

Session 20 - Tax-free acquisitions

- ▶ For tax purposes, a reorganization is a transaction in which one corporation acquires the stock or assets of another corporation
- ▶ Similar to taxable acquisitions discussed previously except that in a reorganization the consideration used by the acquiring corporation is its own stock (or the stock of its parent)
- ▶ Generally transactions meeting the definition of a "reorganization" are not taxable



Tax-free acquisitions

- ▶ Why are these allowed?
 - Shareholders are not "cashing out," rather they are maintaining their same investment in the underlying assets, but in a different corporate form
 - However, in many situations going through a reorganization can be the next best thing to cashing out, but without the tax cost



An example

- ▶ You start your own business, organize it as a corporation, operate it for several years, it becomes quite profitable
- ▶ Microsoft decides that they would like to acquire your business, and make you an offer you can't refuse
- ▶ Your corporation is merged into a subsidiary of Microsoft
 - you turn in your old shares and receive in exchange 1,000,000 shares of Microsoft common stock
- ▶ Even though owning Microsoft stock is almost as good as owning cash, this transaction is not taxable, you are only taxed if you sell the Microsoft stock in the future



How are reorganizations non-taxable?

▶ Target shareholders:

- No gain or loss on the exchange of their stock for stock in the acquiring corporation
- Basis in new stock equal to basis in old stock

▶ Target corporation:

- No gain or loss on the transfer of its assets to a new corporation

▶ Acquiring corporation:

- No gain or loss on the transfer of the corporation's own stock in exchange for target stock or assets
- Basis in stock received from Target shareholders equal to the Target shareholders old basis
- Basis of assets received from Target equal to Target's old basis

▶ Thus, there is no "step up" in the basis of the assets acquired



Effect of "Boot"

- ▶ Any consideration received by Target shareholders other than stock of the acquiring corporation is considered "non qualifying property" (in tax jargon this is referred to as "boot")
- ▶ Generally, any realized gain on an exchange that is part of a reorganization must be recognized up to the amount of boot received
 - Boot can have additional consequences in reorganizations
 - strict rules for some types of reorganizations regarding the amount of consideration other than stock that may be received and still have the transaction qualify as a reorganization
 - "Continuity of Shareholder Interest" requires a "material part" of the consideration received by Target shareholders consist of stock of the acquiring corporation
 - Therefore, too much boot can cause a transaction to fail to qualify as a reorganization, resulting in all of the realized gain being taxable



General rules applicable to all reorganizations

- ▶ Continuity of ownership interest - see above
- ▶ Continuity of business enterprise - surviving corporation must continue a significant portion of the target corporation's business after the reorganization
- ▶ Valid business purpose - some reason for the reorganization other than tax savings is required for the transaction to be respected by the IRS and the courts
- ▶ Step transaction doctrine - the reorganization cannot be part of a larger plan that if taken in its entirety would be a taxable transaction



Continuity of Business Enterprise

- ▶ A transaction constitutes a tax-free reorganization only if the acquirer:
 - continues T's historic business or
 - uses a significant portion of T's historic business assets in a business
- ▶ Facts and circumstances analysis
- ▶ Ensures that T's shareholders maintain, if only indirectly, a substantial part of their equity participation in T's enterprise following A's acquisition. T shareholders as a group must:
 - exchange a "substantial part" of their stock for A stock in the reorganization -- generally 40-50%



Business Purpose

- ▶ To qualify as a tax-free reorg, A's acquisition of T must serve a valid business purpose
- ▶ The transaction must have a “commercial” basis, the principal motive cannot be tax avoidance
- ▶ If A & T are dealing at arm's length and are not owned by substantially the same shareholders, the business purpose requirement will generally not be an issue
- ▶ If the parties are related, business purpose will be a substantial concern especially in the presence of tax attributes such as NOLs



Whose business purpose?

- ▶ Does business purpose have to be determined at the corporate level or will a shareholder-level business purpose be sufficient?
- ▶ Mixed Evidence:
 - The IRS takes the position that a valid corporate business purpose must exist
 - The courts, however, have honored a valid shareholder purpose when that purpose was viewed as also serving a corporate objective
 - Motives of both A and T may be considered



Step transaction doctrine

- ▶ A judicially created “substance over form” concept that permits a series of formally separate steps to be collapsed and treated as a single transaction
 - If a taxpayer “inserts” one or more steps in a reorganization (primarily for more favorable tax consequences) these intermediate steps will be ignored
- ▶ Step-transaction may be beneficial in certain settings (invoked by taxpayer)



Example

- ▶ Sam operates a dry cleaner as a sole proprietorship. DRY-CORP, a national dry cleaning enterprise with offices coast to coast, approaches Sam and offers to acquire his business for DRY-CORP shares. To avoid gain on the transaction, Sam sets up SAMCORP and contributes his dry cleaner in a “351” transaction. Shortly afterwards, DRY-CORP exchanges some of its shares for all of Sam’s SAMCORP shares.
- ▶ Step-Transaction Doctrine ignores 351 transaction.
- ▶ Sam is assumed to have exchanged his dry cleaner assets for DRY-CORP shares in a fully taxable transaction.



Type A: Statutory Merger

- ▶ Type A: Statutory Merger
 - in accordance with state or federal merger laws
 - all assets and liabilities of Target are merged into the acquiring corporation
 - Target shareholders become shareholders in acquiring corporation
- ▶ The acquiring corporation may be smaller than Target before the transaction (it is possible for a minnow to swallow a whale)



“A” Reorganization (Merger)

► Advantages:

- Greater flexibility -- no restriction that the consideration be “solely voting stock”
 - Cash and other property can be used (up to 50% -- why not more than 50%?)
- No requirement that “substantially all” assets of the target be acquired unwanted assets of the target can be disposed of before transaction



“A” Reorganization (Merger)

► Disadvantages:

- Compliance with applicable state corporation laws is required
 - Both acquiring and target corporation shareholders have to approve plan
 - Dissenting shareholders (of both A & T) can have shares independently appraised & purchased for cash
- All liabilities of T must be assumed
- Transfer of titles, leases and contracts may be necessary



Tax Consequences

▶ Target

- No gain or loss is recognized by T
- The assumption of T's liabilities does not trigger the recognition of gain

▶ Acquirer

- The acquiring corporation does not recognize any gain or loss when it receives property in exchange for its stock or debt
- The basis of the property acquired equals its basis in T's hands
- Carryover holding period



Tax Consequences - T Shareholders

- ▶ Three possibilities exist:
 - Shareholders receiving only A stock
 - Shareholders receiving only boot (e.g., cash, other property)
 - Shareholders receiving A stock and boot
- ▶ Shareholders receiving only A stock
 - Transaction is tax-free for these shareholders
 - Basis in new A stock = Basis in old T stock
- ▶ Shareholders receiving only boot (e.g., cash, other property)
 - Taxed as if shares were sold in a normal taxable transaction
 - Gain = FMV of property received - Basis
 - CG or OI depending on holding period



Tax Consequences - T Shareholders

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 - Transaction is tax-free for these shareholders
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 - Taxed as if shares were sold in a normal taxable transaction
 - Gain = FMV of property received - Basis
 - CG or OI depending on holding period
- ▶ Shareholders receiving A stock and boot
 - How much gain is recognized?
 - What is the basis in the stock and other property received?
 - What is the character of the gain recognized?



Tax Consequences - T Shareholders

- ▶ Shareholders receiving A stock and boot
- ▶ How much gain is recognized?
 - If a shareholder receives money or property in addition to A stock, gain must be recognized to the extent of the lesser of
 - the shareholder's realized gain (FMV of property received - Basis)
 - or
 - the FMV of the "boot" received



Example

- ▶ Tom owns 100% of T. His basis in his T shares is \$10,000.
- ▶ T has a FMV of \$100,000.
- ▶ ABC Corporation acquires T in a merger satisfying the “A” reorganization requirements. ABC pays Tom with ABC shares worth \$60,000 and \$40,000 cash.
- ▶ Realized gain = $\$100,000 - \$10,000 = \$90,000$
- ▶ Recognized gain
= lesser of ($\$90,000$, boot ($\$40,000$)) = $\$40,000$



Shareholders receiving A stock and boot

- ▶ What is the basis in the stock and other property received?

Basis of old T shares transferred to A

Plus: Any gain recognized by the shareholder

Minus: FMV of “boot” received
Money received

= Basis in new A stock



Continuing the example

Basis of old shares	\$10,000
Plus: Any gain recognized	40,000
Minus: FMV of “boot” received	
Money received	40,000
= Basis in new A stock	\$10,000



What type of gain

- ▶ What is the character of the gain recognized by shareholders receiving “A” stock and Cash
 - The tax law treats a shareholder who receives both A stock and cash as if they had received payment in A stock only followed by a redemption of a portion of their stock
 - Character depends on how deemed redemption is treated



Substantially Disproportionate Rules

- ▶ Deemed stock redemption must qualify as “substantially disproportionate” under Section 302(b)(2) for the shareholder to receive capital gain treatment:
 - After the redemption, the shareholder owns less than 50% of the total combined voting power of all classes of voting stock
 - After the redemption, the shareholder owns less than 80% of his or her percentage of voting stock before the redemption



Other Type A Mergers

▶ Triangular Type A

- In a triangular merger, the assets of Target are merged into a subsidiary of the acquiring corporation
- Target shareholders become shareholders in acquiring (parent) corporation



Other Type A Mergers

► Reverse Type A Triangular Merger

- In a reverse triangular merger, the assets of a subsidiary of the acquiring corporation are merged into Target
- Target shareholders become shareholders in acquiring corporation (the parent corporation of the newly merged corporation)
- The reason for using a reverse triangular merger is that sometimes Target has assets that cannot be transferred (A reverse triangular merger keeps Target intact as the surviving corporation).



“Solely for Voting Stock” Reorganizations

- ▶ Two types of reorganizations qualify under the “solely for voting stock” provisions:
 - If A acquires T’s stock solely for A voting stock, the transaction may qualify as a “B” reorganization
 - If A acquires T’s assets solely for A voting stock, the transaction may qualify as a “C” reorganization

