

# ALI-ABA Corporate Taxation

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Hilton Embassy Row, Washington, DC

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## Taxable and Tax Free Merger and Acquisition Structures

### Panel

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# Subjects

- Administration Budget Proposals in Corporate Tax
- Taxable Acquisitions
  - Intermediary Transactions
  - Rescission
  - Ralph's
  - Contingent Purchase Price Issues
  - Other Cases of Note (Flextronics, MediaSpace)
- Tax-Free Acquisitions
  - Reg. 1.368-2(k)
  - Step Transaction Issues
  - Liquidation / Reincorporation
  - "D" Reorganizations
  - Nonqualified Preferred Stock

Reg. § 1.1502-13(c)(6)(ii) (3/3/2011)

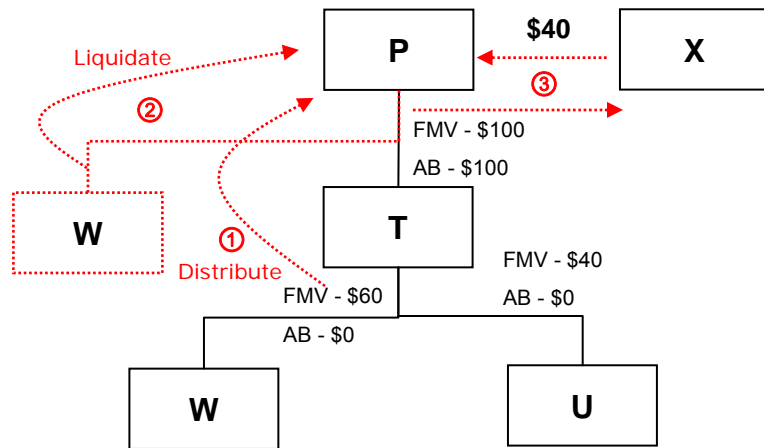
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- **Limitation on treatment of intercompany items as excluded from gross income:**

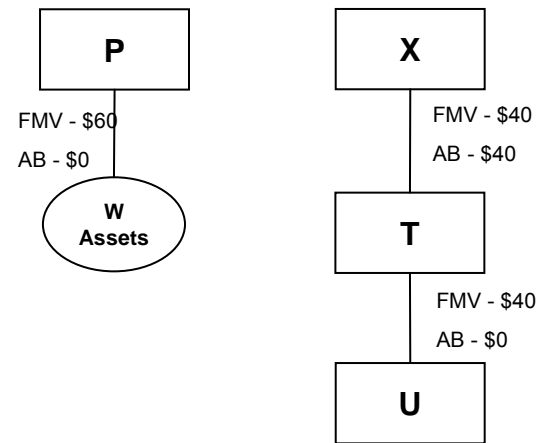
Notwithstanding the attribute redetermination rule of Reg. § 1502-13(c)(1)(i), S's intercompany income or gain is redetermined to be excluded from gross income only to the extent one of the following applies:

- (A) B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations.
- (B) The corresponding item is a loss that is realized, but not recognized under section 311(a) on a distribution to a nonmember (even though the loss is not a permanently and explicitly disallowed amount within the meaning of paragraph (c)(6)(ii)(A) of this section).
- (C) The Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code and regulations.

## Example – Bust-Up Transaction



- In Year 1, P buys T for \$100. T owns 100% of Unwanted (U) with a \$0 basis and \$40 value and 100% of Wanted (W) with a \$0 basis and \$60 value.
- Step 1: In Year 2, T distributes the W stock to P.
- Step 2: In Year 3, W liquidates into P in a section 332 transaction.
- Step 3: In Year 4, P sells T to X, a third party for \$40.



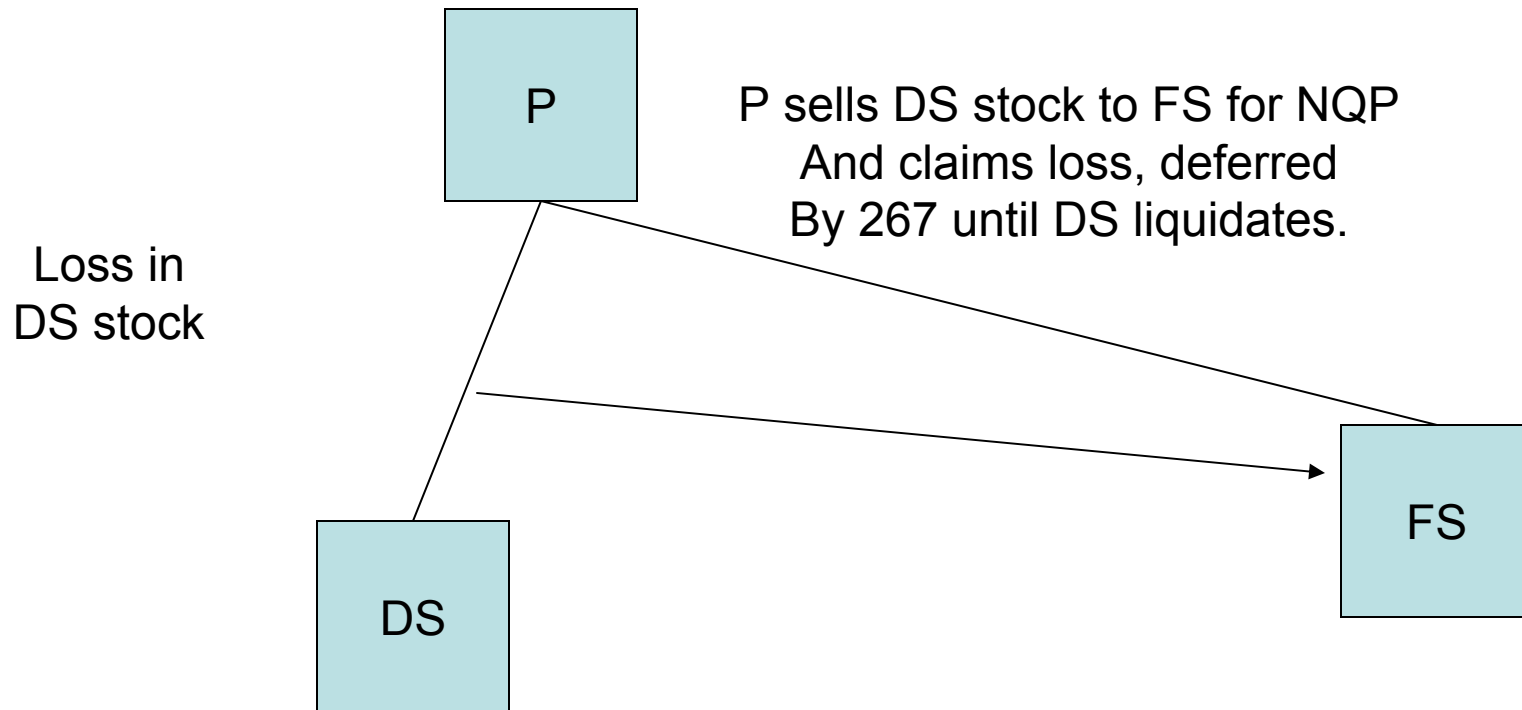
- T has a \$60 section 311(b) intercompany gain upon the distribution of W to P.
- If the \$60 gain is eliminated upon W's section 332 liquidation, P could sell T without the recognition of gain or loss.

# Administration 2012 Budget Proposal

- Repeal “boot dividend within gain” limitation in §356(a)
- Repeal provisions relating to “nonqualified preferred stock” for stock issued after 12/31/2011 (General Explanation, p. 88).
  - Loss recognition transaction
    - Must mean transaction that would be under sec. 351 but for the fact that NO stock is received
  - To avoid related party rules in 304?

## Administration Budget Proposals

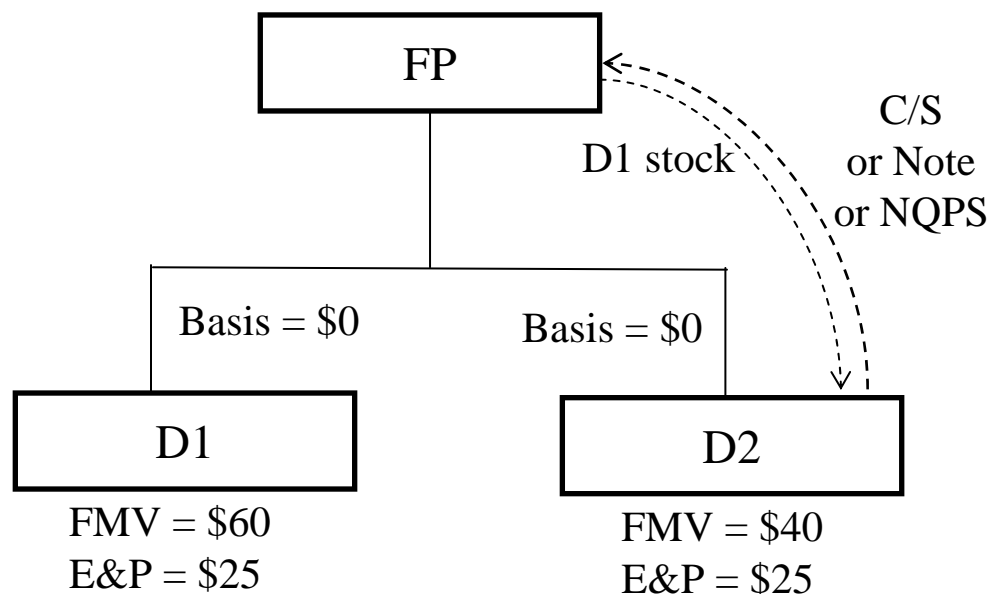
- CCA 201025046:



## Administration Budget Proposals

- LTR ont'd
  - The CC (Corp) cogently explained why the taxpayer would not obtain the loss recognition under the matching rule and section 267.
  - Why does the Treasury want to throw out the baby with the bath water? (assuming there ever was a baby in 351(g)?
  - Why did not Treasury every undertake to write regulations under 351(g)?

## Administration Budget Proposals



FP, a foreign corporation, owns all the stock of domestic corporations D1 and D2, all common stock.

FP's basis in both the D1 stock and the D2 stock is \$0.

D1 stock FMV is \$60. D2 stock FMV is \$40.

D1 and D2 each has \$25 E&P.

FP transfers the D1 stock to D2—

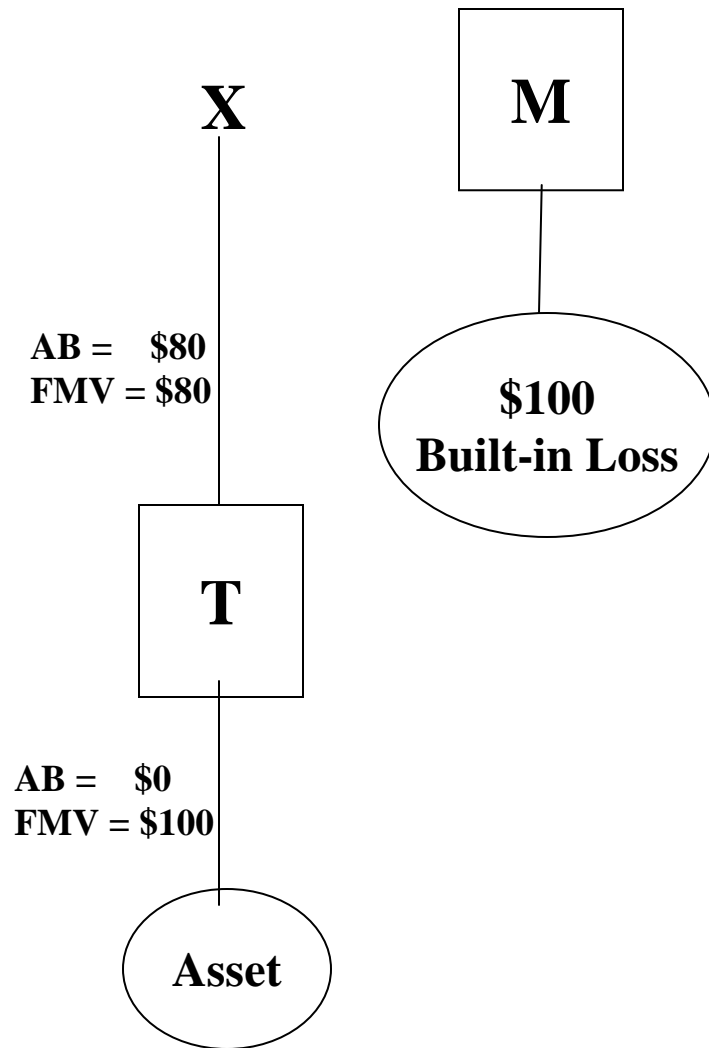
- For additional D2 common stock (or as a capital contribution for no consideration)
- For a \$60 D2 note
- For D2 nonqualified preferred stock (\$60 FMV)

What is D2's basis in the D1 stock?

# Taxable Acquisitions

- Intermediary Transactions
- Rescission
- Ralph's
- Contingent Purchase Price Issues
- Other Cases of Note

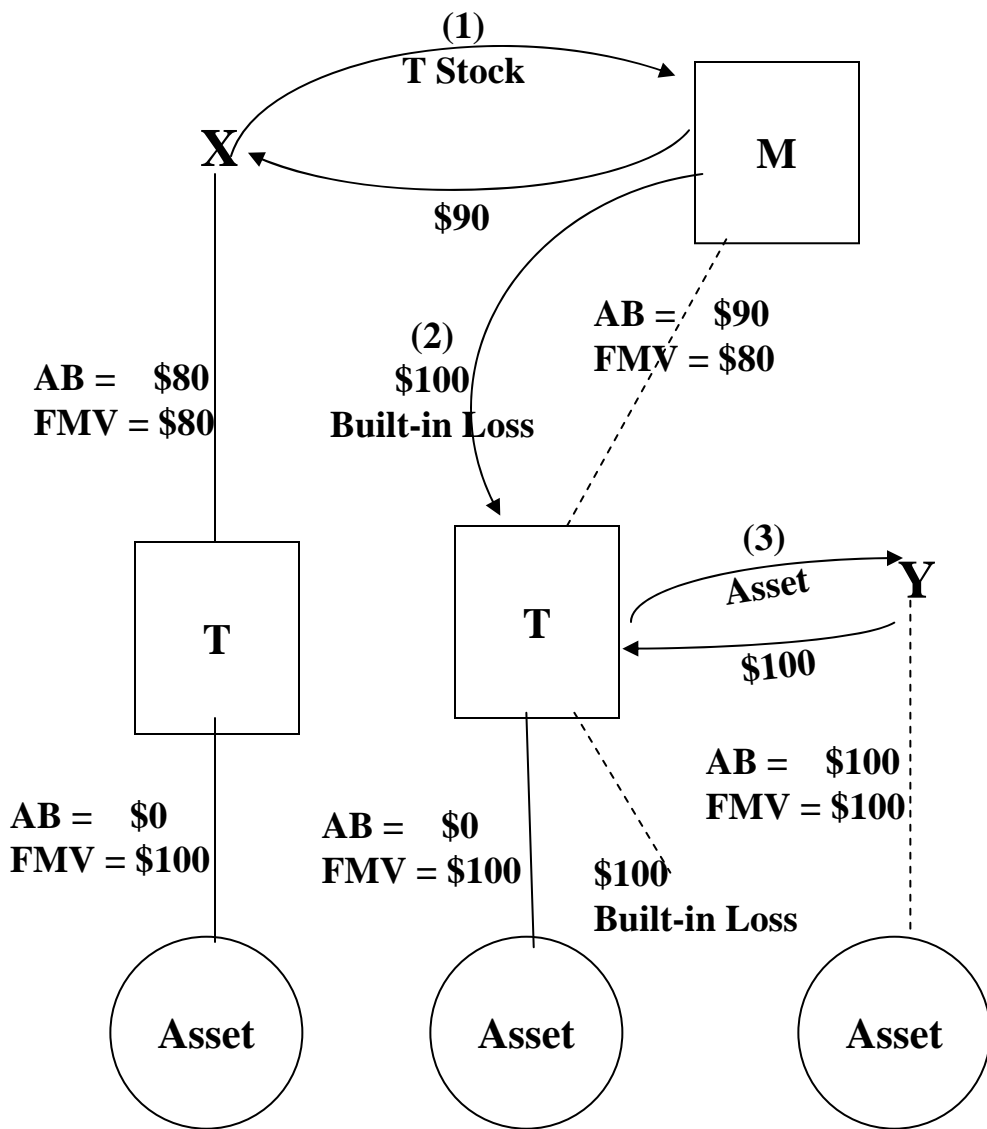
## Intermediary Transactions: Notices 2001-16, 2008-20 & 2008-111



- Y**
- Corporation T owns Asset with \$0 basis and \$100 value. T has no other property, debt or tax attributes.
  - X (classification does not matter) owns all the stock of T with \$80 basis. Because of T's \$0 basis in Asset, the fair market value of the T stock is \$80.
  - Corporation M has a \$100 built-in loss tax attribute.
  - Y (classification does not matter) wants to acquire Asset. Y is willing to pay \$100 for Asset with a cost basis or \$80 for the T stock or for Asset with a \$0 basis.

# Intermediary Transactions: Notices 2001-16, 2008-20 & 2008-111

## - Continued



- X, M, T and Y engage in the following transactions:
  1. X sells the T stock to M for \$90.
  2. M makes its built-in loss attribute available to T.
  3. T sells Asset to Y for \$100.
- Do any of the following variations matter?
  - M pays \$80, instead of \$90, for the T stock.
  - M finances its purchase of the T stock with funds borrowed from X, Y or T .
  - Y's purchase of Asset from T takes the form of a forward cash merger of T into Y.
  - T has other assets that it retains after the sale of Asset to Y, and M either retains the T stock or liquidates T and retains the other assets.
  - At the time X sells the T stock to M, Y is subject to a binding commitment to buy Asset from T (negotiated with X or with X and M).
  - Y is unaware of any transaction between X and M and negotiates only with M to buy Asset from T.
  - Y's purchase of Asset from T takes place more than one year after M's purchase of the T stock from X.

## **Notice 2001-16 and Notice 2008-20**

- IRS issued Notice 2001-16 on January 19, 2001. It was the first attempt at dealing with intermediary transactions.
- Notice 2001-16 identifies certain transactions as an intermediary tax shelter, including the use of an intermediary (i) that is a member of a consolidated group that uses consolidated tax attributes to shelter the gain otherwise resulting from the sale of T assets or (ii) that is an entity not subject to tax.
- IRS issued Notice 2008-20 on January 17, 2008, to identify the components of the “intermediary tax shelter” described in Notice 2001-16.
- Notice 2008-20 was effective as of January 17, 2008, but IRS clarified that it did not affect whether a transaction prior to January 17, 2008 was required to be disclosed or registered.

## Notice 2008-111 – Applicability

- Notice 2008-111 supersedes Notice 2008-20 and is generally effective January 19, 2001.
- Notice 2008-111 states:

“The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the types of transactions described in Notice 2001-16. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.”
- What if taxpayers relied on Notice 2008-20 in filing or not filing disclosures under Notice 2001-16?

## Notice 2008-111 – Overview

- The IRS issued Notice 2008-111 on December 1, 2008, to identify the components of an intermediary transaction tax shelter (an “intermediary transaction”) described in Notice 2001-16.
- The Notice provides that a transaction will be treated as an intermediary transaction with respect to a particular person only if that person engages in the transaction pursuant to the “plan” and the transaction contains the four objective components indicative of an intermediary transaction.
  - With respect to an intermediary transaction, the “plan” occurs when a transaction is structured to cause the tax obligation for the taxable disposition of assets with built-in gain to arise, in connection with the disposition by shareholders of the target of all or a controlling interest in the target’s stock, under circumstances where the person(s) primarily liable for any federal income tax obligation with respect to the disposition of assets with built-in gain will not pay that tax.

## **Notice 2008-111 – Plan**

- A person engages in the plan if the person *knows or has reason to know* the transaction is structured to effectuate the plan.
- Any X that is at least a five percent shareholder of T (by vote or value), or any X that is an officer or director of T, has knowledge of the plan if any of the following *knows or has reason to know* the transaction is structured to effectuate the plan: (i) any officer or director of T; (ii) any of T's advisor's engaged by T to advise T or X with respect to the transaction; or (iii) any advisor of that X engaged by that X to advise it with respect to the transaction.
- A person can engage in the transaction pursuant to the plan even if it does not understand the mechanics of how the tax liability purportedly might be offset or avoided, or the specific financial arrangements, or relationships of other parties or of T after the stock disposition.

## Notice 2008-111 – Components

- Component 1 — (Built-in Tax)—A corporation (T) directly or indirectly (*e.g.*, through a pass-through entity or a member of a consolidated group of which T is a member) owns assets the sale of which would result in taxable gain (“T’s built-in gain assets”) and, at the time of the stock disposition, T (or the consolidated group of which T is a member) has insufficient tax benefits to eliminate or offset such taxable gain, or the tax (“T’s built-in tax”), in whole. For purposes of this component, T will not be considered to have any built-in tax if, on the Stock Disposition Date (defined below), such amount is less than five percent of the value of the T stock disposed of in the stock disposition.
  - Notice 2008-20 did not disregard T’s built-in tax equaling less than five percent of the value of the T stock disposed of in the stock disposition.
- Component 2 — (Sale of Stock)—At least 80 percent of the T stock (by vote or value) is disposed of by T’s shareholder(s) (X), other than in liquidation of T, in one or more related transactions within a 12-month period. (Notice 2008-20 Had required the disposition of at least 50 percent of the T stock by vote or value). The first date on which at least 80 percent on the T stock (by vote or value) has been disposed of by X in a stock disposition is the “Stock Disposition Date.”

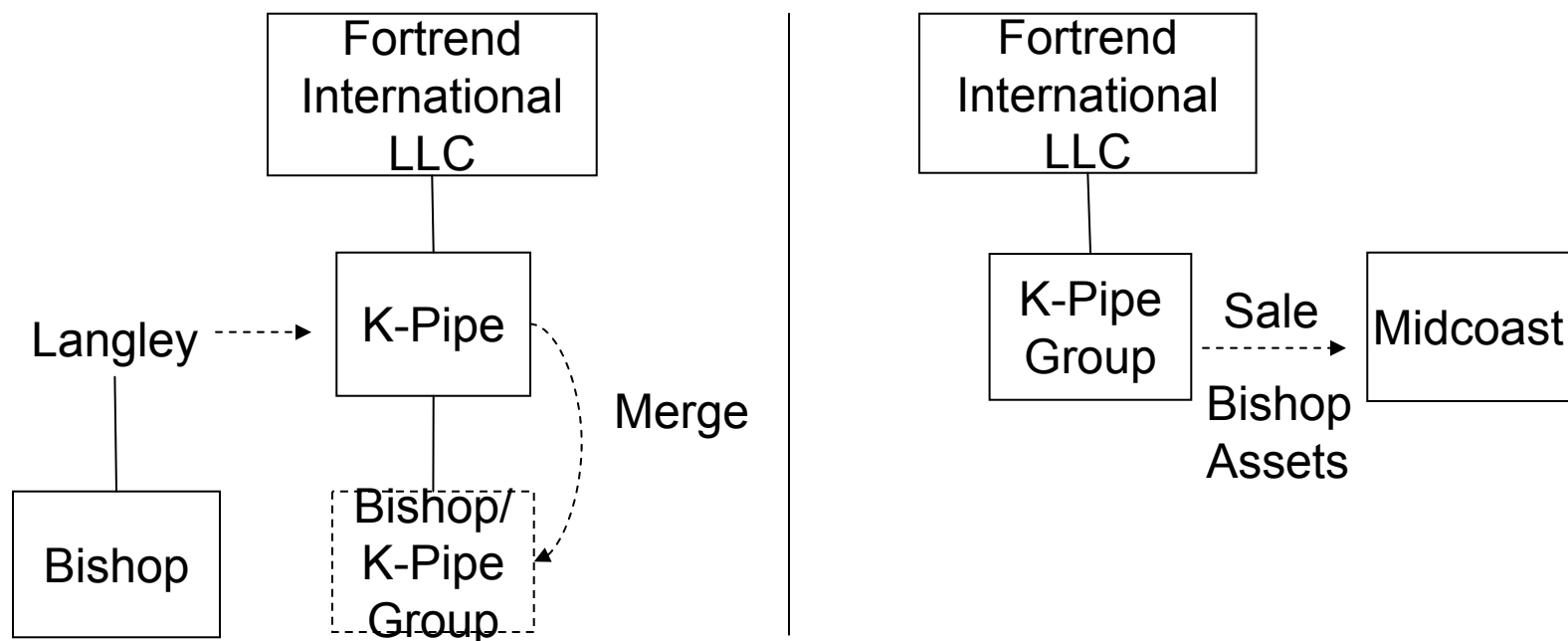
## Notice 2008-111 – Components – Continued

- Component 3 — (Sale of Assets)—Either within 12 months before, simultaneously, or within 12 months after the Stock Disposition Date, at least 65 percent (by value) of T’s built-in gain assets are disposed of (“sold T assets”) to one or more buyers (Y) in one or more transactions in which gain is recognized with respect to the sold T assets. (Notice 2008-20 measured the 12-month period from the disposition of “all or most” of T’s built-in gain assets.)
- Component 4 — (Offset of Built-in Tax)—At least half of T’s built-in tax that would otherwise result from the disposition of the sold T assets is purportedly offset, avoided, or not paid. (Notice 2008-20 required an offset, avoidance, or nonpayment of “all or most” of T’s built-in tax.)

## Notice 2008-111 – Safe Harbors

- A transaction is not an intermediary transaction with respect to the following persons under the following circumstances:
  - Safe Harbor 1 — Any X, if the only T stock it disposes of is traded on an established securities market (within the meaning of §1.453-3(d)(4)) and prior to the disposition X (including related persons described in Sections 267(b) or 707(b)) did not hold five percent (or more) by vote or value of any class of T stock disposed of by X.
  - Safe Harbor 2 — Any X, T, or M, if, after the acquisition of the T stock, the acquiror of the T stock is the issuer of stock or securities that are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such an issuer.
  - Safe Harbor 3 — Any T, if the only Sold T Asset it acquires are either (i) securities (as defined in Section 475(c)(2)) that are traded on an established securities market (within the meaning of §1.453-3(d)(4)) and represent a less-than-five-percent interest in that class of security, or (ii) assets that are not securities and do not include a trade or business as described in §1.1060-1(b)(2).

# *Enbridge Energy Co. v. United States*



- In *Enbridge Energy Co. v. United States*, 553 F.Supp.2d 716 (S.D. Texas 2008), the court determined an intermediary company to be a sham.
- The taxpayer, Langley, sold the stock of his solely owned pipeline corporation, Bishop, to an intermediary, K-Pipe. K-Pipe then merged into Bishop, with Bishop surviving. Bishop then sold all the Bishop assets to Midcoast.

# *Enbridge Energy Co. v. United States*

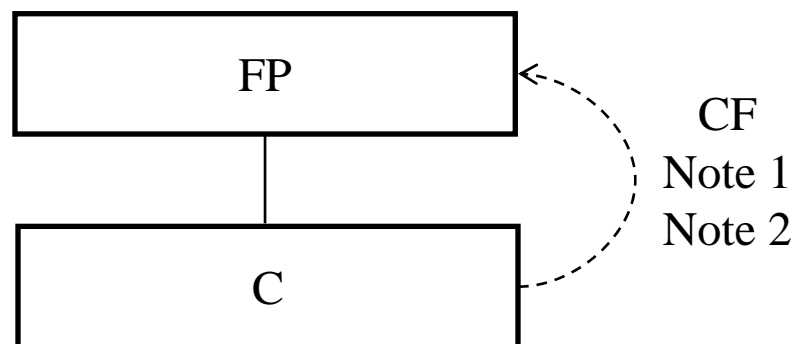
## **District Court Decision**

- The district court disregarded the involvement of K-Pipe as a conduit and treated the transaction as a purchase of the Bishop stock by Midcoast, followed by a liquidation of Bishop.
- The court treated the transaction as a stock sale and liquidation because Langley would not have considered a straight asset sale. Thus, Midcoast did not receive a cost basis in Bishop's assets.
- The court disregarded K-Pipe as a conduit based on the following factors:
  - Whether there was an agreement to do a transaction before the intermediary participated;
  - Whether the intermediary was an independent actor, or assumed any risk;
  - Whether the intermediary was brought in at the behest of the taxpayer; and
  - Whether there was a nontax purpose for the intermediary's participation.

*Enbridge Energy Co. v. United States*  
**District Court Decision – Continued**

- Although there was no formal agreement between Bishop and Midcoast, the court found that Midcoast's tax advisors identified Fortrend as an intermediary, and that there was no nontax purpose for Fortrend's participation. Moreover, the entity formed for the transaction, K-Pipe, was a shell and did not have any other business activities.

## Rescission: PLR 201016048

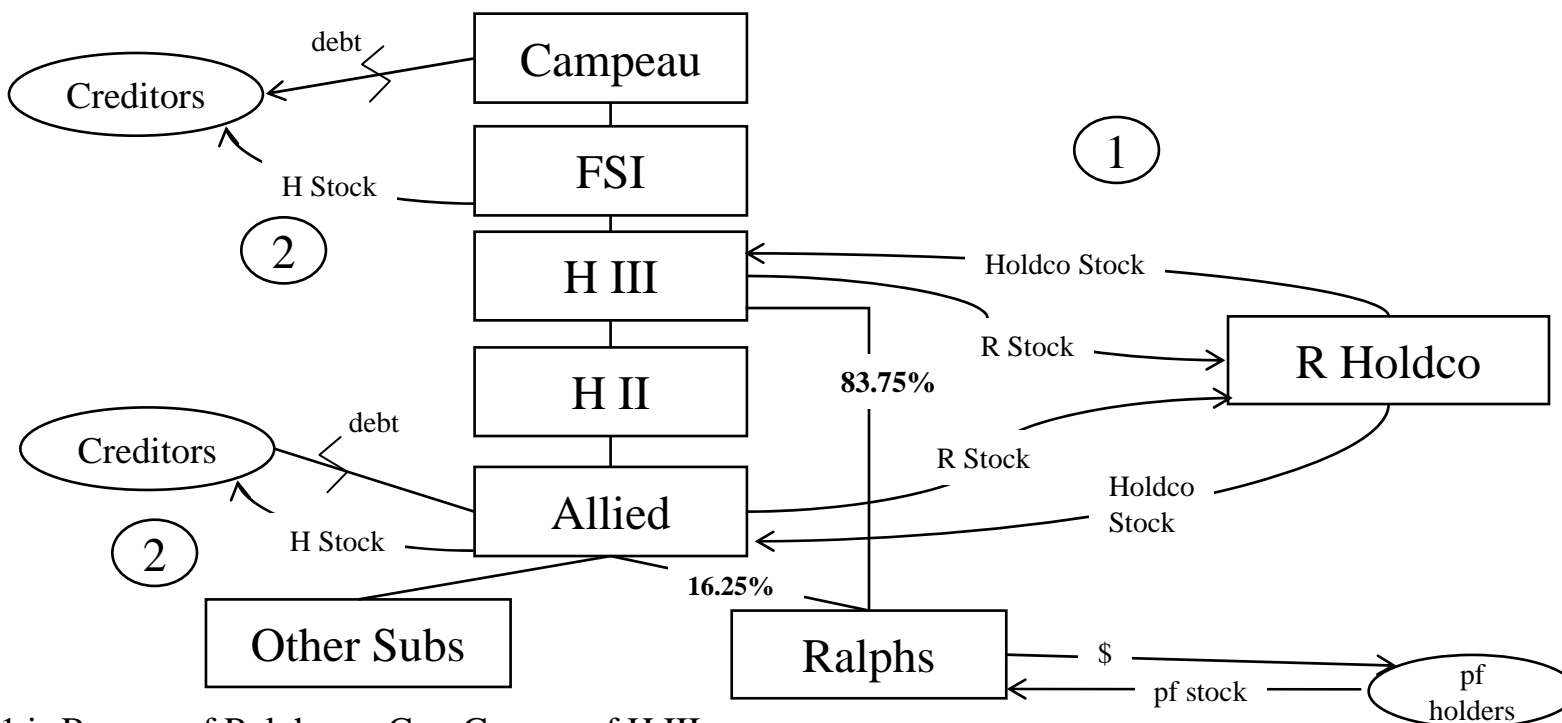


- Foreign parent FP owns all the stock of domestic corporation C
- C has debt to FP through a credit facility (CF), Note 1 and Note 2
- FP cancels Note 1 and CF in exchange for shares of C stock (§108(e)(8))
- FP and C rescind the transaction in same tax year.
- Following the rescission, FP will cancel a portion of Note 1 and/or Note 2 as a capital contribution to C (§108(e)(6))
- Taxpayer represented:
  - Neither [C] nor [FP] is or will be bound by any legal obligation regarding the Subsequent Debt Cancellation at or before the Effective Time of the Rescission
- Would the result be the same if, after rescission, Note 1 and CF are cancelled? *See* PLR 201008033

# RALPHS GROCERY

T.C. Memo. 2011 – 25 (January 27, 2011)

## FSI/Allied Bankruptcy Reorganization – February 3, 1992



### IRS:

Step 1 is B reorg of Ralphs; or C or G reorg of H III;

Step 2 distribution does not break COI – *McDonald's* not applicable because *Alabama Asphaltic* preserves COI in creditors.

### R Holdco:

Steps 1 & 2 are 338(h)(10) QSP (R stock for Allied and FSI debt).

Implies deemed transfer of debt by creditors to Holdco; Holdco acquisition for the debt?

### Court:

Step 1 is not a reorg; Step 2 does break COI: *Alabama Asphaltic* requires creditors to take “proactive steps” to attain “effective command” over debtor’s property; creditors here did not (did not put FSI in bankruptcy, did not ask for trustee, did not file a plan of reorg., etc.)

# Ralph's Grocery

- The year at issue in the case preceded the 1998 revision of the continuity regs. That reversed the McDonalds of Zion decontrol thread.
- *Example 1:* In 2011 Bankrupt is owned by shareholder X, whose equity is worth nothing. Bankrupt owes 100 to a group of creditors. Bankrupt reorganizes into New Bankrupt and the court approved plan of reorganization directs that all of the stock of New Bankrupt be distributed to the creditors, who cancel their debt claims. Because the only equity owner under the Ralphs rule, X, got no stock, the reorganization is taxable.

# Ralph's Grocery

- *Example 1 Alternate:* Bankrupt desires nonrecognition treatment for reorganization. The plan directs that the stock of New Bankrupt be distributed to X (the old shareholder), and X will "sell" the stock to the creditors in discharge of their debt claims. That gives the former equity owner, X, temporary ownership of the stock of the reorganized corporation, which creates a continuity of ownership that is not destroyed by the sale, on account of the change in the continuity regulation that occurred in 1998?[1] Will IRS oppose the reorganization treatment and argue that the distribution of the stock to X should be ignored because it did not conform to the "economic substance" of the transaction?: X was not entitled to any stock. Therefore, by ignoring the transitory holding by X, the New Bankrupt stock actually went directly to the creditors and because they were not prior owners under the Ralphs rule, there was no continuity and the reorganization was taxable. Thus, whether the stock originally is distributed to X or to the creditors, the normal bankruptcy reorganization is likely to be a taxable event under the Ralphs rule.
- [1] Reg. section 1.368-1(e)(3) and (4).

# Ralph's Grocery

- *Example 2:* In 2011 FSI is bankrupt; it owns Holdings III which is not bankrupt, which owns Ralphs. FSI has one creditor, Z. Holdings III exchanges the stock of Ralphs to RHC for all of its stock and then exchanges the RHC stock with Z for the debt claims against FSI. Because the retransfer of the RHC stock will not destroy continuity under the 1998 regulations, it does not matter now (as it did in 1992) whether Z is an equity owner, unless Z is a related person. But because creditor Z is a corporation that owns all of the stock of RHC immediately after the transactions, it is a "related person" to RHC,[1] the boot that Holdings III receives from Z destroys continuity and the reorganization would be taxable, because under the Ralphs rule Z cannot be viewed as the former indirect equity owner of Ralphs that can provide continuity of interest in its own right.[2]
- [1] Reg. section 1.368-1(e)(4)(i).
- [2] If Z could be viewed as the former indirect owner, the sale of the stock to Z would not break continuity. The owners of a shareholder's shareholder have been treated as indirect owners of the reorganized corporation. Rev. Rul. 84-30, 1984-1 CB 114, showed that indirect continuity could exist through shareholders of a shareholder, and Reg. section 1.368-1(e)(3) adopted the same approach, as confirmed by T.D. 8760 (1/23/1998), which allowed Rev. Rul. 84-30 to be obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388. Reg. section 1.368-1(e)(3) states that continuity will be broken by a related party acquisition of the stock for boot, but then states: "The preceding sentence does not apply to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation." On the facts of Ralphs, the creditors of its ultimate parent were the indirect owner of Ralphs before the rule of the Ralphs case, but not under the rule of Ralphs.

# **Contingent Consideration and Contingent Liabilities in Acquisitions**

# Overview

- Contingent Consideration
- Deal Escrows
- Contingent Liabilities
- Discussion Problems

# Contingent Consideration

- Installment Sale Rules: Preference for closed transaction.
- Open Transaction: Disfavored by IRS, but sometimes used by taxpayers in disposition transactions.
- Election Out: Affirmative action to recognize all gain or loss attributable to contingencies in year of sale.

# Contingent Installment Sales

- General Rule: Pro rata basis recovery.
- Maximum Selling Price: Assume maximum payments will be received. Accelerates gain.
- Time Limitation: If no maximum selling price, basis recovered over time specified for payment.
- If neither maximum price or specific time, basis recovery is over 15 years, unless PLR is obtained.

# Imputed Interest Rules

- Section 483 or Section 1274 applies. In most acquisition scenarios, interest is not taxable as income to holder or deductible by seller until contingency is resolved. Treas. Reg. 1.483-4 and 1.1275-4(c).

# Tax Consequences of Guessing Wrong

- What happens if little is received under the contingent payment rights, yet significant basis has been allocated thereto?
- Problem: Capital Loss. If holder is individual, no carryback. If C corp., 3 years.
- This problem can be solved by electing out of the installment method, but will seller be willing to pay tax currently on amounts projected to be received?  
(Preview: How do contingent liabilities affect this question?)

# Determining Character of Gain or Loss When Paid

- *Arrowsmith*: Refer to character of gain or loss reported at time of sale to characterize subsequent loss.
- If we reject *Arrowsmith* as the appropriate reference point, the character issues become extremely uncertain.
- Consider contingent right as either a “debt instrument” or a “contract right”.

# Debt Instrument Analysis

## (Not a Contract Right)

- Debt Instrument: Section 1271(a) imposes sale or exchange treatment at maturity of debt instrument, rejecting the holding of Supreme Court in *Fairbanks*.
- This would produce capital gain or loss.
- “Debt Instrument” broadly defined in Section 1275 regulations, but considerable uncertainty remains under debt vs. equity authorities.

# **Contract Right Analysis**

## **(Not a Debt Instrument)**

- Contract Right: Section 1234A might apply to always require capital gain or loss. This result is unlikely.
- Dozens of cases have attempted to determine whether a transfer of a contract right to what would be ordinary income might be a capital asset (e.g., lottery ticket winners).

# **Section 453A: Interest Charge on Installment Sale Tax Liability**

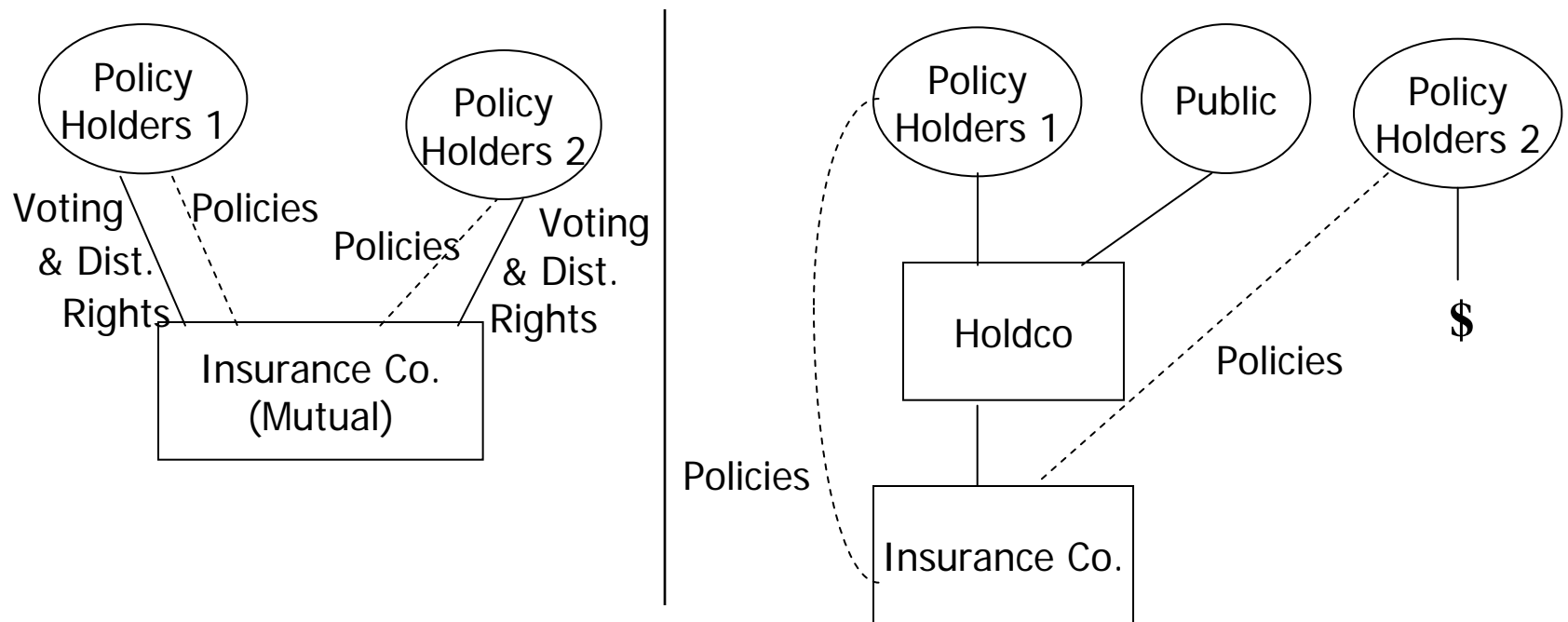
- More than \$5 million in face amount of installment notes held at year end.
- Only applies to installment sales of property involving more than \$150,000 in value.
- Concept: The government is making the seller a loan by waiting to collect tax until note is actually paid. The government wants interest – annually – even if seller has not received cash.
- Note: Applied to each partner or S corp shareholder separately. Notice 88-81.

# How Does Section 453A Apply to Contingent Consideration?

- No regulations or IRS guidance address this issue.
- TAM 9853002: Implies that Section 453A applies to contingent obligations under installment sales based on maximum possible payment, BUT no true-up allowed when less than maximum is received!!
- If open transaction treatment is properly utilized, Section 453A should not apply, as no “installment obligation” exists.
- Can it be concluded that it is “more likely than not” that Section 453A can be ignored until contingencies are satisfied and all payments are received? Many contingent obligations do not have a “face amount”, so \$5mm requirement is not met?

# What Is Left of the Open Transaction Doctrine?

## Example: Life Insurance Company Demutualization



*Fisher v. United States*, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Aug. 6, 2008)

*Paulsen v. Commissioner*, 469 U.S. 131 (1985)

*Burnet v. Logan*, 283 U.S. 404 (1931)

*Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq.* 1948-1 C.B. 2

# Deal Escrows

Several Issues:

- Is the seller deemed to receive the escrowed proceeds upon establishment of the escrow (installment sale, closed transaction, or open transaction)?
- Who is taxed on the income during the escrow period?
- Should tax distributions be made during the escrow period?

# Current Taxation of the Seller

- Purpose of the escrow is determinative.
- If escrow protects the SELLER (i.e. security for payment), seller is deemed to receive proceeds of escrow in year of sale. See 453 regs.
- If escrow protects the BUYER (as with indemnities in acquisitions), seller's amount realized is deferred.

# Current Taxation of the Seller

- IRS agrees that escrow for buyer's benefit is eligible for installment sale treatment. PLR 200521007. Confirms vitality of pre-1980 rulings re: restrictions on payment. Rev. Rul. 77-294 and Rev. Rul. 79-91.
- Case law provides some contrary argument: *Granneman v. Unites States*, 649 F. Supp 949 (E.D. Mo. 1986). (Note intended to be paid by buyer, not out of escrow.)

# Current Taxation of the Seller

- Further support for installment sale treatment: IRS Publication 537 (citing “substantial restriction” requirement).
- Query: How useful is the installment sale method if the Section 453A interest charge applies on the principal in excess of \$5 million? How many taxpayers own the “installment note”?
- If escrow with “substantial restrictions” could be reported on the open transaction method, Section 453A interest charge will not apply.

# Taxation of Escrow Income

- The “homeless income” problem.
- Congressional response: Section 468B(g)(1).
- Proposed regulations issued in 1999 treat the *buyer* as the owner of the income on the escrowed funds.
- Until regulations are finalized, either buyer or seller may be allocated the escrow income, as determined by contract.

# Taxation of Escrow Income

- Note that the agreement of the parties as to which party will report the income will not impact the timing of seller's gain recognition on the sale. See Prop. Reg. 1.468B-8(d) and *Anderson v. Commissioner*, 20 T.C.M. 697 (1961).
- Conceptually, the parties are free to deal with the tax liability produced by the income on the escrowed funds in any manner that they choose without influencing the timing of the underlying gain recognition.

# Tax Distributions from Escrow

- Assume that the buyer is treated as the owner of the income produced in the escrow.
- If we give the buyer a tax distribution to pay the tax currently, buyer gets a double benefit because buyer will ultimately get an interest deduction that would likely offset the interest income when the escrowed funds (with the residual interest income) are ultimately paid to the seller. (This is not an issue if in fact buyer retains the escrow proceeds.)
- The following slides compare the overall economic impact of treating the seller and buyer as the owner of the income and allowing tax distributions to each.

# Escrow Earnings Illustration

## Assumptions:

Ordinary Income Rate	40%
Capital Gains Rate	20%
Earnings on Escrowed Funds	10%
AFR on Delayed Payment	10%
Tax Basis of Property Sold	\$0
Amount Escrowed	\$100

	Buyer Treated As Owner of Earnings	Seller Treated As Owner of Earnings
Escrow Amount	\$100	\$100
Interest Earned in Year One	\$ 10	\$ 10
Tax Due (40%)	\$ 4	\$ 4
Tax Distribution from Escrow	(\$ 4)	(\$ 4)
Remaining Escrow Proceeds	\$106	\$106

# Escrow Earnings Analysis

	Buyer Treated As Owner	Seller Treated As Owner
<b>Seller Tax Treatment Upon Termination of Escrow</b>	<p>Total payment received by seller = \$106. \$96.36 is principal and \$9.64 is interest.</p> <p>Tax on \$100 principal = \$20.</p> <p>Tax on interest = \$3.86.</p> <p>Total tax paid = \$23.86.</p> <p>Net proceeds to seller = \$82.14.</p>	<p>Total payment received by seller = \$100 purchase price.</p> <p>Tax on \$100 principal = \$20.</p> <p>Already viewed as owner of the \$6 of residual interest proceeds.</p> <p>Net proceeds to seller = \$86.</p>
<b>Buyer Tax Treatment Upon Termination of Escrow</b>	<p>Buyer increases the tax basis of the purchased asset by \$96.36. Buyer is also treated as paying \$9.64 of interest to seller. Assuming a 40% effective tax rate, the interest deduction provides buyer with a \$3.86 tax benefit in the year of escrow termination.</p>	<p>Buyer increases the tax basis of the purchased asset by \$100.</p>

# Escrow Earnings: Summary

- There is a tax (and economic) effect to choosing whether buyer or seller is treated as the owner of the income on the escrow even where an equivalent tax distribution is made to cover taxes.
- Buyer does not need a full tax distribution to reimburse buyer for taxes on the escrow, as the ultimate payment to seller will produce additional interest deductions.

# Contingent Liabilities

- Fixed liabilities in asset sales. Impact on buyer and seller.
- Compare contingent liabilities: Should there be symmetry with fixed liabilities? How do we get there on a conceptual basis?
- Buyer's own costs? If so, avoids the problem entirely, as it is not an assumed liability.

# **Examples of Possible Contingent Liabilities**

- Environmental Liabilities
- Product Liability
- Worker's Compensation
- Retiree Medical
- Patent Infringement

## **Example: *Illinois Tool Works***

- Buyer purchased business and assumed liability for pending patent claim. Buyer could have settled case for less than \$1mm but continued to trial.
- Judgment: \$15mm. Tax treatment of payment? *Illinois Tool Works, Inc.*, 117 T.C. 39 (2001).

## **Example: *Illinois Tool Works***

- Tax Court and Seventh Circuit were not sympathetic that all parties valued the liability claim at no more than \$1mm.
- Eventual payment required capitalization by buyer solely because the liability arose in connection with an asset acquisition.

# **Buyer's Treatment of Contingent Liability Expenditures**

- Problem: What seem like ordinary course payments are converted to capitalized expenditures.
- Factors
  - Did the liability arise before the asset acquisition?
  - Has the liability been reflected in seller's financial statement?

# Buyer's Basis Increase - General

When should buyer increase basis?

- Never (if payment is deductible)
- At closing (very difficult if amount not known)
- When paid (probably the correct answer under current law – reinforced by Section 461 regulations)

# **Buyer's Basis Increase – Section 461(h)**

## **Economic Performance**

- If liabilities are expressly assumed by buyer, economic performance occurs as the seller includes the corresponding amount in amount realized.
- Section 338 regulations state that no basis is awarded to buyer until the liability is fixed and economic performance requirement is satisfied.

# **Seller's Amount Realized:**

## **Timing Issues**

- Authorities are far from clear as to when the seller realizes gain on the sale from contingent liabilities assumed by the buyer.
- Closed transaction approach dictates seller's inclusion of additional amount realized at closing.
- Another approach would be to include only as buyer increases basis (open transaction).  
Issue: How is seller supposed to determine what buyer is doing with assumed liabilities?

## **Seller's Amount Realized:** **Other Issues**

- What is seller's amount realized from buyer's assumption of contingent liability at closing? Gross value or present value of liability?
- Note: Even if all cash deal, contingent liability assumption might put the seller into the installment sale method with adverse basis allocation consequences.

## Seller's Deduction

- Several cases hold that seller is entitled to a “deemed payment” deduction equal to the amount realized relating to the contingent liability. See, e.g., *Commercial Security Bank*, 77 T.C. 145 (1981).
- Theory: Seller received a lesser purchase price, so seller effectively received additional consideration and then paid the liability.

## Seller's Deduction: Timing

- Seller's deduction is generally deferred until contingent liability becomes fixed.
- Economic performance requirement is satisfied in sale of a trade or business when amount is included in seller's amount realized. Treas. Reg. 1.461-4(d)(5)(i).
- Special timing cases: Section 404(a)(5) and nuclear power plant decommissioning costs.

## **The Twist:**

### **Buyer's Income Recognition**

- In some cases the assumption by buyer of the contingent liability has resulted in BUYER recognizing immediate income!
- See Rev. Rul. 71-450 and outline page 60.
- Theory: Seller “paid” the buyer to assume the obligation by accepting a reduced purchase price. Fortunately, matching deduction to buyer should be imputed, but timing problems are significant.

# Examples of Buyer Income from Assumed Liabilities

- Acquisition of publishing company assets WITH agreement to provide future advertising services at a discount. *TFH Publications*, 72 T.C. 623 (1979).
- TAM 9823992: Prepaid subscription income deferred by partnership treated as liability assumed.
- Preamble to recent consolidated return regulations implies that the buyer income theory applies whenever a shareholder assumes seller's obligation to provide future services in a Section 332 liquidation. Importantly, example involved prepaid subscription income. See T.D. 9376 (Jan. 16, 2008).

# **Contingent Purchase Price and Contingent Liabilities in Acquisitions – Discussion Problem**

# Contingent Purchase Price and Contingent Liabilities

## Discussion Problem:

### Facts: “S,” “O” and “Business”

- “S” (Seller) is a U.S. business entity with substantial net worth. S could be a partnership, an LLC, a C corporation or an S corporation.
- “O” (Owner) owns all the equity of S. O could be one or more individuals, partnerships, LLCs, trusts, C corporations or S corporations, or a combination of them. The equity interests in S may or may not be publicly-traded.
- As its only activity, S owns and operates “Business,” which manufactures and distributes machine tools and related products in the U.S. All of S’s assets and liabilities pertain to Business.
- S’s assets are typical for a manufacturing business and include cash, inventory, accounts receivable, machinery and equipment, land and buildings, and a variety of intangibles, including workforce in place, patents, trademarks licenses and goodwill.
- S’s fixed liabilities are also typical for this type of business. They include loans payable to banks, accounts payable to vendors of products and services and compensation accrued and payable to employees.

## Facts: S's Contingent Liabilities and Contracts

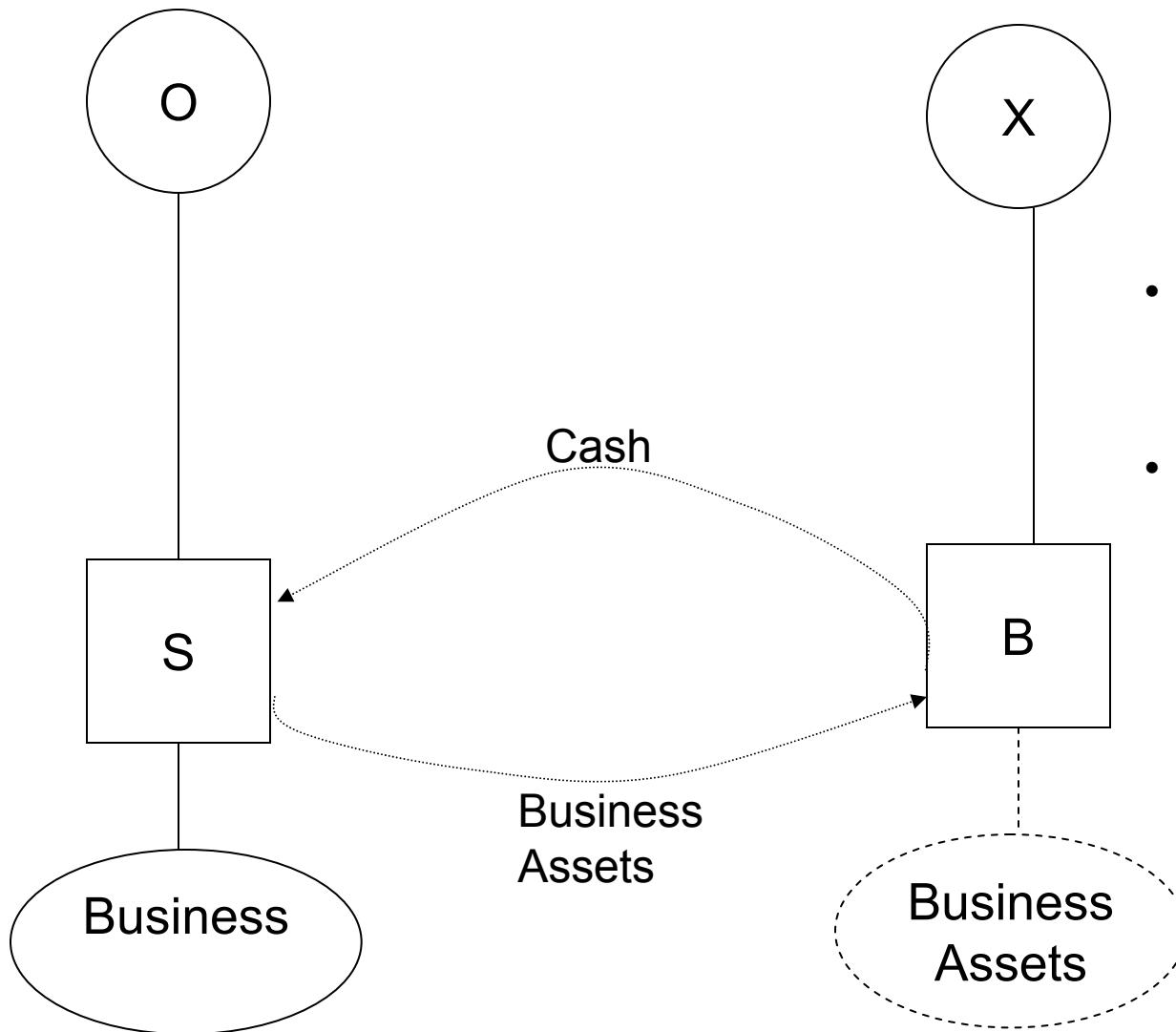
- S has a number of contingent liabilities. That is, it is uncertain whether any amounts will be payable with respect to these liabilities and, if so, what amounts or when. The contingent liabilities include the following:
  - Vested and non-vested deferred compensation for employees.
  - Potential product warranty and workers' compensation claims. S is not aware of any specific warranty or workers' compensation claim, but experience shows that such claims are likely.
  - The EPA has begun to examine Business's waste sites, but environmental counsel advises S that the waste program has not risen to a level to require clean-up or other liability.
  - S may have future costs in light of its promise to pay medical benefits to retirees from Business.
  - S has been sued for patent infringement in connection with Business, and the case is pending.
- S has entered into contracts to deliver goods to customers. Based on projections, some of the contracts are expected to generate high margins, and others either low margins or losses.
- S has entered into fixed-price contracts to buy commodities used in Business. Some of the fixed prices are higher, and some are lower, than current market prices.

## Facts: “B,” “X” and Sale of Business to B

- S wants to sell Business.
- “B” (Buyer) is a U.S. business entity owned or to be formed by “X”. B and X are unrelated to O and S.
- B wants to acquire Business.
- B may be willing to take responsibility for some or all of S’s fixed and contingent liabilities arising from Business.
- Alternative 1 (Scenarios 1-5 and 9): B acquires Business for cash and/or notes.
- Alternative 2 (Scenarios 6-8): B acquires Business for an equity interest in B (partnership interest or stock).

## Scenario 1

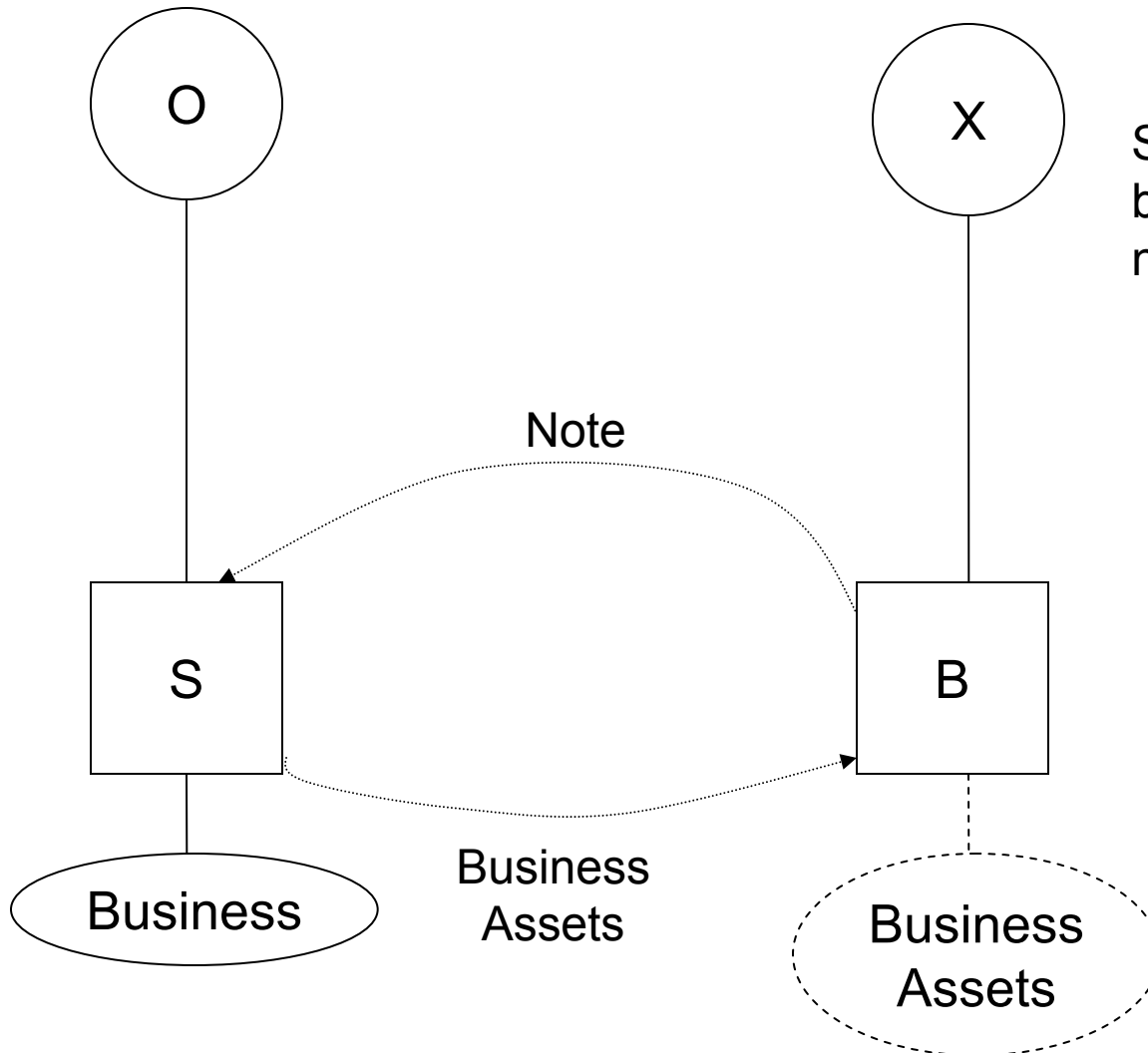
### Taxable asset sale for cash but no liability assumption



- B buys the assets of Business for a fixed cash payment
- B does not assume any fixed or contingent liabilities

## Scenario 2

### Taxable asset sale for a note but no liability assumption

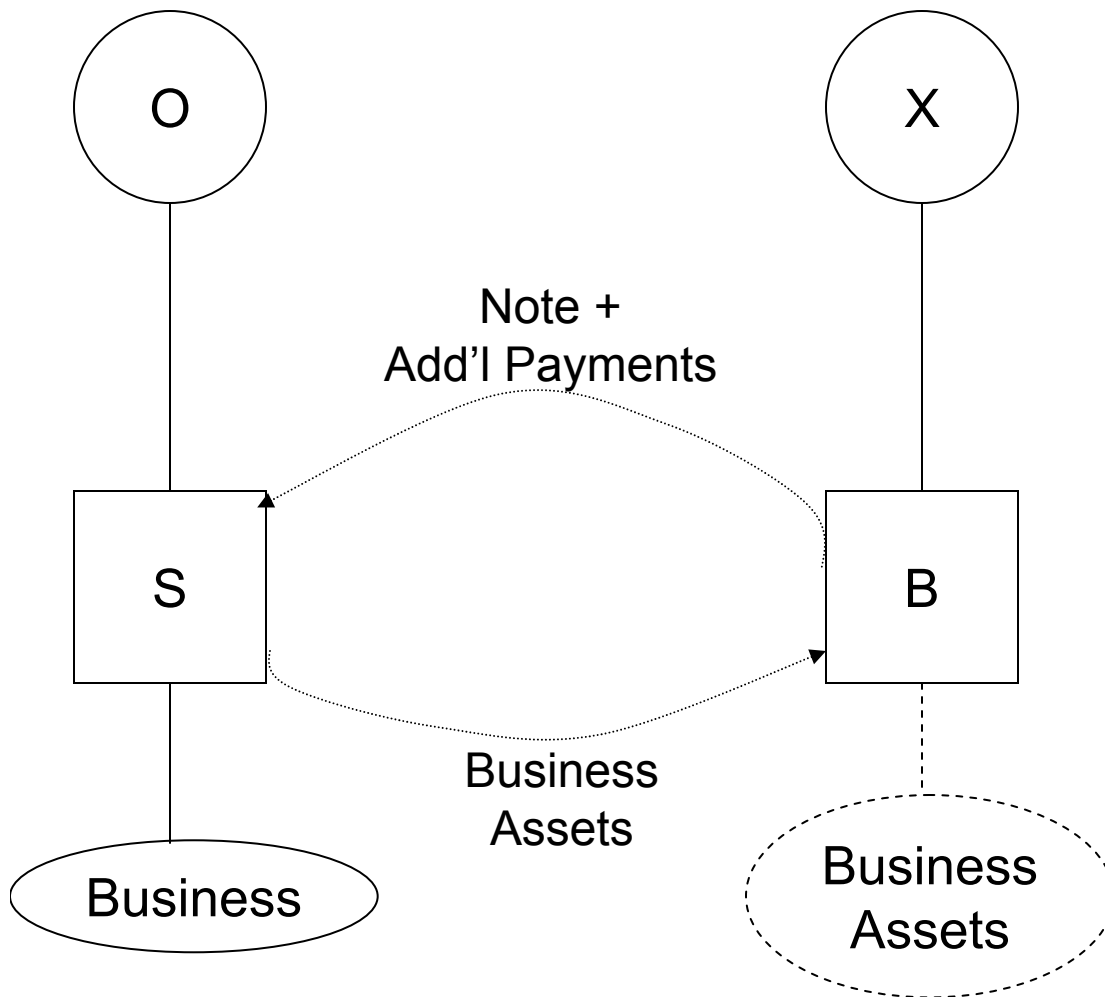


Same as Scenario 1, but B buys the Business assets for a note having these terms:

- Fixed amount
- Principal payable in 3 years
- Interest at market rate (>AFR), payable semi-annually

## Scenario 3

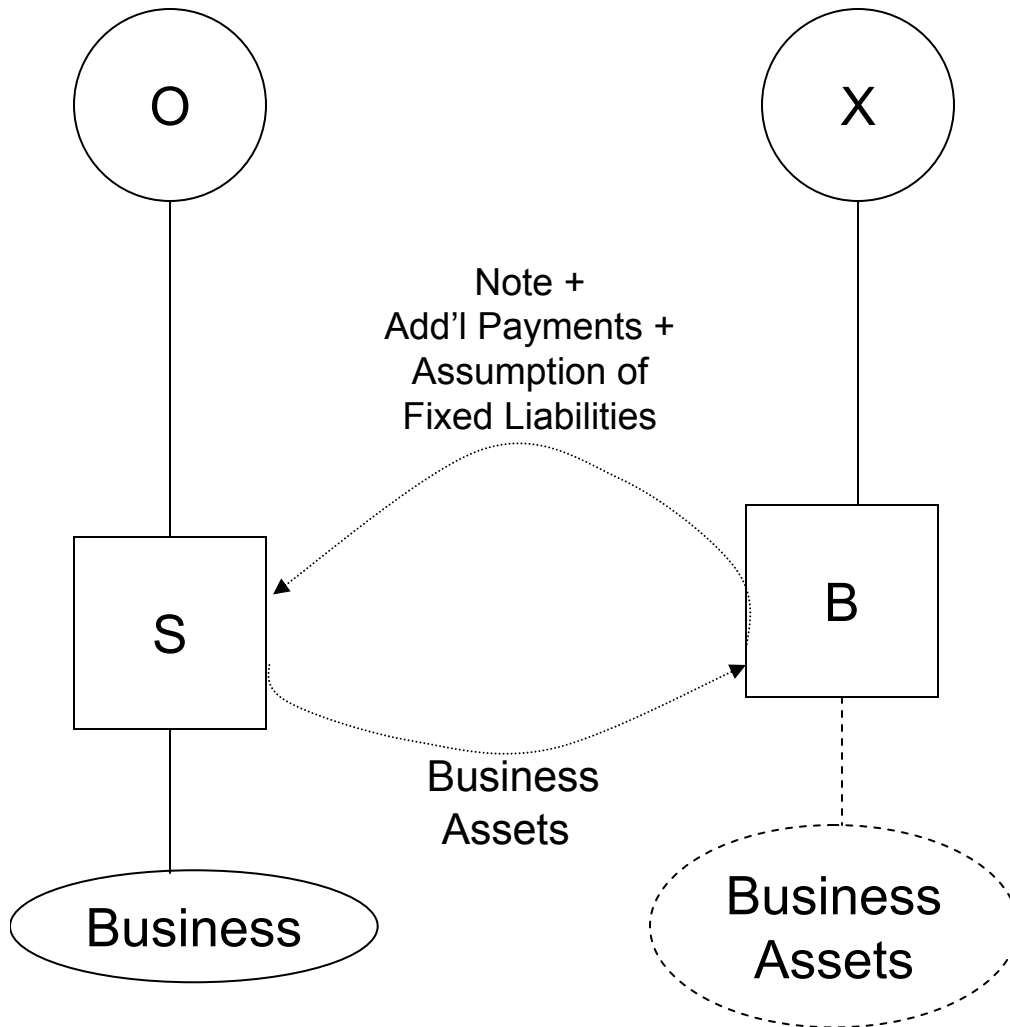
### Taxable asset sale for a note and additional payments but no liability assumption



- Same as Scenario 2, but S and B cannot agree on the value of the Business assets
- Thus, in addition to issuing its note, B agrees to make additional payments, with market interest, based on Business's profits over 3 years after closing

## Scenario 4

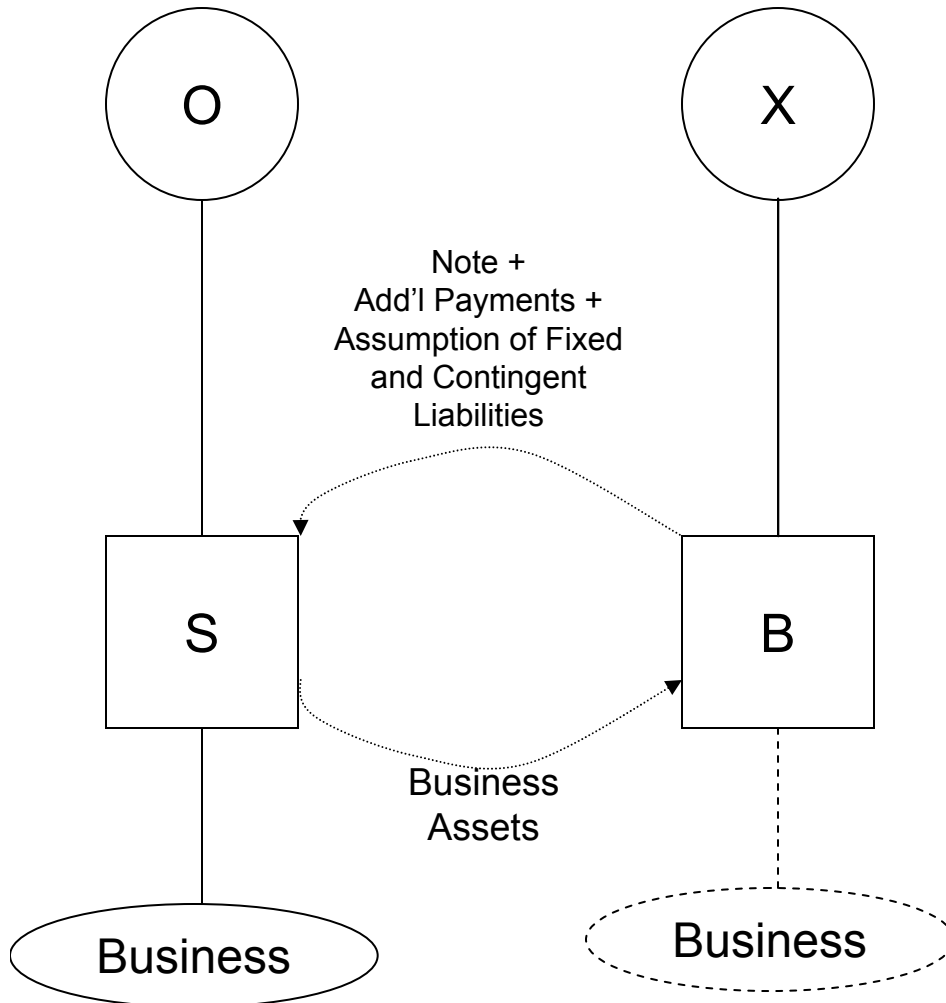
### Taxable asset sale for a note, additional payments and assumption of fixed liabilities



- Same as Scenario 3, except that B also assumes S's fixed liabilities but not its contingent liabilities

## Scenario 5

### Taxable asset sale for a note, additional payments and assumption of fixed and contingent liabilities



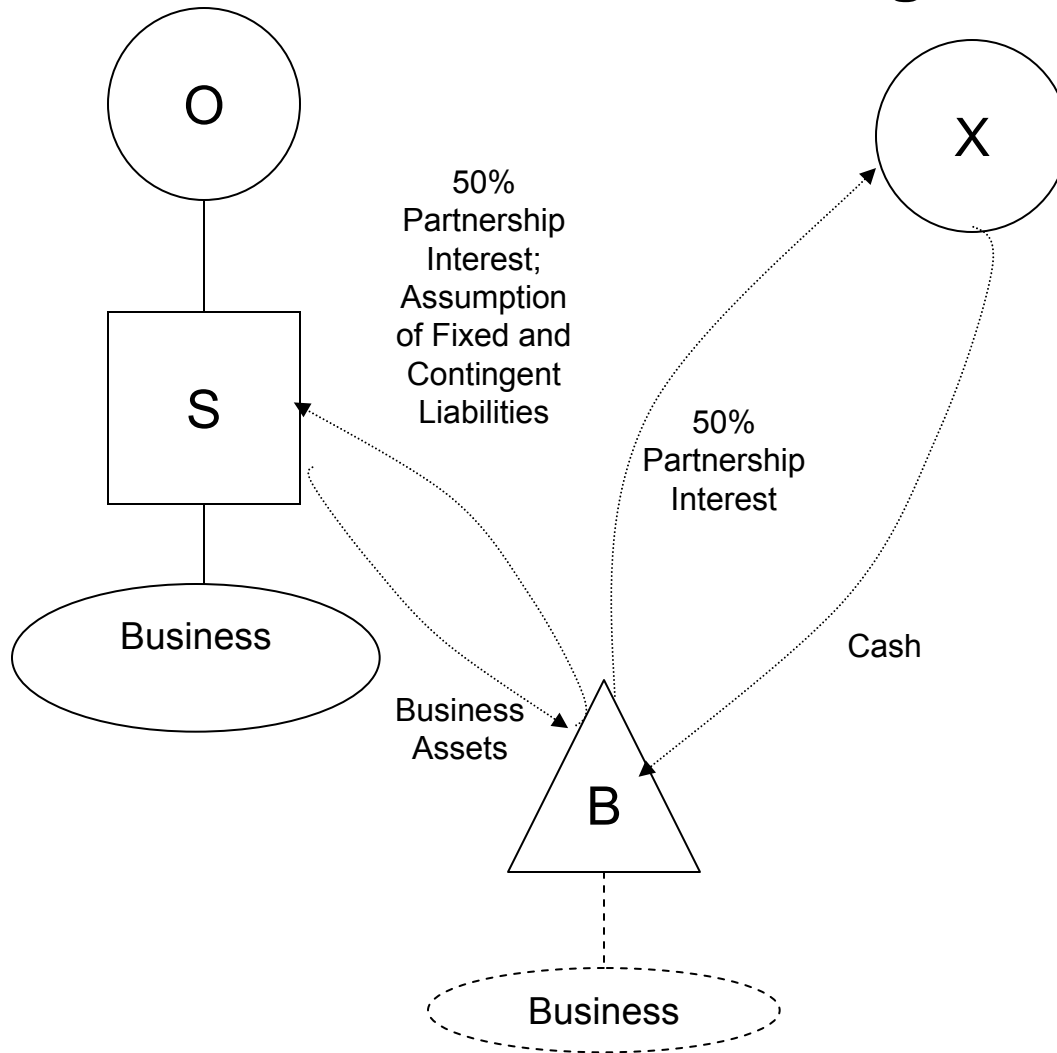
Same as Scenario 4 except that B assumes S's fixed and contingent liabilities

The disposition of S's contingent liabilities after the acquisition is as follows:

- Each year: B pays warranty claims; amounts are less than expected (or alternatively, more than expected)
- Each year: B pays medical benefits to retirees from Business
- Year 3: B pays a worker's compensation claim
- Years 2-4: B pays deferred compensation, some of which vested before, and some after, the acquisition
- Year 5: B pays for massive clean-up of S's waste site
- Year 6: B pays a large and unexpected judgment in the patent infringement case

## Scenario 6

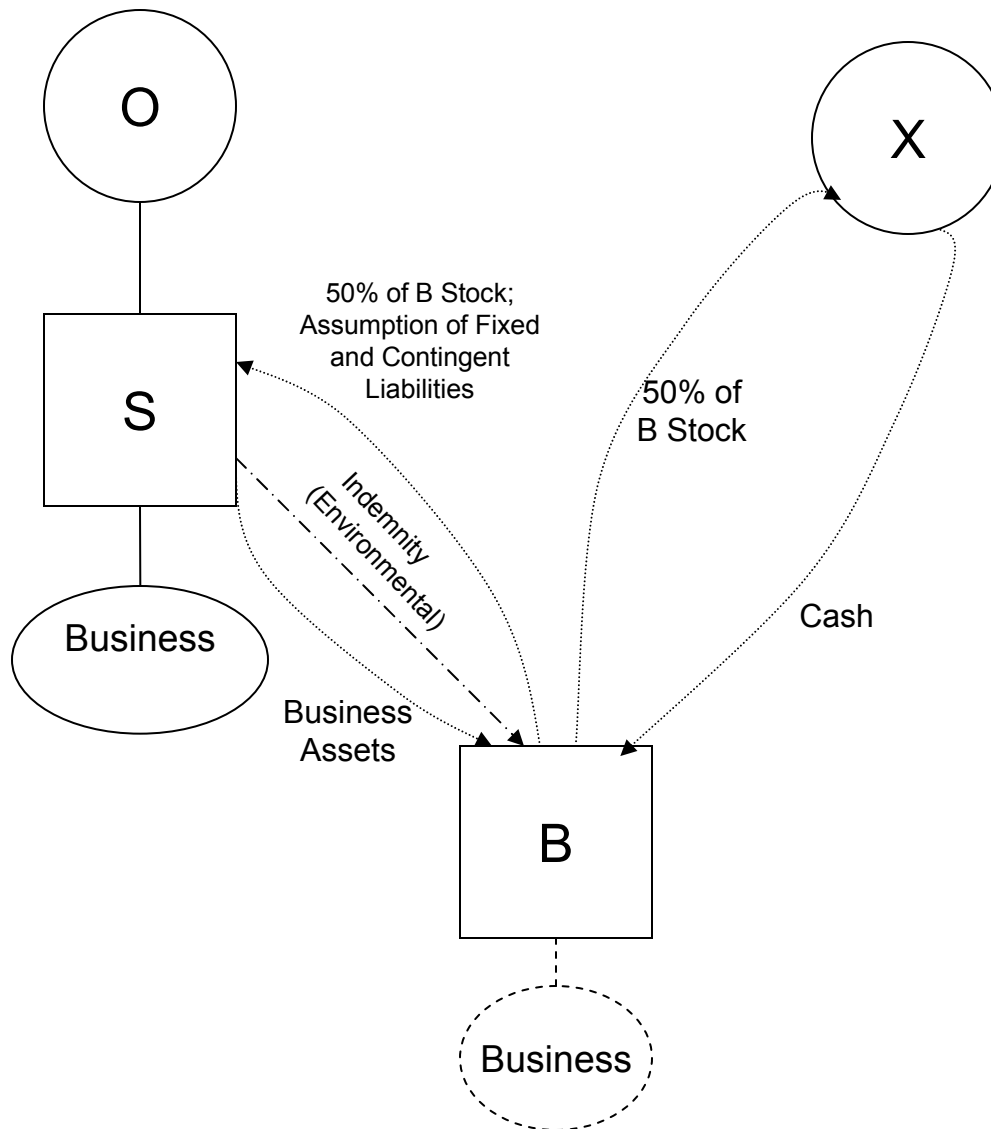
### Section 721 transaction involving S's assets and S's fixed and contingent liabilities



- X and S form partnership B
- X transfers cash to B for a 50% partnership interest
- S transfers the Business assets to B for a 50% partnership interest
- B assumes S's fixed and contingent liabilities
- The disposition of S's contingent liabilities is the same as in Scenario 5.

## Scenario 7

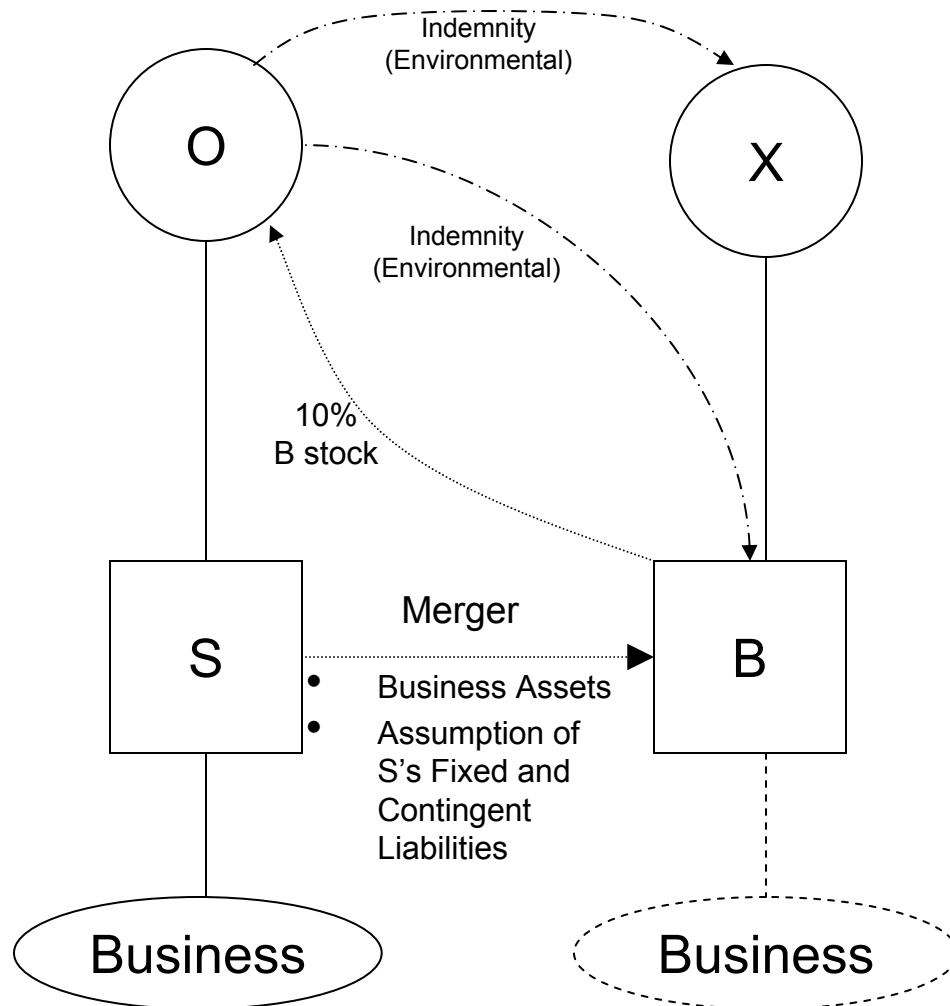
### Section 351 transaction involving S's assets and S's fixed and contingent liabilities



- X and S form B, a new corporation
- X transfers cash to B for 50% of the B stock
- S transfers the Business assets to B for 50% of the B stock
- B assumes S's fixed and contingent liabilities
- S agrees to indemnify B for environmental cleanup costs in excess of a fixed amount
- The disposition of S's contingent liabilities is the same as in Scenario 6

## Scenario 8

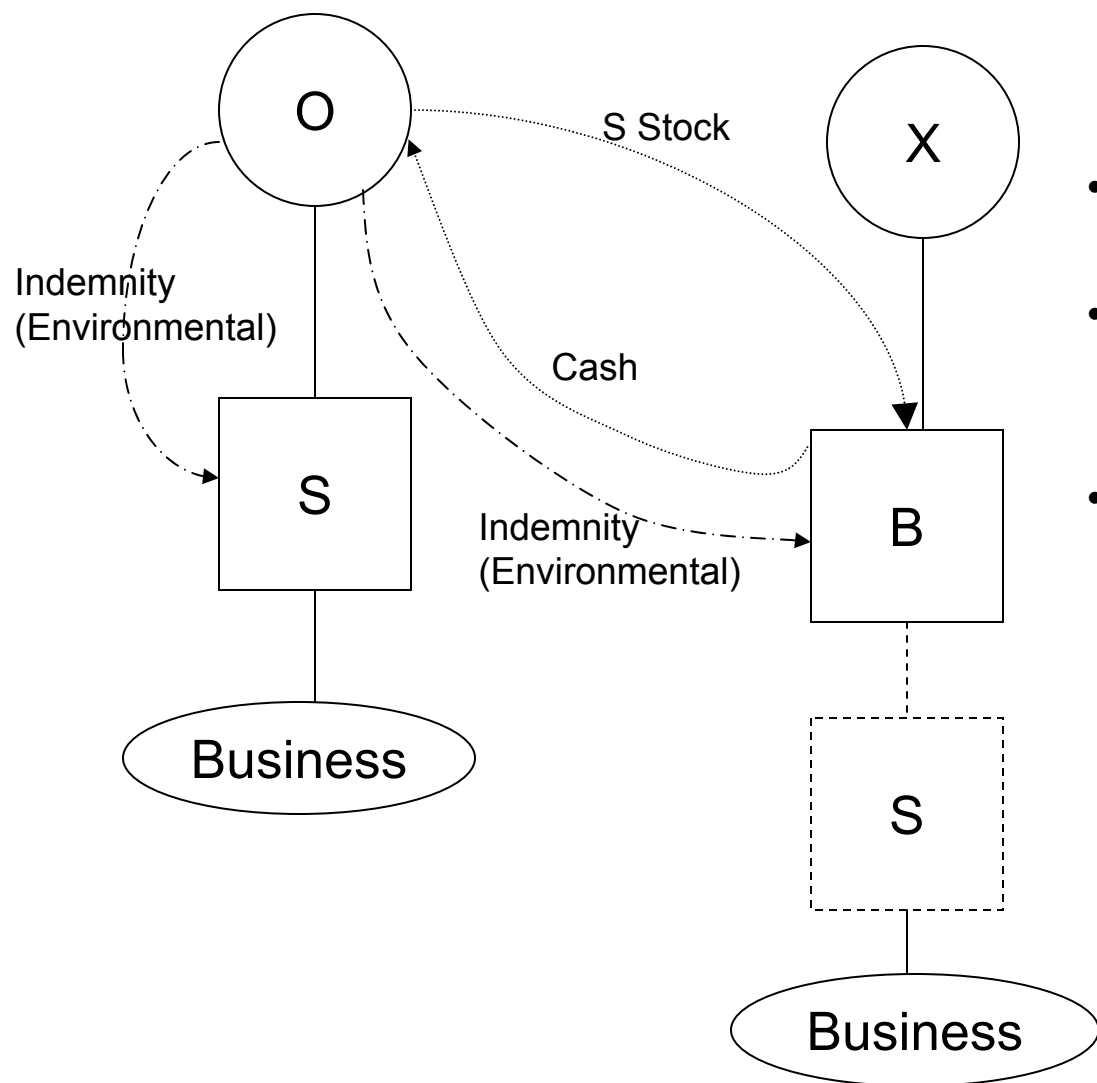
### Tax-free type-A reorganization with shareholder indemnity



- S and B are corporations
- S is merged into B:
  - S transfers its assets to B
  - B assumes all of S's fixed and contingent liabilities
  - O's stock in S is cancelled
  - O receives 10% of the B stock in exchange for its S stock
- O agrees to indemnify B for environmental cleanup costs in excess of a fixed cap
- The disposition of S's contingent liabilities is the same as in Scenarios 6 and 7

## Scenario 9

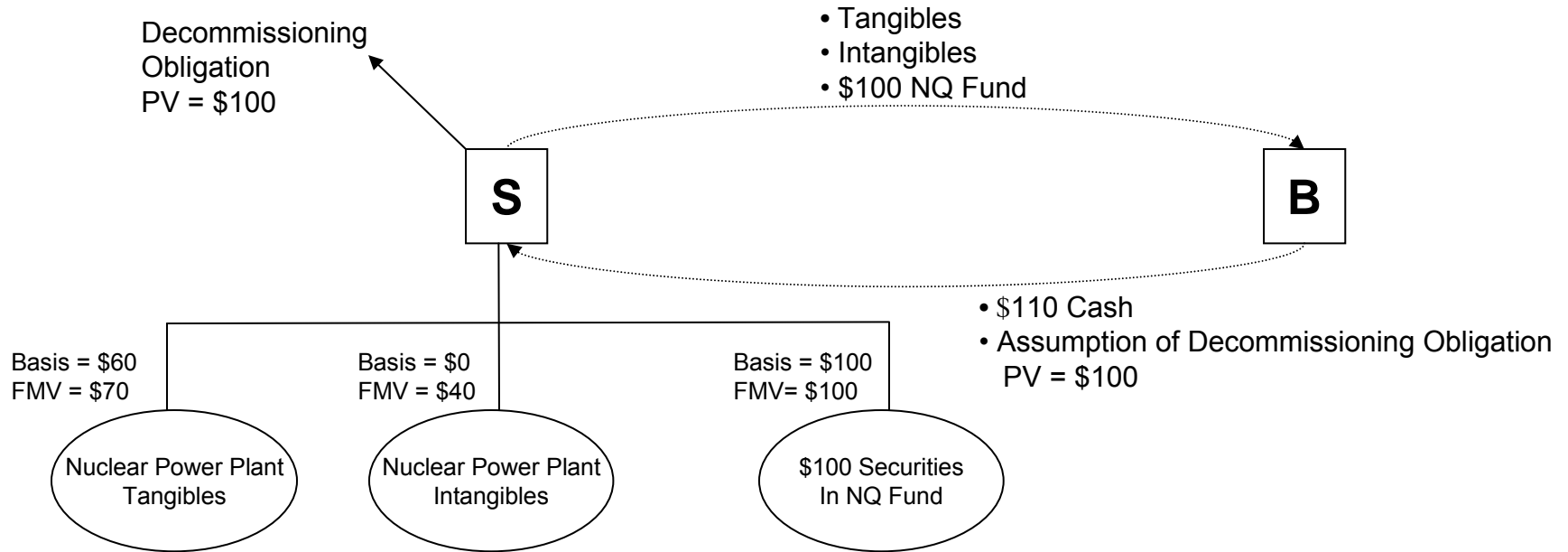
### Taxable sale of S stock for cash with indemnity



- O sells the stock of S to B for cash
- O agrees to indemnify S and B for environmental cleanup costs in excess of a fixed cap
- The disposition of S's contingent liabilities is the same as in Scenarios 6-8

# Another fact pattern

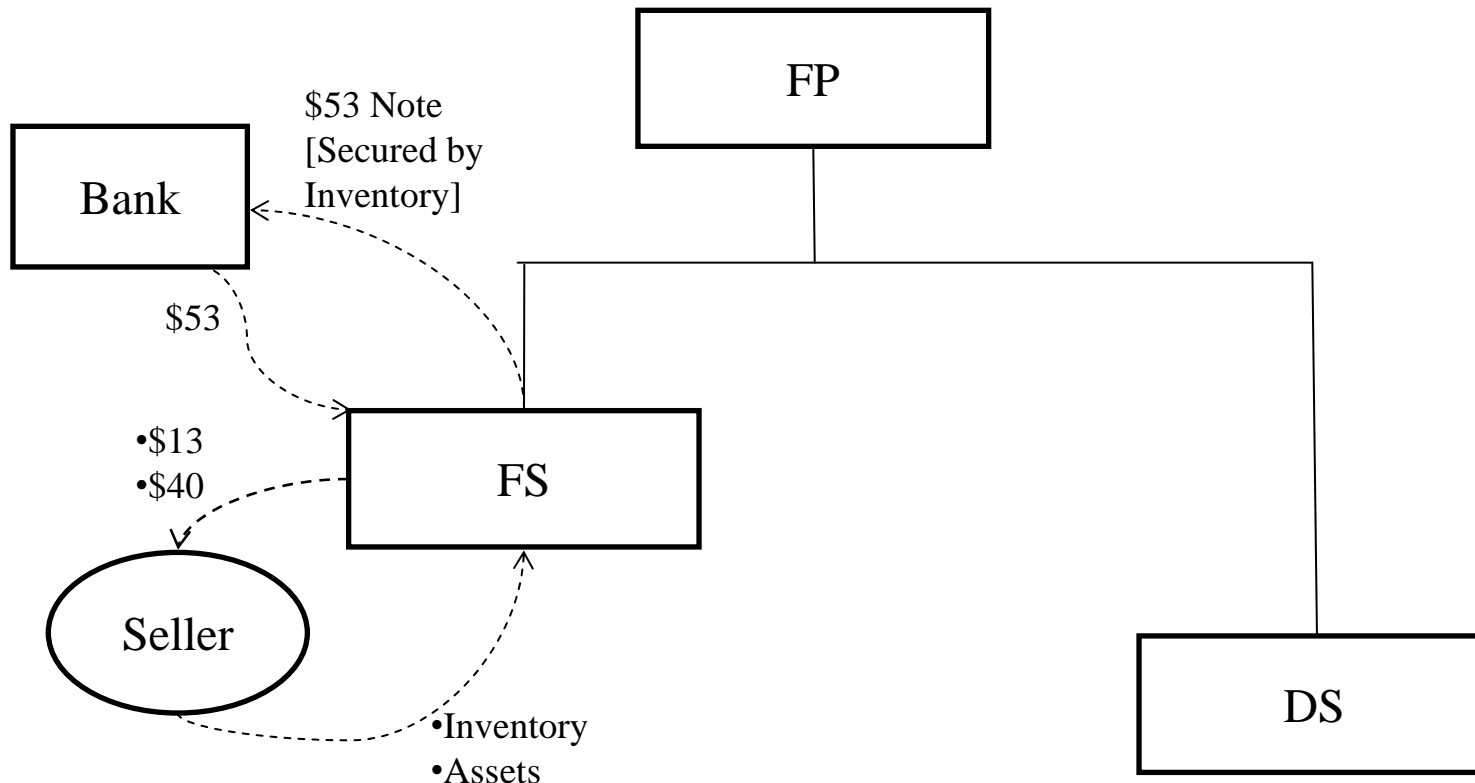
## Nuclear power plant decommissioning



1. S owns a nuclear power plant.
    - S's basis in the tangible assets associated with the plant is \$60, and their FMV is \$70
    - S's basis in the intangible assets associated with the plant is \$0, and their FMV is \$40
    - It is expected that the plant, will be decommissioned in 2049. The out-of-pocket cost is expected to be \$500, and the present value of S's obligation to pay decommissioning costs is \$100
    - S has set aside marketable securities (\$100 basis and FMV) in a "nonqualified fund" to fund the decommissioning costs
  2. B buys the plant
    - S transfers the tangibles, the intangibles and the nonqualified fund to B
    - B pays S \$110 cash and assumes the decommissioning obligation
  3. Between the sale and 2049, the securities in the nonqualified fund accumulate FMV from \$100 to \$500
  4. In 2049, the plant is decommissioned at \$500 cost, paid out of the nonqualified fund
- See Reg. § 1.338-6(c)(5).

## **Other Recent Cases of Note**

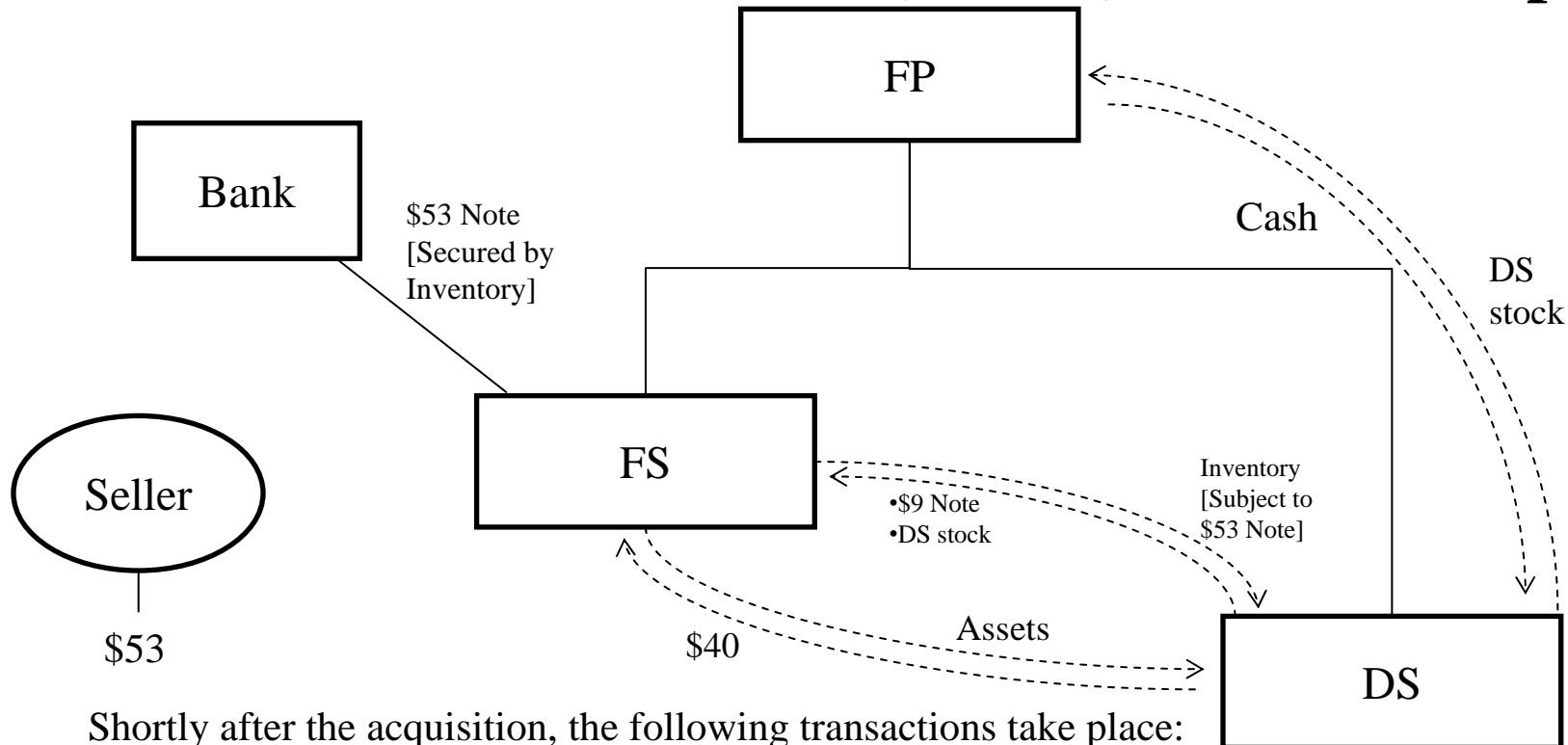
# *Flextronics America, LLC v. Commissioner,* **T.C. Memo 2010-45—Acquisition**



FP, a foreign corporation, has foreign subsidiary FS and U.S. subsidiary DS  
In 1998, FS acquires a factory (Inventory and Assets) from unrelated Seller:

- 1 Seller sells the factory to FS for \$53 cash (Inventory for \$13, Assets for \$40)
- 2 FS finances the acquisition with a \$53 loan from Bank, secured by Inventory

# *Flextronics America, LLC v. Commissioner,* T.C. Memo 2010-45 (cont'd)—Basis Bump



Shortly after the acquisition, the following transactions take place:

- 3 FS transfers Inventory to DS, subject to the \$53 note, for DS stock and a \$9 note
- 4 FP transfers cash to DS for additional DS stock
- 5 FS sells Assets to DS for \$40 cash
- 6 DS sells Inventory in the ordinary course of business and retains Assets

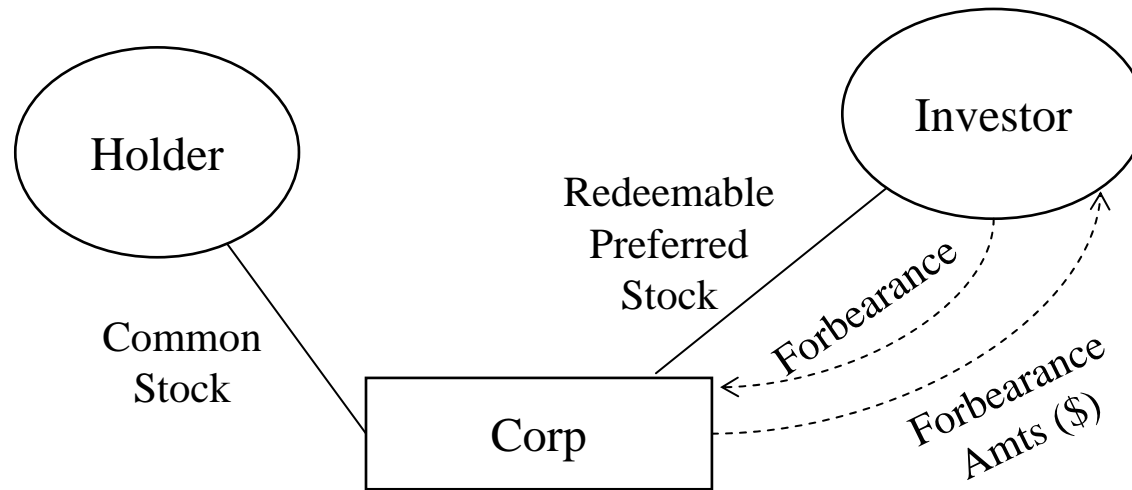
Does the transfer of Inventory by FS to DS qualify under section 351?

What is DS's basis in Inventory? Does it matter if the loan is paid by FS or DS?

See §357(c), amended in 1999, and §§357(d) and 362(d), enacted in 1999

Compare *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006)

## *Media Space, Inc., v. Commissioner, 135 T.C. No. 21*



- Investor owns redeemable preferred stock, amounts payable if redemption is delayed
- Investor's preferred stock is due for redemption, but Corp does not have the necessary funds
- Corp and Investor reach agreement separate from Corp's charter
  - Investor forbears from demanding redemption
  - Corp continues to pay dividends and pays forbearance amounts higher than provided in charter
  - Corp will not redeem common stock before the preferred stock (restriction not in charter)

Is the forbearance amount deductible as interest?

Is the forbearance amount deductible as ordinary and necessary expense? If so, must it be capitalized?

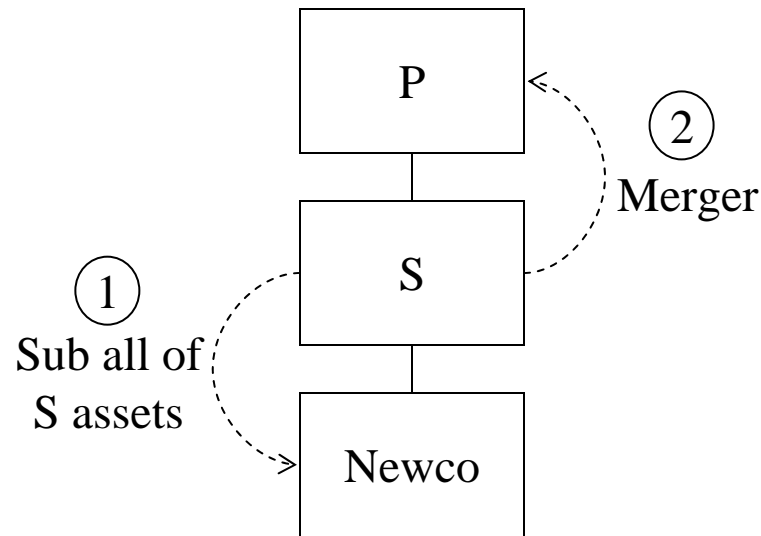
*See* Rev. Rul. 69-333 ("interest" on cumulative preferred dividends in arrears taxed as dividend);

GCM 39103 (Dec. 23, 1983) (rights in corporate charter vs. separate agreement)

# Tax-Free Acquisitions

Reg. 1.368-2(k)  
Step Transaction Issues  
Liquidation / Reincorporation  
“D” Reorganizations  
Nonqualified Preferred Stock

# What Is This Transaction?



- S transfers substantially all of its assets to Newco in exchange for Newco stock.
- S merges into P. S transfers its remaining assets and Newco stock to P.
- What is this transaction?
  - Downstream §368(a)(1)(D) reorganization with §§361/356 asset distribution to P?
  - §368(a)(1)(F) reorganization with §301 asset distribution to P? (What if S transfers all of its assets to Newco before the merger)?
  - §351 asset transfer to Newco followed by §368(a)(1)(A) merger? *See* PLRs 201026010 and 200733002.
  - Upstream §368(a)(1)(A) merger followed by §368(a)(2)(C) asset drop to Newco? *See* Rev. Rul. 58-93.
- What is P's basis in the Newco stock?
- Where do S's attributes end up?

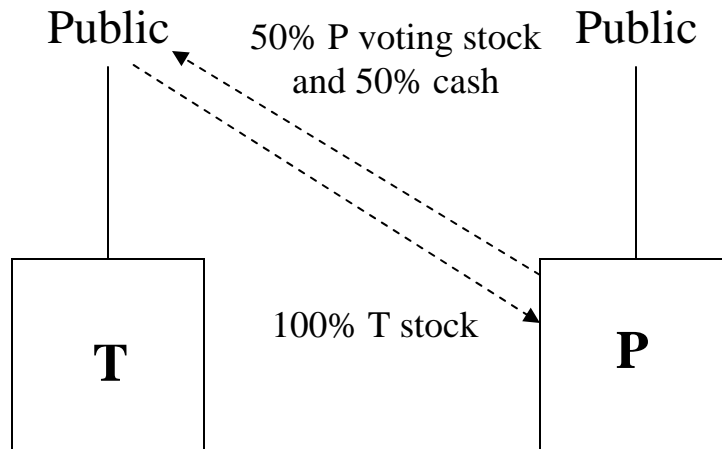
# Reg. 1.368-2(k)(1)

- 2007 version: “Except as otherwise provided in this section, a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) **shall not be disqualified** by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.”
- 2009 version: “A transaction otherwise qualifying as a reorganization under section 368(a) **shall not be disqualified or recharacterized** as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of §1.368-1(d) are satisfied and the transfer(s) are described in either paragraph (k)(1)(i) or (k)(1)(ii) of this section.”

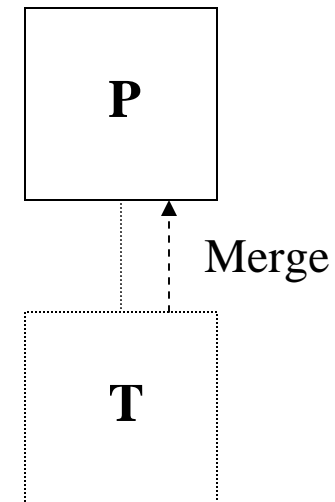
# Step Transaction Issues

# King Enterprises Transaction

## Step 1

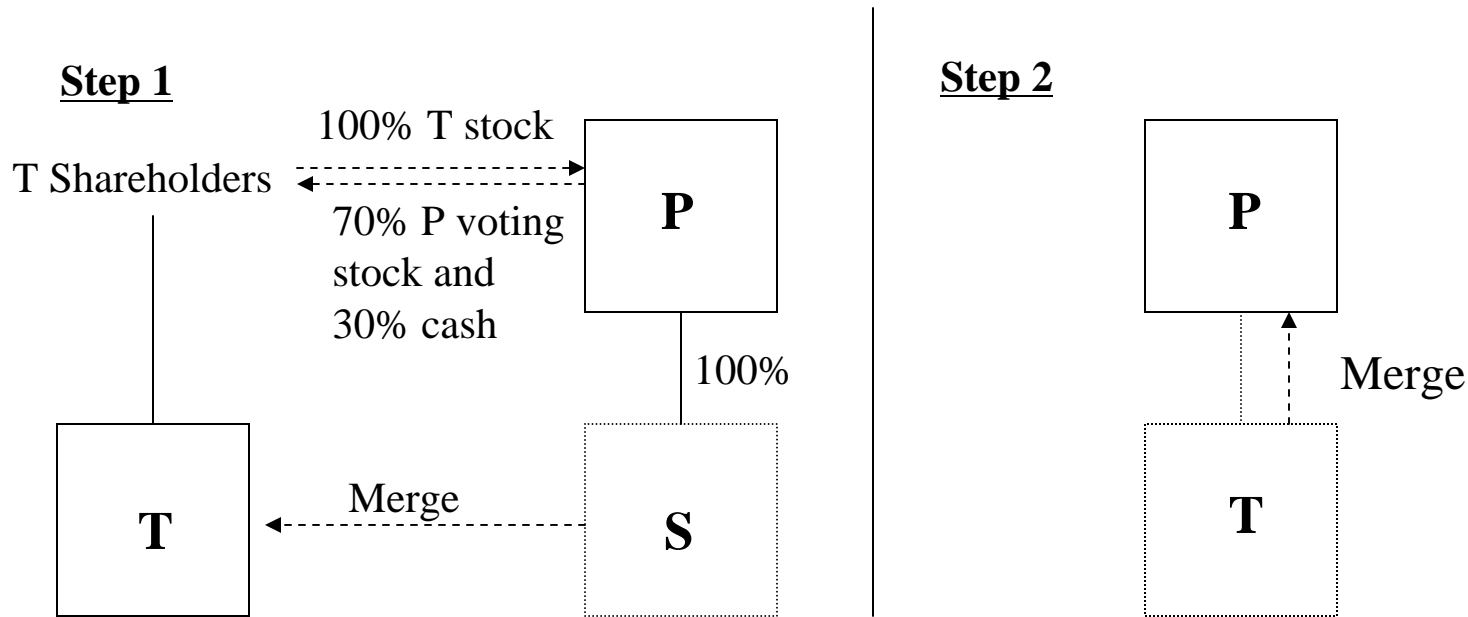


## Step 2



**Facts:** The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an “A” reorganization. *See King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-1 C.B. 1297 (May 11, 2001).

# Rev. Rul. 2001-46 - Situation 1



**Facts:** P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

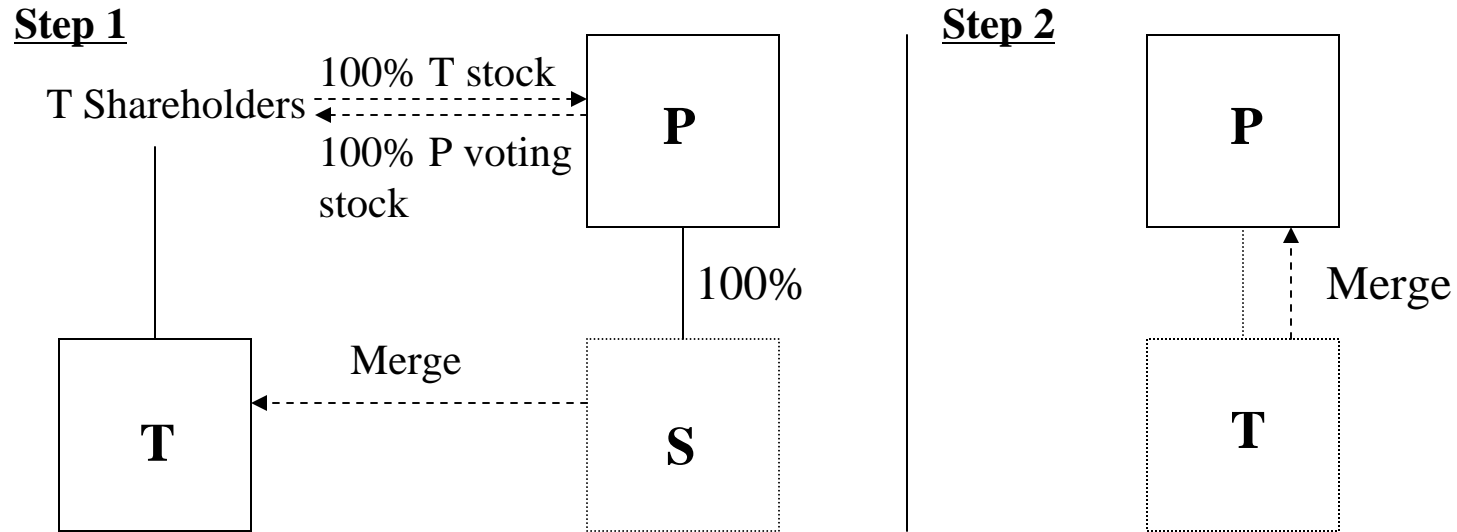
**Step vs. No Step:** If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. If step transaction principles applied, the transaction should be treated as a single statutory merger of T into P under section 368(a)(1)(A). See *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). If so, P would acquire the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

**Result:** On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T. In 2006, the Service finalized the regulations issued in 2003.

## Final Treas. Reg. § 1.338(h)(10)-1(c)(2), (e)

- The IRS issued final regulations on July 3, 2006, which adopted the substance of temporary regulations issued in 2003.
- The final regulations provide that “a section 338(h)(10) election may be made for T where P’s acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . ” Treas. Reg. § 1.338(h)(10)-1(c)(2).
  - This rule applies regardless of whether, under the step transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under section 368(a). Id.
  - If a section 338(h)(10) election is made under these facts, P’s acquisition of T stock will be treated as a qualified stock purchase (a “QSP”) for all federal tax purposes and will not be treated as a reorganization under section 368(a). See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 12 & 13.
  - However, if taxpayers do not make a section 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under section 368(a). See id. at Ex. 11.
- In issuing the final regulations, the IRS rejected a recommendation that the final regulations allow section 338(g) elections, as well as section 338(h)(10) elections, to turn off the step transaction doctrine, because extending the election as such would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a reorganization under section 368(a).
- The IRS stated in the Preamble to the final regulations that it would continue to study whether the corporate purchaser requirement of -3(b) should be amended (e.g., an individual cannot make a QSP, although an individual can form a corporation to satisfy the QSP requirement if that corporation is treated as purchasing the target stock, which it may not be if that corporation liquidates following the stock purchase).
- The final regulations are effective for stock acquisitions occurring on or after July 5, 2006.

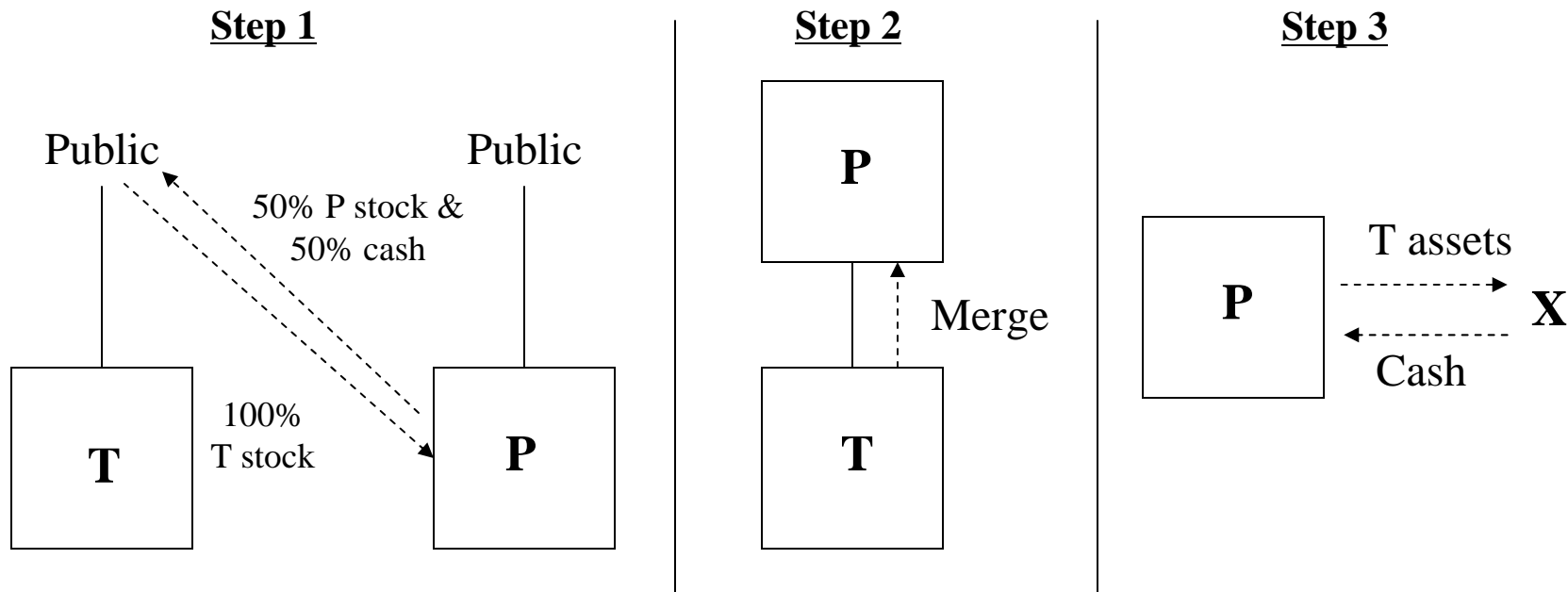
## Rev. Rul. 2001-46 - Situation 2



**Facts:** Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

**Result:** Step transaction principles apply to treat the transaction as a merger of T directly into P.

# King Enterprises Transaction - Variation



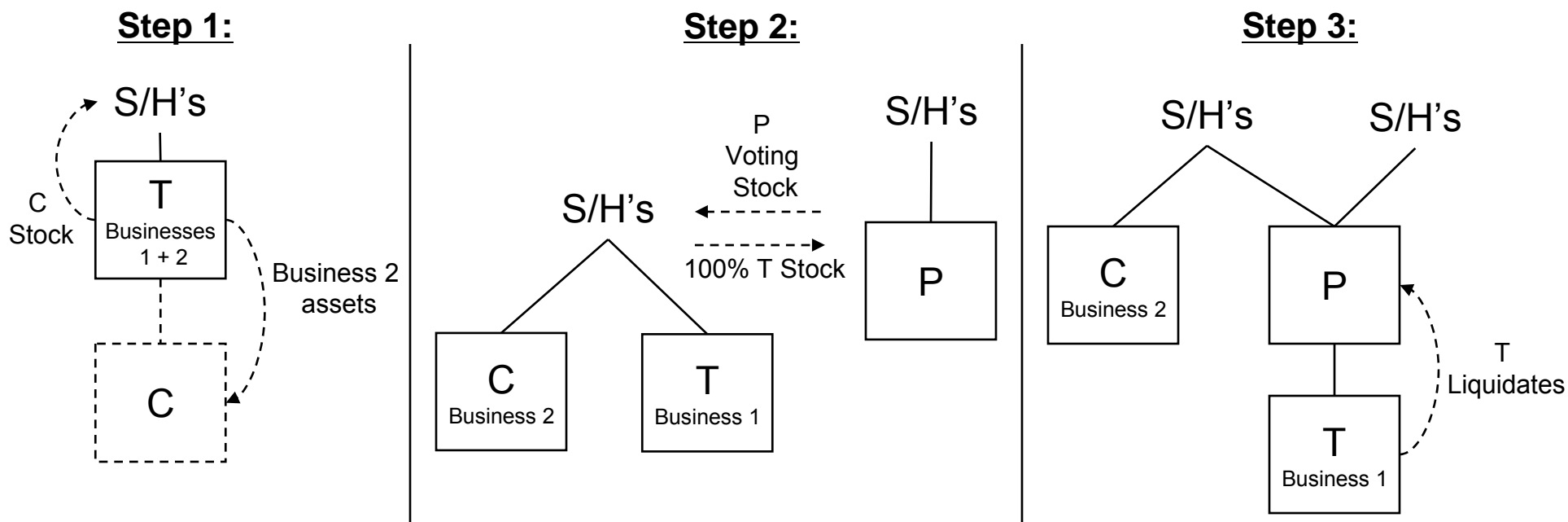
**Facts:** Same facts as in *King Enterprises*, except P sells T's assets to X a third party immediately after the merger of T into P.

**Questions:** (1) Does the Step-Transaction Doctrine apply?

(2) What is the result of this transaction for federal income tax purposes?

**Variation:** P shareholders exchange 100% P stock for T stock, and T sells its assets immediately after the reorganization.

# King Enterprises Transaction – Variation



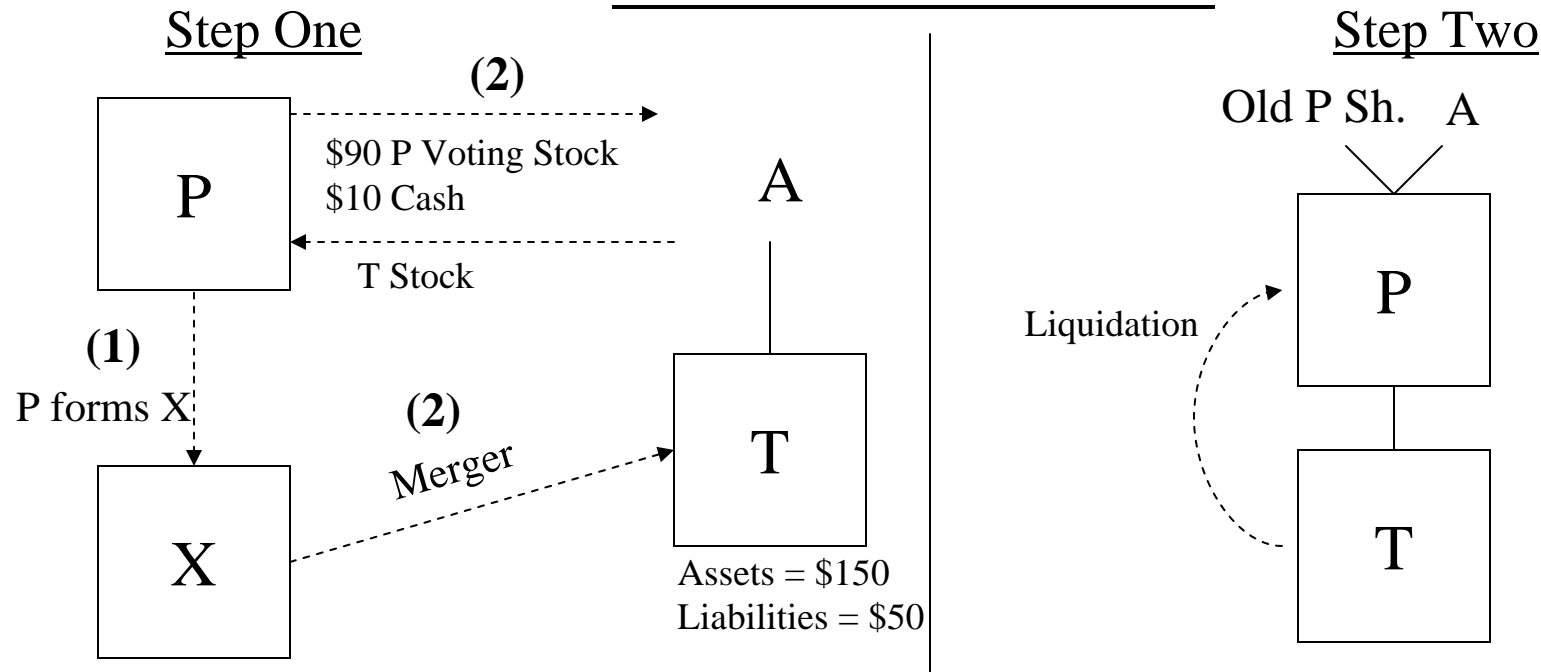
**Facts:** T currently operates two businesses. T contributes all of its Business 2 assets to C, a newly formed wholly owned subsidiary. T distributes the stock of C to T shareholders in a spin-off. P acquires T from the T shareholders in exchange for P stock. Immediately thereafter, T is liquidated into P.

**Form:** The above steps in form constitute a section 355 transaction, a B reorganization, and a section 332 liquidation.

**Result:** Step transaction principles apply to treat P's acquisition of T as if: (1) P acquired a portion of T's assets (Business 1) and (2) T liquidated. See Rev. Rul. 67-274; *Elkhorn Coal*. Under Rev. Rul. 67-274, P's acquisition of T is not a valid B reorganization. Because T liquidates into P, Rev. Rul. 67-274 combines the steps and treats the transaction as an acquisition by P of T's Business 1 assets. In this transaction, the acquisition does not qualify as a C reorganization because *Elkhorn Coal* steps together the spin-off and the acquisition such that P cannot be said to acquire substantially all of T's assets. Therefore, the transaction will be a taxable acquisition and not a tax-free reorganization.

**Issue:** Can P's acquisition of T be treated as a qualified stock purchase followed by a section 332 liquidation? See Rev. Rul. 2001-46; Treas. Reg. § 1.338-3(c)(1)(i), (2); Treas. Reg. § 1.338(h)(10)-1(c)(2), (e).

# Rev. Rul. 2008-25

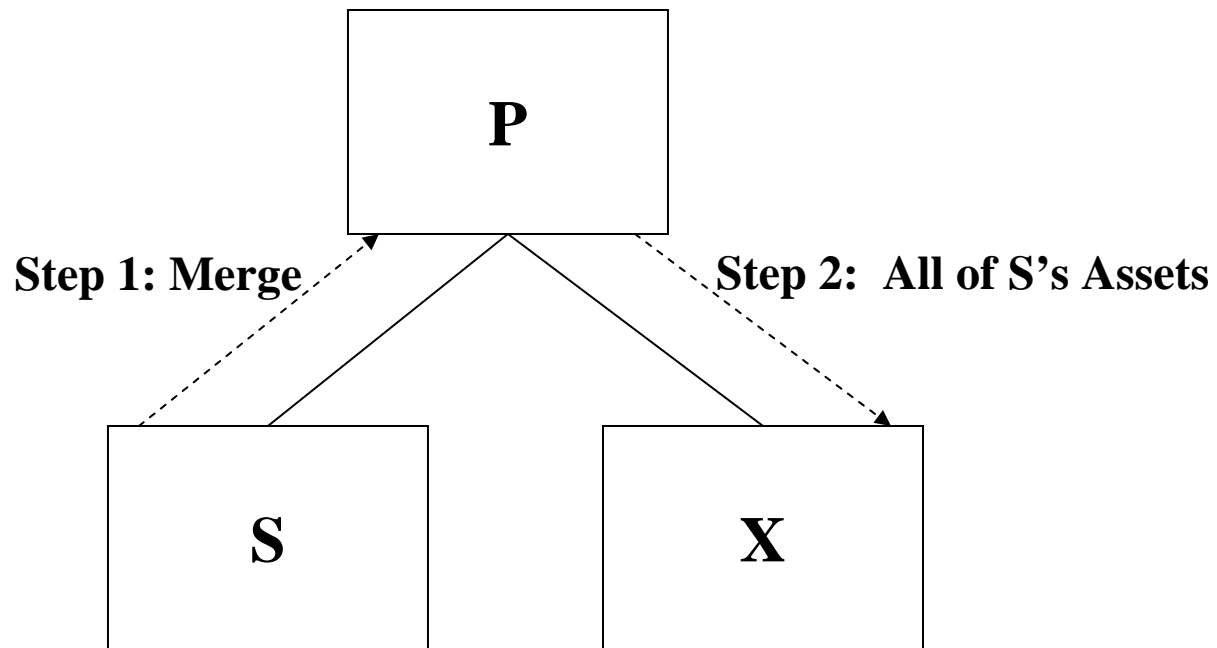


**Facts:** A, an individual, owns all of the stock of T. T holds assets worth \$150 and has \$50 of liabilities. P, an unrelated corporation, has net assets worth \$410. P forms X for the sole purpose of acquiring the stock of T in a reverse subsidiary merger. In the merger, P acquires all of the stock of T, and A exchanges the T stock for \$10 in cash and P voting stock worth \$90. Following the merger and as part of an integrated plan that included the merger, T completely liquidates into P. In the liquidation, T transfers all of its assets to P, and P assumes all of T's liabilities.

**Result:** The merger does not constitute a tax-free reorganization because T's liquidation does not fall within the safe harbor from the application of the step transaction doctrine (*i.e.*, Treas. Reg. § 1.368-2k). When the merger and liquidation are integrated, the transaction fails the requirements of a tax-free reverse subsidiary merger set forth in section 368(a)(2)(E) because T does not hold substantially all of its properties and the properties of the merged corporation. Moreover, viewing the merger and the liquidation as integrated steps does not cause the transaction to be treated as a tax-free "A", "C" or "D" reorganization or a section 351 exchange. For example, the transaction would not constitute a tax-free "C" reorganization because 40% of the consideration exchanged by P is not solely P voting stock (*i.e.*, \$50 assumption of liabilities and \$10 cash). The deemed taxable exchange of T assets to P would not permit P to obtain a cost basis in the T assets because Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d) reject the step transaction approach in so far as a taxpayer may obtain a cost basis in assets acquired in a stock purchase in absence of a section 338 election.

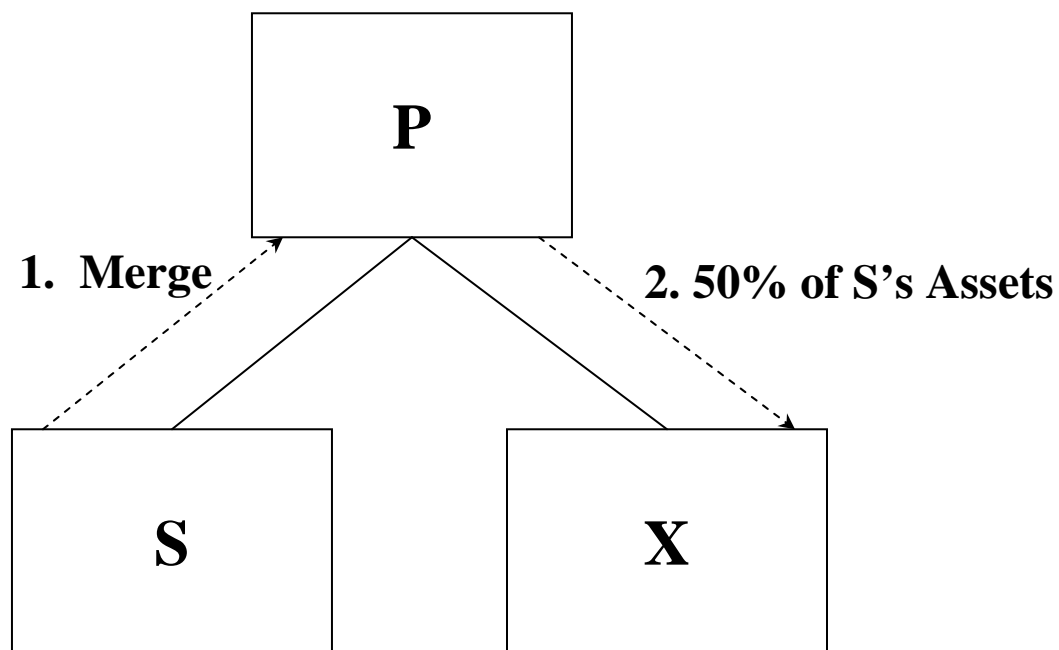
Liquidation / Reincorporation:  
Rev. Rul. 69-617

## Rev. Rul. 69-617



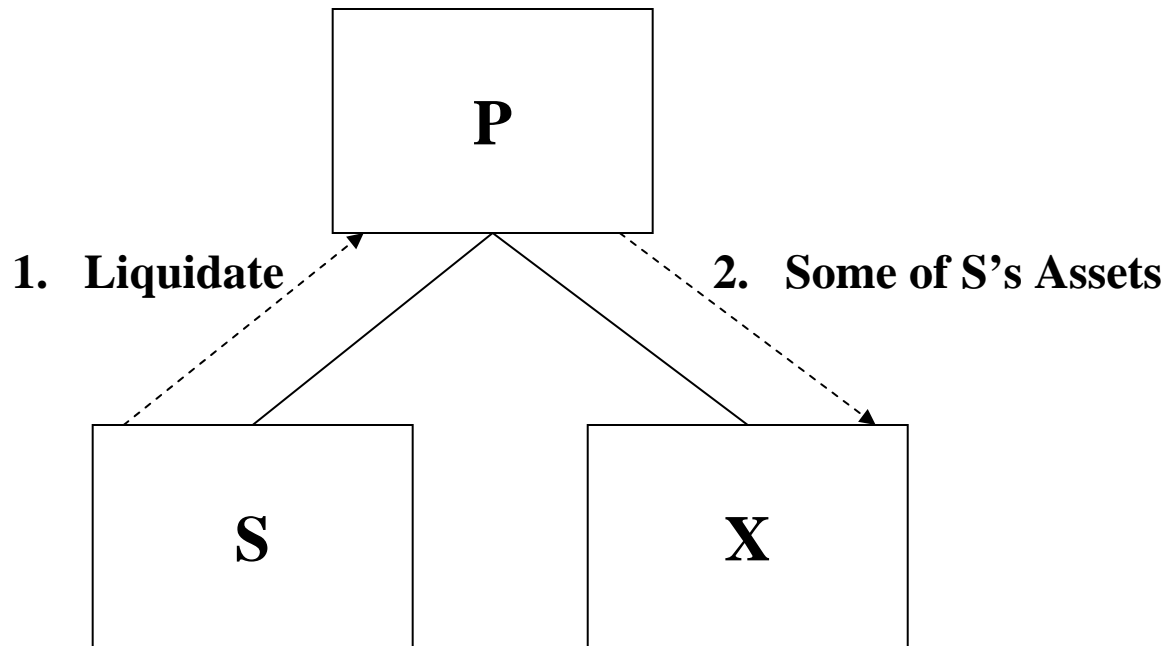
**Facts:** P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers all of the assets received from S to X.

## Rev. Rul. 69-617 (Variation)



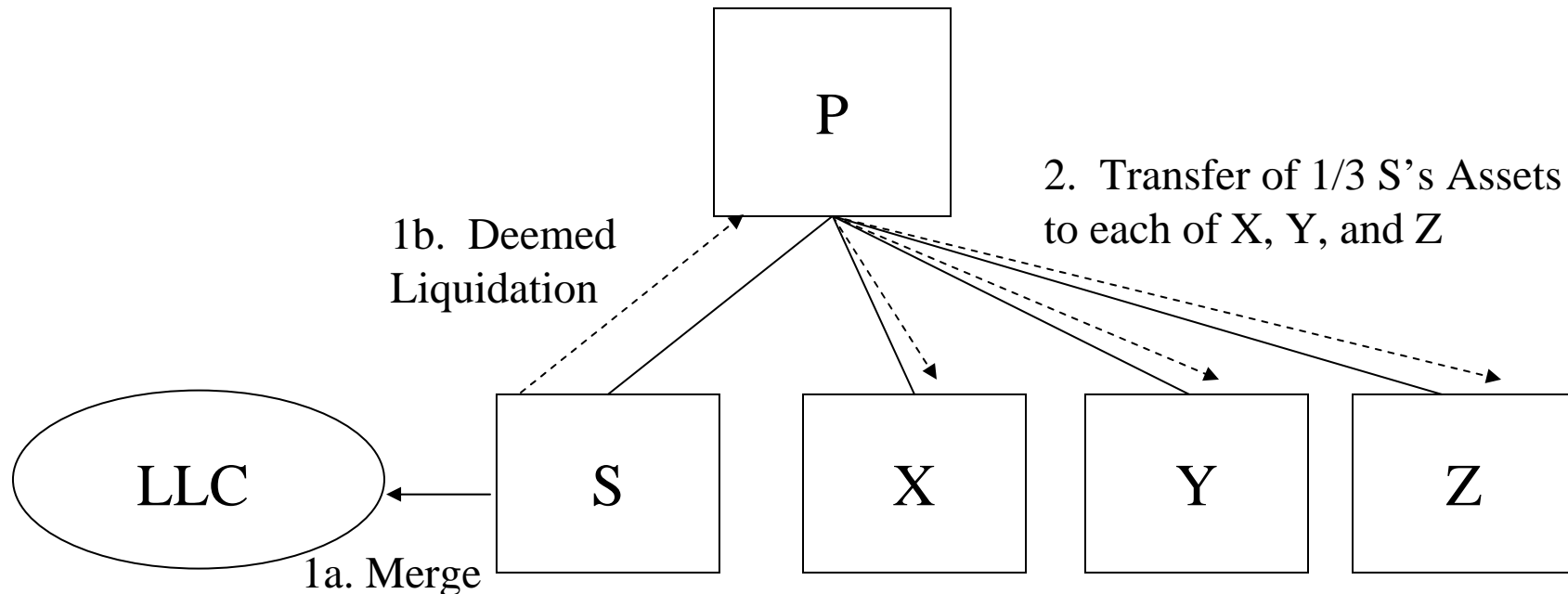
**Facts:** P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers 50% of the assets received from S to X. Although this transaction appears to raise “liquidation/reincorporation” issues, private letter rulings allow the partial drop of S’s assets to X following the Section 368(a)(1)(A) reorganization. See, e.g., PLR 9222059 (Jun. 13, 1991); PLR 9422057 (Mar. 11, 1994); PLR 8710067 (Dec. 10, 1986). These rulings rely on Rev. Rul. 69-617 and treat the transaction as a merger followed by a Section 368(a)(2)(C) drop of assets. At least one ruling would allow a double-drop of S’s assets following the reorganization. See PLR 9222059 (Jun. 13, 1991).

## Rev. Rul. 69-617 & The New Bausch & Lomb Regulations



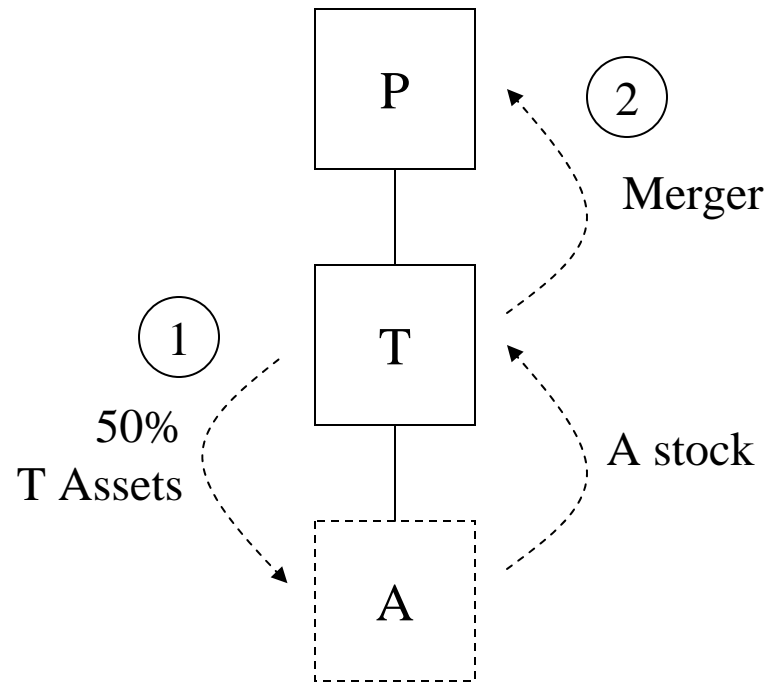
Facts: P owns all of the stock of S and X. S liquidates, distributing all of its assets to P. P then transfers some of the assets received from S to X. Can this transaction be treated under the analysis of Rev. Rul. 69-617 as a C reorganization followed by a drop of assets under Section 368(a)(2)(C), given the new Bausch & Lomb regulations? See Treas. Reg. Section 1.368-2(d)(4). What if X were a newly formed corporation?

## Rev. Rul. 69-617 (Variation) & The New Bausch & Lomb Regulations



Facts: P owns all of the stock of S, X, Y, and Z. S merges into an LLC created by P, causing a deemed liquidation of S for tax purposes. LLC then transfers 1/3 of S's historic assets to X, Y, and Z respectively. (P will be treated as transferring such assets to X, Y, and Z for tax purposes).

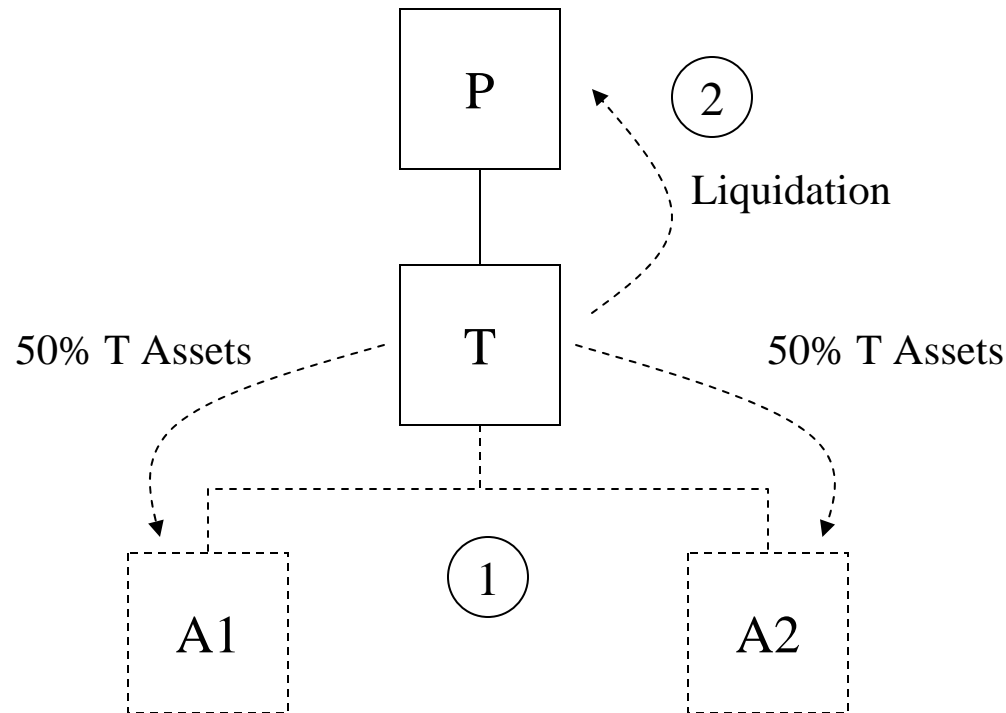
Rev. Rul. 69-617 vs. Drop & Upstream Merger  
PLR 200733002



**Facts:** P owns all of the stock of T. T drops 50% of its assets into a newly formed corporation (“A”) and merges up and into P.

**Result:** Can this transaction be treated as a valid upstream ‘A’ reorganization? See PLR 200733002.

# PLR 200733002 Variation -- Double Drop and Liquidation

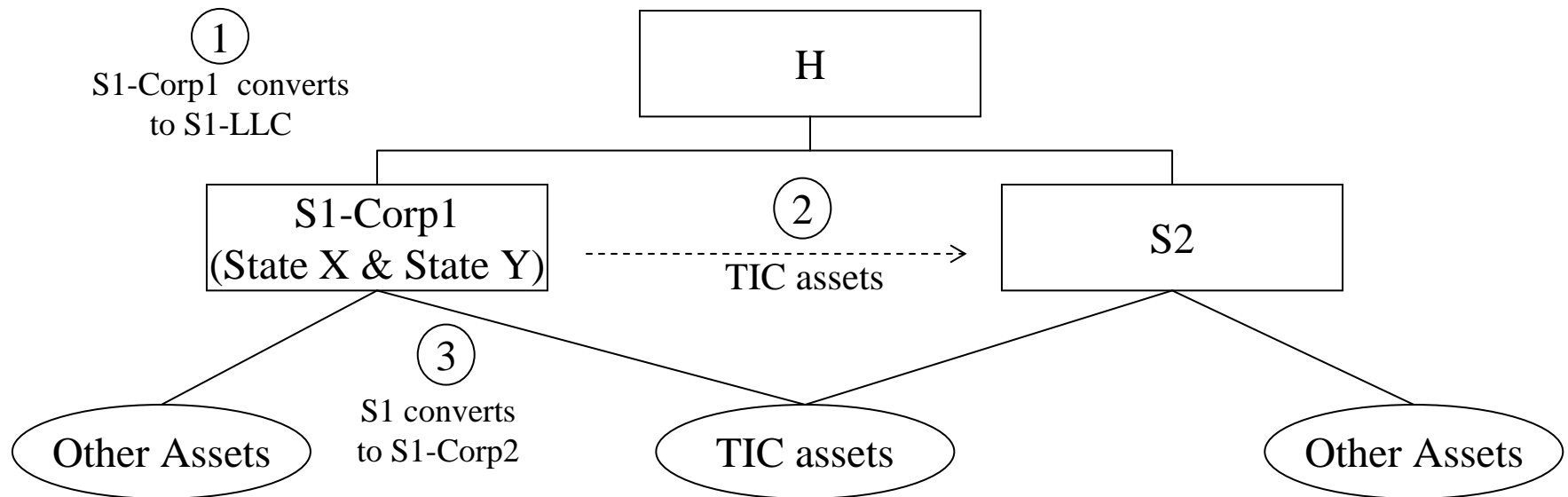


**Facts:** P owns all of the stock of T. T drops 50% of its assets into each of two newly formed corporation (“A1” and “A2”) and liquidates into P. The requirements of section 355 are not satisfied.

**Result:** What is this transaction? Can it be two section 351 exchanges followed by an upstream ‘C’ reorganization? What if the section 355 requirements are satisfied? What if the A1 transaction satisfies the section 355 requirements but not the A2 transaction? What if substantially all of T’s assets were transferred in one drop?

# PLR 200952032

## Liquidation-Reincorporation

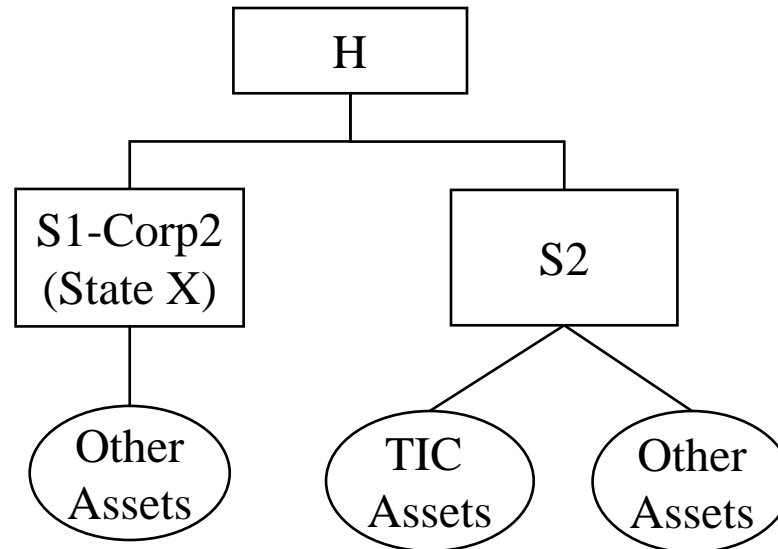


- H owns domestic corporations S1-Corp1 and S2
- S1-Corp1 and S2 hold assets as a tenancy-in-common (TIC) and other assets
- S1-Corp1 is incorporated in both State X and State Y
- H wants S1-Corp1 to transfer its TIC assets to S2 in a tax-free manner and eliminate S1-Corp1's State Y affiliation
- S1-Corp1 converts to State X S1-LLC, a disregarded entity
- S1-LLC transfers the TIC assets to S2 for no consideration
- S1-LLC converts to S1-Corp2, incorporated only in State X

# PLR 200952032

## Liquidation-Reincorporation (cont'd)

After Transactions:



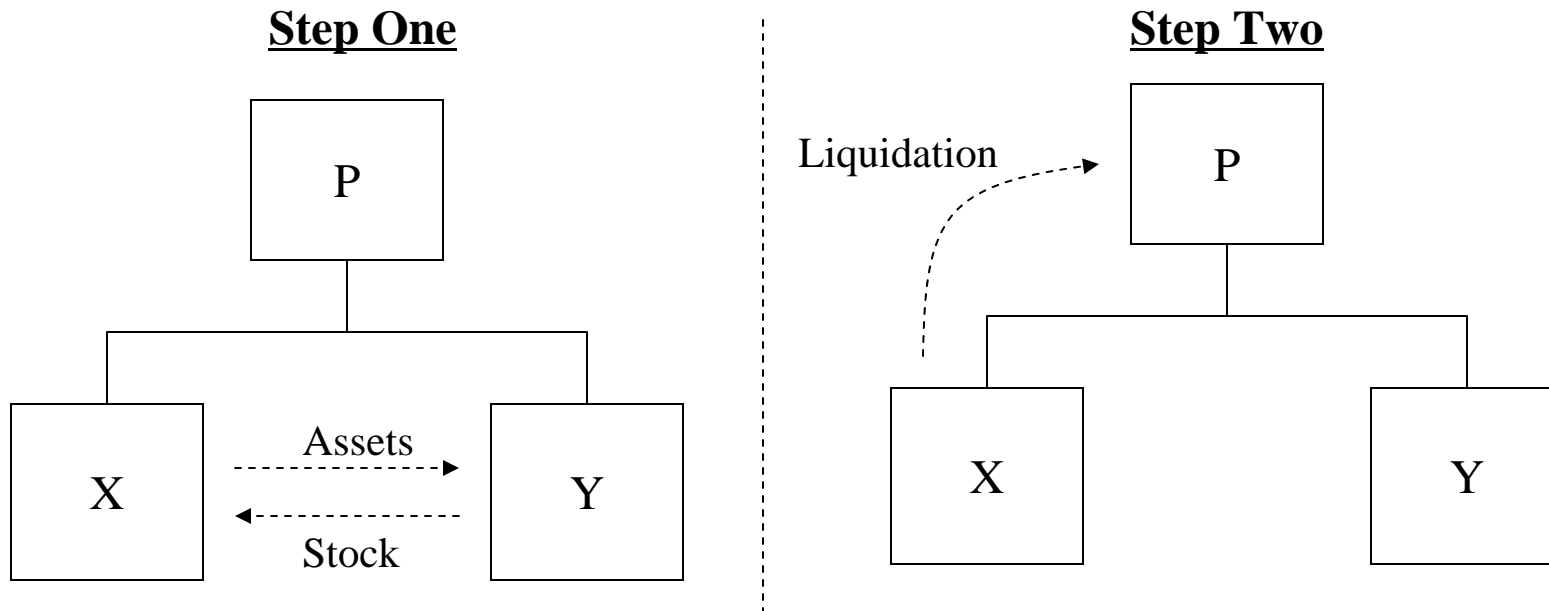
## PLR 200952032

### Liquidation-Reincorporation (cont'd)

- IRS rules that conversion of S1-Corp1 to S1-LLC is a transfer of substantially all of S1-Corp1's assets to H in deemed exchange for H stock, followed by deemed distribution of the H stock received by S1-Corp1 back to H in complete liquidation of S1-Corp.
  - Upstream type-C reorganization with two §368(a)(2)(C) asset drops, as in Rev. Rul. 69-617, 1969-2 C.B. 57.
  - PLR does not state whether S1-Corp's interest in the TIC Assets or its Other Assets constitutes “substantially all” of S1-Corp's assets.
- IRS rules that transfer of S1-Corp1's former interest in TIC Assets is §§351/368(a)(2)(C) transfer by H to S2.
- IRS rules that conversion of S1-LLC into S1-Corp2 is §§351/368(a)(2)(C) transfer of former S1-Corp1 Other Assets by H to S1-Corp2.
- Why is the transaction not an F reorganization with a distribution? *See* Treas. Reg. §1.368-2(k) (“shall not be recharacterized”); *But see TASCOCO v. Comm'r*, 63 T.C. 423 (1974), *aff'd without opinion*, 546 F.2d 423 (4th Cir. 1976).
- What if instead S1-Corp1 had converted to S1-LLC and transferred all its assets to a newco, without reincorporating? *See* §368(a)(1)(F) (“however effected”); Treas. Reg. §1.368-2(k).
- What if H is domestic and S1-Corp1 is foreign?

# “D” Reorganizations

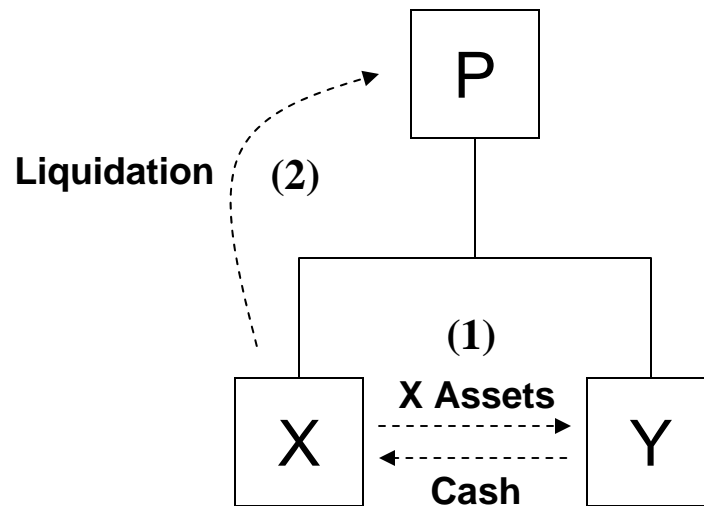
# 'D' Reorganizations – Stock



**Facts:** P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for stock. X then liquidates into P.

**Result:** This transaction qualifies as a tax-free 'D' reorganization under section 368(a)(1)(D). A transfer by one corporation (X) of substantially all of its assets to another corporation (Y) qualifies as a reorganization described in section 368(a)(1)(D) if, immediately after the transfer, one or more of the transferor corporation's shareholders (P) is in control of the acquiring corporation (Y), and if stock or securities of the acquiring corporation (Y) are distributed in a transaction which qualifies under section 354, 355, or 356. See Section 354(b)(1).

## 'D' Reorganizations – Cash – Rev. Rul. 70-240



**Facts:** P, X, and Y are corporations. P owns all of the stock of X and Y. X transfers all of its assets to Y in exchange for cash. X then liquidates into P.

**Result:** This transaction qualifies as a tax-free 'D' reorganization under section 368(a)(1)(D). In the transaction, X distributes substantially all of its assets to D and its shareholder (P) is in control of Y after the exchange. However, the requirement that stock or securities of the acquiring corporation (Y) be distributed is not technically satisfied. This requirement is treated as satisfied because a distribution of Y stock in this example would be a meaningless gesture. See Rev. Rul. 70-240; see also Rev. Rul. 2004-83.

# 'D' Reorganizations – Temporary Regulations

- On December 18, 2006, Treasury and the IRS issued temporary under sections 368(a)(1)(D) and 354(b)(1)(B) in response to requests for immediate guidance regarding whether certain all-cash acquisitive transactions can qualify as a 'D' reorganization. See Temp. Treas. Reg. § 1.368-2T(l).
- On March 1, 2007, Treasury and the IRS amended the temporary regulations so that certain related party triangular reorganizations that qualify as tax-free triangular reorganizations under section 368 would not be treated as 'D' reorganizations with boot under the temporary regulations.
- The temporary regulations provided that a transaction may be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) even if there is no actual issuance of stock and / or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions.
  - In such cases, transferee will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor's assets.
  - The nominal share of stock in the transferee will then be deemed distributed by the transferor to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee.

# 'D' Reorganizations – Final Regulations

- On December 17, 2009, Treasury and the IRS issued final regulations on the treatment of transactions as acquisitive 'D' reorganizations where no stock and/or securities of the transferee is issued and distributed in the transaction.
  - The final regulations also confirm the determination of basis in stock of the transferee and the treatment where the reorganization involves consolidated group members.
- The final regulations generally are effective for December 18, 2009 and apply the nominal share and deemed stock rule to transactions occurring on or after that date.
- Nominal Share and Deemed Stock Rule
  - The final regulations adopt the general approach set forth in the temporary regulations and deem the issuance of stock where no stock and/or securities is issued and distributed in the transaction, provided that the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee in identical proportions.
  - The final regulations clarify that the transferee will only be deemed to issue a nominal share if the transferor corporation receives full consideration in exchange for its assets.
  - In cases where no consideration is received, or the value of the consideration received is less than the fair market value of the transferor's assets, the transferee is treated as issuing stock with a value equal to the excess of the value of the assets over the value of the consideration received.
  - As under the temporary regulations, the final regulations provide that the nominal share or the deemed stock will be deemed to be distributed by the transferor corporation in satisfaction of the distribution requirement under section 354(b)(1)(B), and then further transferred through chains of ownership to reflect the actual ownership of the transferor and transferee.

# 'D' Reorganizations -- Final Regulations

- Nominal Share and Deemed Stock Rule (Continued)
  - The constructive ownership rules of section 318 apply with modification.
    - Section 318(a)(1) applies such that an individual and all members of his or her family described in section 318(a)(1) will be treated as one individual.
    - Section 318(a)(2) applies without regard to the 50-percent limitation in section 318(a)(2)(C).
  - De minimis variation in shareholder identity or proportionality of ownership is permitted.
    - The final regulations do not define what level of variation would be treated as de minimis, although an example does conclude that a 1% ownership in the stock of the transferee by an individual who owns no stock in the transferor is de minimis variation in identity and proportionality where the other three shareholders own 34%, 33%, and 33% of the stock of the transferor and each owns 33% of the stock of the transferee. See Treas. Reg. § 1.368-2(l)(3), ex. 4.
  - Section 1504(a)(4) stock is not taken into account.
  - Triangular Reorganizations
    - The nominal share and deemed stock rule does not apply to triangular reorganizations (i.e., transaction otherwise described in Treas. Reg. § 1.358-6(b)(2) or section 368(a)(1)(G) by reason of section 368(a)(2)(D).
  - These rules of application were included in the temporary regulations.

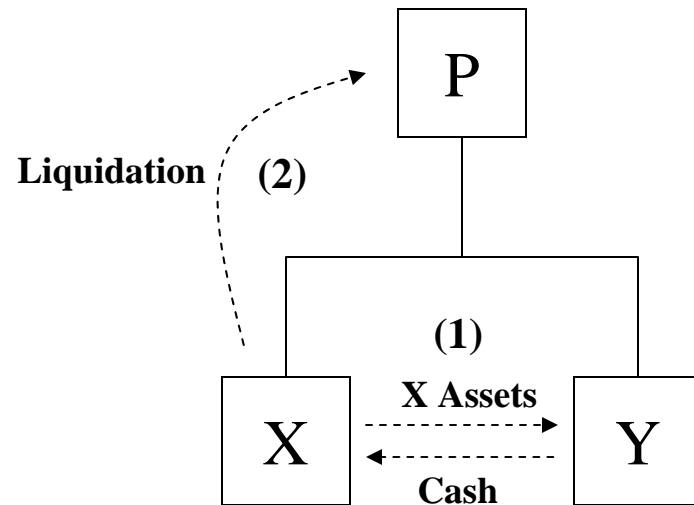
# 'D' Reorganizations -- Final Regulations

- Basis Allocation Issues
  - The final regulations did not adopt comments that would treat the nominal share as having tax significance solely to satisfy the distribution requirement in section 354(b)(1)(B).
  - Instead, the final regulations treat the nominal share as qualifying property for purposes of basis allocation and future stock gain or loss recognition.
  - The final regulations clarify that, in case of a reorganization in which the property received consists solely of non-qualifying property equal to the value of the assets transferred (as well as the nominal share), the shareholder or security holder may designate the share of stock of the transferee to which basis, if any, of the stock or securities surrendered will attach.
  - This is distinguished from current Treas. Reg. § 1.358-2(a)(2)(iii), which the preamble notes technically only applies to reorganizations in which no consideration is received or the value of the consideration received is less than the fair market value of the transferor's assets.
  - That regulation provides for a substituted basis in the stock deemed received followed by a deemed recapitalization for the shares actually held by the transferor immediately after the reorganization.

# 'D' Reorganizations -- Final Regulations

- Application of the Nominal Share and Deemed Stock Rule in Consolidation
  - The final regulations confirm that the nominal share will be given effect in connection with all-cash 'D' reorganizations involving consolidated return members.
  - Under the consolidated return regulations, an all-cash 'D' reorganization involving consolidated return members will result in a deemed issuance of stock by the transferee corporation followed by a redemption of the deemed stock for the consideration actually received in the exchange.
  - The final regulations confirm that, upon the deemed issuance and redemption, the remaining stock basis or excess loss account ("ELA") will shift to the nominal share.
  - Thus, gain or loss inherent in that basis or ELA may be triggered upon the deemed transfer of the nominal share through chains of ownership, subject to the intercompany transaction rules of Treas. Reg. § 1.1502-13.

## 'D' Reorganizations -- Direct Ownership

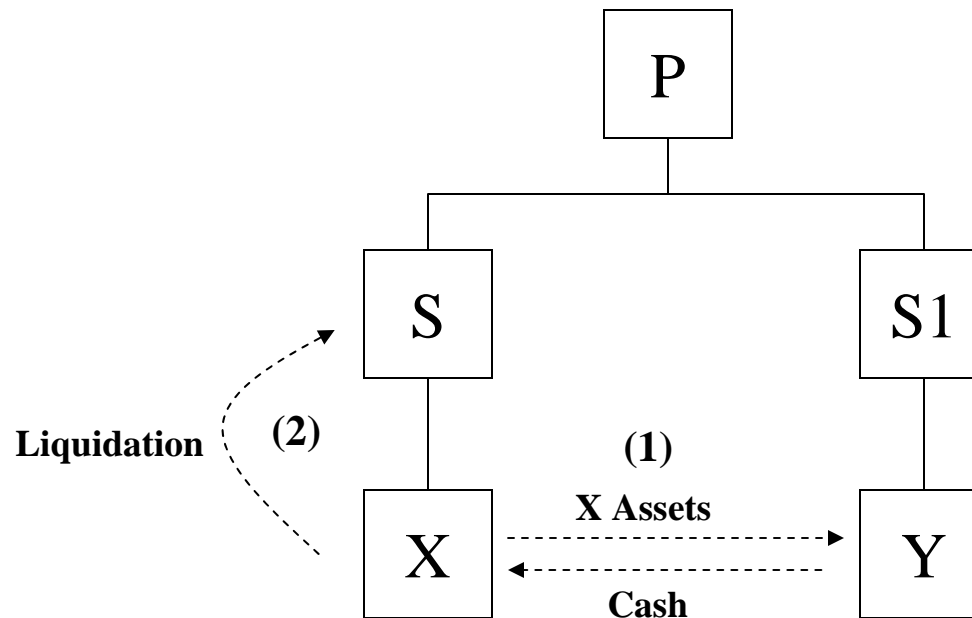


**Facts:** P owns all of the stock of X and Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into P.

**Result:** The transaction will be treated as a 'D' reorganization because the distribution of Y stock would constitute a meaningless gesture. See Rev. Rul. 70-240. Note that the same result would be obtained if P transferred X stock to Y in exchange for cash and, immediately thereafter, X liquidated into Y. See Rev. Rul. 2004-83.

The result does not change under the final regulations because there is complete shareholder identity and proportionality of ownership in X and Y. See Treas. Reg. § 1.368-2(l)(2); Cf. Treas. Reg. § 1.368-2(l)(3), ex. 1.

## 'D' Reorganizations -- Indirect Ownership



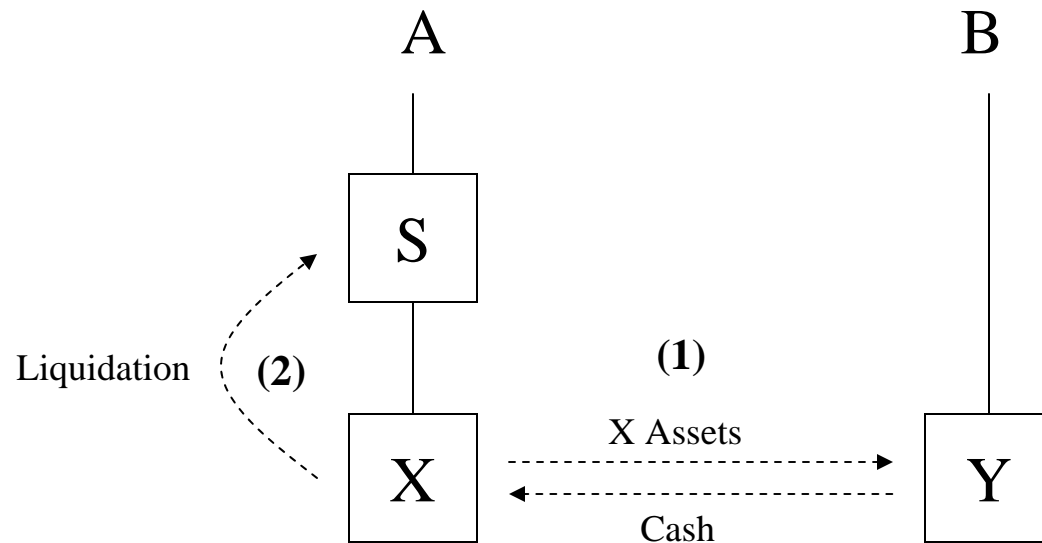
**Facts:** P owns all of the stock of S and S1. S owns the stock of X and S1 owns the stock of Y. X transfers its assets to Y in exchange for cash and immediately thereafter liquidates into S.

**Result:** The transaction will be treated as a 'D' reorganization under the 2006 temporary regulations because there is complete shareholder identity and proportionality of ownership in X and Y under section 318 principles. See Treas. Reg. § 1.368-2(l)(3), ex. 4. The nominal share of Y stock will be treated as going up to P and back down to S1.

In the consolidated return context, the following events are deemed to occur: (i) Y is treated as issuing its stock to X in exchange for X's assets; (ii) X is treated as distributing Y stock to S in a liquidation; and (iii) Y is treated as redeeming its stock from S for cash. See Treas. Reg. section 1.1502-13(f) and (f)(7), ex. 3.

The final regulations confirm that the remaining basis or ELA in the Y stock treated as redeemed will shift to the nominal share. What happens when the nominal share is treated as distributed from S to P and then contributed to S1?

# 'D' Reorganizations -- Constructive Ownership

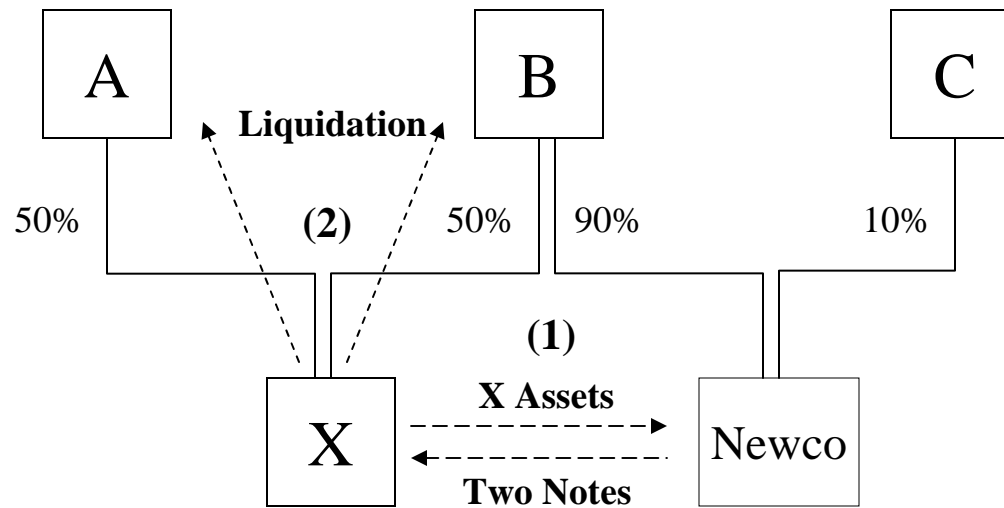


**Facts:** A and B are mother and son. A owns the stock of S which owns the stock of X. B owns the stock of Y. X transfers its assets to Y and immediately thereafter liquidates into S.

**Result:** Has there been a 'D' reorganization? Does S control Y after the transaction? Would a distribution of Y stock be a meaningless gesture?

The final regulations adopt the constructive ownership rules of section 318(a)(1) to treat A and B as the same person and, thus, there is complete shareholder identity and proportional ownership in X and Y. The transaction is treated as a valid "D" reorganization under the temporary regulations. See Treas. Reg. § 1.368-2(l)(3), ex. 2; See also PLR 9111055.

## 'D' Reorganizations -- PLR 200551018

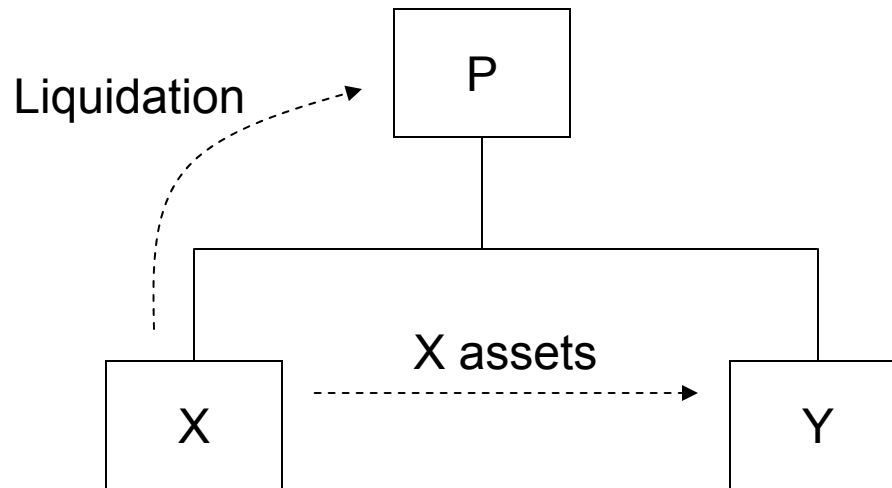


**Facts:** A and B own 50 percent of the stock of X. B and C own Newco, with B owning 90 percent and C owning 10 percent of the stock, respectively. X Corporation transfers its assets to Newco in exchange for two notes. Immediately thereafter, X liquidates, distributing one note to each A and B.

**Result:** PLR 200551018 assumes that the transaction does not qualify as a 'D' reorganization in holding that Newco is entitled to amortize the cost of goodwill acquired as a result of the purchase of X assets.

Under the final regulations, there is no shareholder identity and proportionality of ownership in X and Newco and, thus, this transaction does not qualify as a tax-free 'D' reorganization. See Treas. Reg. § 1.368-2(l)(3), ex. 6.

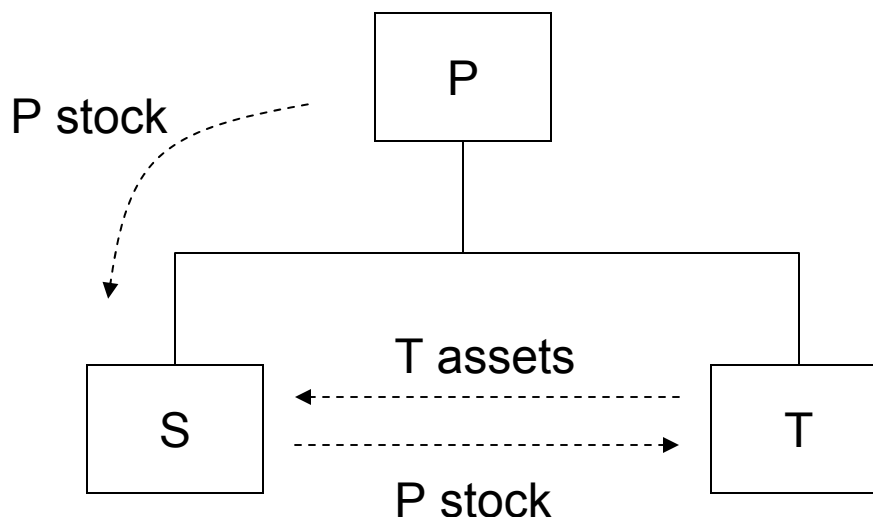
## Final Regulations – Deemed Stock



**Facts:** P owns all of the stock of X and Y. X transfers all of its assets to Y and then liquidates.

**Result:** This transaction should qualify as a 'D' reorganization because Y is deemed to issue stock to X in exchange for the X assets and X is treated as distributing the deemed stock to P in the liquidation. As a technical matter, the temporary regulations treated Y as issuing a nominal share in exchange for the X assets even though prior guidance suggested that Y would be treated as issuing deemed shares equal in value to X assets received in the exchange. The final regulations clarify that Y will be treated as issuing deemed stock rather than a nominal share.

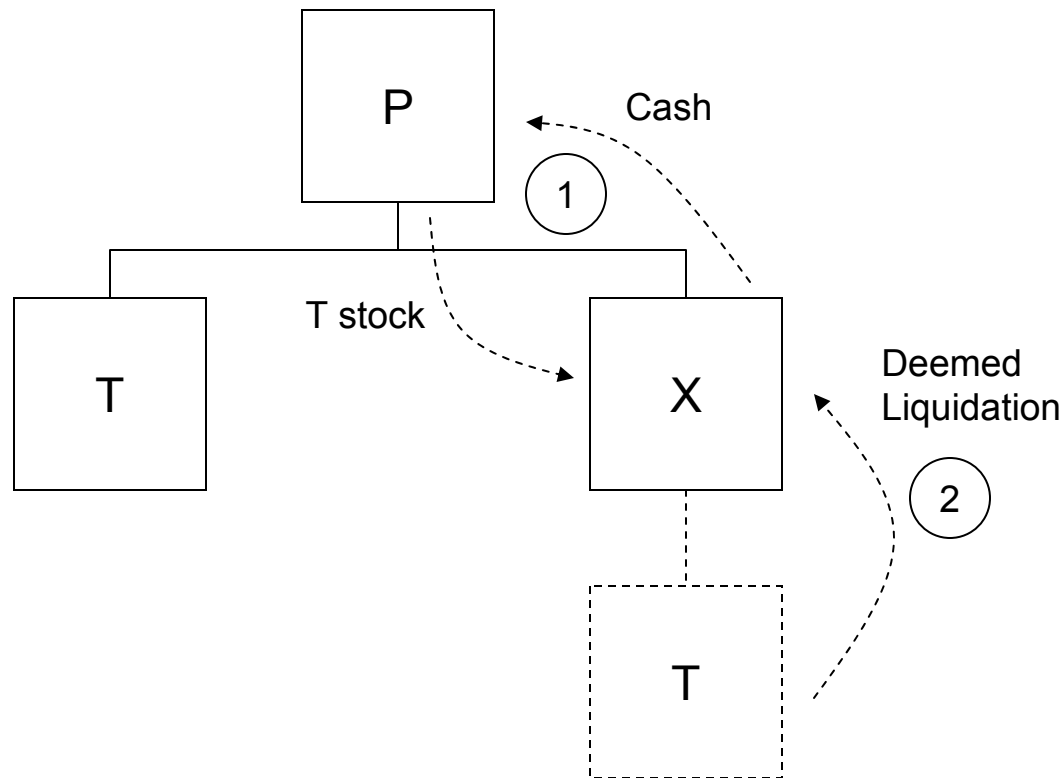
# Final Regulations -- Triangular Reorganizations



**Facts:** P owns all of the stock of S and T. T transfers substantially all of its assets to S solely in exchange for P stock and T liquidates.

**Result:** This transaction satisfies the technical requirements of a 'C' reorganization and is not treated as a 'D' reorganization by reason of the nominal share and deemed stock rules. Prior to the March 2007 amendment to the temporary regulations, this transaction was treated as a valid 'D' reorganization under the temporary regulations, even though no stock of the acquiring corporation, S, is transferred in exchange for T's assets. Because section 368(a)(2)(A) precludes the transaction from being treated as a 'C' reorganization if it also a 'D' reorganization, the temporary regulations would have treated the transfer of P stock as boot in a 'D' reorganization. The March 2007 amendment prevents this transaction from being treated as a 'D' reorganization under the temporary regulations. The final regulations retain this amendment. See Treas. Reg. 1.368-2(l)(2)(iv).

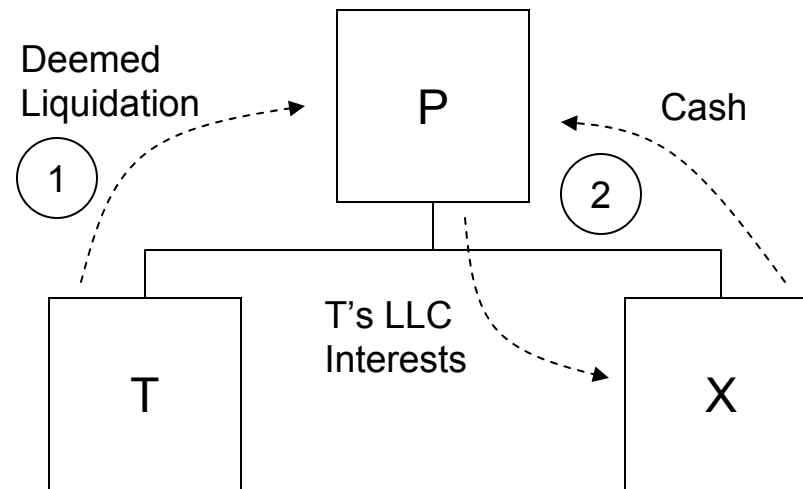
## 'D' Reorganizations – Stock Sale & Deemed Liquidation



**Facts:** P, T, and X are corporations. P owns all of the stock of T and X. P transfers the stock of T to X in exchange for cash. In connection with the transfer of stock, T elects to be treated as a disregarded entity for federal income tax purposes.

**Result:** This transaction qualifies as a tax-free 'D' reorganization under section 368(a)(1)(D). See Rev. Rul. 2004-83. T is treated as transferring its assets to X in exchange for X stock, which it distributes to P in a transaction described in section 356.

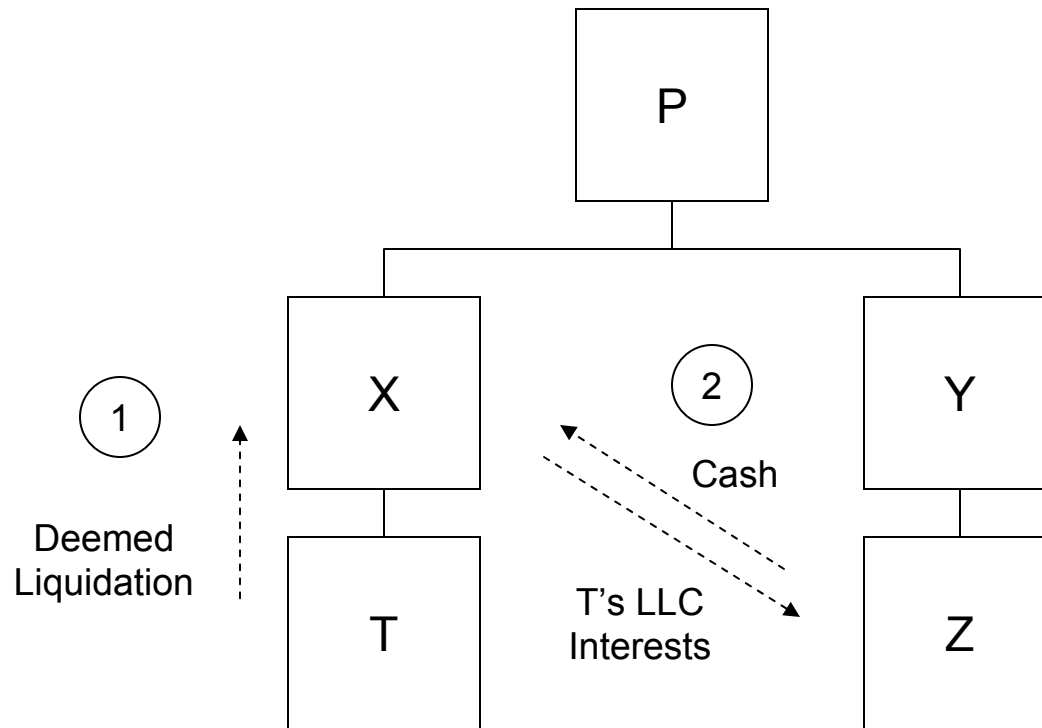
# Check-and-Sell Transaction



**Facts:** P, T, and X are corporations. P owns all of the stock of T and X. T checks the box to be treated as a disregarded entity and P sells T's LLC interests to X.

**Result:** Is the transfer treated as an asset transfer or a stock transaction? See *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004).

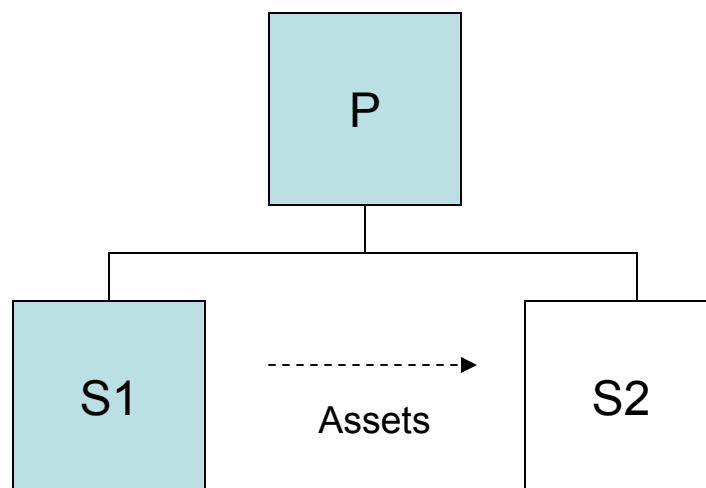
## Check-and-Sell Transaction – Variation



**Facts:** P, X, Y, T and Z are corporations. P owns all of the stock of X and Y, and X and Y own all of the interests in T and Z, respectively. T checks the box to be treated as a disregarded entity and X sells T's LLC interests to Z.

**Result:** Is the transfer treated as a liquidation followed by a sale? *See Dover Corp. v. Commissioner*, 122 T.C. 324 (2004). What result if X sells only part of its LLC interests in T?

## Cross-Chain Section 351 Exchange

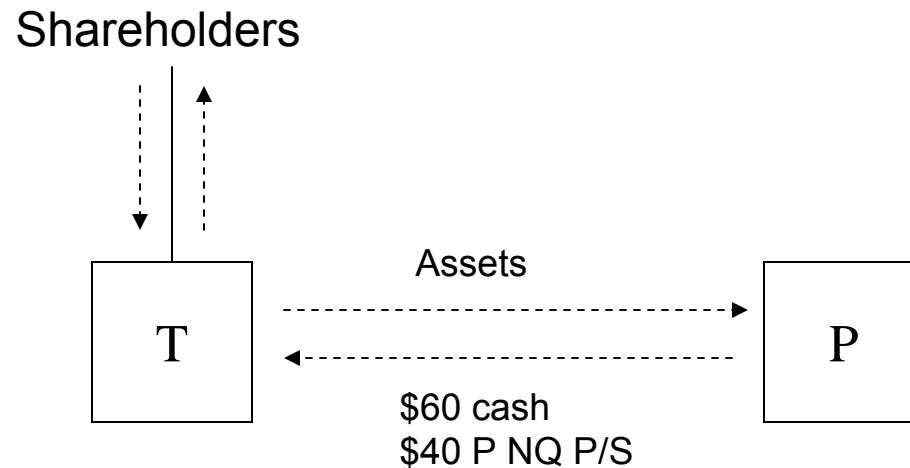


**Facts:** P owns all of the stock of S1 and S2. P and S1 are members of a consolidated group. S2 files a separate return. S1 transfers assets to S2 but does not receive stock or other consideration in exchange. S1 continues its business activities after the transfer of property.

**Result:** To qualify as a section 351 exchange, S1 must transfer property to S2 in exchange for stock and be in control of S2 immediately after the exchange. S1 satisfies the control requirement because it is treated as owning the S2 stock held by P, a member of its consolidated group under the consolidated stock attribution rule of Treas. Reg. § 1.1502-34. However, it is unclear whether S1 can satisfy the exchange requirement because it does not receive S2 stock in the exchange. Consistent with the final regulations on “D” reorganizations, should S2 be deemed to issue stock to S1, with the S2 stock distributed up to P?

# Nonqualified Preferred Stock in Reorganizations

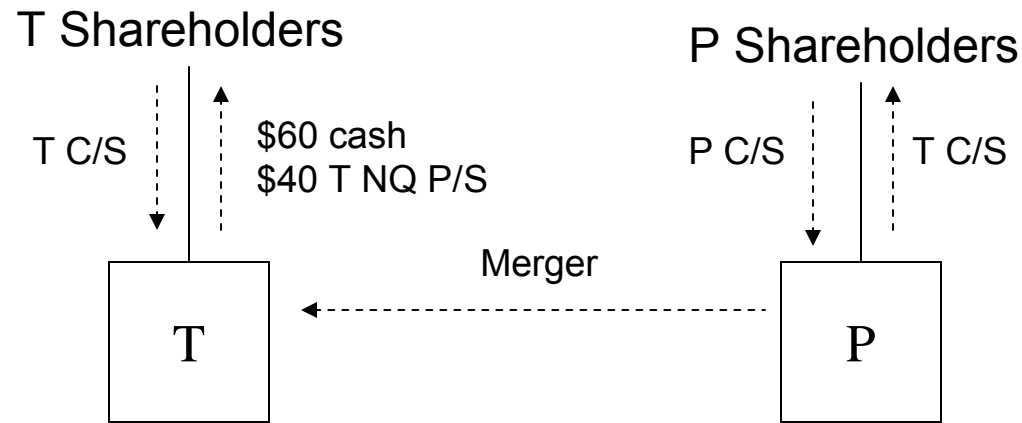
# Use of Nonqualified Preferred Stock – Example 1



**Facts:** T transfers all of its assets to P in exchange for \$60 cash and \$40 of P nonqualified preferred stock. T then distributes all of the consideration to its shareholders in cancellation of its stock.

**Result:** Can there be a tax-free reorganization? What is the result for T's shareholders?

## Use of Nonqualified Preferred Stock – Example 2



**Facts:** P merges into T. In connection with the merger, T's shareholders exchange their T common stock for \$60 cash and \$40 of T nonqualified preferred stock. P's shareholders exchange their P common stock for T common stock.

**Result:** Can there be a tax-free reorganization? What is the result for T's shareholders?