



Domestic Tax Free Mergers and Acquisitions TEI Breakfast Series

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General Concepts of Tax Free Acquisitions

- Acquirers: Sections 368 (Corporations), 351 (Corporations), and 721 (Partnerships).
- Reasons for Tax Free Combinations:
 - Sellers want to continue investment and carry over high value potential in combining businesses,
 - Buyer wants sellers to retain stake in the operations,
 - Inability or unwillingness of Buyer to fund a cash purchase.
- Reasons Against Tax Free Combinations:
 - Issuance of shares dilutes Ownership
 - Stock can be volatile; cash is king
- Many tax free acquisitions involve mergers. Simplest approach to force participation by all target shareholders.
- Tax free acquisitions can also be accomplished through a transfer of assets or transfer of shares.
- Tax free acquisitions can be structured with acquirer's stock and cash, with stock received tax free.

General Concepts of Tax Free Acquisitions

- Specific Requirements applicable to each provision form is important. Sometimes there is an overlap.
- Section 368 has seven approaches to tax free acquisitions, excluding E reorganizations (i.e, recapitalizations) and F reorganization (change in form). We will not cover the seventh form – G reorganization (Title 11 acquisition).
- Only 351 transfers is where the transferors must “control” the acquirer following the transaction. Other transactions allow the transferors/sellers to achieve tax free transfers without regard to their level of ownership in the acquirer.
- Compliance with a corporate law merger statute does not by itself qualify a transaction as a reorganization

Section 368 Acquisitions

- **Common Requirements to all Section 368 transactions.**
 - Continuity of Interest (“COI”). Reg. 1.368-1(e)
 - Substantial part of the value of the proprietary/equity interests in the target corporation must be preserved through an equity interest in acquiring corporation.
 - Character of Consideration Received in the Acquiring Corporation.
 - Stock of Acquiring Corporation is a key component. Voting/Nonvoting/Common/ possibly Preferred, but receipt of “nonqualified preferred stock” would be taxable. (Section 356(e)(1)).
 - At least 40% of the consideration received should be stock of the acquiring corporation. Reg. 1.368-1(e)(2)(v) Ex. 1. Compare 50% test of Rev. Proc. 86-42.

Section 368 Acquisitions - COI

- Source of Cash Consideration
 - Cash received by target shareholders solely from target corporation independent assets (See Reg. 1.368-1(e)(1)(ii), -1(e)(8) Ex. 9) versus cash received from acquiring corporation either directly or through borrowing funded by the acquiring corporation. This can surface in connection with redemptions of the shares of the target shareholders immediately prior to or soon after the acquisitions.
- COI requirement can be satisfied through limited group of target shareholders. Rev. Rul. 66-224. Not all target shareholders need to participate but need to satisfy corporate rule that all shareholders be treated equally.
- Target shareholders must receive acquirer’s shares in exchange for their target shares, and not in exchange for an amount owed as a creditor, except in G reorganization. See Alabama Asphaltic and Reg. 1.368-1(e)(6) in a title 11 or similar case.

Section 368 Acquisitions - COI

- Post-Acquisition Ownership
 - Target shareholders no longer need to have a post-acquisition an unrestricted right of ownership without a preconceived plan or arrangement for disposing the acquirer's shares. Numerous cases over the years applied the acceptable level of post-acquisition continued ownership. The IRS position had been that five years of unrestricted rights of ownership was sufficient. Rev Rul. 66-23.
 - Position abandoned in Reg. 1.368-1(e)(1)(i), -1(e)(8) Ex.1(i) and Ex.3. Now target shareholders do not need to own acquirer's shares for any specific time, provided that any transfer (or agreement to transfer) is to a person unrelated to the acquirer. Reg. 1.368-1(e)(8) Ex. Even a preexisting agreement to purchase the acquirer's shares (by someone other than the acquirer or related party) from the target shareholders is acceptable.

Section 368 Acquisitions - COI

- Historic Shareholders
 - Target shareholders no longer need to have been historic shareholders (old and cold) to engage in tax free acquisition. This was a problem where corporation whose shares were all acquired in a cash stock purchase was thereafter merged into another subsidiary corporation of the acquirer.
 - Position abandoned (in part) in Reg. 1.368-1(e)(i), -1(e)(8) Ex.1(ii) and 3, provided a "qualified stock purchase" occurs. Now target shareholders do not need to have held target shares for any specific time in advance of acquisitive reorganization in many cases. The same is also true where all target shares are acquired for cash by acquirer and target corporation is then merged into subsidiary of acquirer. Reg. 1.338-3(d)(2), -3(d)(5) Ex; Reg. 1.368-1(e)(8) Ex 4(ii).
 - Beware if less than all of the target shares are acquired for cash by the acquirer and then merge the target corporation into a subsidiary of the acquirer where only consideration issued is acquirer's stock. Reg. 1.368-1(e)(3), -1(e)(8) Ex. 2. Serious consideration must be given to continuity of interest requirement.

Section 368 Acquisitions - COI

- Date for Measuring Continuity of Interest. Reg. 1.386-1(e)(2).
 - Fluctuation in acquirer's shares public trading price from the signing date to the closing date can affect whether the requisite continuity of interest threshold is met.
 - Where the contract (including merger agreement) is considered a "binding contract" that provides for "fixed consideration," the value of the shares on the last day before the contract is binding can be used for purposes of continuity of interest consideration. Example: If cash consideration is just below 60% of the aggregate consideration on the merger signing date, reduction in acquirer's share value from contract date to closing date causes cash to represent more than 60% of the aggregate consideration. Application of this special rule allows 40% continuity of interest threshold level to be met in spite of post signing acquirer's share value reduction.

Section 368 Acquisitions – Common Requirements

- Business Purpose
 - Corporate business purpose versus shareholder business purpose.
 - Section 269(b). If principal business purpose is to avoid federal income tax, tax benefit resulting from combinations of corporations can be disallowed.
- Continuity of Business Enterprise ("COBE"). Reg. 1.368-1(d)
 - The acquiring corporation must either (i) continue the target corporation's historic business (**business continuity**) or (ii) use a significant portion of the target corporation's historic business assets in a business (**asset continuity**).

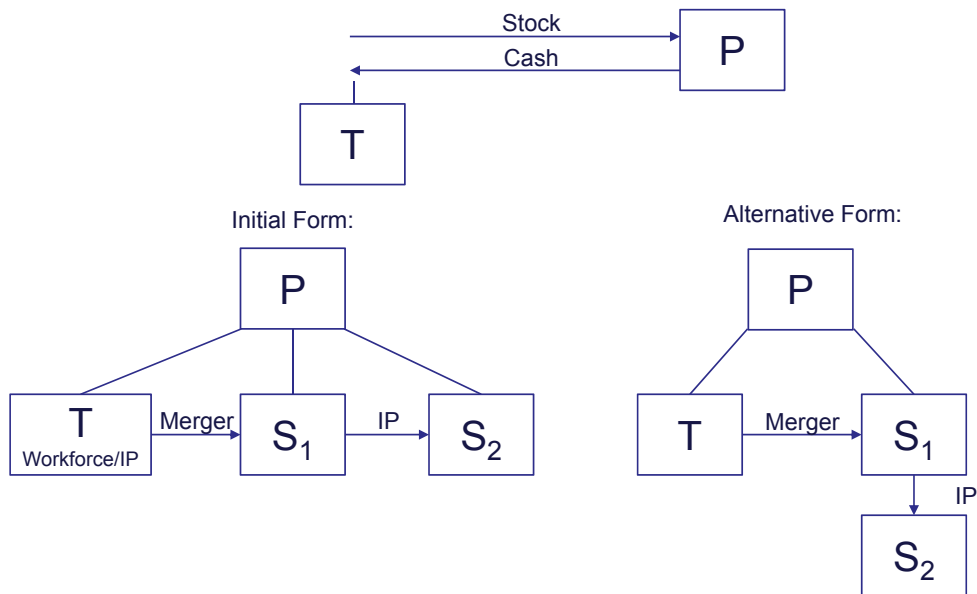
Section 368 Acquisitions - COBE

- For business continuity, if target has more than one line of business, then continuing a significant line of business is sufficient.
- Significant business or assets must be continued by the acquiring corporation or by members of the “qualified group.” The qualified group means corporations in the chain where the acquiring corporation owns 80% of the vote and value, and extends to certain partnership operations.
- Continuation of target corporation’s operations, not transferee’s operations, is important for COBE purposes. Rev. Rul. 81-25.

Section 368 Acquisitions - COBE

- **EXAMPLE for further consideration:** P owns all of S1 and S2. P purchases stock of T solely for cash. T merges into S1 and retains workforce but S1 transfers IP assets to S2. If workforce is not considered a significant portion of the business, has COBE requirement been met in the P-S merger? Are S1 and S2 within the same “qualified group?” Concern is that S2 is not a subsidiary in the chain of corporations under the acquiring corporation (S1) in the merger.
- If P transfers S2 shares to S1 and engages in same transaction, problem solved.

COBE Consideration

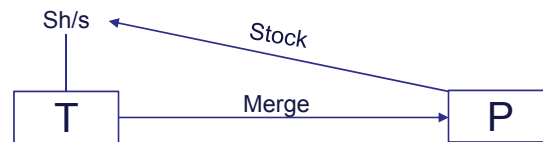


Section 368 Acquisitions - COBE

- **Statutory Mergers and Consolidations: “A Reorganizations.”**
 - Direct merger of target into corporation that issues its shares to target shareholders. Section 368(a)(1)(A): A reorganization.
 - All assets and liabilities of target become assets and liabilities of acquirer, and the target ceases separate legal existence. Reg. 1.368-2(b)(1)(ii).
 - Target’s operations (including potential liabilities) are consolidated with acquirer.
 - Post-merger drop down of assets by acquirer to subsidiary permitted. Section 368(a)(2)(C); Reg. 1.368-2(k).

Section 368 Acquisitions - A Reorg

- If target C corporation merges into acquirer corporation and fails either continuity of interest, COBE or business purpose requirement, have a taxable sale of assets for consideration deemed received from acquirer followed by a deemed taxable distribution of consideration by the target corporation to the selling shareholders. **DISASTER.**



Failing as Tax Free Reorganization:

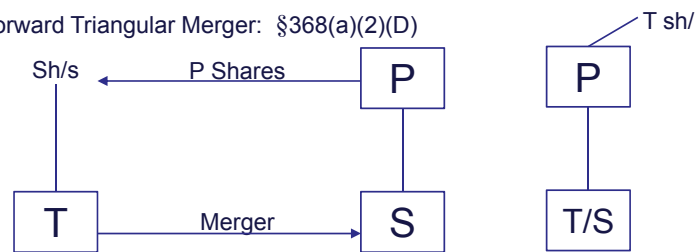
- T has gain on transfer of assets as if P shares received by T taxable sale
- Transfer of P shares to T shareholders treated as receipt and taxable liquidating distribution by T to T shareholders

Section 368 Acquisitions - Triangular Reorg

- Triangular Mergers. Both are subcategories of A reorganization.
 - Reasons for triangular acquisitive reorganizations:
 - Isolate assets and potential liabilities from acquirer.
 - Might be able to avoid shareholder approval by the acquirer's shareholders.
 - Form a new subsidiary without having a minority interest outstanding.
 - In reverse merger, might limit necessary consent that would be needed on an asset transfer.
 - Avoid getting approval of each target shareholder, which would be necessary in a straight stock-for-stock exchange.
 - Forward triangular merger (acquirer forms wholly-owned shell corporation, target corporation merges into shell corporation, and target shareholders receives shares of the acquiring parent corporation). Section 368(a)(2)(D), Reg. 1.368-2(b)(2).

Section 368 Acquisitions - Triangular Reorg

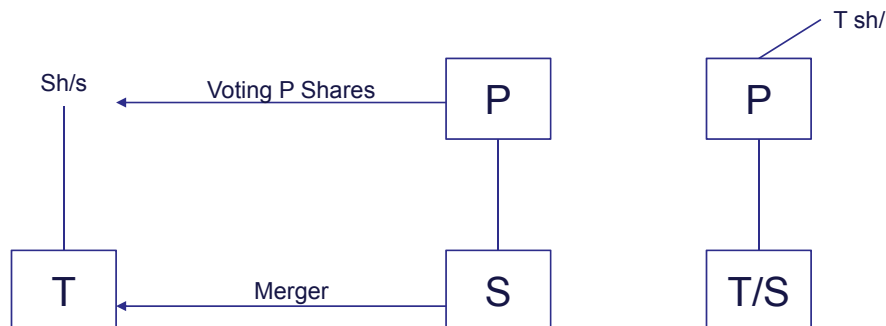
Forward Triangular Merger: §368(a)(2)(D)



- Additional requirements over a straight A reorganization:
 - “Substantially all” properties of target corporation must be transferred.
 - Target is merged into subsidiary corporation.
 - Merger would have qualified as an A reorganization if effected directly into the acquirer’s parent corporation. Meaning that target shareholders can receive up to 60% of consideration in taxable cash and can use merger signing date rule.
 - No stock of subsidiary is used.
 - Target shareholders can receive voting or nonvoting shares of parent corporation of shell subsidiary and receive up to 60% boot.

Section 368 Acquisitions - Triangular Reorg

- Reverse triangular merger (acquirer forms wholly-owned shell corporation, shell corporation merges into target corporation, and target shareholders receives shares of the acquiring parent corporation). Section 368(a)(2)(E), Reg. 1.368-2(j).

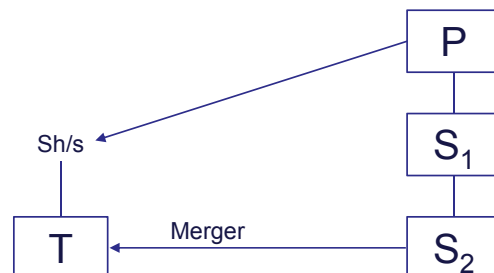


Section 368 Acquisitions - Triangular Reorg

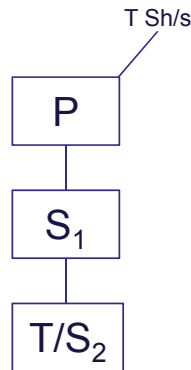
- Additional requirements over a straight A merger:
 - Surviving shell corporation holds “substantially all” properties of shell subsidiary and target corporations.
 - Target shareholders must exchange stock constituting “control” (80%) solely for voting stock of parent corporation. If acquirer already owns more than 20%, then cannot have a reverse Section 368(a)(2)(E) merger, but consider an alternative structure for a tax free acquisition of remaining shares.
 - Target shareholders can receive up to 20% boot. [60% permissible cash under the COI rule is overridden by statutory requirement]
 - Test of whether 80% of the aggregate consideration consists of acquirer’s voting shares is determined at time of closing, not at time merger agreement is signed. The special continuity of interest rule that uses the value of acquirer’s shares as of the merger date is not applicable.

Section 368 Acquisitions - Triangular Reorg

- Substantially All properties requirement.
 - This requirement is more stringent than COBE requirement.
 - 70% of gross assets and 90% of net assets. Reg. 1.368-2(j)(3)(iii); Rev. Proc. 86-42.
- Cannot use shares of grandparent corporation in a forward or reverse triangular acquisition, but using grandparent corporation can qualify as a B reorganization. See below. Rev. Rul. 74-565, Rev. Rul. 74-564, Reg. 1.368-2(j)(6) Ex 4.



Section 368 Acquisitions – Triangular Reorg



Section 368 Acquisitions - Triangular Reorg

- Examples in regulations on reverse triangular merger. Situations surface either where (i) not all of the target's shareholders want to participate in tax free treatment and some shareholders want to be cashed out or (ii) acquirer purchased some of target's shares for cash in advance of a total acquisition.
 - If target shares are redeemed in advance of acquisitions with target's own cash, such shares are ignored to determine whether 80% of consideration is paid in acquirer's voting stock. Reg. 1.368-2(j)(6) Ex. 2 and 3.
 - If target shares are purchased with the acquirer's cash, such shares are treated as outstanding prior to the reorganization and taken into account in determining whether control of the target corporation is acquired and whether 80% of the consideration is paid in acquirer's voting stock.
 - Cash paid by target corporation in redemption of shares in advance of acquisition is taken into account in determining whether "substantially all" of the target's properties are transferred. If too much of target's cash is used to redeem shares, this can prevent "substantially all" requirement from being met.

Section 368 Acquisitions - Triangular Reorg

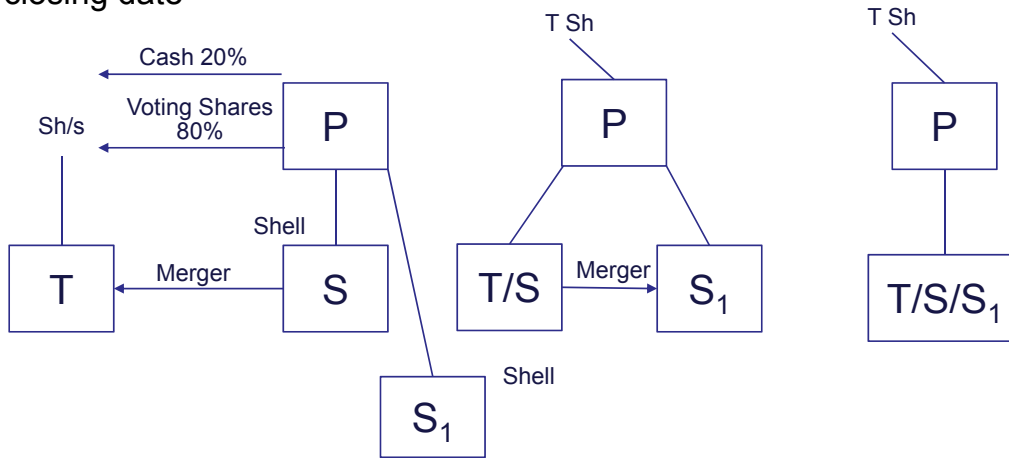
- If acquirer already owns some shares in the target corporation, must be assured that remaining target shareholders are transferring “control” (80%) of the target corporation. If the acquirer already owns more than 20% of the target corporation shares, the reverse merger cannot qualify under the Section 368(a)(2)(E) requirements but can qualify as a tax-free B reorganization (Reg. 1.368-2(j)(6) Ex. 4, and 5) or consider using a different acquisition structure.
- If acquirer plans to have acquired target corporation issue new shares in connection with the acquisition, need to assure that parent retains 80% control of the acquired target corporation.

Section 368 Acquisitions - Triangular Reorg (Alternative Forms)

- Double Merger: Structuring Acquisition by Public Company to take into account possible decline in share value after Merger Signing Date. See separate handout dated May 6, 2010.
 - Reverse merger is preferred approach. However, 80% requirement might not be met if acquirer’s share value declines between merger signing date and closing date. An integrated forward merger into another subsidiary corporation after the reverse merger can solve the problem because the requisite level of acquirer’s stock needed in a forward merger is only 40%.

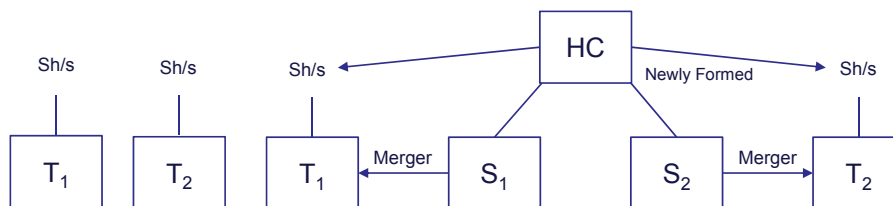
Double Merger

P's stock value declines between merger agreement signing date and closing date

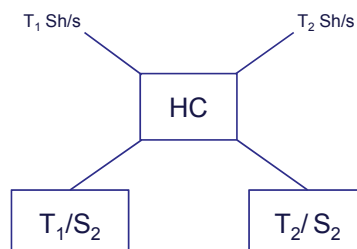


Section 368 Acquisitions - Triangular Reorg (Alternative Forms)

- Double Dummy Merger: Consider if merging two unrelated corporations of similar size into a holding company structure.

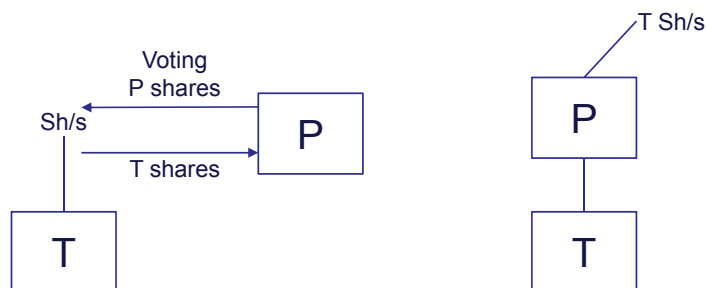


Tested Under Section 368(a)(2)(E) and Section 351



Section 368 Acquisitions - B Reorg

- Stock-for-Stock Acquisitions: “B Reorganizations.”
 - Acquisition of target shares by acquiring corporation in exchange solely for voting shares of acquirer (or parent of acquirer), provided acquirer is in “control” of target corporation immediately after the acquisition (regardless of the amount of target shares acquired).



Section 368 Acquisitions - B Reorg

- Exchange is between shareholders of target and acquiring corporation. A transitory shell merger subsidiary can also participate by merging into the target corporation to achieve the same B reorganization result because the shell merger sub is ignored and the transaction is treated as a transaction directly with the target shareholders. This result can surface where all of the Sections 368(a)(2)(E) requirements not met.
- Control. Section 368(c).
 - 80% of total combined voting.
 - 80% of shares of each class of nonvoting stock. Rev. Rul. 59-259.
 - Similar control definition used in Section 368(a)(2)(E) reverse triangular merger, but in that context “control” must be acquired in the acquisition transaction. In a B reorganization, acquirer must only own control of target after transaction without need to transfer control in the transaction.

Section 368 Acquisitions - B Reorg

- Voting shares of acquirer or its parent corporation, but not a combination of shares of both corporations. Reg. 1.368-2(c) (same rule for triangular reorganizations and C reorganization).
 - Common or preferred voting shares can be issued by the acquirer, but receipt of “nonqualified preferred stock” would be taxable. (Section 356(e)(1)).
 - Restricting target shareholders from voting the acquirer’s shares prevents B reorganization. Rev. Rul. 72-72.
 - Convertible debentures are not voting shares. Rev. Rul. 69-91.
- For attempted triangular reverse mergers that do not qualify under Section 368(a)(2)(E), consider B reorganization, see Rev. Rul. 74-564 and Rev. Rul. 74-565

Section 368 Acquisitions - B Reorg

- Control of target corporation must be acquired solely for voting shares.
 - Can acquiring corporation acquire 20% or less of target shares for cash? Is there a de minimus amount that can be acquired for cash?
 - What if initial purchase is “old and cold”?
 - Taint of any cash purchase can be purged by unconditional sale to an unrelated third party. Rev. Rul. 72-354.
 - What if target corporation redeems target shares with cash supplied by acquiring corporation? Arthur McDonald 52 T. C. 82 (1969); Rev. Rul. 75-360.

Section 368 Acquisitions - B Reorg

- Payment made by acquiring corporation that are not in exchange for target corporation shares is permissible. Examples of permissible cash payments:
 - Acquisition of target's debts. Rev. Rul. 69-142; Rev. Rul. 70-41.
 - Amount paid to target shareholders only in their capacity as creditor or employee.
- Dealing with minority or dissenting shareholders—purchase by target using own cash would not disqualify B reorganization. Rev. Rul. 68-285 (similar concept in reverse triangular reorganization), but check continuity of interest limitation. See Also Rev. Rul. 70-172 (distribution of property by target corporation to its shareholders in advance of B reorganization permitted.)

Section 368 Acquisitions - B Reorg

- Fractional shares-cash payment permitted. Rev. Rul. 66-365.
 - Assumption of target liabilities guaranteed by target shareholder could be treated as boot in some instances. Rev. Rul. 79-4, Rev. Rul. 79-89, Rev. Rul. 70-65.
 - Payment of target corporation's reorganization expenses can be acceptable. Rev. Rul. 73-54, Rev. Rul. 76-365.
 - Payment of cash for target shares by acquirer's subsidiary prevents B reorganization. Rev. Rul. 85-139.
- Creeping Control. Reg. 1.368-2(c).
- If separate acquisitions of target's outstanding shares occur over a period of years solely for acquirer's voting shares, only the acquisition(s) where the acquirer reaches 80% or more can qualify as a B reorganization.

Section 368 Acquisitions - B Reorg

- Series of acquisition of the target shares occurring over a relatively short period of time such as 12 months are aggregated. Effects: (i) if all of the acquisitions over short period were for the acquirer's voting shares, then each acquisitions can qualify as a B reorganization and (ii) if one of the acquisitions over short period was for acquirer's cash, then none of the acquisitions can qualify as a B reorganization.
- Creeping control is not permitted in a reverse triangular reorganization because "control" must be acquired in one transaction, but transaction might qualify as a B reorganization. Reg. 1.368-2(j)(6) Ex. 4 and 5.

Section 368 Acquisitions - B Reorg

- Target Corporation must remain a separate corporation following B Reorganization. Effect of liquidation or merger of target corporation into the acquirer.
 - Liquidation of target corporation into acquirer as part of an integrated plan defeats B reorganization. Rev. Rul. 2008-25.
 - Test transaction as a transfer of target corporation's assets to the acquirer--a possible C reorganization. Rev. Rul. 67-274.
 - If transaction fails as a C reorganization, then view as a taxable stock acquisition followed by a tax free liquidation. Limits problem to one level of tax at the selling target shareholder level.
 - Merger of target corporation into acquirer as part of an integrated plan defeats B reorganization, but transaction is viewed as a direct merger of target into the acquirer tested as an A reorganization under Section 368(a)(1)(A). Rev. Rul. 2001-46 (Sit 2).

Section 368 Acquisitions - B Reorg

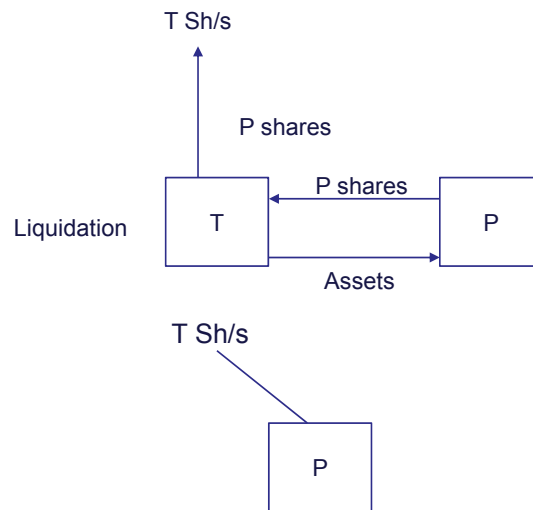
- Transfer of assets to new subsidiary corporation followed by stock sway of shares of new corporation with acquiring corporation. Rev. Rul. 70-140; Maurice Weikel TC Memo 86,858.
- Drop down of shares of target corporation Section 368(a)(2)(C).
- Poison Pill Rights. Rev. Rul. 90-11; PLR 8808081.

Section 368 Acquisitions – C Reorg

- Transfer of Assets Without Merger: “C Reorganizations.” Section 368(a)1)(C).
 - Requirements.
 - Acquisition by one acquirer of “substantially all” properties of target corporation.
 - In exchange for assets, acquirer’s (or the acquirer’s parent corporation) voting shares are issued.
 - Target corporation must distribute consideration received and remaining assets in liquidation.

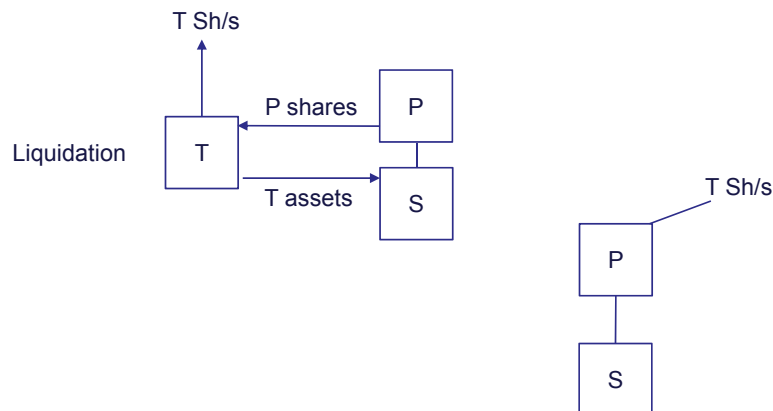
Section 368 Acquisitions – C Reorg

Straight C Reorg



Section 368 Acquisitions – C Reorg

Triangular C Reorg



Section 368 Acquisitions – C Reorg

- Acquisition by one corporation.
 - Drop down to acquirer’s subsidiary permitted. Section 368(a)(2)(C).
 - Acquisition of some assets by parent corporation and some assets by second-tier subsidiary corporation permitted. Rev. Rul. 64-73.

Section 368 Acquisitions - C Reorg

- “Substantially All” properties requirement- Rev. Proc 86-42.
 - Net Value of assets transferred must be equal to at least (a) 70% of gross value of target’s assets and (b) 90% of net value of target’s assets. See Examples.
 - Beware if (i) target corporation retains assets but transfers liabilities and (ii) target corporation transfers small amount of net assets and retains assets to satisfy liabilities (70% gross asset test not met). Rev. Rul. 57-518.
 - Sale of a business and transfer of remaining business and sale proceeds will not defeat “substantially all” requirement. Rev. Rul. 88-48
 - Dividend of assets can impair “substantially all” requirement, but not regular quarterly dividend. Rev. Rul. 74-457.

Section 368 Acquisitions - C Reorg

– Bittker & Eustice Examples

▪ Application of “Substantially All” Test:

– Net value of assets transferred must be equal to at least:

- 70% of gross assets
- 90% of net assets

– X’s assets -

\$90	Operating assets
30	Liquid assets
<u>20</u>	Liabilities
\$120	Gross value x 70% = \$84
\$100	Net value x 90% = \$90

– Example (1)

X transfers \$90 operating assets and retains liquid assets to pay liabilities

- 70% of gross assets
- 90% of net assets

If X retains liabilities, the net value of assets transferred is not reduced by liabilities. Accordingly, X transfers \$90 of assets satisfying both tests.

Section 368 Acquisitions - C Reorg

– Example (2)

X transfers operating assets and acquiring corporation assumes liability

X retains liquid assets

Applying net value test (B & E)

Since acquiring corporation assumed liabilities, X is transferring only \$70 (\$90 operating assets less \$20 liabilities assumed) for purposes of net value test. Accordingly, X fails net value test because only 70% (70/100) of net value is transferred. So beware if target retains assets but transfers liabilities.

– Example (3)

Assume X’s liabilities are \$100 and, accordingly, X’s net worth is \$20.

Assume X transfers \$20 of operating assets. X has not transferred 70% of gross value of its assets

Section 368 Acquisitions - C Reorg

- Consideration paid by acquirer.
 - If acquirer issues only voting shares, ignore liabilities transferred in determining whether any boot received.
 - If acquirer transfers any cash or other property in addition to voting shares, acquirer's voting shares must have a value of at least 80% of gross value of target's assets. See Examples
 - Liabilities transferred is same as cash or other property received in this case.
 - To extent that target corporation retains assets, then less boot can be paid.
 - If target corporation has a very large amount of liabilities as compared to gross value of assets, transaction might not qualify as a C reorganization. Reg. 1.368-2(d)(1);

Section 368 Acquisitions - C Reorg

- Consideration Permitted
 - If Acquirer transfers voting shares and cash, acquirer's voting shares must have value equal to at least 80% of gross value of target's asset.

	\$90	Operating assets	Gross value of assets = \$120
- X's assets -	30	Liquid assets	80% of \$120 = \$96
	20	Liabilities	If acquirer pays any cash, then must receive at least \$96 of acquirer's shares.
 - Example (1)

Acquiring corporation issues only voting shares to X's shareholders. Qualifies as a "C" reorganization. Disregard liabilities.
 - Example (2)

X transfers all assets and liabilities and acquiring corporation issues \$96 voting shares (80% of \$120 gross value) and \$4 cash. Qualifies as a "C" reorganization even if all liabilities assumed because \$4 cash and \$20 liabilities is 20% of X's gross value.

Section 368 Acquisitions - C Reorg

- Example (3)

X transfers all operations assets (\$90) and \$10 of liquid assets but retains \$20 of liquid assets and \$20 liabilities. Acquiring corporation must issue at least \$96 of voting shares. If acquirer pays any cash, the test is that acquiring corporation must issue voting shares with a value equal to no less than 80% of gross value of target's assets, not 80% of gross value of assets transferred. Thus, if acquiring corporation issued only \$80 of voting shares and \$20 cash, transaction is not a "C" reorganization.

- Example (4)

X transfers all operating assets (\$90) but retains \$30 liquid assets and \$20 liabilities.

Transaction qualifies as a "C" reorganization only if solely voting shares of acquiring corporation are issued. If acquirer transfer \$89 of its shares and \$1 cash in transaction, then X would not be receiving voting shares with a value equal to at least 80% of its gross value (\$96). This example illustrates that the more assets that are retained, the less amount of cash can be given.

Section 368 Acquisitions - C Reorg

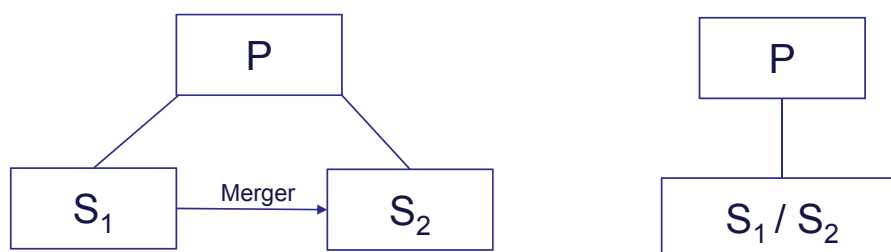
- Substance over Form.

- Forward triangular merger of target corporation into shell subsidiary followed by liquidation of subsidiary into parent corporation failed Section 368(a)(2)(D) treatment but test as a C reorganization. Rev. Rul. 72-405. If combination of subsidiary into parent corporation occurred as a merger, then test simply as an A reorganization.

Section 368 Acquisitions – D Reorg

- Combination of Brother-Sister Corporations: “D Reorganizations.”
 - D reorganizations are in two form:
 - Divisive Reorganizations: Formation of new corporation coupled with a Section 355 transaction. Transfer of an active business by a corporation to a subsidiary corporation followed by a distribution of the shares of the controlled corporation.
 - Acquisitive (Non-Divisive) Reorganization – Transfer of assets to a second corporation coupled with a Section 354 transaction.
Requirements:
 - transfer of substantially all of the “assets” of a corporation to a second corporation,
 - complete liquidation of the transferor corporation, and
 - one or more of the shareholders of the transferor corporation, including any combination thereof, “control” the second corporation.

Section 368 Acquisitions - D Reorg



- Acquisitive D Reorganization-Special Rules.
 - Can occur whether the transfer is merely a transfer of assets or pursuant to a statutory merger.
 - Section 357(c) (gain if liabilities assumed exceed tax basis of assets transferred) applies to a D reorg—outside consolidated return.
 - Overlap between A and D reorganization. Re. Rul. 75-161.
 - The mere incorporation of a division into a new subsidiary does not qualify as a D reorganization. Rev. Rul. 76-188. But see §351.

Section 368 Acquisitions - D Reorg

- Distribution Requirement.
 - Shares of transferee must be distributed by the transferor corporation to its shareholders.
 - This step is not required if the shares of the transferor corporation and the transferee corporation are held by the same persons in the same proportion. Reg. 1.368-2(l)(2); Rev. Rul. 70-240.
 - Further consideration needs to be given to this step if the shares of the transferor and transferee corporations are held in different proportions. Warsaw Photographic Associates., Inc. 84 T.C. 21 (1985).
- Control Requirement.
 - For this purpose only, “control” is defined as either 50% of voting shares or 50% of value of all outstanding shares. In making this determination, certain attribution rules are taken into account. Section 368(a)(2)(H).

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Treatment of Parties to a Reorganization.
 - Treatment of Corporate Transferor (Target Corporation) Section 361, 357, and 358.
 - The target corporation cannot realize a loss in connection with a qualified reorganization and does not recognize gain in connection with the receipt (or deemed receipt) of the acquirer’s shares, securities, or other property. NOTE: Gain with respect to the acquirer’s consideration is recognized only if retained by the target corporation, which will not happen. The target corporation does not retain any assets in these transactions.
 - If target corporation distributes its own property to shareholders in connection with reorganization, target recognizes gain, but not loss, inherent in such assets. Section 361(c)(2).
 - If acquirer’s shares or securities are transferred to target corporation’s creditors. Section 361(c)(3).

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Special Reporting by Acquirer.
 - A tax free acquisition mandates that a Form 8937 or a Web posting be made that details the effect of the transaction on the tax basis of the target shareholders. Section 6045B; Reg. 1.6045B-1.
 - The required filing with the IRS or Web posting must be made by the earlier of 45 days following the organizational action or January 15 following the calendar year of the organizational action. For a December 31 closing, the required filing or posting must occur within 15 days. See Special Rule for S Corporations Reg. 1.6045B-1(c).
 - Notice to each target shareholder must also be provided, but a Web posting of the necessary information by the required due date is sufficient.
 - The Web posting might only be available if the requisite information is posted by the due date. If no posting occurs by the original due date, then filing with the IRS and providing information to each target shareholder seems required.
 - The required information includes the “quantitative effect” of the organizational action on the target shares. This information can be provided by a few illustrations.

Section 368 Acquisitions – Parties to Reorg Tax Effect

- Treatment of Corporate Transferee (Acquiring Corporation).
Sections 1032 and 362.
 - No recognition of gain or loss on issuance of shares by acquirer.
 - In a triangular reorganization, no gain or loss occurs when the acquirer shares are transferred through a subsidiary corporation format. Reg. 1.1032-2(b).
 - If the subsidiary that effectuates the transaction has held (old and cold) and uses the acquirer’s shares, gain is recognized. Reg. 1.1032-2(c), -2(d) Ex 2.
 - Issuance of securities by acquirer does not trigger gain or loss.
 - Transfer of other appreciated property by acquirer to the target shareholders is a taxable event. Rev. Rul. 72-327.

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Basis of Acquired Property Received by Acquirer. Section 362(b).
 - Tax basis of target's assets received by acquirer is equal to the basis of such assets to the target plus any gain recognized by the target corporation on such transfer. Because the target corporation should never have gain with respect to the transfer of assets, there should be no additional step on the carryover assets.
 - In a B reorganization and a reverse merger transaction, the target corporation's assets are not transferred and so no change to consider.
 - In an A merger, a forward triangular merger, and a C reorganization, the assets are transferred and the carryover tax basis rule applies.
 - No step up to the assets received by the acquirer for gain recognized by the target shareholders or by the acquiring corporation. Rev. Rul. 72-327.

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Basis of Shares received by Acquirer.
 - Tax basis of shares received carries over.
 - In a B reorganization, special procedures are available if the acquirer is unable to determine the tax basis of the shares received. Rev. Proc. 2011-35. See TEI 2012 Report.
 - Where a triangular reorganization occurs using a subsidiary corporation, the tax basis of the shares of the acquiring controlled subsidiary must be determined. This point surfaces in forward and reverse triangular mergers, triangular C reorganizations, and triangular B reorganizations.
 - Reg. 1.358-6 has a series of rules to determine the tax basis of the acquirer's shares in the controlled subsidiary.

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Treatment of Target Corporation Shareholders and Security Holders. Sections 354, 356, 358.
 - Provisions are applied separately to each target shareholder and security holder.
 - In general, securities are debt instruments with a term of ten years or more. Debt instruments with a term of five years or less are not a security.
 - Securities cannot satisfy the continuity of interest requirement. However, if COI is otherwise satisfied, securities can be issued in connection with a tax-free reorganization.
 - Completely tax-free exchanges.
 - Target shareholder exchanges shares solely for shares of acquirer or acquirer’s parent.

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Target security holders exchange securities solely for securities and/or shares of acquirer (or acquirer’s parent), but principal amount of securities received cannot exceed principal amount of securities surrendered. –Not applicable to a B reorganization.
- Target shareholder who owns shares and securities exchanges such solely for shares of acquirer (or acquirer’s by parent).—Not relevant to B reorganization.
- Target shareholder who owns shares and securities exchanges such for shares and/or securities of acquirer (or acquirer’s parent), but principal amount of securities cannot exceed principal amount of securities surrendered.—Not relevant to B reorganization.
 - If target’s securities are surrendered for acquirer’s shares, consider Section 108.
 - Gain triggered if acquirer’s shares and/or securities issued for accrued interest. Section 354(a)(2)(B).
 - If acquirer issues “nonqualified preferred stock,” then gain recognized. Sections 354(a)(2)(C) and 356(e).

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Partially Taxable Exchanges.
 - If target shareholder or security holder receives cash or other property (other than shares or securities of acquirer) or receives securities having a principal amount in excess of securities surrendered, then gain but not loss is recognized. Section 356. This additional amount is referred to as boot.
 - Gain recognized is limited to cash and value of boot received.
 - Target shareholders who owns blocks of stock with different tax basis must calculate gain and unrealized loss on each block of stock separately. Rev. Rul. 68-23.
 - If target shares and securities surrendered are not publicly traded, in general any gain recognized from a note to receive cash might be delayed through installment sale reporting, provided note is not publicly traded or payable on demand. Section 453(f)(6); Prop. Reg. 1.453-1(f)(2).

Section 368 Acquisitions – Parties to Reorg Tax Effects

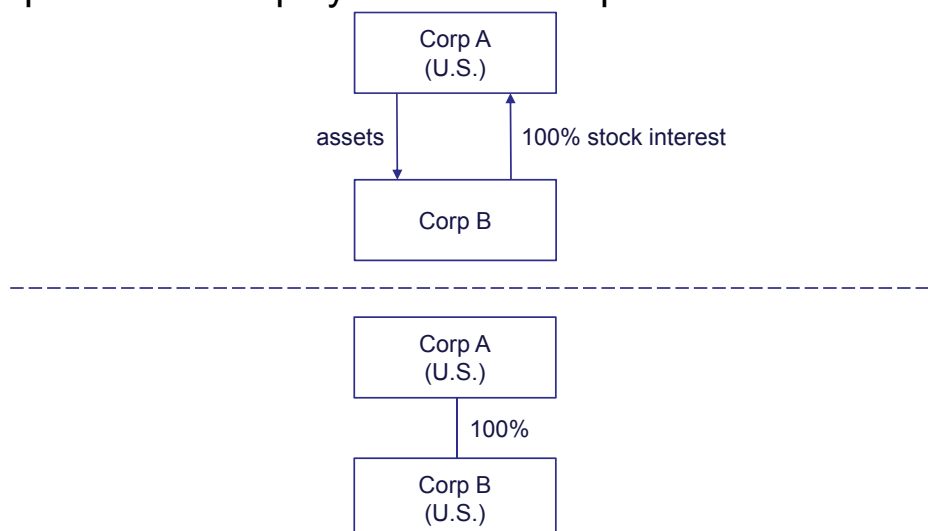
- Character of Recognized Gain. Section 356(a)(2).
 - If boot received by target shareholder has “effect of a dividend distribution,” then gain recognized by target shareholder is ordinary dividend income to extent of shareholder’s ratable share of E&P and the remainder, if any, is capital gain.
 - Determination of whether exchange has effect of a dividend takes into account the Section 318 attribution rules.
 - Test for determining whether boot has a dividend effect is applied by treating transaction as if all consideration paid in acquirer’s shares and then acquirer purchased a number of its shares equal to the boot amount in redemption of such shares, and apply Section 302 redemption tests.
 - If acquirer is a public company, the boot received should qualify as capital gain. Rev. Rul. 76-385.

Section 368 Acquisitions – Parties to Reorg Tax Effects

- Basis of Shares Received by Target Shareholders and Security Holders.
 - The tax basis of shares received is the same as the tax basis of the shares surrendered (“substituted basis”) increased by gain recognized by such person less money and value of boot received. Same rule for securities.
 - Tax basis of boot received is its fair market value.
 - If shares surrendered were acquired on different dates at different prices, the average cost of such shares surrendered is used as the tax basis of shares received, unless shares received can be specifically traced to the shares surrendered. Rev. Rul. 55-355.
 - If target shareholder receives either (A) shares and securities or (B) shares or securities of more than one class, the substituted tax basis is allocated among such shares and securities based on the values of each asset. Section 358(b)(1); Reg. 1.358-2(b)(2).

Section 351

- Generally, transfer of appreciated assets to a controlled corporation for equity interest in corporation is tax free



Section 351 - Continued

- Corp B takes carry over basis in contributed assets.
- Corp A's basis in Corp B stock received in exchange is equal to basis Corp A had in the contributed assets, with adjustments.
- Examples of Section 351 transactions:
 - Organization of a corporate subsidiary
 - Incorporation of a partnership
 - Three approaches – Revenue Ruling 84-111
 - Incorporation of a disregarded entity

Section 351 - Continued

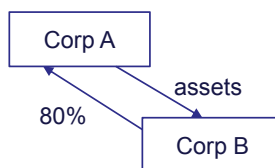
- Transferor group must be in control of transferee corporation immediately after transfer
- Section 368(c) control test -- Transferor group must own immediately after the transfer:
 - Stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote; and
 - For each non-voting class of stock, at least 80% of the total number of shares.
- Step transaction doctrine can apply
 - A subsequent transfer of shares received by the transferor group in the exchange can result in a failure of the “in control immediately after” test.
 - A failed Sec. 351 transaction is treated as a taxable asset sale.

Section 351 - Continued

- Boot – Section 351(b)
 - If the transferor receives cash or other property (boot) in addition to transferee corporation stock, transferor has gain to the extent of the boot.

Example

- In exchange for 80% of Corp B stock and \$100 cash, Corp A contributes assets with:
 - FMV -- \$1,000
 - Tax Basis -- \$700



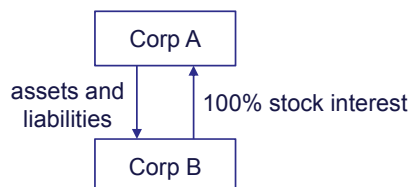
- Result – Corp A recognizes \$100 gain

Section 351 -- Continued

- Transfer of Liabilities – Section 357(c)
 - If the amount of liabilities transferred exceeds the aggregate adjusted tax basis of the assets transferred, the transferor recognizes gain in the amount of the excess.

Example

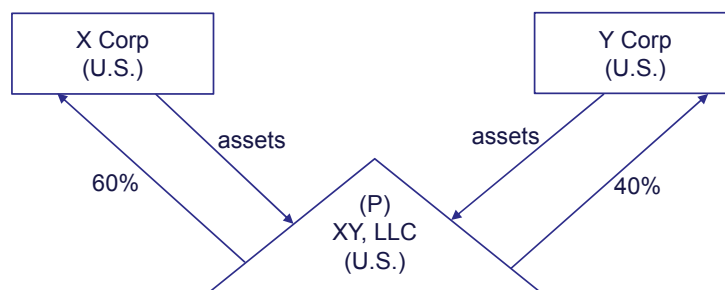
- In exchange solely for 100% of Corp B stock, Corp A contributes assets with aggregate tax basis of \$500 and FMV of \$900.
- \$650 of liabilities are transferred.



- Result -- Corp A recognizes \$150 gain (\$650 - \$500). This result avoids Corp A taking a negative tax basis in Corp B stock. But see Reg 1.1502-80(d) in consolidated return context (no gain and ELA created).

Section 721

- Subchapter K analog to Section 351
- Generally, transfer of appreciated assets to a partnership for equity interest in the transferee partnership is tax free



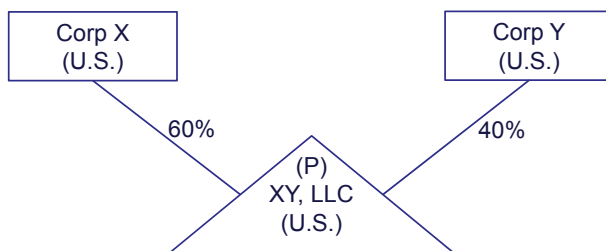
- XY, LLC takes carry over basis in contributed assets.
- Generally, X Corp and Y Corp take basis in XY, LLC equity interests equal to basis in the contributed assets, with adjustments.

Section 721 - Continued

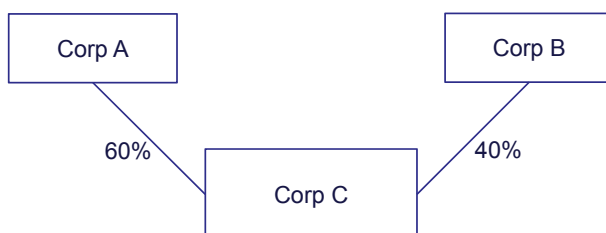
- If contributing partner receives boot, must consider disguised sales rules.
- If liabilities transferred with assets to partnership, liability shift can result in taxable gain to contributing partner.

Domestic Joint Ventures

Partnership Joint Venture



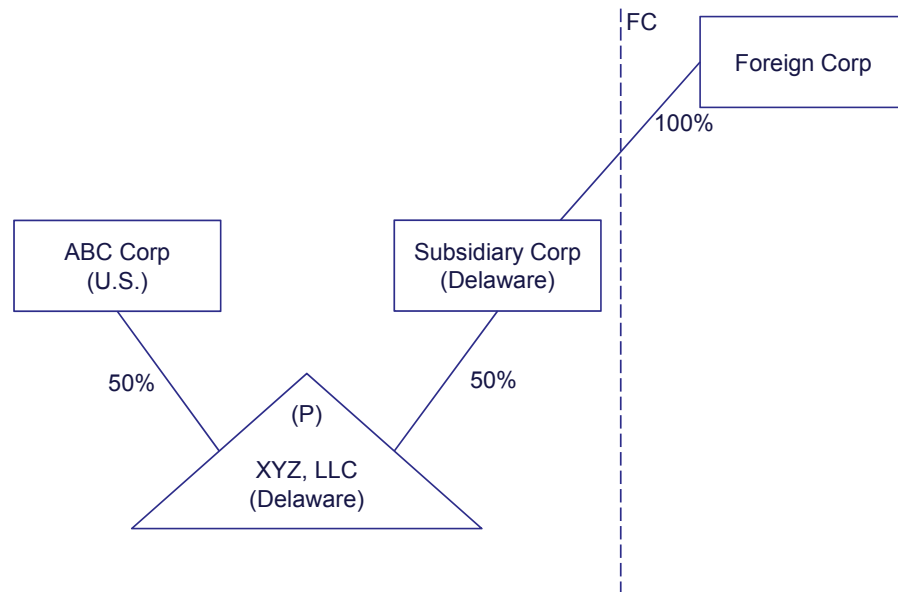
Corporate Joint Venture



Joint Venture – Partnership or Corporation?

- Partnership generally is much preferred approach
 - Benefits of consolidation even if joint venturer owns less than 80%
 - Cash distributions – generally tax free
 - Section 721 permits adding more partners tax free because no “in control immediately after” requirement as in Section 351
- Corporation can be a prudent choice if IPO is anticipated.

International Joint Venture - Inbound



Favorable Tax Consequences for Joint Venturers

- ABC Corp
 - Benefits of consolidation
 - Cash distributions - generally tax free
- Note: If U.S. joint venturers are individuals, one layer of U.S. federal income tax and flow through of losses.
- Foreign Corp
 - Treaty Benefits -- Avoids U.S. permanent establishment
 - Avoids filing U.S. tax returns.

“F” Reorganization - Section 368(a)(1)(F)

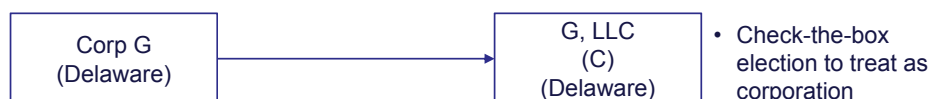
- A mere change in identity, form, or place of organization of one corporation, however effected, is tax free.
- F reorganizations concern one continuing corporation.
 - For U.S. federal income tax purposes, the resulting/successor corporation is the same entity as the predecessor corporation.

▪ Examples:

- Reincorporation from one state to another



- Convert from corporation to LLC - corporation



“F” Reorganizations and Step Transaction Doctrine

- Revenue Ruling 96-29
 - Bubble Concept -- If a putative F reorganization is part of a series of planned transactions, the putative F reorganization is given independent significance. Consequently, the step transaction does not apply, and the applicable piece of the transaction will be respected as a valid F reorganization.
- T.D. 9739, released September 2015, maintains this bubble concept.

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Jim is a partner in the firm's Tax practice group who focuses his practice on tax planning for numerous types of transactions, including mergers and acquisitions, corporate joint ventures, limited liability companies, partnerships, cross-border, Internet start-ups, securitizations and various financial transactions. Prospective transactions are domestic and/or international in scope and tax advice covers domestic, international, and state and local tax issues. Jim also works on taxpayer controversies with the IRS and state tax authorities (examinations and appeals).

In 2014, Jim received the firm's Malvin E. Bank Award for Exemplary Client Service. This award is presented to an outstanding lawyer who demonstrates the highest commitment to providing extraordinary client service and whose behavior reflects the utmost loyalty and commitment to clients' best interests.

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Tom is Chair of the firm's Taxation Practice Group. Tom focuses his practice on handling taxpayer controversies with IRS (examinations, appeals, litigation, and criminal tax matters), advising clients on structuring prospective transactions, and obtaining rulings and other technical guidance from the IRS National Office. He also has significant experience in handling mergers and acquisitions, real estate and partnership transactions and tax aspects of energy transactions. Tom is also a Certified Public Accountant (active) in Ohio.

Tom serves as an officer of the ABA Section of Taxation. In the past, he has served in various leadership positions such as President of The American College of Tax Counsel; Council Director of the ABA Section of Taxation and Chair of the Administrative Practice Committee; President of the Tax Club of Cleveland; Chair of the Cleveland Tax Institute; and Chair of the Cleveland Bar Association General Tax Committee. Tom is a member of the American Bar Association, the Ohio State Bar Association and the American Institute of Certified Public Accountants. He is listed in The Best Lawyers in America, Who's Who in America and Ohio Super Lawyers.

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Frank has represented major U.S. businesses (including NCR, Motorola, Mead/MeadWestvaco, Parker-Hannifin) and well-established midmarket businesses on a range of federal income taxation matters, including mergers and acquisitions; structuring and compliance of executive compensation arrangements within tax limitations of Section 409A, the \$1 million compensation deduction limitation on public corporations, and Section 280G; tax controversies and obtaining rulings; representation of QALICBs in New Markets Tax Credit transactions; and like-kind exchanges.

As part of his practice, Frank submits comment letters and participates in discussions with government representatives, makes presentations and drafts summaries on developing issues which are shared with clients. Within the firm, he has held many administrative positions, including as a member of the firm's eight-person Executive Committee.

Frank is a member of the American Bar Association, Tax Section and the Dayton Bar Association.