IV. TAX-DEFERRED ACQUISITION METHODS

For a sale-of-assets transaction, there are several tax structures that allow for tax-deferred treatment for the target corporation and its shareholders. Under Code section 361(c), the proceeds can be distributed on a tax-deferred basis to the shareholders. Similarly, under Code section 354(a), an exchange of stock in consideration for the target's assets is also tax deferred.

It is better to view the tax-deferred structures as corporate "marriages" rather than as typical asset sales. The two entities, the target or selling entity and the acquiring or purchasing entity, merge or consolidate without incurring an immediate tax consequence. To achieve this corporate union, the parties are allowed, under the tax law, to select any one of five possible tax-deferred reorganizations: Code section 368(a)(1)(A), 368(a)(1)(B), 368(a)(1)(C), 368(a)(2)(D), or 368(a)(2)(E). These reorganizations are commonly referred to as "A," "B," "C," "forward triangular," and "reverse triangular" mergers, respectively. Keep in mind, however, that the parties not only must successfully meet the specific tax rules under each section but also must comply with more general demands in the reorganization arena.

☛ It cannot overemphasized that failure to satisfy either the general reorganization rules developed by judicial authorities or the more specific reorganization provisions defined by statutory pronouncements will be fatal to a tax-deferred acquisition. The result will be a wholly taxable exchange triggering the typical sale-of-assets scenario tax consequences described in Chapter T-III.

Before reviewing the specific rules for the five types of tax-deferred reorganizations, the general requirements that apply to all five forms of reorganization should be reviewed. These four general requirements have been judicially crafted over many years of tax litigation and must be adhered to in all of the five types of reorganization. They are discussed below.

In addition, the IRS has issued temporary regulations, which also serve as the text of proposed regulations, that furnish guidance on how taxpayers can satisfy the COI requirements. These temporary regulations modify COI rules for corporate reorganizations.

In general, the new temporary regulations at T.D. 9316, Treasury Regulation 1.368-1T, and Preamble to Proposed Regulation 3-19-07, discuss the signing date rule, the definition of fixed consideration, shareholders' elections, contract modifications, and contingent consideration. The regulations are effective March 20, 2007, and apply to transactions arising under a binding contract entered into after September 16, 2005.

☛ The new temporary regulations should go a long way toward facilitating the COI requirement in acquisitions. For example, under the pre-2005 regulations, any contract modification automatically triggered a new signing date for the acquisition contract. The temporary regulations specifically state that such a modification will not trigger a new signing date if the terms of the original contract would have disqualified the acquisition as a reorganization under Code section 368.

Because of the scope and length of the regulations, only their major aspects are reviewed below:

- **Overview:** In cases in which the consideration to be tendered to the target corporation's shareholders is fixed in a binding contract and includes only stock of the issuing corporation and money, the issuing corporation stock to be exchanged for the proprietary interests in the target corporation would be valued as of the end of the last business day before the first date on which there is a binding contract to effect the potential reorganization (the signing date rule).

  Under the regulations, consideration is fixed in a contract if the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation. The signing date rule is based on the principle that, in cases in which a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.

- **Escrowed Stock:** There are three issues:
    1. **Pre-closing covenants:** As is common in reorganizations (of public or private companies) an escrow arrangement is employed to secure customary target representations and warranties. Such an arrangement will *not* violate the fixed consideration requirement. The regulations include pre-closing escrow arrangements (see Treasury Regulation section 1.368-1(e)(2)(iii)(C)(2), (D)).
    2. **Effect of escrowed consideration on satisfaction of COI:** Forfeited stock and forfeited non-stock consideration, even if to the issuing corporation, are *not* treated as determining whether the COI requirement is satisfied in the target corporation (see Treasury Regulation section 1.368-1(e)(2)(v)).
    3. **Revenue Procedure 84-42:** The final regulations on escrowed stock will not amend or rescind IRS Revenue Procedure 84-42 which authorizes the Treasury to issue private letter rulings on the placing of stock in escrow (see IRS Revenue Procedure 2005-3).
- **Anti-Dilution Provisions:** The presence of a customary anti-dilution clause in the contract will not violate the fixed consideration requirement. Absence of such a clause, however, *will* violate the fixed consideration caveat in cases in which the issuing corporation's capital structure is modified between the first date of the binding contract for the potential reorganization and the effective date of the binding contract for the reorganization (see Treasury Regulation section 1.368-1(e)(2)(iii)(E)).

    ☛ The final regulations fail to address restricted stock or variations of restricted stock. Planners are cautioned about treating such stock as "other consideration." The regulations merely indicate that the Treasury is continuing to consider the appropriate treatment of such equity on COI.

- **Contract Modifications:** Any contract modifications that relate to the amount or type of consideration the target shareholder will receive have the effect of commencing the running of the period as to a binding contract. The regulations also provide that any modification that provides for the issuance of additional shares of the issuing corporation's stock is *not* treated as a modification, provided that the executed reorganization would have resulted in a COI if there had been no such modification (see Treasury Regulation section 1.368-1(e)(2)(iii)(B)).

(ii) The facts are the same as in Example 2(i), except that the consideration placed in escrow consists solely of eight of the Purchaser shares and $12 of the cash. Because the contract provides for the number of shares of Purchaser and the amount of money to be exchanged for all of the proprietary interests in Target, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the Purchaser stock on January 2 of Year 1. Because, for continuity of interest purposes, the Target stock is exchanged for $32 of Purchaser stock and $48 of cash, the transaction preserves a substantial part of the value of the proprietary interest in Target. Therefore, the transaction satisfies the continuity of interest requirement.

EXAMPLE 3: Redemption of Stock Received Pursuant to Binding Contract

The facts are the same as in Example 1, except that Amanda owns 50% of the outstanding stock of Target immediately prior to the merger and receives 10 Purchaser shares and $30 in the merger and an additional 10 Purchaser shares upon the release of the stock placed in escrow. In connection with the merger, Amanda and Subsidiary agree that, immediately after the merger, Subsidiary will purchase any Purchaser shares that Amanda acquires in the merger for $1 per share. Shortly after the merger, Subsidiary purchases Amanda's Purchaser shares for $20. Because the contract provides for the number of shares of Purchaser and the amount of money to be exchanged for all of the proprietary interests in Target, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the Purchaser stock on January 2 of Year 1. In addition, Subsidiary is a person related to Purchaser. Accordingly, Amanda is treated as exchanging her Target shares for $50. Because, for continuity of interest purposes, the Target stock is exchanged for $20 of Purchaser stock and $80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in Target. Therefore, the transaction does not satisfy the continuity of interest requirement.

EXAMPLE 4: Modification of Binding Contract — Continuity Not Preserved

The facts are the same as in Example 1, except that on April 1 of Year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the Target shareholders will receive 50 Purchaser shares (an additional 10 shares) and $75 of cash (an additional $15 of cash) in exchange for all of the outstanding Target stock. On March 31 of Year 1, the value of the Purchaser stock is $0.50 per share. Although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Because the modified contract provides for the number of Purchaser shares and the amount of money to be exchanged for all of the proprietary interests in Target, the modified contract is a binding contract providing for fixed consideration as of April 1 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the Purchaser stock on March 31 of Year 1. Because, for continuity of interest purposes, the Target stock is exchanged for $25 of Purchaser stock and $75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in Target. Therefore, the transaction does not satisfy the continuity of interest requirement.

b. Treatment of Creditors

In light of increased numbers of corporate reorganizations to satisfy creditor demands in or out of a bankruptcy filing in 2008, the IRS issued new *final* regulations affecting corporations, creditors, and their shareholders effective on December 12, 2008.

IRS Treasury Decision No. 9434 provides final guidance regarding when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest (COI) is preserved in a reorganization.

These regulations, at new Treasury Regulation section 1.368-1(e)(6), state that:

> ... claims of the most senior class of creditors to receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (together, the senior claims) differently from the claims of classes of creditors junior to the senior claims (the junior claims). The final regulations treat such senior claims as representing proprietary interests in the target corporation. While such senior claims, and all junior claims, are treated as representing a proprietary interest in the target corporation, the determination of the value of the proprietary interests in the target corporation represented by the senior claims is made by calculating the average treatment for all senior claims. The final regulations provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims.

The effect of the new final regulations is that there is a 100% COI if each senior claim is satisfied with the same ratio of stock to non-stock consideration and no junior claim is satisfied with non-stock consideration. For further analysis see the IRS website **www.irs.gov**.

4. Step Transaction

An acquisition will not qualify for tax-deferred status if the transaction includes other "steps" which, viewed together with the acquisition, render the entire transaction not in compliance with the statutory, regulatory, and judicial requirements. This "step" transaction rule is one of the fundamental judicial doctrines in the tax law. In essence, the doctrine specifies that all the steps in a single transaction must be viewed as a whole in determining the substance of the transaction. Of concern for tax-deferred reorganizations, for example, is whether the antecedent transactions undertaken by the parties are "old and cold" or whether such transactions should be integrated with the acquisition. Another concern is whether the existence of a binding commitment to perform acts subsequent to a transaction requires that the subsequent acts be treated as part of the principal transaction.

EXAMPLE

In 1994, H.J. Heinz Credit Company (HCC), a subsidiary of the H.J. Heinz Company (Heinz) purchased 3.5 million shares of Heinz stock. In January, 1995, HCC transferred slightly more than 3.3 million shares of the shares back to Heinz in exchange for a convertible note.

This transaction was treated by Heinz as a non-pro rata redemption, taxable as a dividend, and HCC's basis in the redeemed shares was added to the remaining 175,000 Heinz shares that HCC retained.

In May 2005, HCC sold the 175,000 shares and, because of the increased basis from the non–pro rata redemption, declared over a $124 million capital loss which, on a consolidated basis, reduced Heinz' taxes in the carryback years of 1992, 1993, and 1994.

The IRS denied the capital loss of over $124 million, arguing that it lacked a business purpose and was a mere step transaction.

In agreeing with the IRS, the Court of Federal Claims found that the redemption was a mere sham, lacked business purpose, and violated the step transaction doctrine. The end result, noted the court in applying the step transaction doctrine, was that the initial acquisition of the Heinz stock by HCC and subsequent redemption were, in actuality, component parts or steps of a single transaction intended merely to obtain a desired tax result. See *H.J. Heinz Co. v. United States*, Ct. Fed Cl. 99 AFTR 2d (2007), which can be found online via the website **www.findlaw.com.**

- Merger transactions effected under the statutes of foreign jurisdictions or of a U.S. possession (that is, American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and the Virgin Islands), qualify as a section 368(a)(1)(A) statutory merger or consolidation, provided that such foreign jurisdiction statutes operate in material respects like those of the states.
- Stock acquisition of a target corporation followed by the conversion of the target corporation from a corporation to a limited liability company (LLC) under state law cannot qualify as a valid section 368(a)(1)(A) statutory merger or consolidation.

EXAMPLE 1

Acquirer acquires the stock of Target from the Target shareholders in exchange for consideration consisting of 50% Acquirer voting stock and 50% cash. Immediately after the stock acquisition, Target files the necessary documents to convert from a corporation to an LLC under state law. Acquirer's acquisition of the stock of Target and the conversion of Target to an LLC are steps in a single integrated acquisition by Acquirer of the assets of Target.

Since Target continues to exist as a juridical entity after the conversion, Acquirer's acquisition of the assets of Target does not qualify as a valid section 368(a)(1)(A) statutory merger or consolidation. See Regulation section 1.368-2(b)(1)(iii).

☛ It is crucial to note that the final regulations test the existence and composition of the transferee unit only immediately *after* the purported statutory merger or consolidation transaction and not before, as the following example illustrates.

EXAMPLE 2

Acquirer and Target, both corporations, own respectively 60% and 40% of Partnership, an LLC treated as a partnership for Federal income tax purposes. Pursuant to state law, Target merges into Partnership and simultaneously all the assets and liabilities of Target become the assets and liabilities of Partnership and Target ceases its separate legal existence. In the merger, the Target shareholders exchange their stock of Target for stock of Acquirer. As a result of the merger, Partnership becomes an entity that is disregarded as an entity separate from Acquirer for Federal income tax purposes.

Since all the assets and liabilities of Target, the combining entity and sole member of the transferor unit, become the assets and liabilities of the transferee unit of Acquirer, the combining entity of the transferee unit and Partnership, a disregarded entity that Acquirer is treated as owning immediately after the transaction, with Target ceasing its separate legal existence, this qualifies as a valid section 368(a)(1)(A) statutory merger or consolidation. See Regulation section 1.368-2(b)(1)(iii).

3. Section 368(a)(1)(C): Stock for Assets Reorganization

A reorganization under Code section 368(a)(1)(C), or "C" reorganization, consists of the acquisition by the acquiring corporation, in exchange solely for all or part of its voting stock (or of its parent's voting stock), of substantially all of the property of the target corporation. "Substantially all the property" has been held to mean at least 90% of the fair market value of the target's net assets and at least 70% of the fair market value of the target's gross assets immediately preceding the transfer. The principal advantage of a C reorganization is that the acquiring corporation acquires only those liabilities of the target that it chooses to assume. A major disadvantage is the requirement, under most state laws, that the target's shareholders approve the asset sale.

While cash is technically allowed in a C reorganization, the "boot relaxation" rule of section 368(a)(2)(B) means that although up to 20% of other property (including cash) can be treated as non-boot consideration, this amount must include all liabilities assumed.

☛ Things are often not as they appear. Because the 20% of other property *must* encompass liabilities assumed, there is little if any flexibility to provide cash as part of this 20% on a nontaxable basis.

Finally, despite posing as an asset acquisition, the C reorganization still requires the acquiring corporation to take a carryover basis in the acquired property.

M. American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (ARRA), which provides additional economic stimulus to spur recovery from the financial implosion in 2008, became law on February 17, 2009. ARRA includes specific tax provisions that affect businesses, as outlined below.

1. IRS Notice 2008-83, 2008-42 IRB 905, is repealed effective for any ownership change after January 16, 2009. After a change of ownership, Internal Revenue Code section 382, which limits the amount of the acquiring corporation's taxable income in a post-change year that can be offset with the target's pre-change losses, once again includes banks' losses on loans in its scope.

> ☛ Code section 382 is the so-called "built-in-losses" provision and IRS Notice 2008-83 allowed banks' losses on loans to be exempt from the definition of pre-change losses. This resulted in several banks skirting the limitations of Code section 382. After January 16, 2009, the provisions of section 382 will apply to acquisitions in the banking industry.

2. A bonus depreciation of 50% is allowed on property placed in service after December 31, 2008. Such property must be acquired and placed in service before January 1, 2010.
3. The rapid expensing limits under Code section 179 are increased to $250,000, and the investment ceiling limit is increased to $800,000, largely helping small businesses, effective through 2009.
4. For businesses with gross receipts of $15 million or less (again, small businesses), the net operating loss (NOL) carryback period is increased from two years to any whole number of years that is three, four, or five years in which the company paid a tax for tax years ending after December 31, 2007, where an NOL arises.

EXAMPLE

Company is a calendar-year small business with a 2008 NOL eligible for the new carryback provision. Assuming that Company had taxable income in 2005 through 2007, the 2008 NOL is carried back to 2005, then 2006, and finally 2007 (three-year carryback period), given the fact that Company had NOLs in 2003 and 2004 negating the four- or five-year carryback.

> ☛ Not all NOLs may be carried back. NOLs attributable to interest allocable to a corporate equity reduction transaction (CERT) are denied the carryback option. Because of certain technical rules involving CERTS, the new law should be consulted.

10. The $1.0 million compensation deduction per year of employee remuneration to the CEO, the CFO, and the three highest-paid other officers is reduced to $500,000.

☛ The scope of the new tax deduction limitation on remuneration is *broadened* from the limitation under the Troubled Asset Relief Program (TARP), which affects primarily financial institutions, to include *all* entities that take TARP assistance. Of course, as before, nothing prohibits a corporation from paying remuneration in excess of the $500,000 if it is willing to sacrifice the tax deduction of Code section 162(m)(5).

- Facilitating taxpayer convenience and compliance and compliance in the filing of tax returns and in other phases of tax administration;
- Avoiding duplicative taxation.

The MTC consists of compact members (states that have enacted the Multistate Tax Compact into their respective state law), sovereignty members (states that support the MTC via financial contributions but are not compact members), and associate members (states that participate in MTC activities but are neither compact nor sovereignty members).

In 2008, there were 20 compact members (including the District of Columbia), 7 sovereignty members, and 21 associate members. Three states were nonmembers. For a current listing of each state's status, see the MTC website at **www.mtc.gov**.