Corporate Reorganization – Taxation Outline

Corporate Reorganization – Taxation

I. Acquisitive reorganizations
   A. Introduction
      1. Historical background
         Historical nonrecognition policy for reorganization if shareholder receives new stock with no
         aggregate change in value in exchange for their old stock. Policy borne out of assumption that reorgs
         are simply change in form, ala 351 rationale, but will recognize gain up to the extent of boot received
         in the reorg.

         Reorganizations v. taxable acquisitions
         See chart from Corp Tax.
         Taxable acquisitions trigger immediate tax reckoning at either the SH level, corp level, or both.
         Reorgs potentially entirely tax-deferred
         SH level: 354(a)(1) nonrecognition on reorg exchange
         Corp level: 361 nonrecognition of gain or loss on exchange
         Basis
         SH level: 358 356
         Corp level: 362 361

      2. Overview of reorganizations
         336(c), 354, 355, 356, 358, 361, 362(b), 368(a)(1), (b), (c); 381(a), 1032
         From class:
         Corp X (MO) wishes to incorporate in DE. X creates shell DE corp Y, then all shareholders 351
         exchange their shares and corp 1032 exchanges its assets for all of Y’s stock. Finally, X liquidates into
         Y, who takes a 334(b) carryover basis and carryover tax attributes via 381(a)(1) from X. No tax on
         corp asset gain or loss from X via 337, and Y’s gain inherent in old X stock disappears under 332. SH
         gets 358 exchange basis. Complete tax-free transaction.

         What if you liquidate first, and then contribute to the new corp?
         Step1, liquidate in-kind to SH; Step 2, SH contribute all liquidation assets to new corp.
         Consequences:
         Step 1 – 336 corp level recognition on asset appreciation or diminution
         331(a) SH level recognition of stock gains
         Step 2 – 351 nonrecognition on contribution
         334(a) SH FMV basis in liquidated assets will create full basis in new corp stock.

         What if MO corp contributes assets to DE directly?
         Step 1, 351 asset contribution from X to Y, X becomes holding company for wholly-owned Y
         subsidiary; Step 2, liquidates by retiring its old stock to SH in exchange for stock in Y.
         Consequences:
         Step 1 – 351 nonrecognition on contribution
         358 AB of new stock = the AB of the contributed assets
         What of liabilities contributed from X exceed value of assets? 357(c) triggered
         336 corp level tax on asset appreciation (FMV stock Y – AB assets old)
         Step 2 – 331(a) tax to SH on stock in Y, and new stock basis FMV
         Assets still have low basis because of 362 carryover, so there may be a triple tax when Y sells
         and realizes appreciation on the transferred assets

   Policy introduction
   Assume: Corp 1 owns Blackacre
   Corp 2 owns Whiteacre
   Equal FMV

   Compare:
   (1) Corp 1 swaps RE with Corp 2
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1031(a) like-kind exchange
Would trigger 1001(c) but for 1031(d)’s like-kind tax deferral in basis configuration
Result: Tax free transaction

(2) SHs of Corp 1 swap stock with SHs of corp 2
1031(2)(B) denies exemption for stock swaps
1001(c) immediately recognizes all gains
Result: All SH pay tax on appreciation of stock

Why the difference? Stock is indirect ownership. Because a stock swap with no continuity could create a vehicle for indefinite tax deferral, where SHs would sell stock for other stock instead of cash, thus deferring as long as they wanted to.
Exception: 1036, stock swaps in the same corp. Limited to common for common and preferred for preferred, but not common for preferred. A cross-swap would represent a change in continuity because of the assumption or loss of the equity ownership associated with common stock ownership. Continuity is the key!

Since stock is still only indirect ownership, is there any other relief for exchanging stock between corps without massive tax consequences? 354(a)(1) – the fundamental basis for nonrecognition in corp reorg tax. Allows swap for corps if both are reorganizing. And how does the Code define reorganizations? 368.

Book:
“Reorganization” is a term of art for corp readjustments that fall into one of these three categories (all defined in 368 – note: NO LIKE-KIND EXCHANGE STANDARD IN 368):
(1) Acquisitive reorganizations
Transactions in which the acquiring corp acquires the assets or stock of another. Includes statutory mergers or consolidations (“A” reorgs), acquisitions of the target stock for voting stock in the acquirer (“B” reorgs), acquisitions of assets of the target for voting stock of acquirer (“C” reorgs or “practical mergers” due to their similarity to statutory mergers), and other, more complicated transactions.
(2) Divisive reorganizations (also 355)
Reorgs that result in the division of one corp into two or more separate entities. Usually preceded by a “D” reorg.
(3) Nonacquisitive, nondivisive reorganizations
Adjustments to the structure of a single, continuing corp. Includes recapitalizations (“E” reorgs), changes in identity, form, or place of incorporation (“F” reorgs), certain transfers of virtually all of the assets from one corp to another, and then liquidation of the transferor (nondivisive “D” reorgs), and transfers of one corp.’s assets to another corp pursuant to a bankruptcy reorg plan (“G” reorgs).

To qualify as reorg, judicial doctrines have also been developed to enforce the rationale for nonrecognition. Principally:
(1) Continuity of proprietary interest,
(2) Continuity of business enterprise, and
(3) Business purpose.

From class:
So why wouldn’t the second scenario above have tax deferral available to them? Because it was a shareholder swap without the necessary corporate involvement. Therefore, NOT technically a reorg.

B. Types of acquisitive reorganizations
   1. Type A: Statutory mergers and consolidations
      368(a)(1)(A); Skim 354(a), 356(a), 357, 358(a), 361, 362(b), 368(a)(2)(C), (b); 381(a)(2), 1032.
      Reg 1.368-1, -(2)(a), (b)(1).

      338 – Preempt the subjective Kimbell-Diamond holding.
A qualifies for a reorg because of the retaining of proprietary interest.

a. Continuity of proprietary interest (COI): Quantity and quality

**Southwest Natural Gas 410 (5th Cir. 1951)**
Ask whether SHs are bailing out of their equity interest, or if they are continuing on with their equity investment in some similar corporate form.

Continuity of interest requires a showing:
1. that the transferor corp or its shareholders retained a substantial *proprietary* stake in the enterprise, represented by a material interest in the affairs of the transferee corp, and
2. that interest received represents a substantial part of the value of the property transferred.

Note:
1. *Proprietary* stake – equity ownership is the quality of the consideration offered for the stock. Can’t be a lot of cash and a tiny bit of common stock. *Has* to be an equity interest of some sort.
2. Has to be certain amount of asset value that is preserved in the equity
3. Materiality of (1), *supra*. Software developer creates program; MS takes developer’s corp over for $50k cash and $50K MS common. Tax deferral?

**RR 66-224**
Corp X merges into Corp Y. X has four equal shareholders, two of whom Y paid $50K cash apiece for their X stock, and the other two whom Y exchanged $50K apiece of Y stick for their old X stock. IRS says that continuity is OK and transaction is a reorg. Same results if each shareholder had been paid $25K in cash and $25K in Y stock for their X stock.

The continuity of interest test for A reorganizations:

Quality – Stock, even nonvoting preferred (B&C reorgs require voting stock targets)
Quantity – 50% is fine, 30% too low, 38% is enough (US case long ago)

b. Continuity by historic target shareholders

**Kass 413 (Tax Court 1973)**
Kass was a minority shareholder in ACRA, which was an acquisition target of TRACK. TRACK made a tender offer and gained substantial control of ACRA, after which the remaining ACRA shareholders were offered a 1-for-1 stock swap for TRACK stock, after which ACRA would be liquidated into TRACK. Kass took the swap offer and claimed nonrecognition on a reorg basis. IRS and court disagreed, saying that the swap was part of an integrated transaction to acquire ACRA, and not a reorganization. Therefore, shareholders must be viewed as a whole in determining whether or not there is a substantial property interest in the acquirer, and Kass did not have sufficient continuity of interest in TRACK. This last step was in substance a subsidiary liquidation, and the minority shareholders are in harm’s way.

**Seagram Corp. 417 (Tax Court 1994)**
The difference between this and Kass is that Seagram was able to gain a hostile bid for Conoco and purchased 32% of the outstanding shares. Conoco entered into a friendly two step merger agreement with DuPont and completed the first step. In the initial round of offers, only 22% of the Conoco shareholders didn’t bail out and take cash from either DuPont or Seagram. Seagram conceded and tendered their 32% to DuPont in exchange for DuPont stock and claimed it as a $500M loss because of the inflated tender price they paid for the it stock during their offer. IRS balked, saying that it was part of a 368 reorg and required nonrecognition. Seagram said that they didn’t have continuity of interest, but the court said that they “stepped into the shoes” of the long term shareholders when they made their tender offer for Conoco.

Why? Competing Seagram offer treated as a historic target shareholder. Basically, since there was no acquisition, Seagram becomes like any other shareholder. When targets are announced, traditional SHs tend to bail out before the tender offer can be completed, taking
advantage of inflated target prices to avoid the possible failure of the usually conditional offers. When tender offers succeed, the majority of the target shareholders tendering to the acquirer tend to be new shareholders that bought at the inflated price.

Note: Final regs under 338 provide that if P acquires T in a 338 qualified stock purchase but P doesn’t make the 338 election, P will be treated as owning the stock for continuity purposes if T later transfers its assets to a P subsidiary in an otherwise tax-free reorg.

c. Post-acquisition continuity
What if there is a prearranged sale of received stock by a majority of the target’s shareholders? Does that destroy continuity?

**McDonald’s of IL 422 (7th Cir. 1982)**
McDonald’s wanted to reacquire franchises and treat the acquisition as pooling of interest, so they forewent a cash buyout and created a stock buyout with a subsequent registration and offering back to McDonald’s. The offer was not contractual, though; McDonald’s merely offered to facilitate the stock sale, and the former franchisers were under no obligation to participate in the sale. However, the franchisers had no intention of maintaining continuity of interest; the registration and sale of the received stock was integral to the deal. IRS said that interest pooling was inappropriate; the transaction was a reorganization (and should forbid McD’s from taking an upped basis over the mandatory reorg 362(b) carryover basis). Court said that as long as transactions are interdependent, they will be looked to as a whole. Because of this, the transaction would fail the continuity of interest test, and isn’t a reorg.

The three versions of the step-transaction doctrine:
(1) End Result Test
(2) Interdependence Test
(3) Binding Commitment Test – Very narrow view. Constricts analysis because it requires a contractual obligation to even examine the substance of the transaction.

See Reg 1.368-1(e)(1), *Example 3*

d. Continuity of business enterprise (COBE)
**Bentsen v. Phinney 433 (S.D.TX. 1961)**
Reorg doesn’t require the company which continues to exist to be in the same line of business. IRS would like it to be that either you continue the historic business of the acquired company, or that if not, you at least use the historical assets of the acquired company. See Reg 1.368-1(d) for this assertion making it to regulation form.

*RR 81-25*
The continuity of business requirement is asymmetrical; the acquired corp has no obligation.

This is crazy, thinks Wiedenbeck, because all you have to do is switch the entities from who is acquiring and who is acquired.

**Problems 438**
1. Assume Acquirer and Target are incorporated in a state with merger and incorporation laws that OK anything approved by a majority of the voting shareholders. Do the following qualify as “A” reorgs?
   (a) T merges into A in an all cash merger. T transfers all assets to A and is dissolved, with all T SHs receiving cash for their stock.
      Yes, it’s a statutory merger. But it violates the continuity of interest test because of the cash out of T’s SHs.
   (b) Same as (a), except that T SHs receive nonvoting preferred A stock instead of cash.
      Good A reorg because stock creates continuity of interest.
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(c) The SHs of A and T agree to form Consolidated Corp and transfer all the A and T assets to it in exchange for Consolidated common to everyone. A and T both dissolve.
   This is OK under state law because of the state consolidation law. But for that, the results would still be the same because it could be treated as simply two mergers.
(d) Same as (b), except all T SHs receive NV preferred of A worth $200K and A notes worth $100K.
   Stock plus boot. Still a reorg because the boot is less than the stock that upholds proprietary continuity, but the boot is of course taxable.
(e) Same as (d), except that T SHs receive A NVP worth $100K and A long term bonds worth $100K.
   Now the proprietary interest:boot ratio is 50:50, and this is more questionable. If the transaction is already completed, litigate it. If not, restructure it.
(f) Same as (e), except that the bonds are convertible at any time into A NVP.
   If it ain’t stock now, it ain’t stock for proprietary purposes. Destroys continuity.
(g) Same as (d), except that 75% of T’s SHs (owning 33 1/3% of T) receive notes worth $100K and the other 25% receive A stock worth $200K.
   If the target SHs, no matter in what combination, continue a proprietary interest, then the SHs in any grouping don’t matter. See RR on 412.
(h) A acquired 70% T five years ago for cash. In the current year, T merges into A, and the minority SHs of T receive A stock worth $18K and $72K cash (20:80 ratio).
   Step transaction? If it applies, it isn’t a reorg unless the previous transaction was part of an integrated plan. If not, then these are independent transactions in which the “old and cold” stock is part of continuity.
(i) As part of a takeover plan, A acquired 80% of the T stock six months ago in a tender offer for $240K cash. T then merges into A, and the remaining T SHs receive $60K of A stock in exchange for their T stock.
   Only 20% continuity. Seagram with no competing bidder.

2. A and T agree to a merger of T into A. T SHs will receive solely A stock. Is there a valid “A” reorg if:
   (a) SHs holding 75% of the old T stock make a binding commitment prior to the merger to sell their new A stock to a third party?
      McDonald’s. IRS doesn’t care as long as the buyer isn’t the acquiring corp or members of its affiliated group. It is a reorg.
   (b) The 75% T SH is approached by a third party a week after the transaction and agree to sell at the time?
      Same deal. Doesn’t matter in step transaction review; doesn’t matter here.
   (c) Which group of SHs (the 75% or 25% groups) is most concerned with the results in (a) and (b) above, and why?
      The 25% group is most concerned, because the 75% owners are gonna have to pay whether they bail out or not.

   (a) Is the reg consistent with the result in Bentsen?
      See RR after Bentsen, supra.
   (b) Would the COBE issue arise in the example if P were merged into T and T’s farm machinery manufacturing business were sold but P’s lumber mill business were continued?
      No.

2. Type B: Acquisitions of stock solely for voting stock
   368(a)(1)(B) – Stock-for-stock reorg. Skim 354(a), 358, 362(b), 368(a)(2)(C), (b); 1032(a).
   Reg 1.368-2(c)

When solely stock is exchanged, A issues stock in exchange for T stock, and T simply continues operations as a controlled subsidiary. Any boot invalidates a B reorg (“No B in ‘Boot’”). Policy? No
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one knows if there really is a policy behind it, but anything less than ALL stock won’t harmonize with the plain language of the statute. Should this use of “solely” be like 351 “solely,” which means you can have boot, but it’ll be taxed?

Chapman 440 (1st Cir. 1980)
ITT, acquiring corp, purchased 8% of Hartford Insurance on the open market before engaging in a B reorg stock sway. ITT swapped for enough shares to bring them into control when added to their already purchased interest. IRS sued as taxable reorg. CA affirmed. Even if the stock swap acquires control (i.e. the 80% test), ONLY stock may be exchanged under a B reorg.

RR 67-274

RR 55-440

Problems 459
1. (a) 
(b) 
(c) 
(d) 
2. (a) 
(b) 
(c) 
(d) 

3. **Type C: Acquisitions of assets for voting stock**
   368(a)(1)(C), (a)(2)(B), (a)(2)(G); Skim 336(c), 354(a), 356(a), 357, 358(a), 361, 362(b), 368(a)(2)(C), (b); 381(a)(2), 1032(a).

Problems 468
1. (a) 
(b) 
(c) 
(d) 
2. (a) 30% becomes boot in step-transaction assessment, moving this from an attempted B reorg to a failed C reorg.
   (b) Same facts as (a), except redemption is not a distribution of cash and investment securities, but operating assets. This IS a division of business operations and fails the “substantially all” test to prevent divisions under the guise of reorg.
   (c) A has held 30% of T’s stock for several years. A exchanges its voting stock for the remaining 70% of T. A then liquidates T. Really a C reorg because of the liquidation. Issue is Bausch & Lomb, where liquidation is where you get assets and 30% are attributable to longstanding stock ownership, and only 70% are really attributable to the reorg. Fails C requirements.
   However: Since 2000, different result. Now ignore historic longstanding investments in reorgs provides historical ownership is “old and cold”. **Reg 1.368-2(d)(4)(i)** (reversed Bausch & Lomb). If not old and cold, effectively become asset acquisitions for cash, and fails C requirements.
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(d) Same facts as (C), except A owns 10% prior instead of 30%. Even under B&L, would have been a
good C reorg because 90% stock acquisition attributable to reorg and 10% historical ownership
would become boot.

Note: If this were to also include massive liability assumption, there’s a possibility that simply
exchanging stock wouldn’t mean that swap was fully acquiring target corp. look at total
percentages.

4. Triangular reorgs

368(a)(1)(B) (first parenthetical) and (C) (first parenthetical)

Could’n’t do ΔA after 1954 until forward subsidiary (triangular) merger authorization in 368(a)(2)(D).

Problems 472

1. (a) T merges into P, T SH receive P stock, P transfers assets to S. A merger with a drop, permissible
under (a)(2)(C).
(b) (a)(1)(C) paren OKs for ΔC.
(c) Straight up forward Δ reorg, preserving all of target’s voting stock.
(d) (a)(2)(D)(i) no! But is a REGULAR A reorg with S instead of P.
(e) (a)(2)(D)(ii) OK if S notes are true debt (not hybrid equity) then passes continuity of interest test
overall (doesn’t matter w/ dissenting T SHs).

Note: If this were to also include massive liability assumption, there’s a possibility that simply
exchanging stock wouldn’t mean that swap was fully acquiring target corp. look at total
percentages.

2. Tax free reorg?
(a) P forms S by transferring P voting stock to S in exchange for S stock. S then transfers its P stock to
T’s SHs in exchange for all of T stock. Triangular B reorg (first parenthetical clause).
(b) P forms S by transferring voting stock to S in exchange for S stock. S then meres into T, which has
only one class of stock. In the merger, T SHs holding 80% of the stock receive P stock in
exchange for their T stock. Holders of the other 20% of T, who dissent from the merger, receive
cash from P. After the transaction, T is a wholly owned subsidiary of P. Reverse triangular
merger (368(a)(2)(E)), not dissimilar from the result of a B reorg (where T becomes first-tier
subsidiary). Why use one rather than another? Dissenters were bought out with cash, which
would invalidate a B reorg (no “B” in “boot”).
(c) Same as (b), above, except that P transfers both P stock and P notes (worth 20% of the total
consideration) to S; the stock and notes are then transferred to all of T’s SHs in exchange for their
T stock. SHs holding 80% of the T stock receive P stock and the remaining dissenters receive
notes. Reverse triangular merger under Regulation provisos. Is ultimately asking if boot can be
paid out of subsidiary instead of directly from P. Sure.
(d) Same as (c), above, except that SHs holding 80% of the T stock receive a combination of P stock
and notes while dissenting 20% of T receives cash. Violates (ii) requirement form “amount of
stock that constitutes control.” More than 20% boot disqualifies transaction.
(e) Same as (c), above, except that T’s SHs receive 80% P voting stock and 20% T operating assets.
Policy is policing against divisive transactions.
(f) Same as (e), above, except that P owned 30% of T’s stock prior to the transaction and it acquires the
remaining 70% of T’s stock for P voting stock. Creeping B reorg. Control test is immediately
after the exchange, and control must be obtained through the transaction itself. Since less than
80% control came by way of the transaction, not a valid reverse triangular.

C. Treatment of the parties to an acquisitive reorganization

1. Consequences to shareholders and security holders
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354(a), 356(a), (c), (d), (e); 358(a), (b), (d), (e), 368(b).
Regs 1.354-1(a), (b), (d) Example (3), (e); 1.356-1,-3,-4; 1.358-1, 02(a)(1)-(4), (b); 1.368-2(f), (g).

Recognition of gain or loss:
Nonrecognition to target SH and security holders under 354(a) when receiving only stock and/or securities from acquirer. A, C, or triangular reorg target SHs may receive boot, which must be recognized as gain to extent of any money received and FMV for boot other than money. Excess in securities received over securities contributed is treated as boot, including when no securities are contributed but some are received. 356(d).

Recognition of gain or loss:
Nonrecognition to target SH and security holders under 354(a) when receiving only stock and/or securities from acquirer. A, C, or triangular reorg target SHs may receive boot, which must be recognized as gain to extent of any money received and FMV for boot other than money. Excess in securities received over securities contributed is treated as boot, including when no securities are contributed but some are received. 356(d).

Characterization of gain:

Basis and holding period:

356(a)(2) allows characterization of boot as a dividend. Sometimes called the “Boot Dividend Rule”. 

Clark 475 (1989)

Capital gain or ordinary income test. Forward triangular merger under 368(a)(2)(E). Clark merged his Basin Corp into N.L. for some stock and over $3M cash. IRS wanted to treat the cash as a dividend. Tax Court and Appeals said cash payments in acquisitions should be treated as a distribution of proceeds of sale of stock from the acquiring corp (and receive sale/CG treatment), not dividend. US upheld. Is the reorg transaction more like a pro rata distribution of assets to SHs, or more like a nontaxable exchange? The question involves a distribution of money or property to shareholders. US says look to overall transaction to see if the transaction is sufficiently within the ambit of a reorg to determine tax treatment. Becomes the port-reorg test. If we viewed the target in isolation and treated the transaction solely as a redemption, the tax consequences would have been quite different. See (b), below, for an actual example of the Clark test.

Æ Possibility of dividend classification still lingers with tiny corp acquisitions of whales.

Problem 487

Target Corp has 10 equal SHs, $100K accumulated E&P, and $500K net worth. Acquiring Corp has 500k common outstanding ($10 par) and $500k accumulated E&P. Assume T SHs own 100 common with $20K basis and $50K FMV. T merges into A in an A reorg. Consequences of following:

(a) Each T SH receives 4,000 shares of a voting common ($40K) and A NVP ($10K). All T SHs have realized gain because they’re disposing of appreciated property. However, 354(a) applies for complete nonrecognition because the transaction is solely for stock. SHs basis carries via 358(a)(1), but the basis has to be divided between the two different types of stock received pro rata - $16K to the common, $4K to the NVP. 358(b)(1)(says look to regulations – pro rata). 1223 tacking also applies.

Additionally, because this is a combination of stocks for consideration, so is the preferred stock tainted 306 stock? Look at 306(c)(1)(B)(i), (ii). The question is not “whether it was like a dividend,” but, “whether it was like a tax-free dividend?” That intent may be best analyzed under Clark, with whether a transaction is considered a redemption or a dividend.

(b) Same as (a), but instead of the NVP each T SH receives 20-year market rate interest bearing A notes with a principal and FMV amount of $10K. A security is a debt obligation that is relatively long term. These notes seem to qualify as “securities” under 354(a)(1). So the analysis then turns to (a)(2), which says that SHs need to trade securities straight up for securities to get nonrecognition, and thus preventing equity bailout. So the notes become $10K boot because there were no securities surrendered. Now we go to the boot rule in 356(a)(1), and the realized gain on the transaction is recognized up to the value of the boot as characterized by 356(a)(2). The Clark test: Step 1 – T SHs deemed as receipt of $50K A voting common (5K apiece – total 550K
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outstanding stock in A). Step 2: T SHs deemed as redeeming 1K apiece back to A post reorg in exchange for the notes. Before the redemption, each T SH owned .909% of A; post redemption, and when total outstanding shares goes from 550K to 540K, .741% ownership of A. Meaningful reduction of SHs interest? Not according to 302(b)(2), because 80% Davis test would require a .72 drop in ownership. Last issue: when do we realize the capital gain on the notes? Could you invoke installment method? Probably. Basis? 358(a)(1): A stock AB = T stock AB ($20K) - $10K boot received + $10K recognized gain = $20K. 358(a)(2): Notes AB = FMV ($10K).

(c) Same as (b), except that each SH has a $45K basis in their T stock. Taxed on gain, not boot. Recognized gain is $5K under 356(a)(1). Character of gain still comes out under Clark analysis. Basis: 358(a)(1) (recognized $5K) A stock AB = $45K - $10K + $5K = $40K stock AB. Notes AB = FMV, 358(a)(2).

(d) Same as (b), except that two of the SHs receive all of the notes (principal and FMV of $100K), and the remaining SHs receive voting common worth $400K. Realized gain = $30K. nonrecognition for the eight solely-for-stock SHs. The other two have in substance sold out for deferred payments (installment sale of stock). Can’t use 354(a)(1), so what about 356(a)(1)? It doesn’t apply either, because there was no stock transferred at all. The only protection they may have are deferred payment sale installment reporting under 453.

(e) Same as (b), except that T had $50K of accumulated E&P. On the facts as we got them, 356(a)(2) doesn’t apply. Btu the editors probably screwed up on writing this question and meant to add that a majority owner of A is the parent of one T SH. Assume A1 owns 70% of A. Prior to the redemption, T1 constructively owned 350K shares of A plus the 5K from the reorg/550K total outstanding, or 64.5%. After the redemption, 350K + 4K/540K, or 65.5%. Not a meaningful reduction, eh? Carryover of T’s tax attributes to A under 381(a), so the E&P of both corps are merged.

Shareholder level consequences: Nonrecognition rule 354(a) as modified by Boot rule 356(a).
Basis: 358(a)(1) 358(a)(2).

Corp level: NR 361(a)(corp level exchange); 361(c)(distribution – retains Gen Utilities for this limited circumstances)
Basis: 362(b) carryover basis for receipt of asset; 358(a).

2. Consequences to the target corporation
336(c), 357(a), (b), (c)(1); 358(a), (b)(1), (f); 361.
Reg 1.357-1(a).

Treatment of the reorganization exchange. 361(a) is the nonrecognition provision for transactions in stock and securities reorganizations. 357(a) provides that assumption of debt by the acquirer is not considered boot. Primarily for A, C, and forward triangular mergers.

Treatment of distributions. 361(c). If a target distributes other than “qualified property,” it must recognize gain (but may not recognize loss) as ordinary sale at FMV to the distributee. This is a carve-out for appreciated property, normally stock, distributed by the target during the reorganization.

Sales prior to liquidation. Any target sales of received assets from the acquirer in a reorg are fully taxable events, even if they are necessary to pay off creditors.

Basis and holding period. If the target retains property received form an acquiring corp (only capable in C reorgs where Commissioner has waived 368(a)(2)(G) requirement), it is treated as a distribution to target’s SHs who then immediately recontributed it to the “new” corp as a contribution to capital. Corp’s basis depends on SHs – if it was boot to SHs, it gets FMV basis to corp; if it was nonrecognition property, then it gets exchanged basis treatment and tacking periods if applicable.

3. Consequences to the acquiring corporation
362(b), 368(b), 1032.
Reg 1.1032-1.
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Recognition of gain or loss. Only recognition would come with a boot transfer from the target. Everything else is a nonrecognition.

Basis and holding period: In general. A, C, or forward triangular target assets take transferred basis increased by gain recognized by the target on transfer. 362(b). Generally only occurs when target withholding received boot from distribution to its SHs. See 1(d), infra. In B reorgs, the stock acquired gets transferred basis from the target SHs. In any instance, 1223(2) tacking rules apply.

Basis of target stock received in triangular reorgs. Triangular B solely stock reorgs would create a zero basis for the stock transferred from a parent to a disappearing subsidiary. Reg 1.1032-1 allows parent to increase its basis in its subsidiary stock by the net basis (assets minus liabilities) of the target’s assets. In the zero basis example, the net effect is that P’s basis in S’s stock and S’s basis in the acquired T assets would be the same. See 3(b), infra.

In a simple reverse triangular merger where newly formed S merges into T, where T survives as a P subsidiary, P’s basis in its T stock uses the above rule under the assumption that T merged into S in a forward triangular merger. Thus, in wholly tax-free revΔ where 100% T stock is acquired, P’s AB = T’s net basis in assets plus any basis that P had in S’s stock. Just a same result without penalizing because of the corporate fiction.

Problems 493
1. Potential C reorg (assets for stock). Acquiring Corp has $100K accumulated E&P. Target Corp has assets with AB $60K and FMV $100K, plus $50K accumulated E&P. T’s SHs have a $20K aggregate basis in their stock. A acquires all the assets of T in a proper C reorg. Tax consequences to A, T, and T’s SHs?

(a) A transfers its voting stock, worth $80K, in exchange for all of T’s assets which are subject to a $20K liability. T immediately distributes the stock to its SHs in complete liquidation. No consequence to A for issuing voting stock under 1032. Assets received will take AB from target’s hands, or $60K. 362(b). A is the only survivor, so it will have to worry about assumption of tax assets, 381(a)(2), and tacking, 1223(2). It inherits T’s E&P, and must increase its assets accordingly.

T realizes $40K gain from transfer of assets. Non-stock consideration is taken in the form of A’s debt assumption, seemingly frustrating the “solely” requirement of 361(a). However, 357(a) allows the assumption of liability as a nonrecognition satisfaction of the “solely” requirement, so no recognized gain. T’s basis in A stock is the AB of the assets it transferred. 358(a). The assumption of liabilities by A reduces the basis of the transferred assets by the liabilities, reducing the AB to $40K. 357(d). When T distributes the stock (AB $60K, FMV $80K), there is a transfer of appreciated property and a realization to T of $40K, but 361(c) provides nonrecognition on the appreciated property only for reorgs such as this. T SHs get stock with realized gain of $60K that is not recognized under 354(a)(1), and take the stock at an AB of $20K under 358.

(b) Same as (a), except that A transfers $80K of stock and $20K cash to T, which uses the cash to pay off its debt and then distributes the stock to its SHs in complete liquidation. Which result (a) or (b) would A prefer? No consequence to A for issuing voting stock under 1032. No tax on cash boot – only potential tax implications for T. Assets received will take AB from target’s hands, or $60K. 362(b). A is the only survivor, so it will have to worry about assumption of tax assets, 381(a)(2), and tacking, 1223(2). It inherits T’s E&P, and must increase its assets accordingly. In substance, no change from (a).

No change in the $80K stock transfer analysis, except that the liabilities are not deducted form the transferred AB. But by receipt of cash, in substance T has sold some of its assets for cash. But 361(b) allows (Step 1) the cash to be unrecognized because it is (Step 2) being used to pay off debt in a qualified reorg as allowed in 361(c). In substance, the results are precisely the same as in (a). The tax results are logically identical, as well.

(c) Same as (a), except that A transfers stock worth $80K and investment securities with a $10K basis and FMV $20K in return for all of T’s assets without any liabilities. T again distributes the consideration pro rate to its SHs in complete liquidation. 361 doesn’t apply to A because the
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exchange of the non-long-term debt securities is disposal of appreciated property, and will realize and recognize a $10K gain under 1001(c).
T is taking in-kind boot, but the analysis doesn’t change because of 361(b)’s modification of 361(a), provided that the funds are distributed immediately (and they are).
T SHs get nonrecognition on the A stock distributed, but what about the boot? 361(c)’s “qualified property” excludes the securities because they aren’t of a party to the reorg. T’s basis is FMV because the distribution is treated as a sale at FMV to the distributee. However, T takes a basis in FMV on the stock from A because the gain was recognized at A’s level, so the T SHs will benefit from the same AB that T took. All in 358(a)(2) + (f). If there was appreciation post-transfer from A, then the securities would no longer be 361(c) “qualified property” and would be subject to taxation on the gain upon distribution.

(d) Same as (s), except that A transfers $80K stock, $10K A bonds, and $10K cash to T in exchange for T’s assets. Because an immediate distribution would result in hardship for T, T receives Commissioner’s permission not to liquidate and retain the cash, bonds and stock for eventual satisfaction of its liabilities and distribution of the remaining assets to its SHs. The only potential difference is that the bonds are 361-eligible. The cash exchange is the same as in (b). The bonds are simply a promise to pay more cash later, and therefore result in no tax liability to A. T would get the same 361(b) cash protection on the cash boot provided it gets distributed to T’s SHs, but T’s permission not to liquidate creates a problem. Conditions needed to be met for permission: 1) The transaction is deemed a constructive liquidation, and 2) the continuing operation is deemed the formation of a new corporation under 351 (new T). A bonds and cash become boot when distributed to the SHs because T isn’t giving up any bonds in exchange for the A bonds. $20K of the gain is recognized to the SHs under 356(a)(1), and then the Clark analysis for 356(a)(2) should be applied to determine ON A SH BY SH BASIS whether the gain is capital or normal income.
(e) Assume T has no liabilities. A transfers $80K voting and $20K NVP to T for T’s assets. T liquidates and distributes all stock pro rata. The only change to this is that the AB has to be divvied up at the SH level between the two classes of stock (in this case, 80% to the common, 20% to the NVP).

2. Attempted C reorg. T has operating assets with AB $18K and FMV $90K, investment land with AB $2K, FMV $10K and liabilities of $40K.
In a C reorg, A acquires T’s operating assets in exchange for A voting FMV $80K and some stock in Bell, Inc. (unrelated company) with AB $2K and FMV $10K. A doesn’t assume T’s liabilities.
Before liquidating, T sells $40K of A stock and uses the proceeds to pay off its liabilities. T then distributes the remaining $40K of A stock, its investment land, and the Bell stock that has increased to FMV $12K in a complete liquidation. T SHs have AB $10K in their T stock.

(a) Tax consequences to A, T, and T SHs? First, is this a valid C reorg? “Substantially all of assets” requirement to prevent corp divisions from getting reorg treatment, and this probably meets the “substantially all” test for 90% net, 70% gross assets. Additionally, voting stock was issued, but there is boot to boot that falls under the boot relaxation of 357(a). (?) A is issuing voting stock, so no recognition under 1032. A is “selling” appreciated property in the Bell stock, and will realize and recognize gain of $8K on the boot. A’s basis will be 362 AB carryover basis increased by T’s gain, if any. For now, it’s $18K. T: 361(a) doesn’t cover the Bell stock initially, but 361(b) covers it because it is eventually distributed. 361(c)(3) will prevent the application of nonrecognition on the cash realized from the third party sale for cash. T realizes AND RECOGNIZES a $36K gain on the $40K sale of A stock to the third party (S40K FMV - S4K basis). 361(c)(3). T SHs: Basis in the stock distributed starts with 358(a)(1), or $18K. Under 358(f), Bell stock is boot, so the basis in the stock received must be reduced by the boot, or $18K - $10K in-kind – $22 cash/boot received + $22 gain realized for recognition under 361(a), (b) for a final result of $8K.
→ Eventual amount realized to SHs is $62K ($40K stock, $12K Bell stock, $10K land), minus $10K AB stock, which equals $52K realized gain. Subtract boot (land, Bell stock) for $22K of final recognized gain.

(b) Different result in (a) if T transferred $40K of A stock to its creditors in connection with the liquidation? The only difference is that T wouldn’t have realized the $36K from the sale to the
third party. 361(c)(3) only carves out transfers such as this for distribution treatment; not sales to third parties. This would have been preferable for T.

3. Parent Corp creates Subsidiary by transferring P stock as a preliminary step in acquiring the assets of T in a separate subsidiary. T’s SHs own stock FMV $200K, AB $50K. T has assets FMV $200K, AB $100K.
   (a) Assuming a valid 368(a)(2)(D) forward triangular merger, tax consequences to P, S, T, and T SHs? See notes.
   (b) Assuming a valid 368(a)(2)(E) reverse triangular merger, tax consequences to P, S, T, and T SHs?
   (c) What results in (a) if it fails to qualify as a reorg? If it failed on COBE grounds: See notes.
   (d) What results in (b) if it fails to qualify as a reorg?

4. Carryover of tax attributes
381(a); skim 381(c)
For reorganizations involving ASSET acquisitions! This is what happens to the remaining tax attributes of the target: E&P, depreciation and accounting methods, unused NOLs, capital loss carryforwards, etc.
The Code principles are:
   1. 381 generally provides that a target corp’s tax attributes follow its assets in a tax free reorg (other than B and E reorgs),
   2. 382 and 383 restrict the carryforward of of NOLs and certain other losses and credits following a substantial change of ownership,
   3. 384 limits the use of loss carryforwards to offset certain gains following a corporate acquisition, and
   4. 269 allows the Secretary to disallow deductions, credits or other allowances in certain situations where one corp’s stock or assets were acquired for the principle purpose of obtaining the specific deductions, credits, or allowances in question.

i. 381
   1. Applies only to asset transfers with NR 381(a).
   2. NOL carrybacks to pre-org years, 381(b)(3) + Bercy. Post reorg loss can ONLY be carried back to acquiring corp, not target.
   3. E&P pre-reorg deficit of T or P, 381(c)(2).
   4. Limits on use of NOL – not just 381(b)(3) + (c)(1), but abuse is also policed in 382. if there is a major change in ownership from the reorg, then forget about NOL carryanythings.

Bercy Industries 498 (9th Cir. 1981)
The purpose of (b)(3) is to say that NOL limitations are for mergers that are more than one-party deals (as in this case, where the shell corp acquiring Bercy had no other business interests and simply carried on the business of Bercy). However, if there is more that just a shell that acquires a target corp, the rationale of Bercy becomes ineffective.

Problems 502
1. A acquires T in a C reorg. Both are calendar year taxpayers and the transactions are completed on Dec. 31, 1997.
   (a) (b) (c) (d) (e) (f)

2. T merges into A two-thirds of the way through A’s year. Results in the following?
   (a) (b) (c)
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3. (a) (b) (c) (d)

4. (a) (b) (c) (d)

5. Policy: An elective carryover basis regime

In decoupling the corporate and shareholder level tax consequences as per these ALI proposals, the shareholder must be given the same choice of opting to recognize gain from a reorg. This is taken care of in the definition of “qualified asset acquisition,” where T is required to liquidate within one year of the wholly corporate level acquisition. If T took cash for the acquisition, the SHs are taxed when T distributes the cash. If T took A stock for the reorg, SHs receive the A stock from T in liquidation at their basis and with a realized gain on the additional value inherent in the A stock.

As a result of this decoupling, COBE, COPI are wiped out and none of the judicially-developed tests would matter anymore.

How do you treat realized gain for SHs on distribution? As CG or ordinary income? Treat as if all SHs received stock in the acquiring corp. Then treat all SHs who took boot instead of stock as having turned in their stock for a distribution of cash or other consideration.

II. Corporate divisions

A. Introduction

355; 368(a)(1)(D), (c).

1. Types of corporate divisions

Corporate divisions can be classified as either tax-free divisions, or as the transactions they resemble. 355 provides the requirements for divisions to be classified as tax-free. The three types of divisions are:

- Spin-off – Where a corp forms a subsidiary by contributing assets, and then distributes its received stock from the transfer to its shareholders pro rata. Resembles a dividend.
- Split-off – Where corp forms a subsidiary by contributing assets, and then distributes its stock received from the transfer to one or more SHs (doesn’t have to be pro rata) in exchange for their parent stock. Resembles a redemption.
- Split-up – Where corp forms two or more subsidiaries by contributing assets, and then distributes the received subsidiary stock to its SHs in exchange for all of their outstanding parent stock. The parent corp then dissolves, resembling a complete liquidation.

355 is the only carve-out to the repeal of the General Utilities doctrine.

2. Non-tax motives for corporate divisions

3. Historical background of 355

Gregory v. Helvering 513 (1935)

Origin of the business purpose test. Gregory causes her wholly-owned corp, United Mortgage, to create subsidiary Averill by contributing 1,000 shares of UM to Averill, which in return distributed all off its shares to Gregory. As a 368 “D” reorg, this would work even though Gregory was receiving the Averill stock in lieu of UM. Gregory assumed that the distribution would not be deemed a dividend.
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under the predecessor to 355(a). US got this one on substance over form as a tax evasion effort with no valid business purpose. Divisions (reorgs) must pass the valid business purpose test to qualify for tax deferral.

Tax ramifications on Gregory transaction before nullified:
Corp level – no tax on asset appreciation because of Gen. Util.-era NR.
SH level – 331(a) tax on stock appreciation minimized by 334(a) FMV basis in received Averill stock.
Result – one level of taxation at SH LTCG rate.

4. Overview of 355
a. Statutory and judicial requirements
  Control
  Distribution of all stock or securities – (a)(1)(D).
  Active trade or business requirement – (b)(2).
  Not a “Device”
  Business purpose and COI – judicial tests, not in Code.

  355 NR avoids SH level gain taxable under 301 (spin-off), 302 (split-off), and 331(a) (split-up). If
  the assets distributed are appreciated, corp level NR is also avoided through 355(c)(1). Why corp
  NR? If we are to authorize NR as a matter of policy, then there must be NR at both the SH and
  corp level in the post-Gen Util repeal of the 86 revisions.

b. Taxation of the parties
  SH nonrecognition only where the distributing corp distributes stock or securities of a controlled
  corp. Options, rights are boot, not stock. Securities distributed over the amount of securities
  received are boot, just as in 356(d). Boot won’t destroy a qualifying division, but will render
  parties taxable on any gain attributable to the boot.

B. The active trade or business requirement
Lockwood’s Estate 519 (8th 1965)
  Only qualify for tax-deferred status when parent corp has been involved in the business that subsidiary will
  undertake for five years or more. Sub doesn’t have time requirement, only parent. Question is “what is the
  trade or business broadly that is being facilitated by the division,” and not “how long has the sub being
  divided been in operation?”

RR 59-400

Problems 531
1.
  (a) Satisfies as a split-off because in form it involves a redemption. Five year history satisfied because both
  facilities have 5+ years of history. Not even close to questioning under Lockwood. Sometimes called
  “vertical” division of business.
  (b) Same facts as (a), but Boston facility was opened three years ago. Much closer to Lockwood, but under
  the Lockwood rationale should still be OK in satisfying the five year requirement. Geographic
  division is OK because it is merely an expansion of core business, and not a diversification of business
  interests. See Reg 1.355-3 Example 7.
  (c) Same facts as (a), but Boston facility was acquired in taxable transaction three years ago. See (b)(2)(C),
  Reg 1.355-3 Example 8. (b)(2)(B) doesn’t specify “by whom” an acquired business must be actively
  operated by, but only that you succeed to the acquired business’ history and that history is in the same
  line of business as the acquirer’s business.
  (d) “Horizontal” division of business through proportionate spin-off. Is Research, Inc. a functionally
different business than what it was under Lemon, Inc. prior to the spin-off? See Reg 1.355-3(b)(2)(ii),
that in the words of Wiedenbeck says “where it must ordinarily include all of the steps needed to make
a buck,” so see Examples 9, 10, and 11 to illustrate when a fact scenario like this will be labeled as the
same “business” for 355’s purposes. It will qualify in this instance because of the necessity of
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Research as a functional division of the business of Lemon, Inc. But there is a warning that the “device” factor is not eschewed simply by showing this type of relation.

(e) Business realities may prohibit this transaction because Lemon is a hardware manufacturer and Floppy Disk is a software manufacture. Yes, they are both computers, but the test lies in how closely the businesses are at an operational level, and this appears to be a non-qualifier.

(f) Same as (e), except that Floppy Disk merged into Lemon three years ago in an A reorg involving NPV stock and Lemon short-term notes. Assume again that the software is not sufficiently related as in (e). See (b)(2)(C). Gain was recognized in the reorg because of boot received in the short term notes, so the reorg wasn’t tax-free at the SH level. But (e) is somewhat ambiguous as to what level this realized gain would frustrate a tax-free division. Was Congress focusing on SH level gain or corp level gain? Under 361(a) and (b) there wouldn’t have been corp level gain. So what’s the answer? Treasury indicates that corp level may be the focus of this inquiry in some proposed regs.

2.
(a) Maybe – see Reg. 1.355-3(b)(2)(iii) and (iv). Issue is whether leasing property is an “active trade or business,” rather than an investment activity. If this was land, then there would be no question that it was an investment property and not sufficient to pass the test. But in this case, there are also significant maintenance services. Are these services “active” enough in the eyes of (iv)? See Examples 12 and 13.

(b) Almost exactly like Example 12. Assuming that it is the Rental employees that do the services, then this should be OK for two “active” businesses.

(c) Long-term net lease situation takes it outside of “active” categorization. Distinguishable on a policy basis from Example 12.

(d) Not a long-term activity, and probably will be challenged by IRS. Problematic, and probably wouldn’t qualify.

C. Judicial and statutory limitations

1. Business purpose
Reg 1.355-2(b).
Business purpose and “device” limitations are linked. Lack of business purpose will invalidate a tax-free transaction even if it is not found to be a “device” being used to bail out E&P.

Rafferty 533 (1st 1971)
Dad wanted to keep daughters and son-in-laws away from his steel corp, so he structured a stock plan to allow him to split land management component from his steel corp and distribute the divided management corp’s stock to his progeny as gifts. Court basically just issued a restatement of the previous sentence: Lack of business purpose will invalidate a tax-free transaction even if it is not found to be a “device” being used to bail out E&P.

What is the rationale for the device limitation? Where is the risk of a bailout?
Normally bailouts end up with money in SH hands that were at one time E&P. In this case, SHs end up with stock where the concern is that it could be sold immediately, with the unrelated buyer liquidating to obtain the spun-off stock’s portfolio, etc. This then begins to look an awful lot like a preferred stock bailout. The key question is the likelihood that the spin-off will be sold without impairing the controlling corp’s ability to continue making a profit. Many, many similarities to 306 analysis.

RR 85-122
Reg 1.355-2(c).
Is BP test met when stock of a controlled corp is distributed under the circumstances described? P owns all of S stock. P wants to sell debentures, but investors are timid due to S’s poor performance and don’t want their investment dollars propping up poor performance and to get saddled with its debt if’s tanks. P decides to distribute all of its S stock to P SH to divest P from S. IRS holds that valid business purpose has been established.

RR 88-34
Reg 1.355-2(c).
Is BP test met where a distribution of the stock of a controlled corp is made to enable that corp to hire a new president? In this situation, the distribution allows for the hiring of a key employee the business believes is necessary to the continued success of the business. Passes the BP test.

Reduction of state and local taxes aren’t valid BPs. BPs are not valid if the same end maybe reached by an alternate route that doesn’t involve a tax-free distribution of stock.

RR 96-30 indicates that IRS is looking at BPs more loosely these days – even including “fit and focus” justifications into OK BPs.

2. Continuity of interest (COI)  
Reg 1.355-2(c).
Regs say that person(s) who historically owned an interest in corp prior to division must own controlling interests in the modified entities resulting from the division. ONLY historic SHs can be counted for the COI test. COI is independent test of 355 requirements.

3. The “device” limitation  
355(a)(1)(B).
Reg 1.355-2(d).

a. In general  
Division may not be “used principally as a device for the distribution of E&P” of the distributing corp or controlled subsidiary. Divisions may be improperly used to bail out E&P by facilitating the avoidance of dividend taxes. A device can include a transaction that effects a recovery of basis.

Transactions not ordinarily considered a device:
- No E&P in both distributing and controlled corp at time of division;
- In absence of 355, distribution would qualify as redemption to pay death taxes under 303; and
- In absence of 355, distribution would qualify (with respect to each distributee SH) as an exchange redemption under 302(a).

The 302(a) and 303 redemptions lose their presumption of legality if they involve the distribution of stock from more than one controlled corp and facilitate the avoidance of dividend taxes through the subsequent sale or exchange of stock of one corp and then the retention of the stock of another corp.

b. Device factors  
Three factors that are evidence of a device:
1. Pro rata distribution  
Greatest potential for avoidance of dividend taxes. Pro rata distributions can qualify (355(a)(2)), but they are much more highly scrutinized.
2. Subsequent sale or exchange of stock  
Sale shortly after division
3. Nature and use of the assets of the distributing and controlled corporations immediately after the transaction

c. Nondevice factors  
1. Business purpose
2. Distribution corp is publicly traded and widely held, with no single SH owning more than 5% directly or indirectly
3. If stock of controlled corp is distributed to a domestic corp distributee which, without 355, would be entitled to a 243 DRD

Problem 548
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(a) Non pro rata, but is a 302(b)(3) complete termination of interest, so it falls under the nondevice exceptions (1.355-2(d)).

(b) Family attribution fails the 302 test. Would have to argue that there is a waiver of attribution.

(c) Is there still a business purpose still since Ms. Micro sold to Modem prior to the division? COI, 1.355-2(c)(1). No requisite ownership of both controlled corp and sub post-transaction. Both would have to own a majority share on each part that emerges from the transaction, and post this scenario, Ms. Micro is out. However, if the acquisitive reorg liberalization on historic ownership were applied (Seagrams) to this scenario, and if Lemon had been a publicly traded corp, then this could be a valid division.

(d) Do they really need to spin-off to get a new retirement plan? Business purpose fails here because that end may be attained through different means that a corp division.

(e) Business purpose is validly satisfied, so weigh all of the factors to make a determination. Pro rata, functional division raise particular problems with device. 1.355-2(d)(2)(iv)(C). Positive factors: divestiture mandated by regulation. Dunno how the court will come out on this.

(f) Court Holding.

(g) 1.355-2(d)(2)(iii)(C).

(h) Probably isn’t a real rejection but a sham transaction trying to paper over a Court Holding problem. Still a device.

355(e) would now apply on (f), (g), and (h) facts.

D. Tax treatment to the parties of a corporate division
   1. Introduction
   2. Consequences to shareholders and security holders
   3. Consequences to the distributing and controlled corporations
   4. Consequences of failed divisions

   Problem 554
   Step 2
   Distribution:
   SH level – dividend, 301
   Father AB Branch stock = $400K; securities = $100K
   Corp level – 311(b)
   Securities – tax-free securities FMV = AB
   Stock – FMV $400K – AB $100K = $300K gain

E. Use of 355 in corporate acquisitions
   1. Limitations on use of 355 in taxable acquisitions
      a. Introduction
         Anti-avoidance limitations to curtail the benefits of nonrecognition for certain transactions that would have previously qualified as tax-free divisions.
      b. Dispositions of recently acquired businesses
         355(a)(2)(D)
         Amendment of the “active trade or business” requirement that prevents parent from disposing of a recently acquired target’s subsidiary without paying corp-level tax. See example on 556. Requirement not met if control in T was acquired by P within five years preceding T’s distribution of controlled S’s stock. Limitation doesn’t apply if P acquired T in a tax-free transaction like acquisitive reorg.

         If T fails this test, T must recognize gain on the distribution of its S stock to P.

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c. Divisive transactions in connection with certain changes of ownership 355(c), (d)
   i. Pre-distribution limits
      COI
      Corp purchase of control within 5 years – 355(b)(2)(D)
      “Purchase” of distributed or controlled within 5 years – 355(d)
      - Five-year pre distribution COI test
      Plan to acquire 50% control of Distributed or Controlled – 355(e)
   ii. Post-distribution limits
      “Device” 355(a)(1)(B)
      Plan to acquire 50% control D or C, 355(e)

Policy
Form 1: Sale and liquidation       Form 2: Liquidation and sale.

But what about a controlled corp with more than one business?
Form 1: Sale and proceeds distribution       Step 2: Distribution of assets and sale
Step 1 – 1001 asset G/L recognized       Corp level – 311(b)
SH level – 302(b)(4),
Step 2 – Redemption in 302(b)(4)       1001 G/L recognized, FMV AB

But what if the second business was operated in a subsidiary?
Could be positioned as a stock transaction rather than an asset transfer.

Problem 562

2. Dispositions of unwanted assets in conjunction with tax-free organizations

Morris Trust 563 (4th 1966)
See notes, regs on what would be necessary for “acquisition tailoring” to defeat the broad scope of 355(e).

RR 70-225
Distribution to SHs of stock of controlled corp in D reorg, followed by exchange of distributed stock by SHs to unrelated corp as part of an integrated merger plan. Fails 355.

RR 96-30
Unlike above, if SH merger was not part of an integrated plan like above, then transactions qualify in substance as long as they meet the requirements of 355.

See RR 98-27 handout invalidating above RRs. 355(e) will govern these transactions, so no more Court Holding/step transaction doctrine tests as above.

Problem 575

III. Single entity restructuring (Nonacquisitive, nondivisive reorganizations)
E and F reorgs – one-party transactions. Easiest ones.

A. Type E: Recapitalizations
   i. Introduction
      Statute never defines what “recapitalization” is. See 1.368-2(e) for guidance.
      • IRS has always seen it as a change/reshuffling of SH/security holder ownership interests.
      • COBE test inapplicable.
      • 1036(a) silence on corp-level transactions (because 1036 is a SH-level transaction statute) broken to expand to corp level.
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Small break for small, closely held businesses in 354(a)(2)(C).

2. Types of recapitalizations
   a. Bonds exchanged for stock
   b. Bonds for bonds
   c. Stock for stock
      
      Bazley 584 (1947)
      Today would be treated as recapitalization.
   d. Stock exchanged for bonds

B. Type D: Liquidation – Reincorporation (“Nondevisive D”)  

C. Type F: Mere change in identity, form, or place of organization

D. Type G: Bankruptcy

IV. Carryover of tax attributes
   NOL deductions. 381(b) provides general rule for carryovers. 382 provides additional limitations on NOL carryforwards. Congress wants only to facilitate “real” changes in business operations.

V. Consolidated returns