C. Tax Consequences of a Nondivisive Reorganization

This part summarizes the principal tax consequences of a nondivisive reorganization to the participants of the transaction. The general result of the “operative” reorganization rules is to defer the tax consequences of the corporate- and shareholder-level exchanges in the transaction and to preserve the target’s tax attributes in the hands of one of the acquiring parties.

1. Threshold Considerations

Several of the operative rules refer to “stock or securities” of “a party to a reorganization” received pursuant to a “plan of reorganization.” See, e.g., I.R.C. §§354(a)(1), 361(a). Read I.R.C. §368(b), which identifies which corporations are a “party to a reorganization.” As you can see, the term includes the corporation involved in a single-corporation reorganization, both the target and acquiring corporations in an acquisitive reorganization, and all three corporations in a triangular reorganization. In addition, the acquiring corporation remains a party to the reorganization if it subsequently transfers the acquired stock or assets in a transaction satisfying Reg. §1.368-2(k). I.R.C. §368(b) (3rd sentence); Reg. §1.368-2(f) (2nd, 3rd, 13th, and 14th sentences). Importantly, the transferee who obtains the acquired stock or assets in the subsequent transfer is not treated as a party to the reorganization. Therefore, the tax consequences of the subsequent transfer are not controlled by the reorganization provisions but by other rules, such as section 351. This distinction may be important, for example, if the properties transferred are subject to liabilities in excess of basis. Section 357(c), which may require the transferor to recognize gain in that situation, applies to section 351 transactions but not to transfers pursuant to a nondivisive reorganization. I.R.C. §357(c)(1).

The statute clearly contemplates the existence of a “plan of reorganization” but does not specify what constitutes a plan. The regulations similarly require that a plan exist and be adopted by each party to the reorganization, but provide no formal description. Reg. §1.368-1(c) (7th sentence), -3(a) (1st sentence). In general, the regulations indicate that a plan should delineate the parameters of the reorganization transaction and describe its business purpose. Reg. §1.368-1(c) (8th - 10th sentences), -2(g). Of course, the existence of a plan does not preclude the government from recharacterizing either the parameters or the purpose of the transaction.

Finally, several of the operative provisions distinguish between “stock or securities” of a party to the reorganization and all other property (boot). See, e.g., I.R.C. §§354(a), 356(a)(1), 361(a) and (b)(1). As you know, in order to qualify as a reorganization, certain transactions must include “voting” stock as consideration. The operative provisions, however, are generally applicable to all reorganizations and therefore do not distinguish between voting and nonvoting stock. As a result, once the critical determination has been made that a transaction qualifies as a reorganization, its tax consequences are not dependent upon whether the stock received is voting or nonvoting. See Reg. §1.361-1. Similarly, in certain circumstances, “securities” of a party to the reorganization may be received tax free even though they do not constitute qualifying consideration for any reorganization. The term “securities” is not defined and generally refers to a debt obligation having a sufficiently long term, such as five or 10 years, although other factors may also be important.

The following discussion assumes that P Corporation controls S Corporation and, in a qualifying reorganization, S acquires the assets or stock of T Corporation in exchange for stock of S or P (but not both) and (if permissible) certain additional consideration (boot).

2. Tax Consequences to T

Read I.R.C. §§361, 358(a), (f). If T transfers its assets to S solely for stock or securities of S or P in a qualifying reorganization, T does not recognize gain or loss. I.R.C. §361(a). The general rule suggests that T might recognize gain if it transfers its assets for boot, but that impression is deceptive. Section 361(b)(1)(A) and (3) make clear that so long as any boot received is distributed by T (or transferred to T’s creditors) pursuant to the plan of reorganization, T does not recognize any gain. Since a distribution is required in a “C” and nondivisive “D” reorganization and is deemed to occur in a merger, this provision should generally be satisfied. Therefore, in general, T does not recognize gain or loss upon transferring its assets to S no matter what consideration is provided by S. The required distribution ensures that any boot paid by S will potentially have tax consequences to T’s shareholders. T obtains an exchanged basis (reduced by any boot received) in the stock or securities of S or P received, and a fair market value basis in any boot received. I.R.C. §358(a), (f).

Other than a distribution of “qualified property,” which includes stock or securities of S or P, T must recognize gain on the distribution. I.R.C. §361(c)(2). Since T obtains a fair market value basis in any boot received from S, however, the distribution of the boot should produce little or no tax consequences. Therefore, the principal consequence of section 361(c)(2) is to require T to recognize gain (but not loss) upon distribution of any of its properties not transferred to S in the reorganization. In addition, T must recognize gain or loss if it sells (rather than distributes) the qualified property it receives. A transfer of the qualified property to T’s creditors in connection with the reorganization, however, is treated as a distribution of such property to T’s shareholders. I.R.C. §361(c)(3). Thus, T generally recognizes no gain or loss when it transfers property received in the reorganization to creditors.

3. Tax Consequences to S and P

a. Recognition of Gain or Loss

Read I.R.C. §1032(a) and Reg. §1.1032-2. S does not recognize gain or loss if it issues its own stock in the transaction. If it exchanges P stock in a triangular reorganization, the “zero basis” problem described in chapter seven potentially arises since S would ordinarily have a zero basis in any P stock contributed to S in the transaction, and section 1032(a) by its terms is limited to a corporation’s exchange of its own stock. The same transaction, however, could be carried out (without recognition of gain or loss by either S or P) if P acquired T’s assets directly (in exchange for P stock) and then transferred such assets to S (referred to as an “over-the-top” acquisition). The regulations therefore treat a triangular reorganization as if the over-the-top acquisition had occurred, as long as the P stock exchanged by S was provided by P pursuant to the reorganization. As a result, there is no recognition of gain or loss by S or P. Reg. §1.1032-2(b), (d) (ex. 1). If S exchanges P stock not provided by P pursuant to the reorganization, however, S must recognize gain or loss. Reg. §1.1032-2(c), (d) (ex. 2).

b. S’s Basis in T Assets or Stock

Read I.R.C. §§362(b) and (e), 358(e). In general, S obtains a transferred basis in any T assets acquired in a reorganization. Although the statute permits S to increase its basis by any gain recognized by T in the transfer, T ordinarily does not recognize any gain even when it receives boot. Therefore, S’s basis in T’s former assets is generally unaffected by any boot paid or liabilities assumed, a somewhat counterintuitive but necessary result to preserve fully the gains or losses not recognized by T in the transaction. In certain circumstances, to prevent the importation of a net built-in loss that could not have been used (such as if T were a foreign corporation not taxed by the U.S. but S were a U.S. corporation), S’s basis in the property acquired is limited to fair market value. I.R.C. §362(e)(1). In addition, although section 362(e)(2) (the rule prohibiting the duplication of net built-in losses in certain circumstances) is limited to section 351 transactions (see chapter seven), the regulations apply this rule to a reorganization that also satisfies section 351. For example, if X Corporation owns all of the stock of corporations Y and Z and X transfers its Z stock to Y solely for voting stock of Y, the transaction is a “B” reorganization and also satisfies section 351. Under the regulations, if X’s basis in the Z stock transferred is greater than its fair market value, Y’s basis in such stock is generally limited to fair market value. Reg. §1.362-4(b), (g)(2)(i), and (h) (exs. 2, 3).

Section 362(b) also applies to T stock acquired by S in a reorganization. This rule presents practical difficulties if T’s stock is widely held in street name. In that situation, it may be impossible for S to discover the identity of the beneficial owners of T (and, therefore, determine their basis in the stock transferred to S). The IRS has issued guidelines to help overcome the administrative problems. See Notice 2009-4, 2009-1 C.B. 251. Aside from the practical issue, there is a theoretical issue concerning the propriety of this rule. As described in the next section, any gain or loss realized and not recognized by the T shareholders in the transaction is preserved in the stock they receive in exchange. Furthermore, the stock acquisition has no effect on the amount of corporate-level gains and losses. Thus, it is not entirely clear why S should obtain a transferred (as opposed to fair market value) basis in any T stock acquired.

c. P’s Basis in S Stock

If the acquisition of stock or assets constitutes a triangular reorganization, P’s basis in its stock of S is generally increased by the amount of T’s former basis (net of liabilities) in its assets (or the T shareholders’ former basis in their T stock). This adjustment again conforms the results of the transaction to an “over-the-top” acquisition in which P acquires the T assets (or stock) directly and then transfers them to S. The positive adjustment is reduced (but not below zero) by the value of any consideration provided by S (and not by P) in the reorganization. Reg. §1.358-6(a), (b), (c)(1) and (3), and (d)(1) and (2). Example 11-2 illustrates this adjustment:

Example 11-2: T owns a single asset with basis of $100 and subject to a $10 liability. In a qualifying triangular reorganization, S assumes the liability and exchanges P voting stock (worth $200) for T’s asset. S’s basis in the asset acquired from T is $100. I.R.C. §362(b). In addition, P’s basis in its stock of S is increased by $90, which is T’s basis (net of liabilities) in its asset. Reg. §1.358-6(c)(1)(i) and (4) (ex. 1(e)). This adjustment produces the same result as if P had acquired the T asset (and assumed the liability) directly (for P stock), and then transferred the asset to S (which assumed the liability). I.R.C. §§362(b), 358(a)(1) and (d)(1). If S acquires the T asset in exchange for $195 of P voting stock (provided by P), $5 cash (provided by S), and S’s assumption of the liability, S’s basis in the T asset is again $100. In this case, P’s basis in its S stock is increased by only $85. Reg. §1.358-6(d)(1) and (3) (exs. (a), (b)).

If T transfers assets with a net built-in loss in a triangular reorganization, section 362(e)(2) does not apply because the transaction is not covered by section 351 (notwithstanding the deemed section 351 transfer as part of the “over-the-top” recharacterization). Reg. §1.362-4(h) (ex. 10). Section 362(e)(1), however, potentially applies. Prop. Reg. §1.362-3(f) (ex. 9).

d. Survival of T’s Attributes

Finally, read I.R.C. §381(a) and (b) and skim I.R.C. §381(c). In an asset acquisition qualifying as a nondivisive reorganization, the target’s tax attributes, including its loss carryforwards and E&P, survive in the hands of the corporation that directly acquires the assets even if it ultimately retains none of the assets transferred. Reg. §§1.381(a)-1(b)(2)(i) (identifying such corporation as the “acquiring corporation” in a transaction to which section 381(a)(2) applies); 1.312-11(a). The Treasury indicated that this rule generally maintains the target’s attributes in the corporation closest to the target’s former shareholders in a manner that minimizes electivity and administrative burdens. By breaking any required link between the tax attributes and the target’s former assets, however, the rule produces a different result depending upon whether a non-triangular or triangular reorganization is carried out. In the former case, the acquiring corporation succeeds to the attributes even though the acquired assets are subsequently transferred to a subsidiary. In the latter case, the acquiring corporation again succeeds to the attributes even though it is a subsidiary of the corporation whose stock is issued in the transaction. Chapter thirteen describes circumstances in which the successor corporation’s use of the target’s loss carryforwards may be limited after the reorganization.

4. Tax Consequences to T Shareholders and Security Holders

a. Recognition of Gain or Loss

Read I.R.C. §§354(a), 356(a), (c)-(e). In general, a taxpayer who exchanges T stock or securities for stock or securities of S or P in a reorganization does not recognize gain or loss. For the reasons expressed in Bazley, this rule does not apply if, in general, the taxpayer receives an interest in a corporation that is more senior than the one surrendered. Thus, a taxpayer who surrenders a T security may generally receive tax free either stock or securities of S or P. If the principal amount of the security received exceeds the principal amount of the security surrendered, however, the fair market value of the excess is treated as boot. I.R.C. §§354(a)(2)(A)(i), 356(d). A taxpayer who surrenders T stock (and no securities) may generally receive tax free only stock of S or P. If the taxpayer also receives a security of S or P, the fair market value of the security is treated as boot unless receipt of the security is properly characterized as separate from the stock-for-stock exchange. I.R.C. §§354(a)(2)(A)(ii), 356(d); Reg. §§1.356-1(f), 1.301-1(l). If the taxpayer only receives a security (and no stock) in exchange for stock, then section 356(a)(1) does not apply since the taxpayer has not received any qualifying property, i.e., property permitted to be received, under section 354, without the recognition of gain. The security received is therefore taxed under sections 301 and 302. Reg. §1.354-1(d) (ex. 3). Similarly, if a security holder receives anything other than stock or securities, the transaction is taxed under section 1001.

**[Skip or skim lightly]** An exception applies if the S or P stock received constitutes “nonqualified preferred stock” (“NQPS”), as defined in section 351(g)(2) (see chapter seven). For purposes of sections 354 and 356, this stock is generally treated as boot (and not stock) if it is received in exchange for stock other than NQPS. I.R.C. §§354(a)(2)(C)(i), 356(e). Since NQPS is defined as stock that has “debt-like” features, this exception is consistent with the general rule that the receipt of an interest more senior than the one surrendered is taxed as boot. For example, a taxpayer who surrenders stock (which is not NQPS) for NQPS is treated as receiving boot, whereas a taxpayer who surrenders a security for NQPS does not recognize gain or loss. Unless the regulations provide otherwise, NQPS is treated as “stock” for other purposes, such as section 368. Thus, for example, voting NQPS of S or P is qualifying consideration in a “B” reorganization even though receipt of such stock may be taxable to the T shareholder.

Because existing judicial precedents classify a right to acquire stock (a “warrant”) as not stock, the regulations treat a warrant as a security with a zero principal amount. Reg. §§1.354-1(e), 1.356-3(b). The general effect of this rule is to treat a warrant essentially like stock. For example, a taxpayer who exchanges T stock for both stock and a warrant of S or P does not recognize gain or loss; even though the warrant is a security, its value (as boot) is zero. Reg. §1.356-3(c) (ex. 7). On the other hand, a taxpayer who surrenders a T warrant in exchange for a security of S or P is treated as receiving boot equal to the fair market value of the security received (since its full principal amount exceeds the zero principal amount of the security surrendered). Id. (ex. 9). Warrants are not treated as stock for purposes of section 368 and COI, however, and the inclusion of a warrant as consideration in a stock-for-stock exchange otherwise qualifying as a “B” reorganization causes the entire transaction to be a taxable exchange. **[Finish Skip or skim lightly]**

b. Amount and Character of Gain or Loss

Read I.R.C. §356(a). A taxpayer who receives boot in connection with a section 354 exchange must recognize gain but not in excess of the boot received. The taxpayer may have a dividend if the exchange “has the effect of the distribution of a dividend” and the taxable amount does not exceed the taxpayer’s ratable share of the corporation’s accumulated E&P. I.R.C. §356(a)(2).

Comm’r v. Clark, 489 U.S. 726 (1988), involved a forward triangular merger of a target corporation into a subsidiary of a public corporation. The taxpayer owned all of the shares of the target and surrendered them in the merger for stock of the public corporation and boot. In determining whether the boot constituted a dividend, the Court resolved a split in the Circuits regarding the proper interpretation of section 356(a)(2). In Shimberg v. U.S., 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979), the Fifth Circuit had held that the boot should be treated as received in a hypothetical redemption of a portion of the taxpayer’s target stock immediately prior to the merger. Under this test, the boot qualified as a dividend because the taxpayer owned all of target both before and after the hypothetical redemption. In contrast, in Wright v. U.S., 482 F.2d 600 (8th Cir. 1973), the Eighth Circuit had held that the transaction should be tested as if the issuing corporation issued only stock to the taxpayer in the merger and then used the boot to redeem a portion of such stock immediately after the merger. Under this test, since the public corporation was widely held and the hypothetical redemption resulted in a disproportionate reduction of the taxpayer’s interest in such corporation, the redemption qualified under section 302(b)(2) and therefore the boot was not a dividend. Although neither test really took into account the effect of the reorganization on the taxpayer—the focus presumably of section 356(a)(2)—the Court concluded that the Wright test was more consistent with the language and history of the statute.

In general, a taxpayer is less likely to receive a dividend under the Wright test than the Shimberg test. If the acquiring corporation is widely held and more than 20 percent of the consideration received by the taxpayer is boot, such boot will generally not be a dividend under the section 302 tests. Although neither a “C” nor an “A” reorganization by reason of section 368(a)(2)(E) permits boot consideration in excess of 20 percent of the value of the target corporation, that limitation is applied in the aggregate and not on a shareholder-by-shareholder basis. Thus, a given target shareholder in either of those reorganizations, as well as in an “A” reorganization and one qualifying under section 368(a)(2)(D), may generally receive enough boot to avoid dividend characterization.

Under current law, dividend characterization of the boot often has minimal tax consequences. A corporate shareholder of the target must, in certain circumstances, treat any dividend received as an extraordinary dividend without regard to the period such taxpayer held the target stock. I.R.C. §1059(e)(1)(B). In addition, individuals generally pay tax at the same rate on their qualified dividend income and long-term capital gain and, even if any boot received is properly characterized as a dividend, the distributee’s realized gain limits the amount of dividend recognized. I.R.C. §356(a)(2). Thus, for individuals, both the taxable amount and the tax rate are generally the same, regardless of the characterization of the boot. The so-called dividend-within-gain rule, which has been a part of the statute since 1924, is inconsistent with the general treatment of dividends, as illustrated by example 11-3:

Example 11-3: Individual A owns all of the stock of corporations X and Y. A’s basis in each corporation’s stock is $500. X is worth $2,000, has E&P of $1,500, and excess cash of $600. Y is worth $600 and has minimal E&P and no excess cash. If X distributes its $600 excess cash to A, the full amount is taxable as a dividend under section 301. The same result occurs even if A surrenders some X shares, or transfers her Y shares, to X in exchange for the $600. I.R.C. §§302(d), 304(a). If, however, X purchases all of Y’s assets for $600 cash, which Y distributes to A, the transaction qualifies as a “D” reorganization; a nominal share of X is deemed issued to Y (in addition to the $600 cash) and deemed distributed by Y to A. Reg. §1.368-2(l)(2)(i). Therefore, the amount of the dividend to A is limited to the $100 gain realized by A in the surrender of Y stock.

The “dividend-within-gain” limitation and the prohibition on loss recognition place a premium on the manner in which consideration is allocated to the stock surrendered by the taxpayer. In general, if a taxpayer exchanges target stock acquired at different times with different bases, the taxpayer should allocate as much boot received as possible to the high-basis stock to minimize gain. The regulations permit this flexibility so long as the allocation is economically reasonable. Reg. §1.356-1(b) and (d) (ex. 4). Example 11-4 illustrates:

Example 11-4: Taxpayer owns two blocks of T stock, A and B, each worth $500. Taxpayer has a $400 basis in block A and a $100 basis in block B. In a reorganization, taxpayer surrenders both blocks for P stock worth $500 and $500 cash. Without a specific allocation, the consideration is allocated pro rata to each block based on its relative fair market value. Thus, P stock worth $250 plus $250 cash is allocated to each block. Taxpayer recognizes $100 gain on disposition of block A and $250 gain on disposition of block B, all of which may be a dividend. The taxpayer, however, may allocate all of the cash to block A and all of the P stock to block B. Assuming that the allocation is economically reasonable, the taxpayer’s gain (including potential dividend) is limited to $100 on disposition of block A.

c. Basis in Properties Received

Read I.R.C. §358(a). In a reorganization, a taxpayer receives an exchanged basis in any nonrecognition property received, reduced by the boot (including money) received and increased by the gain (including any amount treated as a dividend) recognized. A taxpayer receives a fair market value basis in any boot received. The regulations generally adopt a tracing method under which the basis of each stock or security received in a reorganization is traced to the basis of the stock or security surrendered for it. For this purpose, the terms of a specific allocation made by the taxpayer are respected if it is economically reasonable. Reg. §1.358-2(a)(2)(i) and (ii). To illustrate, if there is no specific allocation made by the taxpayer in example 11-4, the taxpayer’s basis in the P stock acquired in exchange for block A would be $250 ($400 basis in block A plus $100 gain (or dividend) recognized less $250 cash received for block A) and the basis for the P stock acquired for block B would be $100 ($100 basis in block B plus $250 gain (or dividend) recognized less $250 cash received for block B). Under the taxpayer’s allocation, the taxpayer would take a basis in the P shares acquired for block B of $100 (basis in block B); none of the P shares is received in the exchange for block A. Reg. §1.358-2(c) (exs. 4, 5). In short, the allocation permits the taxpayer to defer paying tax on $250 gain and potentially convert it from dividend income to long-term capital gain.

NOTES

1.    Even more flexibility. Proposed regulations issued in 2009 increase the flexibility provided taxpayers by permitting an economically reasonable allocation of consideration received in a reorganization to result in the recognition of losses by target shareholders, notwithstanding section 356(c). To illustrate, assume in example 11-4 that taxpayer’s basis in the block A target shares was $600 (rather than $400). Without a specific allocation, taxpayer would not recognize a loss upon the disposition of the block A shares (I.R.C. §356(c)) and would recognize $250 gain upon disposition of the block B shares. If, however, taxpayer allocated all $500 cash to the block A shares and all of the P stock to the block B shares, taxpayer could recognize a $100 loss on the block A shares (while not recognizing any gain on the block B shares). Prop. Reg. §1.354-1(d) and (e) (ex. 5). Although section 354 would apply to the block B exchange, neither that section nor section 356 would apply to the block A exchange (since no nonrecognition property would be received in that exchange). Thus, assuming the exchange is not equivalent to a dividend, the block A exchange would be controlled by section 302, which permits loss recognition. It remains to be seen whether this type of cherry-picking, generally curbed by the tax law, will be allowed in reorganizations. Cf. I.R.C. §§311(a) and (b), 1211; Rev. Rul. 68-55 (p. 262).