

Chap.11 - Nonacquisitive & Nondivisive Reorgs. p.518

Alternatives:

- §368(a)(1)(D) - Liquidation-reincorporation**
- §368(a)(1)(E) - Recapitalization**
- §368(a)(1)(F) - Change in Form or Place of Incorporation**
- §368(a)(1)(G) - Insolvency Reorganization**

Recapitalizations

§368(a)(1)(E)

p.527

Rearrangement of a single corp's capital structure.
Business objectives for a recapitalization:

- 1) improve the debt/equity ratio by shifting from debt into equity ownership - i.e., a downstream recapitalization.
- 2) change the shareholder ownership relationships between the preferred and common shareholders - e.g., an upstream recapitalization (some shareholders acquire preferred stock and have their ownership interests “frozen”).

COBE & COI Are Not Relevant in Recapitalization

P.527

- 1) "Continuity of business enterprise" (COBE) is not a requirement to have "E" corporate reorganization treatment.
- 2) "Continuity of shareholder interest" (COI) is also not required in an "E" reorganization. Rev. Rul. 77-415.
- 3) A business purpose is required, however. What is an appropriate "business purpose" for implementing a corporate recapitalization?

Types of Corporate Type E “Recapitalizations”

p.528

1) A shift from debt into equity is tax-free. But, recognition is required for any accrued interest portion. See §354 (bondholder) & §1032 (corp), but also possibly COD income (but see §108) where stock value less than bond face amount.

2) An exchange by owner of old bonds for new bonds. No gain recognition occurs except (a) for any bonds received for accrued interest, or (b) if the principal amount of the bonds is increased in the exchange. §354(a)(2)(A) & (B). *continued*

Continued - Corporate

“Recapitalizations”

p.529

3) Stock for stock exchanges (& boot?):

(a) exchange preferred and receive common; or,

(b) exchange common and receive preferred.

Applicable additional Code provisions:

- §§354, 356 & 358 (shareholder level);

- §1032 & §1036 (stock issuances/exchanges)

**- §305(c) (increase in proportionate share interest)
& §306 stock (bailout effect?) – relevant to the
shareholder.**

Rev. Rul. 84-114

p.530

Preferred & cash are received

Nonvoting preferred stock and cash are received in an integrated transaction in exchange for common shares (in an “E” reorganization).

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

Held: Not a dividend since the requirements of §302(b)(1) (no dividend equivalency) are satisfied here (and, therefore, no §356(a)(2) dividend distribution effect). See the (prior) Davis case.

Bonds Received & Stock Transferred - Bazley

p.534

For old shares the shareholders received (1) new shares, and (2) also callable debenture bonds.

Significant "earned surplus" (e&p) existed.

IRS asserts dividend income to the extent of bonds.

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

Held: Receipt of the (callable) debenture bonds was equivalent to the receipt of a cash dividend (i.e., constituting an E&P distribution).

Problem 1(a)

p.538

Exchange transaction

Results to shareholders on this exchange:

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

Problem 1(b)

p.538

Preferred stock is called

Tax results when the preferred stock is called:

- 1) §306(a)(2) redemption.**
- 2) \$10,000 §301 distribution to each shareholder (assuming e&p is then at the \$100,000 level).**
- 3) Reduction of the corp's e&p to zero. §312(a)(1).**
- 4) Tax basis previously allocated from the common to the preferred stock is allocated back to the common stock.**

Problem 1(c)

p.538

Sale of the Preferred Shares

A Code §306(a)(1) "ordinary income" transaction occurs, as measured by reference to the allocable e&p at the time of the preferred stock issuance.

No DRD is available to a corporate recipient.

20% taxation on the amount then received.

Any excess over \$10,000 is treated as:

- i) tax basis recovery, and ii) capital gain.

No e&p reduction occurs (even though deemed "dividend" treatment applies for §1(h)(11)).

Problem 1(d)

p.538

E&P Deficit Upon Issuance

An e&p deficit existed at the time of the distribution of the preferred shares by the 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).

Problem 2

p.538

Stock & Debt Issuance

Each shareholder exchanges \$50,000 of fmV common (\$10,000 basis) for (1) \$25,000 common and (2) \$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 gain realized in the exchange.

The pro-rata distribution is classified as a dividend distribution. Sufficient E&P exists for dividend.

Problem 3(a)

p.538

Debt Principal Is Reduced

Leverage issued 8% bonds: \$1 million face value and \$800,000 current FMV. Leverage redeems for new 12% \$800,000 (face value and FMV) bonds.

“E” Reorganization? Yes; OK for a bond-for-bond exchange since the principal amount does not exceed the \$1million principal amount for the securities surrendered (and no accrued interest?).

COD income to Leverage Corp.? Yes (\$200,000, unless insolvent - §108).

Problem 3(b)

p.538

Debt Principal is Increased

12% bonds with \$800,000 face value are redeemed for 8% bonds (lesser rate) with face amount of \$1 million; both bond packages have same 800x FMV.

§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 (§453 installment gain?). If held by the shareholders - then a §356(a)(2) dividend?

Excess is \$200,000; The FMV of this excess is \$160,000. Therefore, \$40,000 of OID. §1272.

Problem 4

p.538

Receipt of stock for bonds

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/new shareholders. Reg. §1.368-2(e), Ex. 1.

Business objective of this transaction: To improve the corporation's debt/equity ratio.

Does the corporation have COD income? See §108(e)(8) (is the stock value less than the principal amount of debt?) & no §1032 treatment.

“D” Reorg. “Liquidation-Reincorporation”

p.539

Two alternative structures (involving two corporations & similar shareholder groups):

- 1) Operating assets are transferred to the acquiring corp. for stock; the selling corporation then liquidates with the stock (and cash?) distribution to its shareholders.
- 2) All assets are distributed to the shareholders - then the shareholders infuse only the operating assets into a new corporation (retaining cash).

Tax Impact of “Liquidation-Reincorp.” Treatment

P. 540 – After General Utilities repeal:

Tax recognition at both corporate and shareholder level when liquidation reincorporation occurs.

Option: Taxpayer argues D reorganization treatment, with the boot received by shareholders treated as a dividend subject to 20 percent tax rate.

Smothers case

p.540

Transfer of Operating Assets?

IUS elected liquidation and then the operating assets (15 percent of the FMV) were sold to TIL.

Then, a Code §331(a)(1) cap. gain liquidation?

IRS characterized the transaction as a "D" reorganization with §356(a)(2) boot being received.

Held: The “substantially all” test was satisfied and (1) characterization of the transaction as a “D” reorg. resulted, & (2) dividend distribution treatment under §356(a)(2) for non-business assets.

Nondivisive Reorganizations - Summary

Objective: Extract cash from corp. on a capital gains basis and then retain the business operations in another corporate format.

Structures: 1) Liquidate and then reincorporate the operating assets; or,
2) Transfer assets to a new sub, and distribute the new stock sub and other assets to the shareholders.

Current planning: use 1) and infuse the business assets into an LLC to defeat “boot” treatment?

D Reorganization Variants - p.547

- 1) All-cash reorganizations – one corporation purchase all assets of another corporation for cash without issuance of stock. Objective to achieve rearrangement of corporate structure.
No stock issuance required when identity of interest.
- 2) Internal restructuring transactions – p. 549.
No assets removed from corporations and stock control not changed.

Problem 1(a)

p.550

Common Ownership - 2 Corps

Facts: Shareholders have \$200,000 basis in their Brother stock. Brother corporation has operating assets with a \$500,000 value (\$150,000 basis) and \$200,000 of cash (total FMV \$700,000) and \$250,000 of earnings and profits. Sister corporation has \$300,000 of E&P.

Sister purchases Brother's operating assets for \$500,000 cash and Brother then liquidates.

continued

Problem 1(a), cont. p.550

Common Ownership - 2 Corps

Boot of \$700,000 to the Brother shareholders? And income to extent of \$500,000 gain? & dividend treatment (§356(a)(2))?

And, how measured for dividend? Brother's e&p – \$250,000; or, for both corps E&P (total \$500,000)?

If a D reorg: shareholders increase their tax basis of Sister stock by \$200,000 basis in Brother's stock. Carryover basis (\$150,000) to Sister of the tax basis for assets of Brother & tacked holding period.

Problem 1(b)

p.550

Common Ownership - 2 Corps

Differing arguments: After repeal of General Utilities doctrine would IRS prefer sale and liquidation treatment?

- Brother to recognize \$350,000 of gain on sale of operating assets.**
- Shareholders would recognize \$500,000 gain on the liquidation.**

But, shareholders would prefer D reorg. treatment since \$350,000 gain on operating assets is not taxed.

Problem 1(c)

Alternate Structure?

p.550

Assuming dividends and capital gains are subject to tax at the same rate:

- 1) Merge Sister into Brother.
 - 2) Then, distribute dividends (subject to the 20% tax rate, similar to capital gains).
- & no corporate level gain to be recognized since a tax-free corporate reorganization.

Problem 2

p.550

All Cash D Reorg Transactions

Dividend effect to A? Yes, unless a waiver of the §318 ownership attribution rules occurs? Reg. §1.368-2(l)(3), Ex. 2. Control of S through the family attribution rules? Yes, see Code §368(a)(2)(H)(i) and §304(c).

Are §§368(a)(1)(D) and 354(b)(1)(B) satisfied even through no S stock is actually issued? Yes.

But, \$1 million cash distributed to A & dividend effect occurs (but a 20% dividends tax rate).

§356(a)(2) boot distribution, unless §302(b) waiver.

Continued

Problem 2, cont. p.550

All Cash D Reorg Transactions

Since qualifying as a “D” reorganization:

- 1) T recognizes no gain on the transfer of its assets under §361(b).
- 2) S takes assets with a transferred basis under §362(b).
- 3) A recognizes all realized gain under §354(b) and §356(a).
- 4) Cash received would have dividend effect under §356(a)(2) unless using the §302(b) waiver. But, same tax rate as for capital gains.

“F” Reorganization

p. 550

F reorg: A mere change in identity, form or place of corporate organization of one corporation.


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

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

F reorg. treatment is limited to one corp.

Regulations re F Reorganizations

p.552

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- 1) All stock has been distributed in the exchange.
 - 2) Same ownership.
 - 3) New corp. has no property and no tax attributes pre-transaction.
 - 4) Transferor completely liquidates.
 - 5) New corp. only corp. holding property after the transaction.
 - 6) New corp. not holding any new property.

Rev. Rul. 96-29

p.553

Part of Step Transaction - OK

Two transactions involving (1) stock offering or (2) acquisition & place of organization is changed.

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

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

Problem

p.555

Change State of Organization

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

"F" reorganization status. Also a "D" reorg.?

Mechanically accomplished as (1) a §351 drop down and (2) a §331 liquidation.

Why not a cross-border merger for achieving more efficient property transfer arrangements?

Insolvency Reorganizations

§368(a)(1)(G)

p.556

Transfer of assets to another corporation in a bankruptcy restructuring. Liquidations are not bankruptcy reorganizations.

What relevance of the “substantially all” test for purposes of transferring assets? OK here to transfer assets to pay creditors (not shareholders).

The “continuity of interest” test must be satisfied.

But, even short-term creditors may be counted for purposes of satisfying “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 the NOL carryover to the corporation acquiring the assets.

No recognition to the transferring corporation on asset transfers; carryover tax basis for assets.

Problem

p.561

Acquirer's Stock to Creditors

Valid G reorganization since the debtor

(1) transfers all assets and (2) then distributes the stock of Relief. Lenient standards for “continuity of interest” apply.

Creditors are treated as equity owners.

Debtor's shareholders receive nothing - a §165(g) LTCL on their stock (equal to their tax bases).

continued

Problem

p.561

Acquirer's Stock to Creditors

Security holders exchange \$100,000 of securities for \$50,000 stock. No loss is recognized & they have a \$100,000 basis in securities.

Trade creditors - \$50,000 bad debt loss (no §354 applicability) & \$50,000 basis for shares they hold.

Debtor corp. uses the Relief stock to satisfy \$200,000 in obligations with \$100,000 of stock.

Debtor (insolvent) has (unrecognized) COD income & reduces tax attributes (§108). Relief gets \$100,000 NOLs (as reduced - §382(l)(5)(c)).