TAX 101: CORPORATE REORGANIZATIONS PART I – TYPES A & B

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CORPORATE TAXATION IN GENERAL

The income of a C-corporation is taxed at both the corporate and shareholder levels. First, the income is taxed directly to the corporation.[1] Second, when corporate earnings are distributed to shareholders as dividends, the shareholders are subject to tax.[2] Appreciated corporate assets are generally subject to corporate-level tax if they are distributed to the shareholders, yielding the same corporate tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders.[3]

If the stock of a corporation is sold, the selling shareholders pay tax on any gain from their sale of stock.[4] The acquiring shareholder holds the acquired stock at its purchase price basis,[5] but the basis of assets inside the acquired corporation does not change to reflect the stock purchase price unless an election is made to pay "inside" corporate-level tax on any gain associated with this "inside" asset basis change. Such an election may generally be made only if 80% of the stock was acquired by a purchasing corporation, within any 12-month period, in a taxable purchase.[6]

If the assets of a corporation are sold, the selling corporation pays corporate-level tax, and the buyer obtains a purchase price basis for the assets. If the proceeds of the sale are then distributed to the shareholders of the selling corporation, the shareholders are generally subject to shareholder-level tax on such distribution.

TAX-FREE CORPORATE TRANSACTIONS

A number of special provisions enable corporations to combine or separate businesses, and permit corporate shareholders to shift investment interests to the combined or separated enterprises, without the tax impact that would otherwise generally occur on an exchange of appreciated corporate assets for other assets, or of shareholder investment interests for other interests.

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1 Code §11.

2 Code §§1 or 11, depending on whether the shareholder is an individual or a corporation.

3 Code §311(b).

4 Code §1001.

5 Code §1012.

6 Code §338.

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There are three broad categories of reorganizations:

- *Acquisitive transactions*, in which one corporation acquires the stock or assets of another
- *Divisive transactions*, in which one corporation divides its business or subsidiaries into entities separately owned by the corporate shareholders
- *Nonacquisitive, nondivisive reorganizations*, in which there is an adjustment to the corporate structure of a single, continuing corporate enterprise

The types of reorganizations are often referred to by reference to the particular subparagraph of Code §368(a)(1) (defining such transactions) in which they are described. Acquisitive reorganizations generally include statutory mergers (“A-reorganizations”), stock for stock acquisitions with 80% control (“B-reorganizations”), and stock for asset acquisitions (“C-reorganizations” and “D-reorganizations”). In Part I of this article, we discuss A- and B-reorganizations. In Part II, we will discuss C-reorganizations and acquisitive D-reorganizations.[7]

If a transaction qualifies as a “reorganization,” it is generally tax free both to the shareholders and to the corporation. However, to the extent non-stock consideration (such as cash or other property, often referred to as “boot”) is received, gain is generally recognized. The shareholders generally take a substituted basis for the stock or securities they receive. Similarly, the corporation generally takes a substituted basis for the assets it receives. However, basis adjustments are made for both the shareholders and the corporation for the receipt of nonqualified consideration (*i.e.*, to the extent gain or loss was recognized).

In addition to the statutory requirements, most reorganizations are subject to certain judicially developed requirements. These judicial requirements have been adopted by the Internal Revenue Service (“I.R.S.”) in its regulations and administrative guidance. These requirements include “continuity of business enterprise,”[8] “continuity of interest,”[9] and “business purpose.”

STATUTORY MERGER OR CONSOLIDATION (TYPE “A” REORGANIZATION)

One type of acquisitive reorganization is a statutory merger or consolidation, or an A-reorganization.[10] This type of reorganization offers relatively flexible rules for structuring a transaction and is subject to fewer pitfalls than any other acquisitive reorganization. The A-reorganization does not statutorily require that a particular percentage or type of stock consideration be given to old “target” company shareholders, or that a particular percentage of the target corporation’s historic business assets be transferred in the reorganization. The statute only requires that there be “a statutory merger or consolidation.” However, an important limitation on A-reorganizations is the judicially developed “continuity of interest” doctrine (discussed below).

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[7] D-reorganizations can qualify as both “acquisitive” and “divisive.” Part II will be limited to acquisitive D-reorganizations.

[8] Treas. Reg. §1.368-1(d).

[9] Treas. Reg. §1.368-1(e).

[10] Code §368(a)(1)(A)).

In a "merger," two corporations are combined with only one of the corporations "surviving." The acquiring corporation is the surviving corporation. The target corporation is sometimes referred to as the "disappearing" corporation. The target corporation is "merged into" the acquiring corporation.

In a "consolidation" (sometimes referred to as an amalgamation), two or more corporations are combined with the creation of a new entity. None of the pre-existing combining entities survive after the consolidation.

Under an A-reorganization, the acquiring corporation ("Acquiror") absorbs the corporate enterprise of the target corporation ("Target"). The assets and liabilities of the Target transfer to the Acquiror by operation of law.

"If a reorganization fails to qualify as an A-reorganization, and if it cannot be characterized as any other type of tax-free reorganization, it will be treated as a taxable sale of assets between Target and Acquiror, followed by a taxable liquidation of Target."

Prior to 2006, a merger involving one or more foreign corporations could not qualify as an A-reorganization. The previous regulations provided that to qualify as an A-reorganization, the merger or consolidation had to be pursuant to state or Federal merger or consolidation laws. In 2006, final regulations were issued that expanded the term "merger or consolidation" to include mergers or consolidations pursuant to foreign law.[11]

If a reorganization fails to qualify as an A-reorganization, and if it cannot be characterized as any other type of tax-free reorganization, it will be treated as a taxable sale of assets between Target and Acquiror, followed by a taxable liquidation of Target.[12]

Continuity of Interest

If the continuity of interest requirement is not met, the transaction cannot qualify as an A-reorganization. The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance, a substantial part of the value of the proprietary interests in Target be preserved in the reorganization.[13]

Continuity of interest is generally satisfied if at least 40% of the consideration received by Target's shareholders is in the form of Acquiror's stock.[14] There is no requirement that Target's shareholders receive Acquiror's voting stock, or even that they receive Acquiror's common stock.

Deemed Steps

It has been said that "[t]he simplicity of modern mergers obscures the steps that are

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11 Treas. Reg. §1.368-2(b)(1).

12 Rev. Rul. 69-6, 1969-1 C.B. 104.

13 Treas. Reg. §1.368-1(e)(1)(i).

14 Treas. Reg. §1.368-1(e)(2)(v), Ex 1. The 40% threshold is the amount that the I.R.S. has deemed to be sufficient to meet the continuity of interest requirement. However, case law suggests that a lower percentage may still qualify as an A-reorganization. See, *e.g.*, *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935), where 38% of preferred stock was sufficient to meet the continuity of interest requirement.

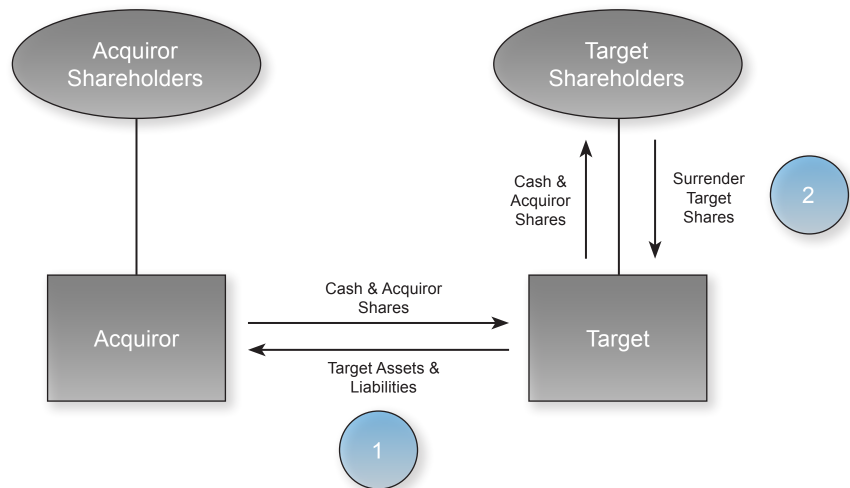
deemed to occur [in a merger] for tax purposes."[15] Thus, although the assets and liabilities of Target transfer to Acquiror by operation of law, the two steps below are deemed to take place for tax purposes.

In the example, it is assumed that, pursuant to the terms of a merger, Target's shareholders receive both cash and common shares of stock of Acquiror, with cash representing less than 60% of the total consideration received and the shares of Acquiror representing at least 40% of the total consideration received.

In the first step, Acquiror is deemed to transfer cash and its stock to Target in exchange for Target's assets and liabilities. Acquiror recognizes no gain or loss on the deemed receipt of the property in exchange for its stock.[16] Target recognizes no gain or loss on the deemed receipt of the cash and Acquiror's stock in exchange for its assets.[17] Acquiror takes the same bases in Target's assets as in Target's hands.[18]

In the second step, Target is deemed to distribute the cash and Acquiror's shares (which Target was deemed to have just received) in a complete liquidation. Target's shareholders receive the cash and Acquiror's stock and surrender their shares in Target. Target recognizes no gain or loss on the deemed distribution.[19] Target's shareholders recognize gain equal to the lesser of gain realized or cash received (*i.e.*, "boot" received).[20] For Target's shareholders, the bases in Acquiror stock received are generally the same as the bases in Target stock exchanged.[21]

<u>Diagram of Deemed Transfers</u>



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[15] B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.22[1], pp. 12-49 (6th ed. 1999).

[16] Code §1032.

[17] Code §361(a) and (b).

[18] Code §362(b).

[19] Code §361(c).

[20] Code §356(a). Note that all or a portion of the gain recognized may be recharacterized as a dividend. Code §356(a)(2).

[21] Code §358.

STOCK FOR STOCK ACQUISITION (TYPE "B" REORGANIZATION)

Another type of acquisitive reorganization is a stock for stock acquisition, or a B-reorganization. In a B-reorganization, one corporation ("Acquiror") acquires all or part of the stock of another corporation ("Target") solely in exchange for "voting stock" of Acquiror (or of Acquiror's direct parent corporation, but not both). Immediately after the acquisition, Acquiror must have "control" of Target.

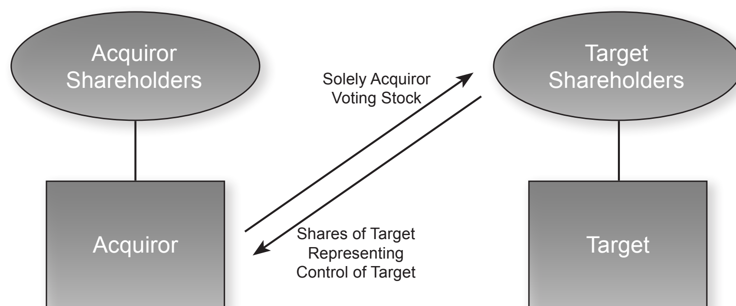
Control

"Control" for this purpose is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[22] As for the statutory phrase "solely for voting stock," the Supreme Court has stated that "'[s]olely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement."[23] However, the I.R.S. and lower courts have allowed some flexibility, ruling that the "solely" for voting stock requirement was not violated when Acquiror issued cash in lieu of fractional shares.[24]

"Creeping" Acquisitions

At times, Acquiror may purchase shares of Target on a stock exchange for cash (the "First Acquisition"), without anticipating that in the future Acquiror may want to acquire control of Target in a B-reorganization. If Acquiror later exchanges its own voting stock for control of Target (the "Second Acquisition"), the question arises as to whether the "acquisition" includes both the First Acquisition and the Second Acquisition, or whether the "acquisition" only includes the Second Acquisition. If both exchanges are part of the same acquisition, it will not qualify as a B-reorganization because Acquiror did not exchange "solely" its voting stock for shares of Target. On the other hand, if only the Second Acquisition is considered, the exchange can qualify as a B-reorganization. It is a facts and circumstances test to determine whether both transactions should be considered part of the "acquisition."

Diagram of a B-Reorganization



In this article we have discussed A- and B-reorganizations under Code §368(a)(1). In Part II, we will discuss C- and D-reorganizations.

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[22] Code §368(c).

[23] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

[24] *Mills v. Commr.*, 39 T.C. 393 (1962), Rev. Rul. 66-365. 1966-2 C.B. 116.

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