Nonacquisitive Nondivisive Reorgs.

§368(a)(1)(D) - Liquidation-reincorporations
§368(a)(1)(E) - Recapitalizations
§368(a)(1)(F) - Change in Form or Place of Incorporation
§368(a)(1)(G) - Insolvency Reorganizations
Recapitalizations
§368(a)(1)(E)
Rearrangement of a corp’s capital structure. Business objectives for a recapitalization:
1) improve the debt/equity ratio by shifting from debt into equity - i.e., a downstream recapitalization.
2) change the shareholder ownership relationships between the preferred and common shareholders - e.g., an upstream recapitalization (acquiring preferred stock).

Rev. Rul. 82-34
"Continuity of business enterprise" (COBE) is not a requirement to have “E” reorganization treatment.
Similar treatment to Rev. Rul. 77-415 that "continuity of shareholder interest" (COI) is not required in an “E” reorganization.
But, a business purpose is required.
This result is not impacted by the 1998 COI and COBE regulations.
Types of Corporate “Recapitalizations”

1) Shift from debt into equity is tax-free. But, recognition is required of the accrued interest element. §§354 & 1032

2) Exchange of bonds for new bonds. No gain recognition except (a) for bonds received for accrued interest, or (b) if the principal amount of the bonds is increased. §354(a)(2)(A).

Continued - Corporate “Recapitalizations”

3) Stock for stock exchanges: (a) exchange preferred and receive common; or, (b) exchange common and receive preferred.

Applicable Code provisions:

§§354 & 356
§1032 & §1036
§305(c) & §306
**Rev. Rul. 84-114**

Nonvoting preferred stock and cash are received in an integrated transaction in exchange for common shares.

Is the cash “boot” received a "dividend equivalent" for §356(a)(2) purposes?

Held: Not dividend equivalency since requirements of §301(b)(1) (no dividend equivalency) satisfied here (and, therefore, no §356(a)(2) dividend distribution effect).

**Bonds Received & Stock Transferred - Bazley case**

For old shares shareholders received new shares and also callable debenture bonds. Significant "earned surplus" (e&p) existed.

IRS asserts income to the extent of bonds.

Taxpayer asserts the securities were received in a tax-free corporate reorganization.

Held: Receipt of the debenture bonds was equivalent to the receipt of a cash dividend (i.e., realized gain).
Example 1(a)
Exchange transaction.

Results to shareholders on this exchange:
1) "E" reorganization treatment.
2) No gain recognition to the shareholders. §354(a)(1).
3) Substituted basis - §358(a)(1) - 1/3 for preferred and 2/3 for common.
4) Tacked holding period. §1223(1).
5) Preferred stock received is §306 stock.

Example 1(b)
Preferred stock is called

Tax results when preferred stock is called:
1) §306(a)(2) redemption.
2) $10,000 §301 distribution to each shareholder (assuming e&p at $100,000).
3) Reduction of e&p to zero. §312(a)(1).
4) Tax basis previously allocated from common to the preferred stock is allocated back to the common stock.
Example 1(c)
Sale of the Preferred Shares

A Code §306(a)(1) "ordinary income" transaction occurs, as measured by reference to e&p at time of preferred stock issuance. No DRD is available to a corporate recipient. 15 percent taxation on the amount received. Any excess over $10,000 is treated as:
  i) basis recovery, and ii) capital gain. No e&p reduction occurs (even though deemed “dividend” treatment for §1(h)(11)).

Example 1(d)
E&P Deficit

An e&p deficit exists at the time of the distribution of the shares by corporation. The preferred stock would not be §306 stock. i) Treatment of the stock redemption when occurring would be determined under §302. ii) The share sale would produce capital gain (after tax basis recovery).
Example 2
Stock & Debt Issuance

Each shareholder exchanges $50,000 of fmv common ($10,000 basis) for $25,000 common and $25,000 bonds. Corp has $250,000 E&P. An “E” reorganization presumably occurs. The securities are “boot”. §356(a)(1)&(d)(1). Each shareholder must recognize $25,000 of the $40,000 of realized gain. Since the distribution is pro-rata it is classified as a dividend distribution.

Example 3(a)
Debt Principal Is Reduced

Leverage issued 8 percent bonds: $1 million face value and $800,000 FMV. Redeems for new 12 percent $800,000 face value and FMV bonds. Reorganization? Yes; OK for bond-for bond exchange since the principal amount does not exceed the $1 million principal amount for the securities surrendered. COD income to Leverage Corp.? yes
Example 3(b)
Debt Principal Increased

12% bonds with $800,000 face value are redeemed for 8% bonds with a face amount of $1 million and both bond packages have the same fair market value.

§356(d)(2)(B) says the fair market value of the excess principal amount is treated as taxable "boot" under §356(a)(1) if the securities have realized gain. If held by shareholders then? Excess is $200,000; FMV of this excess is ?

Example 4

Exchange of bonds transferred for the receipt of stock by shareholder is treated as an “E” reorg.

This is a "downstream" recapitalization.

A nonrecognition event occurs to the old security holders/now shareholders.

Objective of this transaction: Improve the corporation’s debt/equity ratio.

Does the corporation have COD income?
“D” Reorg. “Liquidation-Reincorporation”

Two alternative structures (involving two corporations & similar shareholder groups):
1) Operating assets to the acquiring corp. for cash; the selling corporation then liquidates with a cash distribution to its shareholders.
2) All assets are distributed to the shareholders - then shareholders infuse only operating assets into a new corporation.

Smotherson case

IUS liquidated and then operating assets (15 percent of FMV) inserted into TIL.
§331(a)(1) CG liquidation to shareholders?
IRS characterized the transaction as a "D" reorganization with §356(a)(2) boot received.
Held: The "substantially all" test was satisfied and characterization as a “D” reorg. & dividend distribution under §356(a)(2).
**Example**

**Common Ownership – 2 Corps**

Shareholders have a $200,000 basis in their Brother stock.

Brother corporation has operating assets with a $500,000 value ($200,000 basis) and $200,000 of cash (total FMV $700,000) and $200,000 of earnings and profits.

Sister corporation has $300,000 of E&P.

Sister purchases Brother’s operating assets for $500,000 cash and Brother liquidates.

---

**“F” Reorganization**

Mere change in identity, form or the place of corporate organization.

Often used to change the place of corporate organization (e.g., to Delaware).

Prior attempt to blend multiple corporations together in an "F" reorganization - the potential use of §381(b) in this context has been eliminated.

F reorg. treatment is limited to one corp.
Rev. Rul. 96-29
Part of Step Transaction - OK

Two transactions involving stock offering or acquisition - place of organization changed.

Situation One: Change to Delaware (?) and then issuance of significant additional stock in a public offering. Merger into new corp.

Situation Two: Forward triangular merger and the selling shareholder received new preferred stock of Corp which then changed its place of organization by merger.

Example

Change of corporate status from California to Arizona by an asset transfer in exchange for stock and then the liquidation of old corporation.

"F" reorganization status;
Also "D" reorganization qualification?
Why not a merger for more efficient property transfers?
Insolvency Reorganizations
§368(a)(1)(G)

Transfer of assets to another corporation in a bankruptcy restructuring.
"Substantially all" test for purposes of transferring assets - OK to transfer assets to pay creditors.
“Continuity of interest” test must be satisfied.
Short-term creditors may be counted for satisfying the “continuity of interest” rule.

Insolvency Reorganizations
§368(a)(1)(G), continued

Taxation to shareholder or debt holder who receives an increased amount of debt securities.
Creditor receives interest income to the extent securities received are for unpaid interest on the securities surrendered.
Possible shifting of NOL carryover to the acquiring corporation.
Example

Valid G reorganization since debtor transfers all assets and distributes the stock of Relief.
Lenient standards for continuity of interest. Creditors are treated as equity owners.
Debtor’s shareholders receive nothing - a §165(g) loss on their stock equal to basis - presumably long-term capital loss.
Security holders exchange $100,000 of securities for $50,000 of stock.