - P non-recognition of gain/loss and takes cost basis on assets of acquiring corp

X - CORPORATE DIVISIONS

IN GENERAL

- CORPORATE DIVISION: transactions in which a single corporate enterprise is divided into two or more separate corporations that remain under the same ownership
  - Accomplished when a parent corp (D)—the distributing corporation—distributes to its shareholders stock or securities of one or more controlled subsidiaries (C)
  - If judicial and statutory requirements are met, then the transaction is generally tax free to the distributing corporation and its shareholders
  - RATIONALE: change in form of businesses which continue to be owned and operated by the same shareholders

- ***Gregory***: TP owned UM. UM owned some shares in MCO. If UM dividend-ed up MCO shares to TP, TP would have had dividend. Wrt provision that looked like D reorg (w/o requirement that reorg satisfy 354 or 355), TP caused UM to drop MCO stock into newly-formed ACO (formed solely for purpose of reorg). UM then transferred ACO shares to TP. Then, ACO liquidated after TP owned it and TP received MCO shares in ACO liquidation. At the end, TP continued to own UM and the shares in MCO, which she then sold.
- TP: Shares of ACO came to her in a reorganization and received MCO stock in liquidation, resulting in CG (@ CG rate with basis offset). Upon sale of MCO stock, no gain or loss because all taken into account upon liquidation.
- HOLDING: Treat as a dividend.
  - Transaction and spin-off of Aco had *no business purpose*. ACO was a device designed to bail out UM E&P in the value of MCO stock to TP at CG rate, and avoided dividend
  - SIGNIFICANCE: 355 basic requirements directed at transactions like the one here
    - PURPOSE: allow divisions of business that serve legitimate business purposes or needs and police transactions, which, rather than being a separation of businesses, looks more like a distribution of profits (i.e. a dividend)

TYPES OF CORPORATE DIVISIONS

- **Spinoffs**: distributing corp (D) distributes pro rata its controlled sub's stock (C) to D SH. C may be preexisting or a corporation that was formed by D immediately prior to the transaction.
  - Resembles a **dividend** (pro rata distn of C stock, D SH doesn't surrender anything)
    - Ex: D operates hotel and restaurant chains as separate divisions. D transfers assets of hotel division to a newly formed sub C, then D distributes C stock pro rata to its shareholders. After the distribution, D shareholders own all the stock of both D and C.
    - If transaction fails as Type D & §355, then dividend treatment: not only will A and B have distribution under 301, but corporation may have gain on distribution of appreciation property under 311(b).
  - **Spin-off without Type D**: D operates hotel chain and C operates restaurant chain. D distributes C stock pro rata to shareholders.
  - <u>If fail §355</u>: analyze like dividend
    - SHs → §301 distribution.
    - Distributing corporation → §311
  - P: spin-off looked at more carefully because it's like a dividend, potential to bailout D's E&P, so it's more suspicious
- **Split-off**: D distributes its C stock to some of D SHs in exchange for all or part of TSH's D stock.
  - Resembles a **redemption**
    - Ex: A and B are equal SHs of D, which operates hotel and restaurant chains as separate divisions. D transfers the hotel division assets to a newly formed sub C and distributes the C

stock to B in redemption of all her D stock. After the distribution, A owns all of D stock and B owns all of C stock.
    - Alternatively, D distributes C stock ½ to A and ½ to B so that after the distribution A and B each own ½ of D and C.
  - **SPLITOFF without Type D**: D operates hotel chain and C operates restaurant chain. D makes same distributions as above
  - <u>If fail §355:</u> analyze like redemption
    - SHs → §302 redemption (so either §301 treatment or sale treatment)
    - Distribution corporation→ §311

- **Split-up**: D distributes stocks in two or more controlled subs (C1 and C2), either pro rata or non pro rata (D owns no other assets) to all of D SH.
  - Resembles a **complete liquidation**.
  - Ex: A and B are equal SHs of D, which operates hotel and restaurant chains as separate divisions. D transfers the hotel division assets to a newly formed sub C-1 and D transfers the restaurant division assets to a newly formed sub C-2. D distributes C-1 stock to A and C-2 stock to B in complete liquidation. Alternatively, D might distribute the C-1 and C-2 stock pro rata to A and B.
  - **SPLITUP without Type D**: D is holding company and C-1 operates hotel chain andC-2 operates restaurant chain. D makes same distributions as above.
  - <u>If fail §355:</u> analyze like liquidation
    - SH → §331/§332 liquidation.
    - Distribution corporation → §336/§337 liquidation.

X- §368(A)(1)(D): TYPE D REORGANIZATIONS

- **§368(a)(1)(D):** D reorg requires that one corporation (Transferor) transfers all/part of its assets to another controlled corp (Transferee) and that the transferor than distribute stock/securities of controlled corp either in a non-divisive/acquisitive **§354** transaction or in a divisive §**355** transaction

ACQUISITIVE TYPE D REORG

368(a)(1)(D): a transfer by a corporation of (substantially) all…of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred, but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under 354.

- P buys substantially all of T assets, immediately after transfer, T or former T SH in control of P
  - No requirement on type of P stock used, P can use stock/securities of P or its sub, P can use voting/non-voting stock
  - COI is ensured through control requirement
  - For acquisitive D – distribution needs to qualify under **§354**

Requirement of D reorg

- **§354(b):**
  - **(1)(A)**: P (i.e. C) buys substantially all of T (i.e. D) assets, and
  - **(1)(B)**: T distributes (i.e. liquidates) all its assets to T SHs pursuant to plan of reorg
- **§368(a)(1)(H)(i)** – If §354(b)(1)(A)(B) are satisfied -> pass 304(c) control test – T must control P immediately after exchange (T has 50% vote/value of P stock)

- 354(b) §354(a) doesn't apply to Type D reorg, unless:
  - **354(b)(1)(A):** the corporation to which the assets are transferred (P) acquires **substantially all** of the transferor (T)'s assets AND
    - Essentially same as Type C substantially all requirement (90% net, 70% gross):
      - *Rev. Proc. 77-37*: T transfers its assets representing **at least 90%** of the FMV of **T's net assets** and **at least 70%** of the FMV of **gross assets** held by T immediately prior to the transfer
      - Assets distributed by T to *redeem* stock held by dissenting/other minority SHs & *unwanted assets* sold by T to other buyers are *considered as assets held by T* if the distributions are part of a *reorg plan*
      - Net asset = gross asset – liabilities (note: compare net asset transferred (which subtracts for liab transferred)/T's net asset)
  - **354(b)(1)(B):** the transferor (T) **distributes** any retained assets + stock/securities/other considerations received from the transferee (P), pursuant to plan or reorg
- P: purpose of §354(b) is to force divisive reorg into §355

- **§368(a)(2)(H)(i):** for purpose of non-divisive D reorgs (If §354(b)(1)(A),(B)are satisfied)**,** use **304(c) Control Test (50% vote + value)**
  - control means at least 50% of the total combined voting power of all classes of stock or at least 50% of the total value of share of all classes of stock
  - Thus, stock distributed by P does not need to be voting (can be nonvoting if 50% value test met)

Result of D reorg

- If D reorg req'ts are met, transferor (T) disappears
- T SH controls P
  - Thus, P have both T and P assets, resembles type C reorg

Overlap between C/A and D reorg

- **§368(a)(2)(A):** if a transaction meeting both Type **C** and Type D definitions -> it's treated as type D reorg
- RR 75-161: if meeting both Type **A** and D -> treated as Type D reorg
- P: prevent divisive transactions to bypass §355
  - This used to matter where liabilities exceeded basis b/c §357(c) could be implicated if transaction was a Type D reorg, BUT rule was amended so that §357(c) only applies in the case of divisive Type D (i.e. that satisfies §355)

Tax Consequences

- T SHs (see above)
  - 354(a): general non-recognition
  - 358: basis in P stock
- T CORP (See above)
  - 361(a): non-recognition on exchange of T assets for P stock
  - 361(c): non-recognition on distribution of P stock to T shareholders
  - Then T dissolves
- P CORP
  - 362(b): carryover basis in T assets
  - 1032: non-recognition on issuance of stock

DIVISIVE TYPE D REORG

- First step in a corporate division involves D's transfer of assets of a distinct trade or business to a controlled sub C in exchange for C stock, followed by D's distribution of C stock to D's SH in a spin-off, split-off, or split-up (must meet §355 req't)
  - Divisive D reorg is usually the preliminary step in a corporate division under §355 where corporate property to be divided is not already in another corporation.
- 368(a)(1)(D): a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred, but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under 355

- **Requirements under §368(a)(1)(D)**
  - (1) D (distributing corporation) transfers PART (NOT substantially all) of its assets to C (controlled corporation)
  - (2) Immediately after the transfer D (distributing corporation) or D SHs are in control of C (controlled corporation), AND
    - Use §368(c) "control" = **≥80% by votes** & **80% in number of shares** of each class of non-voting stock. §368(c).

        - Fact that D (distributing corporation) SHs dispose of C's (controlled corporation's) stock, or that C (controlled corporation) issues additional shares is disregarded for control purposes. §368(a)(2)(H)(ii).
    - (3) D (distributing corporation) distributes C's stock/securities to D SHs pursuant to plan or reorg
        - For divisive D reorg - Distribution of C stock must also **qualify** for **§355**
        - D SH get §355/§356 treatment.

- **Tax Consequences**: see below §355 transaction

- Main Considerations re Tax Consequences - §357(c) applies to T (distributing corporation).

X - §355 CORPORATE DIVISION

- P:The underlying premises of §355 is: non-recognition treatment should be available when owners of business merely change form of business while continuing operating it.
- Traditionally, §355 permits tax-free treatment of corporate division that serves legitimate business purposes, while policing potential for SH bailing out corporate E&P at favorable CG rate and avoidance of dividend through transaction that don't serve legitimate biz purpose
- Traditional concern of bailing out corporate earnings at CG rate became moot due to elimination of CG preference in 1986. But §355 continues to prevent recovery of basis.
- After repeal of *General Utilities*, in recent years, the focus of §355 has shifted from preventing SH avoidance of taxation to preventing corporate-level avoidance of taxation on distribution of appreciated property.

§355 REQUIREMENTS

- **§355**: No gain or loss is recognized by SH or security holders on receipt of stock/securities from distributing corporation if the following requirements are met:
    - (0) Distribution must be to SH with respect to their stock or to security holders *in exchange for their securities*§355(a)(1)(A)

    Statutory requirements:

    - (1) Distributing corporation (D) controls controlled corporation (C) before the distribution §355(a)(1)(A)
    - (2) transaction NOT principally a device for distributing E&P §355(a)(1)(B)
    - (3) both D and C must engage in active T/B immediately after distribution §355(a)(1)(C), and for and for 5 preceding years §355(b)(2)
    - (4) D distribute of (i) all stock and securities of C, or (ii) enough stock to constitute §368(c)control of C §355(a)(1)(D)

    Regulatory requirements:

    - (5) Business purpose
    - (6) COI
    - (7) COBE

<u>Statutory Requirements</u>
<u>355(a)(1)(A) D has Prior Control of C</u>:

- §355(a)(1)(A) D must <u>distribute</u> to its SH (with respect to their stock in distributing corp) and security holders (in exchange for its securities) <u>solely stock or securities</u> of C, which it <u>controls immediately before the distribution</u>
  - Use <u>§368(c)"Control"</u> means **≥80% by combined votes & ≥80% number of shares** of each class of non-voting stock
  - The Controlled corporation <u>may be a newly created or preexisting corporation</u>. Reg. 1.355-1(b).
  - D's distribution to SH doesn't have to be pro rata

<u>355(a)(1)(B) not a device for distributing E&P</u>:

D's distribution of C stock/securities <u>must not have been used principally as a device for the distribution (i.e. bailout) of E&P of D or C or both</u>

- §355(a)(1)(B) provides **mere fact** that after distribution, stock/securities of either corp are sold by (other than pursuant to plan) will NOT be construed to mean that transaction is a device
  - But this is construed narrowly in Regs – subsequent sale/exchange is an evidence of device

- 1.355-2(d)(1): whether a transaction was principally used as a device depends on <u>facts and circumstances</u>

- <u>1.355-2(d)(2)(i) **Device Factors**</u>: below factors are evidence of a device
  - 1.355-2(d)(2)(ii) **Pro Rata Distribution**:
    - greatest potential for bail out
    - so pro rata or substantially pro rata distribution of controlled corp stock is evidence of device
  - 1.355-2(d)(2)(iii) **sale**/exchange of distributing corp (D) or controlled corp (C) **stock subsequent to distribution**
    - Greater % of stock sold = stronger evidence of device.
    - Shorter time between distribution and subsequent sale = stronger evidence of device.
    - Subsequent sale pursuant to pre-distributing arrangement = substantial evidence of device.
    - Subsequent sale pursuant to NO pre-distributing arrangement = evidence of device.
- 1.355-2(d)(2)(iv): **Nature and use of assets** of distributing corporation and controlled corporation.
  - evidence of a device exists if either distributing or controlled corp holds *liquid assets* that are not used in or related to reasonable needs of qualifying active T/B
    - e.g., distributing corporation with lots of cash
    - Strength depends on facts and circumstances: ratio for distributing and controlled corp of nonbusiness assets to value of active businesses
      - i.e. *if holds too many non-biz assets* – evidence of device
    - Also evidence of device if distributing corp or controlled corp is a secondary business that services the business of the other corp

- <u>1.355-2(d)(3)(i) **Non-device Factors**</u>: below factors are evidence of non-device
  - 1.355-2(d)(3)(ii)**Corporate business purpose** for the transaction
    - strength of this evidence depends on
      - Importance of achieving the purpose to success of business

        - Extent to which transaction is prompted by a person not having a proprietary interest in either corp or by other outside factors beyond control of distributing corp
        - Immediacy of conditions prompting the transaction
    - 1.355-2(d)(3)(iii) **Public Traded and Widely Held**: If distributing corp is publicly traded and has *no shareholder that directly or indirectly owns more than 5%* of any class of distributing corp
    - 1.355-2(d)(3)(iv) **Distributions to Domestic Corp SH with DRD**: stock of controlled corp is distributed to domestic corporate SH which, without 355, would be entitled to an 65% to 100% §243 DRD (not true if only entitled to 50% DRD)

- <u>1.355-2(d)(5)(i) Presumptive **Non-device Transactions**</u>: - distributions ordinarily not treated as device notwithstanding the presence of any device factors:
    - 1.355-2(d)(5)(ii) **Absence of E&P**: A distribution in which distributing corp and controlled corp have neither accumulated nor current E&P as of date of distribution, taking into account the possibility that a distribution by distributing corp would create E&P if 355 did not apply
    - 1.355-2(d)(5)(iii) **Sale treatment on §302 Redemption**: In <u>absence of §355</u>, the distribution would <u>qualify</u>, with respect to each distributee shareholder, <u>as sale/exchange treatment on redemption under §302(a)</u>
        - Doesn't apply if distributing corp distributes the stock of two or more subs and distribution facilitates avoidance of dividend provisions through subsequent sale of stock of one sub and retention of stock of another
    - P: prevent bailouts of corporate earnings at preferential CG rates where distributing corp distributed controlled corp stock pro rata to distributing shareholders, who then sold D or C stock
        - 1.355-2(d)(1): B/c dividend rate and cap gains rate are the same, device limitation is less significant BUT still serves to prevent tax avoidance through a recovery of basis

<u>355(a)(1)(C) Active Trade or Business</u>

- Basically, both D and C (or D's subs: C1, C2) must engage in active conduct of a trade or business <u>immediately after the distribution</u>, (§355(b)(1)) and for <u>5 year-period preceding</u> the transaction (§355(b)(2))

    Must meet both §355(b)(1) and (b)(2):
- **§355(b)(1): either one of the two req'ts** depending on type of corporate division must be satisfied:
    - 355(b)(1)(A) **Spin-off/Split-off** Active T/B Rule: <u>Immediately after</u> (stock) distribution, <u>both D and C must be engaged in the active conduct of a trade or business</u>
    - 355(b)(1)(B) **Split-up** Active T/B Rule: D (parent) was merely a holding company, having no assets other than stock or securities of two or more controlled subs <u>immediately prior</u> to the (stock) distribution, and each of those <u>subs (i.e. C1, C2) must engage in the active conduct of a trade</u> or business <u>after the distribution</u>
        - If D owns stocks of C1 and C2, and only distributes C1 out (so C1 is the controlled corp stock being distributed), but keeps C2 (not part of distn), D doesn't holds assets other than the controlled corp (C1) immediately prior (b/c D also has C2 stock) -> cannot qualify under 355(b)(1)(B)
- **355(b)(2):** corporation is **engaged in active trade or business IF**:
    - 355(b)(2)(A):<u>corporation</u> is engaged in active conduct of a T/B,
    - 355(b)(2)(B): such T/B was <u>actively conducted</u> throughout the <u>5-year period</u> prior to the distribution,
    - 355(b)(2)(C): the T/B was <u>not acquired</u> in a <u>taxable transaction</u> (i.e. where gain/loss recognized by seller) <u>within 5-year period prior</u> to distribution, **AND**

- Doesn't apply to case where D buys C in tax-free reorg, even if T SH recognize gain from receipt of boot
- 355(b)(2)(D): for the corp conducting the active T/B, control (80% vote/value) was not acquired (by D corp or D's corp SH distributee) in a taxable transaction during the 5-year preceding period
  - BUT distributing corp can acquire in a tax-free transaction: 368 reorg or 332 liquidation
  - P: Prevents a corporation from using 355 to dispose of a recently acquired sub without paying corporate level-tax, ensure continuity

- 355(b)(3)(A),(B) **Separate Affiliated Group**: in determining whether distributing corp or controlled corp is engaged in active conduct of trade or business, all members of such corp's separate affiliated group (SAG) are treated as one corporation
  - Basically, D or C will be deemed as engaged in active biz if any lower-tired corp in the chain conducts active biz
  - SAG: essentially same as definition in §1504(a); generally, subs in which the parent owns 80% or more of the voting power and total value—are treated as one corporation

355(a)(1)(D) Non-Retention Req't– D distributes all or at least 80% of C stock

- Distributing corporation distributes EITHER all stock/securities in Controlled corp it held before distribution OR an amount of stock constituting §368(c) control of Controlled corporation (80% vote and value)
  - Generally requires distribution of all controlled corp stock and securities, but under certain circumstances distributing corp can retain controlled corp stock (as required by loan agreements w/ outside lenders)
    - **Retention**: If distributing corp retains some of controlling corp stock, then it must be established to the Service's satisfaction that the retention of S stock or securities was not part of a tax avoidance plan
  - 1.355-1(b): stock does not include rights to acquire stock
- 355(d) & (e) Anti-Avoidance:
  - The anti-avoidance rules in 355(d) and 355(e) must not be violated; if they are, P (but not its shareholders) may recognize gain on the distribution

Regulatory Requirements

1.355-2(b) Business Purpose

- 1.355-2(b): division must be carried out for a substantial non-tax corporate business purpose germane to the business of distributing corp or controlled corp
  - cannot be only for SH personal business purpose (ex: only for estate planning)
    - but can serve both corp and SH purpose, (ex: brother/sister doesn't get along, corp division will have both corporate and personal purpose)
- 1.355-2(b)(5) Examples:
  - EX #1: To comply with a law or court decree requiring a division of P's businesses—e.g., an antitrust decree.
  - EX #2: *A split-up to resolve a shareholder dispute* or to enable shareholders with different expertise to devote their undivided attention to separate parts of the business.
  - EX #8: To enable a key employee to acquire an equity interest in either P or S.
  - To dispose of a business that is unwanted by a corporation seeking to acquire P.

    - EX #6-7: To reduce state or local taxes provided that the transaction does not also result in a comparable or greater reduction of Federal taxes.
    - To help P secure needed additional *debt capital.*
    - To improve corporate "fit and focus" by allowing senior management of a public company to concentrate on separate dissimilar businesses.
    - To resolve disputes among senior management of a public company over capital allocation where internal competition for new capital has prevented separate businesses from pursuing development strategies that management of each business believes are appropriate.
- ***Rev Proc 96-30:***
    1. Key employee
    2. Facilitate stock offering to raise capital
    3. *Facilitate Borrowing*
    4. *Cost saving*
    5. Fit and focus
    6. Competition
    7. Facilitating a subsequent tax-free acquisition of "Distributing" by another corp
    8. Facilitating a subsequent tax-free acquisition acquisition of another corp by Distributing or Controlled
- Need business purpose for both drop down of business to controlled corp and distribution of controlled stock to shareholders
        - 1.355-2(b)(3) **Business Purpose Of Distribution**: Business purpose requirement is not satisfied if P's goals could have been achieved through a nontaxable transaction that
            - Would not have required the distribution of controlled corp stock
            - AND was neither impractical nor unduly expensive

<u>**1.355-2(c) Continuity of Proprietary Interest**</u>

- §1.355-2(c): Distributing corps <u>historic</u> SHs (i.e. SH prior to distribution) must maintain sufficient COPI following the distribution (in both D and C, or the C subs)
    - §1.355-2(c): Requirement is met if one or more of pre-distribution D's SHs <u>owns at least **50%**</u> (by value) of both Distributing corp and Controlled corp after the division (Regs example suggests 50% threshold, not the 40% threshold for acquisitive reorgs)
    - Maybe be affected if shortly before transaction one of the historic shareholders sells part or all of interest such that historic shareholders own less than 50% post-distribution
- 1.355-2(c)(2) EX#2, 4: Some historic SH may own D corp stock and others may own C corp stock provided that in the <u>aggregate</u> the historic distributing corp SH maintain continuity in both corporations

<u>**1.355-1(b): Continuity of business enterprise**</u> (same req't as in acquisitive reorg, including triangular)

- Reg. 1.355-1(b): after distribution, the businesses existing prior to the division must continue to operate
    - For how long? Longer than immediately after (which is a snapshot. Note this is a separate req't than active business req't)
    - e.g., if a business that had been dropped into a spun-off corporation is sold shortly after the division, this requirement would be violated.

TAX TREATMENT OF THE PARTIES TO A CORPORATE DIVISION

§368(b): Parties to reorg: SH (of D/), distributing corp, controlled corp

Shareholders & Security Holders

No Boot Received

- **355(a)(1) Nonrecognition**: Distributing corp shareholders and security holders generally do not recognize gain or loss on receipt of controlled corp stock or securities if §355 is met
- **358(a) Basis**: Shareholders allocate their old basis in distributing corp stock b/w the distributing corp and controlled corp stock in proportion to their FMVs
    - In case of **SPLIT UP**: SH who receive controlled corp stock in exchange for all of their distributing corp stock take a basis in the new controlled corp stock equal to basis in former stock
        - exchanged basis: **basis in stock received = basis of stock given up**
- 1223(1) **holding period**: tack holding period of distributing corp stock to controlled corp stock

Boot Received

- For purposes of 355, boot includes…
    - any property other than controlled corp stock or securities (cash, short-term debt obligations, stock rights or warrants)
    - 355(a)(3)(A) EXCESS PRINCIPAL AMOUNT: Controlled corp securities to extent that their principal amount exceeds the principal amount of any securities surrendered
    - 355(a)(3)(B) HOT STOCK : controlled corp stock that was acquired by distributing corp stock (or sub of distributing corp) in a taxable transaction within 5-year period preceding distribution
        - UNLESS in 5-year period before distribution, controlled corp becomes a member of distributing corp's SAG (80% vote and value) at any time after stock is acquired and before it is distributed
- 356(b) **Spinoff Recognition**: receipt of boot is treated as 301 distribution (w/o regard to SH's realized gain) and is thus a dividend to the extent of E&P
    - Any remaining portion of the distribution first reduces SH's basis in distributing corp stock and then is treated as capital gain under 301(c)
- 356(a)(1) **Split Offs & Split Ups** Recognition: SH who receives boot recognizes realized gain to the extent of boot
    - 356(a)(2) **Dividend Equivalence**: If exchange has the effect of a distribution of a dividend, the recognized gain is a dividend to the extent of SH's ratable share of distributing corp's accumulated E&P (apply CLARK, see below)
        - 1.356-1(b)(2): Any remaining recognized gain is gain from exchange of property
        - **Dividend Equivalence Test**: apply 302 principles (reduction of proportionate interest) prior to exchange
            - By treating recipient SH as having received the boot in redemption of an amount of distributing corp stock equal to the value of the boot
            - AND by then comparing SH's interest in distributing corp before the exchange w/ the interest SH would have retained if she had surrendered only an amount of distributing corp stock equal in value to the boot
- 356(c) Loss: In no event may loss be recognized
- 358(a) Basis in stock: basis in distributing corp stock reduced by cash + FMV of other property receive and increased by SH's recognized gain
    - 358(b)(2) BASIS ALLOCATION: this amount is allocated b/w distributing corp stock and controlled corp(s) stock in proportion to relative FMV
    - 1223(1) HOLDING PERIOD: tack holding period of distributing corp stock to controlled corp stock
- 358(a)(2) BASIS IN BOOT: FMV of boot (new holding period)

Distributing Corporation

355 Distribution Preceded By Type D Reorg

- **361(a) Nonrecognition on Exchange**: Distributing corp does not recognize gain or loss on transfers of assets to controlled corp in exchange for controlled corp stock/securities in a divisive Type D
  - 361(b) EXCEPTION FOR PROPERTY NOT DISTRIBUTED: Distributing corp recognizes gain if the liabilities assumed by controlled corp exceed the aggregate adjusted basis of assets transferred by distributing corp OR if it otherwise receives boot that is not distributed to shareholders
    - 361(b)(3): amount of cash/property that distributing corp may distribute to creditors w/o gain recognition is limited to the aggregate adjusted basis of assets contributed to controlled corp in Type D reorg
- 361(c) **Nonrecognition on Distribution (liquidation)** of qualified property: Distributing corp does not recognize gain when it distributes controlled corp's qualified property (stock or debt obligations) to distributing corp SHs or security holders, but recognize gain when distribute non-qualified appreciated property
  - 361(c)(2) **Appreciated Property**: Distributing corp recognizes gain on a distribution of appreciated boot in a 355 transaction
  - 361(c)(4): removes liquidating distribution from usually 336(a) recognition applicable to liquidations

- 361(b)(2) **Loss**: in no event will distributing corp recognize loss

- 358(a) **Basis in controlled corp stock**: basis in controlling sub stock is same as aggregate basis in assets transferred by distributing corp

355 without a type D reorg (i.e. §355 ONLY – you can have §355 without D reorg)

- **355(c) non-recognition**: Distributing corp recognizes no gain or loss on a distribution of a controlled corp qualified property (stock or securities i.e. debt) to distributing corp shareholders, but recognizes gain or loss on a distribute of property other than controlled corp stock or securities
  - §355(c) defn of qualified securities is narrower than 361(c)
    - §361(c) qualified property says "obligation", whereas §355(c) says "securities" which means debt

Tax Attributes (in both cases)

- 381: All of P's tax attributes, except E & P, stay with P following a § 355 distribution even if the division is pursuant to a reorganization plan. Section 381 does not apply to divisive Type D reorganizations. All of P's tax attributes thus disappear when P liquidates following a split-up.
- 1.312-10(a): If a § 355 distribution is part of a Type D reorganization, P's E & P are allocated between P and S in proportion to the relative fair market value of the assets held by each corporation after the distribution.

Controlled Corp

355 Distribution Preceded by Type D Reorg

- §1032 Non-recognition: Controlled corp recognizes no gain or loss on issuance of stock in exchange for property (i.e. non-rec on dropdown of D assets in return for Cs' stock)
- §362(b) Carryover Basis: Transferred basis in assets transferred by distributing corp
    - Basis in assets received = basis in assets transferred by D