

Basis Calculations in Section 368 Reorganizations: Tax Deferral Benefits For Subsidiary Shareholders

THURSDAY, DECEMBER 14, 2017, 1:00-2:50 pm Eastern

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Basis Calculations in Section 368 Reorganizations

Dec. 14, 2017

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Emphasis:

International Tax

Tax Planning

Tax Controversy

Corporate/Transactional Tax

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Overview of Tax-Free Reorganizations

Purpose and Overview of Corporate Reorganizations

- Section 368(a)(1) provides for tax-free treatment of six types of “corporate reorganizations.”
- The purpose of the corporate reorganization rules is to exempt from the general treatment of exchanges as taxable events “certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of a continuing interest in property under modified corporate forms.” Treas. Reg. § 1.368-1(b).

Overview of Non-Statutory Requirements

- All reorganizations must be undertaken as part of a “plan of reorganization” for one or more corporate business purposes. Treas. Reg. § 1.368-2(g).
- Two party reorganizations also must have the requisite “continuity of interest” (COI) of the shareholders and security-holders in the old corporation in the new corporation, so as to exclude transactions that are effectively sales. *See* Treas. Reg. § 1.368-1(b). *See also* Treas. Reg. §1.368-1(e) (COI regulations).
- Two party reorganizations also must meet a continuity of the business enterprise (COBE) requirement following the transaction. *See* Treas. Reg. § 1.368-1(d).

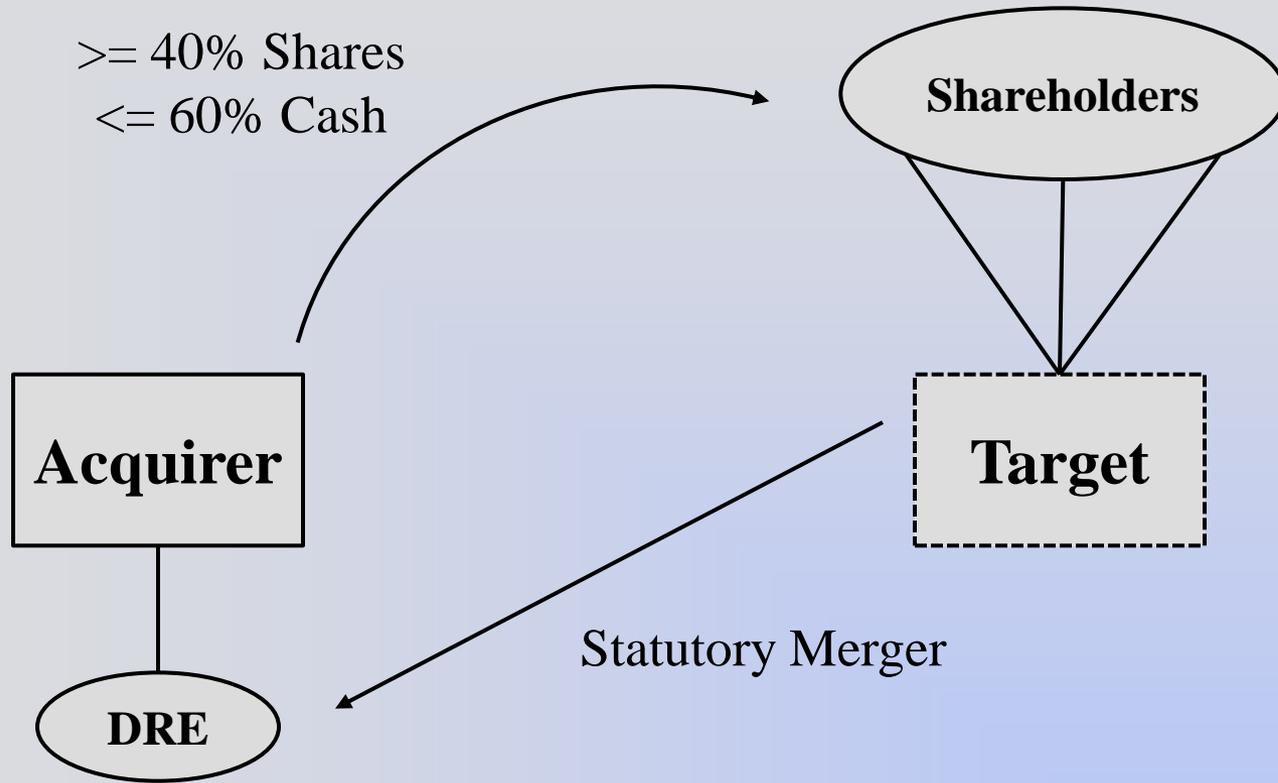
Types of Reorganizations – A through G

- Statutory Merger (“A” Reorganization) –
 - A reorganization may be directly into acquirer or indirectly into / with a subsidiary of Acquirer (a so-called “triangular reorganization”)
- Exchange of Stock for Stock (“B” Reorganization)
- Acquisition of Assets for Stock (“C” Reorganization)
- Transfer of property to a corporation under common “control” with transferor or its shareholders (“D” reorganization)
- Recapitalization involving exchange of stock and/or “securities” in one corporation (“E Reorganization)
- Change of place or form of incorporation (“F” reorganization)
- Certain Bankruptcy Reorganizations (“G” Reorganization)

Section 368(a)(1)(A) – Statutory Merger

- Basic section 368(a)(1)(A) reorganization consists of a statutory merger of the target into the acquirer, with T's shareholders receiving A stock.
- Statutory merger is defined as a transaction effected by statute, whereby through operation of the statute:
 - All of the assets and liabilities of each participant to the combination become the assets and liabilities of another participant; *and*
 - The transferor entity ceases its separate legal existence for all purposes.
- Only other requirement is that statutory merger must satisfy the non-statutory requirements: continuity of interest (COI), continuity of business enterprise (COBE), and business purpose.

A Reorganization / Statutory Merger



- Target's merger into Acquirer's DRE is treated as a statutory merger into Acquirer's "combining unit." This is tested as a Sec. 368(a)(1)(A) reorganization.

Forward and Reverse Subsidiary Mergers –

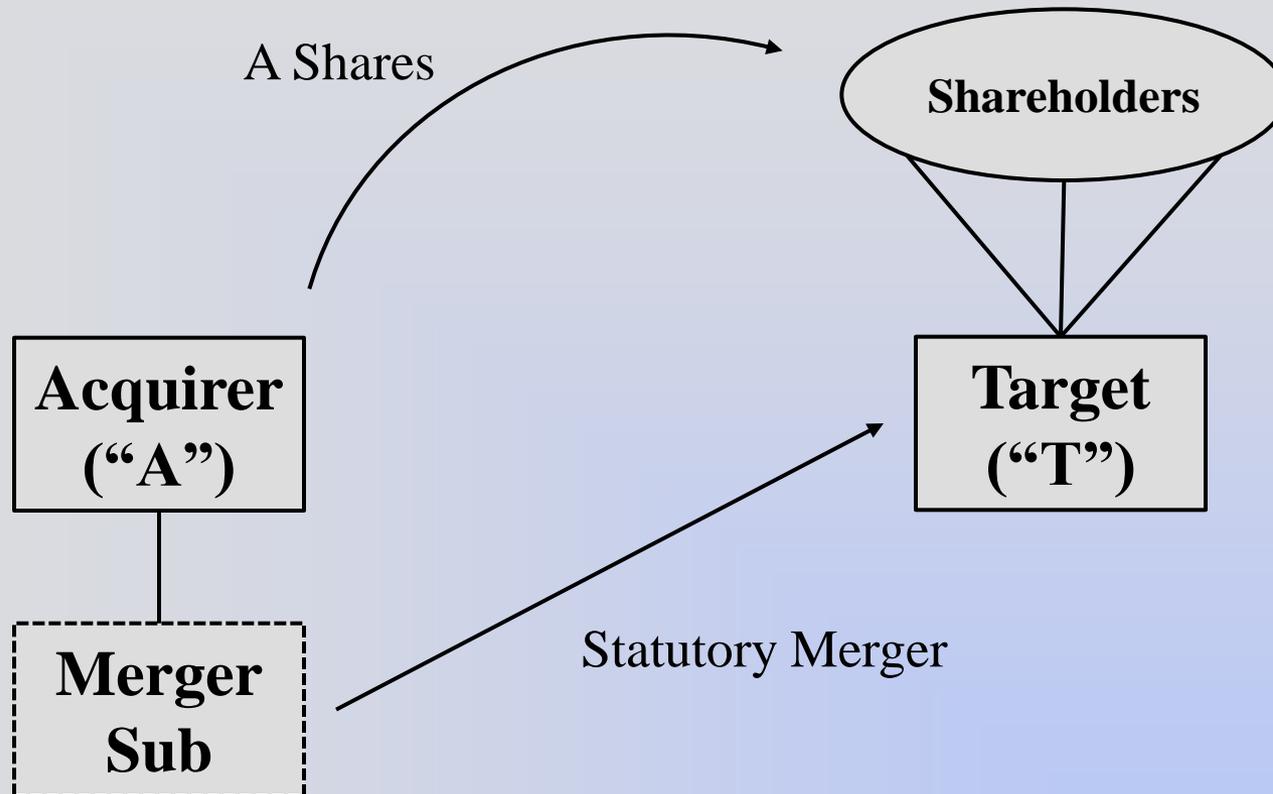
■ Forward Subsidiary Merger (§ 368(a)(2)(D)).

- Direct subsidiary of Parent acquires “substantially all of the assets” of Target in exchange for Parent stock in a statutory merger.
- Qualifies if same transaction into direct parent would have qualified as tax-free.

■ Reverse Subsidiary Merger (§ 368(a)(2)(E)).

- Direct subsidiary of Parent merges into Target in exchange for stock via statutory merger.
- Survivor must hold “substantially all of the properties” of the Target and the merged corporation after the merger.
- Shareholders of the Target must exchange stock constituting Section 368(c) “control” of Target for voting stock of the Parent in the transaction. (Generally, no more than 20% cash is permitted).

Stock Reorganization: Reverse Subsidiary Merger



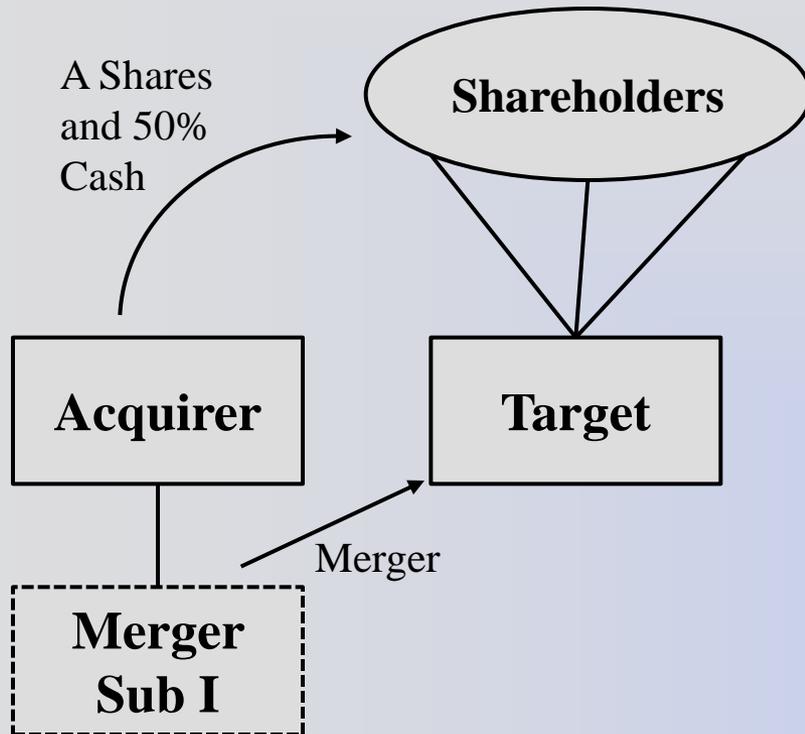
- Merger Sub's merger into T is treated as if shareholders exchanged their T shares for A shares by operation of law.

Integrated Transaction Doctrine

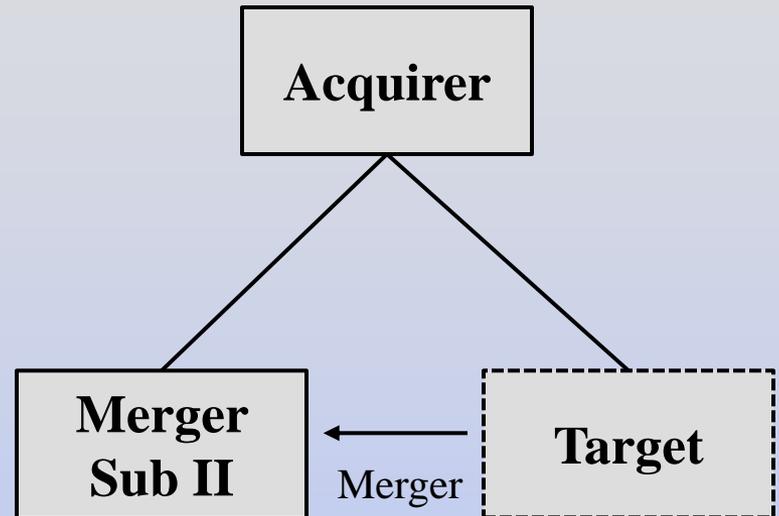
- IRS has issued a series of revenue rulings clarifying role of step-transaction in context of a stock acquisition followed by a merger or liquidation.
 - Rev. Rul. 90-95 – cash reverse merger for 100% of Target’s stock, followed by a merger or liquidation of Target, will be treated as a separate qualified stock purchase followed by a tax-free § 332 liquidation.
 - Rev. Rul. 2001-26 – first step acquisition of 51% of T’s stock, followed by a second step reverse merger for remaining 49%, will be integrated into a valid Section 368(a)(2)(E) reverse subsidiary merger.
 - Rev. Rul. 2001-46 – first step reverse merger, followed by second step forward merger, will be treated as an integrated forward merger to the extent the integrated transaction qualifies as a tax-free reorganization.

Example of Two-Step Merger

Step 1:



Step 2:

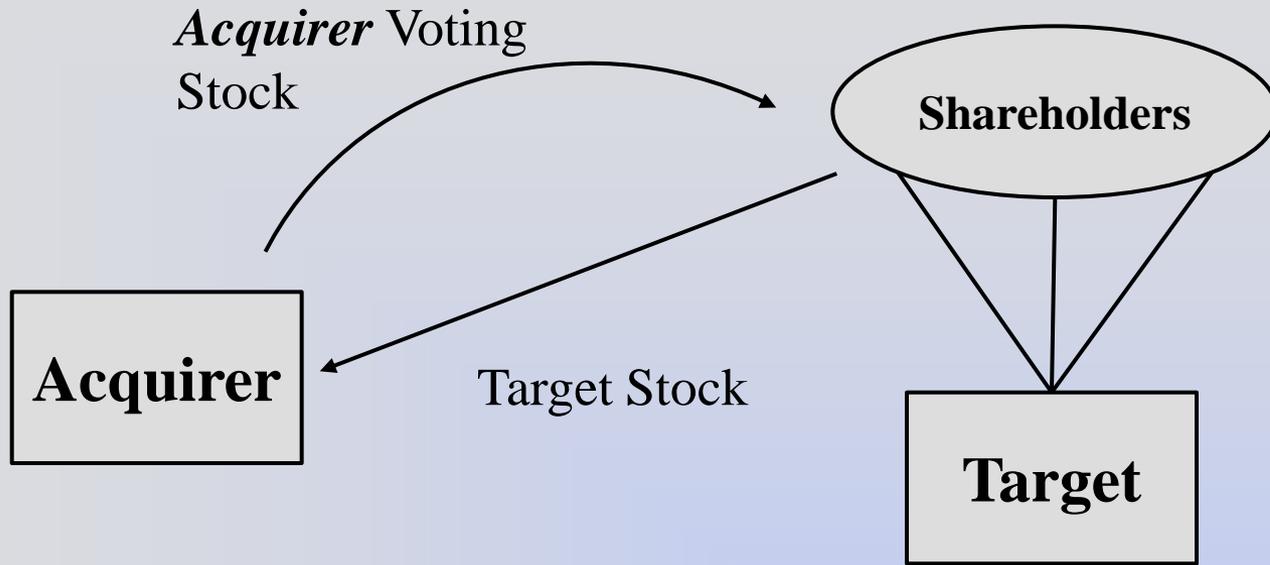


- The two mergers will be integrated into a single Forward Subsidiary merger, if successful (RR 2001-46). If two step is “busted,” step 1 will be respected as a stock purchase, followed by a separate tax-free A reorganization under RR 90-95.

Section 368(a)(1)(B) – Stock-for-Stock Exchange

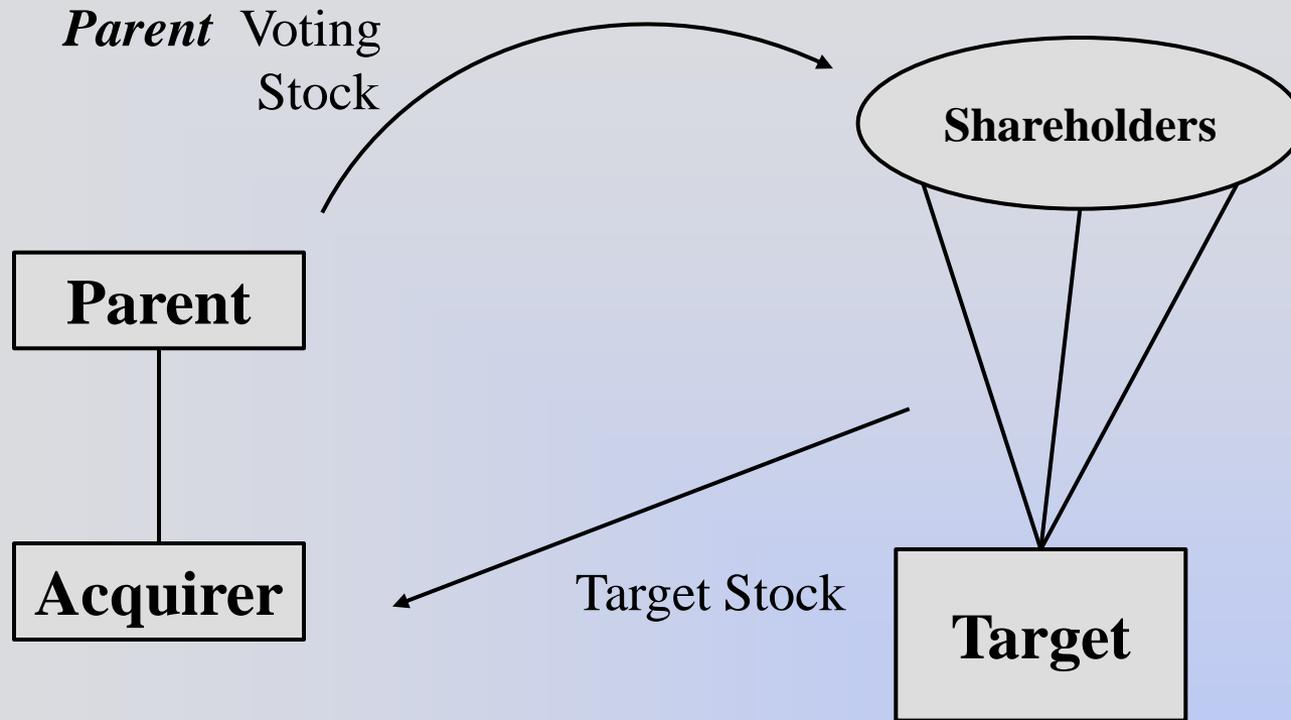
- Section 368(a)(1)(B) applies to a transaction where, solely in exchange for its voting stock, a corporation (or corporation in control of such corporation) acquires stock of a target, and immediately after the exchange has “control” of the target (whether or not it had control immediately before the transaction).
- Control is defined by § 368(c) as ownership of (i) 80% of the total combined voting power of all classes of voting stock and (ii) 80% of the number of shares of all classes of non-voting stock.

Example of a B Reorganization



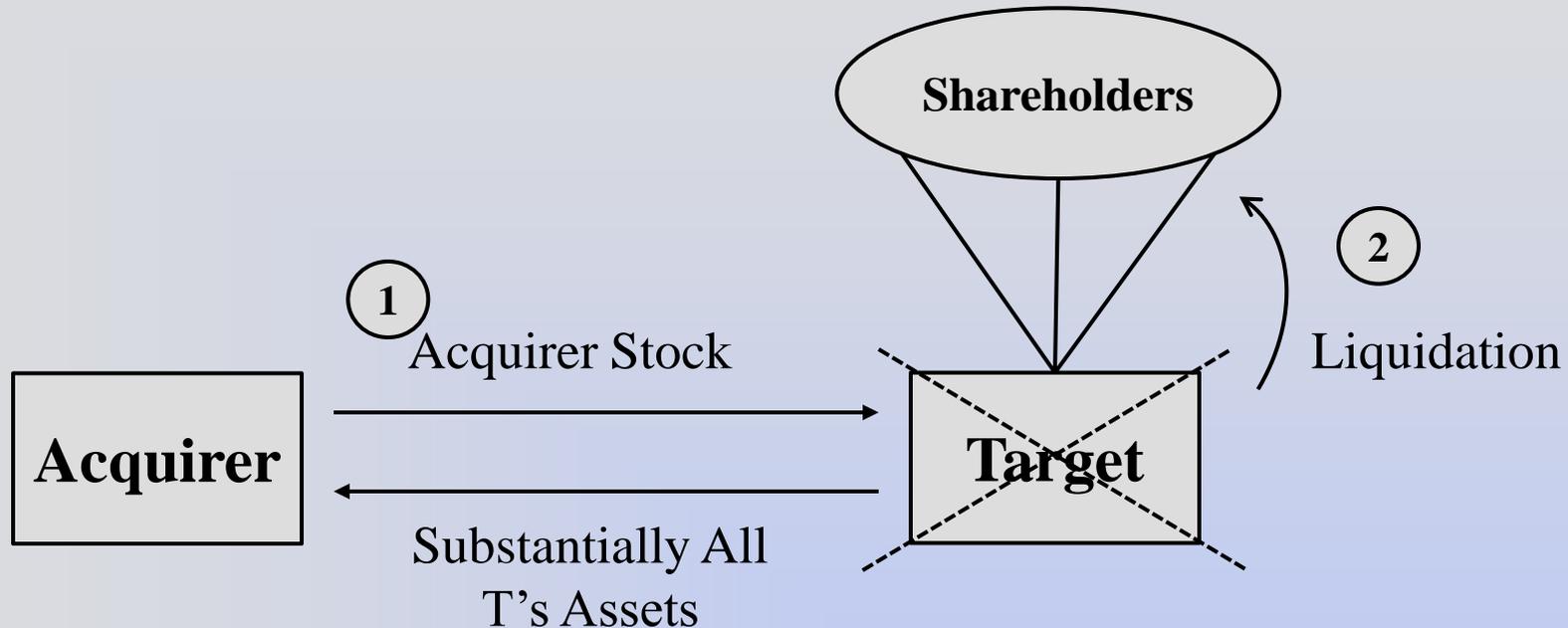
- A reverse merger involving a transitory merger sub may also constitute a “forced” B reorganization. *See* Rev. Rul. 74-564; Rev. Rul. 67-448.

Triangular B Reorganization



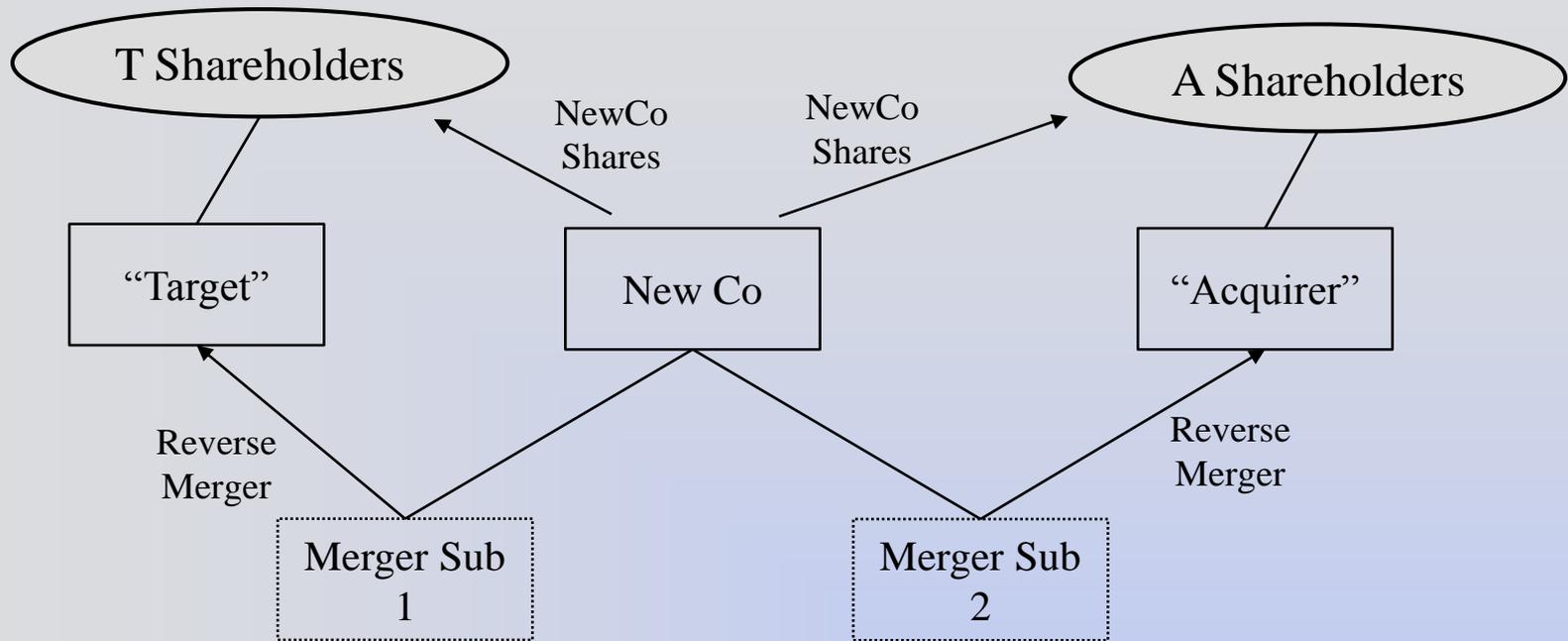
- A first tier subsidiary of Parent may acquire stock of Target in exchange for Parent stock in a Triangular B reorganization.

Example of a C Reorganization



- Alternatively, Target's assets could be acquired by Acquirer's first-tier subsidiary in a Triangular C reorganization.

Double Dummy Transactions and Section 351



- Transactions involving formation of a New Holding Company may constitute a Section 351 transaction, as well as, or instead of, constituting a Section 368 tax-free reorganization.

Treatment of the Parties to the Reorganization

Treatment of the Parties to the Reorganization

Shareholders

- Shareholders do not recognize gain or loss on the exchange solely of stock or securities for stock or securities of another corporation that is party to the reorganization. Sec. 354(a).
 - Exception for securities received in exchange for stock which are treated as “boot.”
- Receipt of money or other property (i.e., “boot”) results in recognition of gain but not loss to the extent of boot received. Sec. 356. Boot may be characterized as a dividend where redemption of stock would be treated as a dividend under Sec. 302(d).
- Shareholder takes a carryover basis in Buyer stock, increased by gain recognized and decreased by cash received. Sec. 358.

Treatment of the Parties to the Reorganization

Corporations

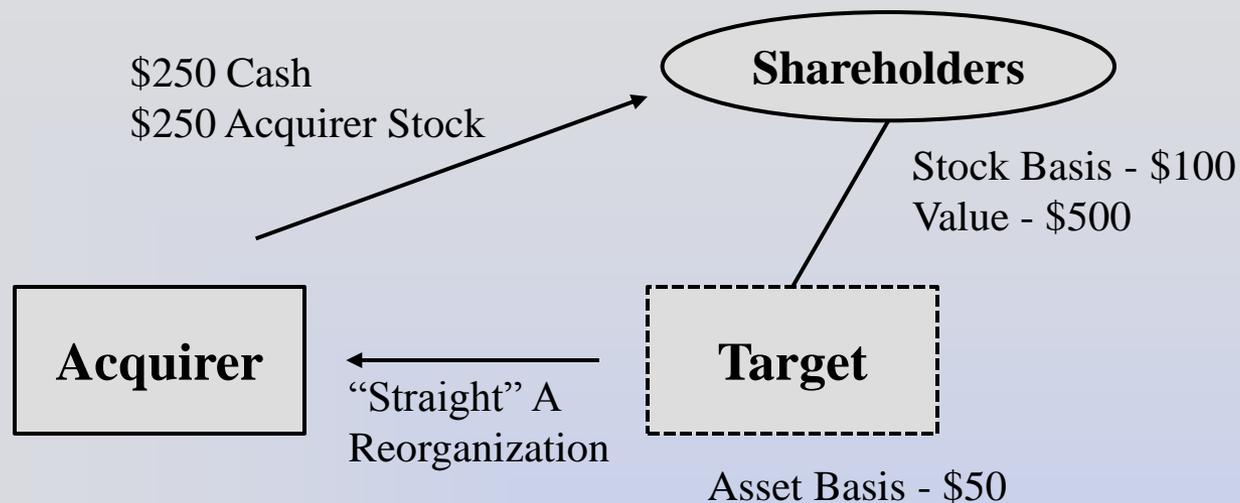
- Section 361(a) provides that a corporation's exchange of its assets for stock or securities of another party to the reorganization is non-taxable.
- Receipt of money or other property is generally not taxable to the extent the corporation distributes the money / other property to shareholders as part of the plan of reorganization. Sec. 361(b)(1)(B).
- Sec. 361(c)(2) provides for taxable gain on distribution of any retained assets under Section 311(b) principles, but insulates distribution of merger proceeds from recognition of gain.

Corporate Basis Rules

- Section 362(a) – provides for carryover basis to the corporate transferee of property in a Section 351 transaction or contribution to capital
- Section 362(b) provides for carryover basis to the transferee of property in a corporate reorganization.

In each case, the transferee's basis is increased to reflect the gain recognized by the transferor.

Corporate Basis Rules - Example



- Shareholders – recognize \$250 of gain on cash received and take a \$100 basis in Acquirer stock under Sec. 358.
- Target does not recognize any gain because transaction qualifies as a reorganization and Target distributes all cash received. See Sec. 361(b)(1)(B).
- Acquirer takes a \$50 carryover basis in Target's assets.

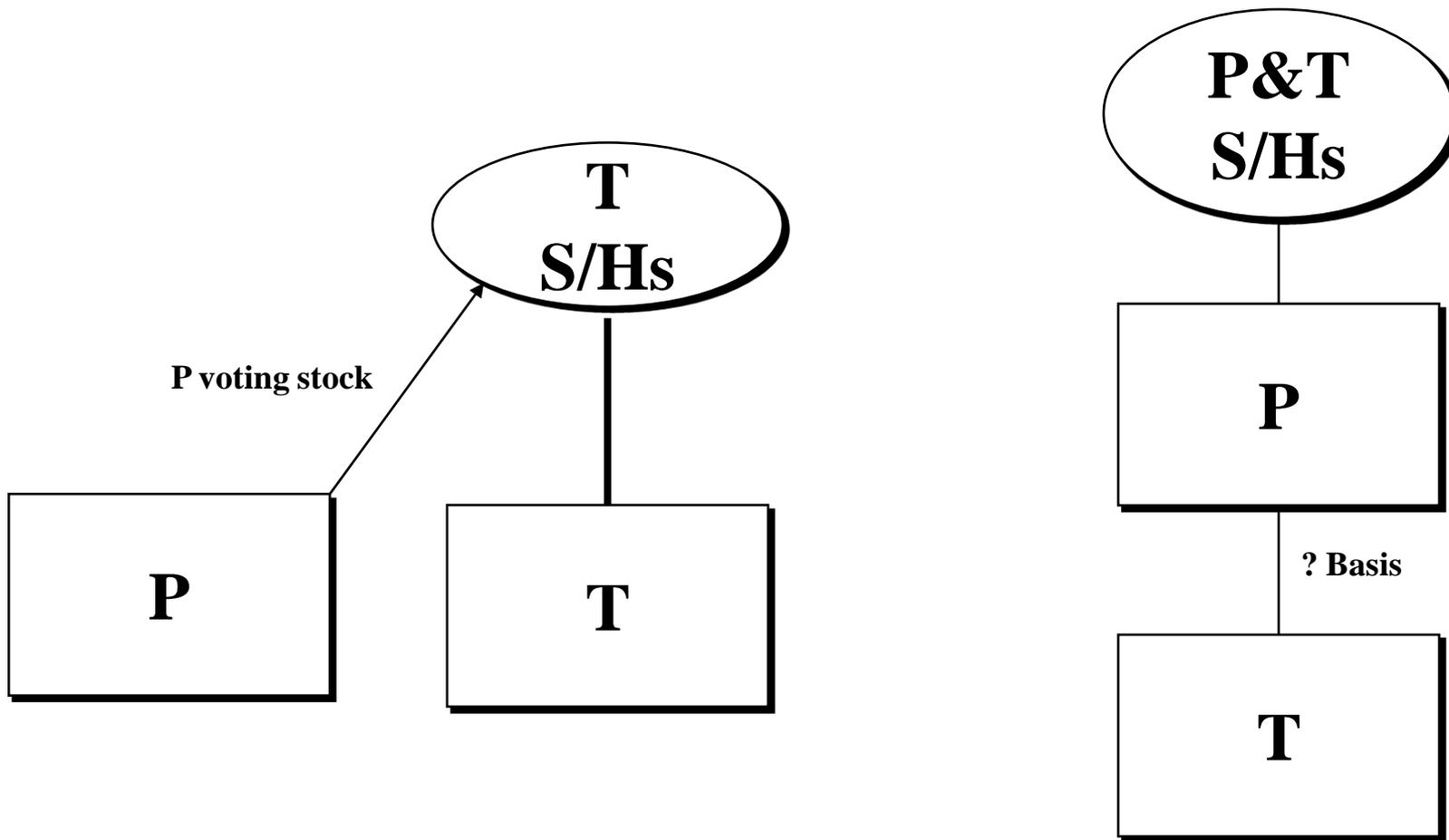
Corporate Basis Rules – Other Applications

- In a B reorganization, Sec. 362(b) provides for basis tracing transferor shareholder's stock to the transferee.
- In a Section 351 transaction, Sec. 362(a) provides for basis tracing, increased by amount of boot paid to the target shareholders.
- Note anti-loss duplication rules (Sec. 362(e)(2)) are applicable to Section 351 transactions where basis is determined under Sec. 362(a), but not to transactions where basis is determined under Sec. 362(b).

III.

Basis calculation rules and IRS guidance in a “Type B” reorganization

Section 368(a)(1)(B) Basis Calculation



Section 368(a)(1)(B) Basis Calculation

- Section 362(b):
- If property was acquired by a corporation in connection with a reorganization, then the basis shall be the same as it would be in the hands of the transferor.
- Generally we think of this provision applying to the basis that the acquiring corporation takes in the assets of the target corporation.
- A section 368(a)(1)(B) reorganization is not an asset reorganization, but a stock reorganization.

Section 368(a)(1)(B) Basis Calculation

- Rev Proc. 2011-35
 - This revenue procedure provides procedures that a corporation (Acquiring) may use to establish its basis in stock of another corporation (Target) when it acquires the Target stock in a transferred basis transaction.
- Optimal method for establishing basis in stock acquired in a section 368(a)(1)(B) reorganization is a **survey** of the surrendering Target shareholders.
 - Not always practical in the context of a publicly traded Target corporation.
- The revenue procedure establishes four methods.

Section 368(a)(1)(B)

Basis Calculation

- Four methods:
 - Surveying
 - Statistical Sampling
 - Estimation Procedure for shares surrendered by registered shareholders and certain reporting shareholders
 - Estimation Procedure for shares surrendered by nominees
- Can use any combination of the above procedures
- Actual knowledge of basis in shares must be used in lieu of any of the above methods
 - Such actual knowledge could be from Target's book and records

Section 368(a)(1)(B)

Basis Calculation

- **Surveying-** Section 4.01 of Rev Proc. 2011-35
 - Timeliness requirement:
 - Timely if it is completed within two years of the transferred basis transaction
 - Identification of the Target shareholders to be surveyed
 - Use Target's books and records, Master Securityholder Files maintained by the stock transfer agent or any SEC filing including Schedule 13 series
 - All reporting shareholders:
 - Own greater than 5% of the Target stock by vote or value
 - An officer or director of Target, or a plan that acquired Target stock for or on behalf of Target employees (such as an employee stock option or pension plan)

Section 368(a)(1)(B)

Basis Calculation

- Conducting the Survey
 - Send letters to the last known address of each shareholder
 - Want to know the number of shares held and the basis of each share
 - Provide the purpose for the request
 - If fail to respond within 30 days must follow up
- Allowable basis
 - Basis reported by surveyed shareholders unless
 - Differs from actual basis known by Acquiring
 - Is inaccurate on its face and differs significantly from the trading prices of the shares at the time within a week of the date that they were acquired

Section 368(a)(1)(B)

Basis Calculation

- **Statistical Sampling**—Section 4.02 of Rev Proc. 2011-35
 - Use standard statistical sampling when the administrative cost of surveying all surrendering shareholders is unreasonably high
 - Factors that determine whether administrative cost is unreasonably high include the time, burden, and financial cost of conducting a full survey
 - Presumed unreasonable high if immediately before the transaction Target stock was traded on an established securities market
- Survey eligible shares:
 - The actual basis is not known
 - Not surrendered by or on behalf of a reporting shareholder

Section 368(a)(1)(B) Basis Calculation

- **Estimation procedure for shares surrendered by registered shareholders and certain reporting shareholders—Section 4.03 of Rev Proc. 2011-35**
 - This section allows an estimation for registered shareholders that did not respond to the survey including reporting shareholders
- Initial estimated basis is determined by treating the shareholder who surrendered the share as acquiring the share by purchase for the adjusted closing price on the date that the shareholder was issued its stock certificate
 - Initial estimated basis must be adjusted for all subsequent transactions and events that would require an adjustment to basis under the Code (for example, to take into account distributions under section 301(c)(2))

Section 368(a)(1)(B)

Basis Calculation

- Estimation procedure for shares surrendered by nominees—
Section 4.04 of Rev Proc. 2011-35
 - This section uses data from Target Security Position Reports or from SEC Form 13F filings (but not both)
 - Surrendering shareholder would be a nominee or reporting shareholder that failed to respond to the survey
- First have to identify when a shareholder first appeared on a report
 - Then use a 3 month average to determine the initial starting basis
 - Then on subsequent measuring dates determine ownership and price adjustments for each period

Section 368(a)(1)(B)

Basis Calculation

- Pre-filing agreements
 - The determination of whether a basis study is done in compliance with one of the procedures described in Section 4 of this revenue procedure may be the subject of a pre-filing agreement
- Reporting Requirements
 - Taxpayers acquiring stock in transferred basis transactions described in this revenue procedure are deemed to satisfy the reporting requirements of §1.368-3 if they include a statement on or with the timely filed original return for the taxable year of the transferred basis transaction that identifies the transferred basis transaction and states that a basis study is pending with respect to the acquired stock.
 - But must file a statement with a timely filed original return for a tax year that is no later than the tax year that includes the date that is two years after the date of the transferred basis transaction

Section 368(a)(1)(B) Basis Calculation

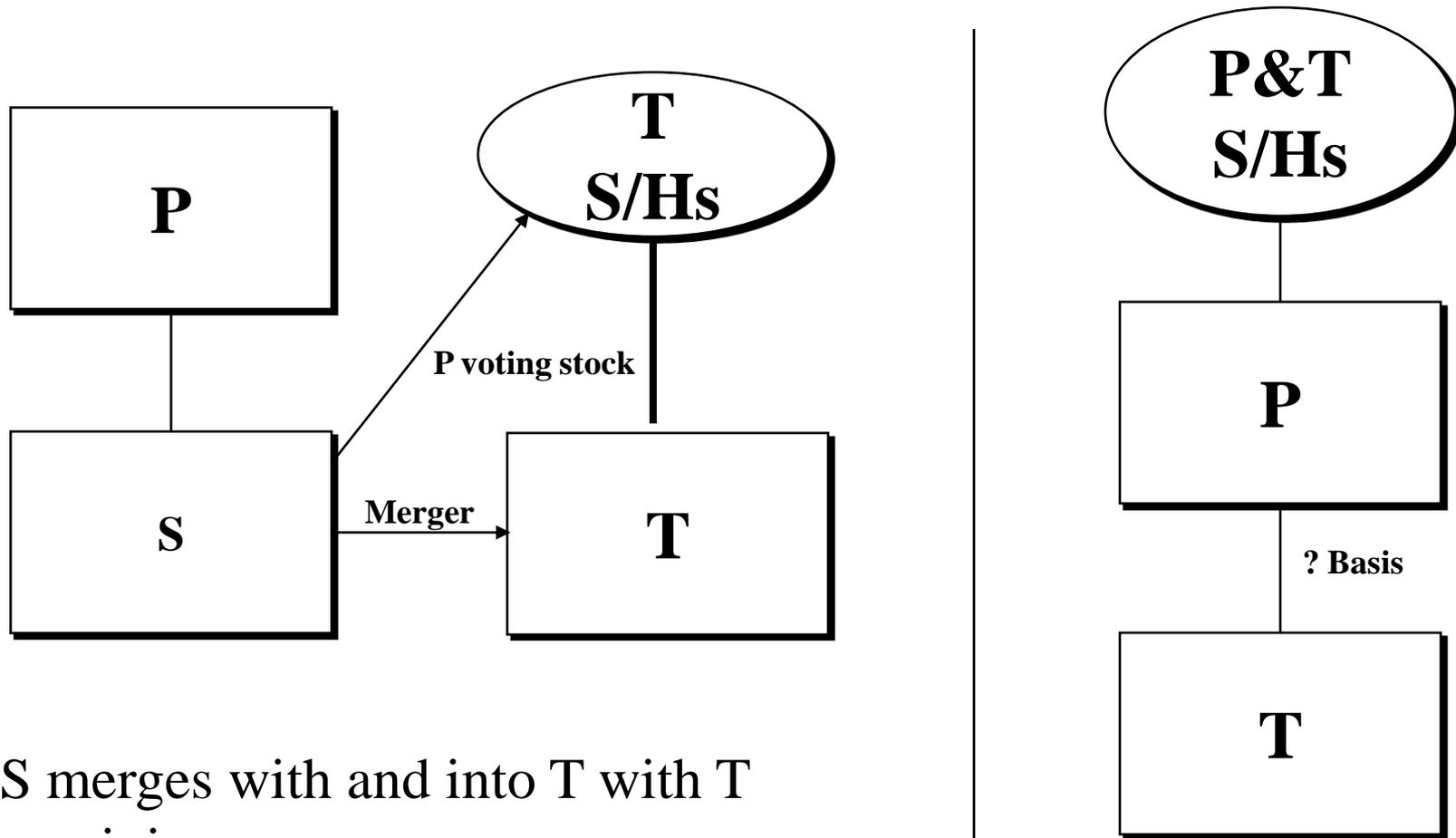
- Exception:
 - Group structure change for a consolidated group and §1.1502-31
- Generally if the Target Shareholders own more than 50% of the stock of the acquiring corporation after a section 368(a)(1)(B) reorganization, the transaction will be a group structure change within the meaning of §1.1502-31 and a “net asset” basis calculation will be used to determine P’s basis in the T stock.

IV. Basis calculation issues in a “reverse triangular” reorganization

Basis calculation issues in a “reverse triangular” reorganization

- To determine basis in a section 368(a)(2)(E) or “reverse triangular” reorganization one must look to §1.358-6(c)(2)
- Generally the basis is determined the same as it would be in the context of a section 368(a)(2)(D) or “forward triangular merger”
- That is P’s basis in T will be determined using an over the top, net asset basis.
- If the reverse triangular merger also qualifies as either a section 351 or section 368(a)(1)(B) transaction then a transferred basis calculation that was just discussed can be used

Basis calculation issues in a “reverse triangular” reorganization

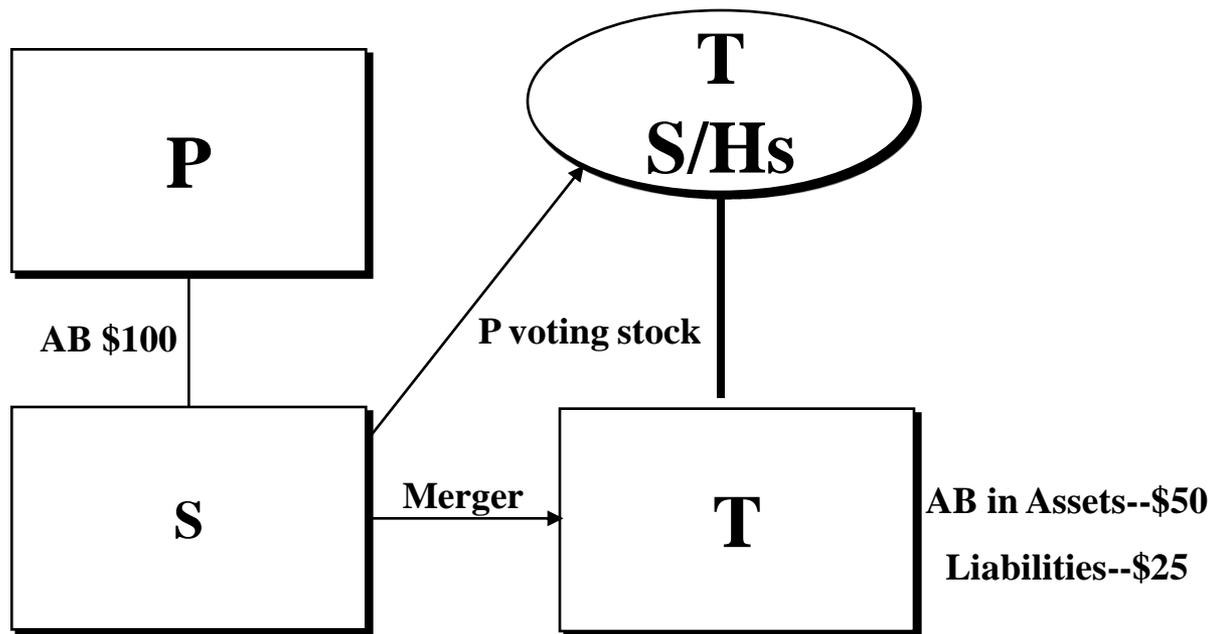


S merges with and into T with T surviving

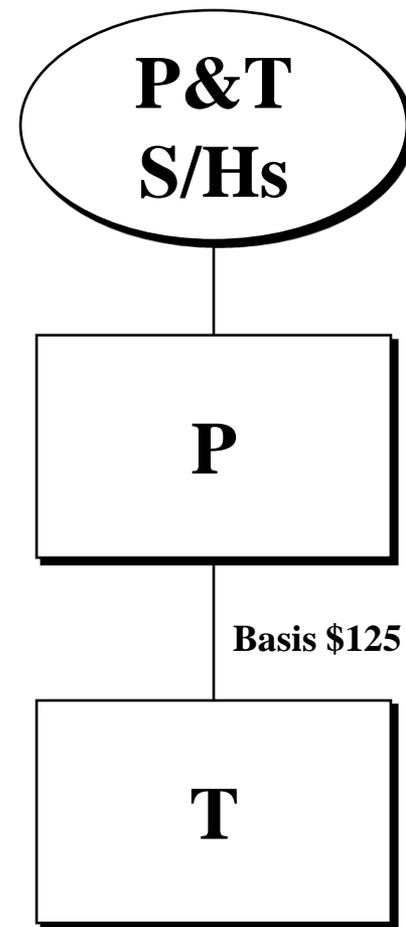
Basis calculation issues in a “reverse triangular” reorganization

- Basis **adjustment** is the over the top model in general
- This is an adjustment, so to the extent that P has basis in S prior to the transaction, the §1.358-6(c)(2) will adjust such starting basis
- Limitations
 - Such basis adjustment cannot be negative
 - Therefore to the extent that T has liabilities in excess of the adjusted basis of the assets transferred such basis adjustment would be zero
 - If consideration is provided by S that was not transferred by P, such consideration cannot provide for a negative adjustment
 - Any consideration provided by P will not be added to P’s adjustment to the T stock

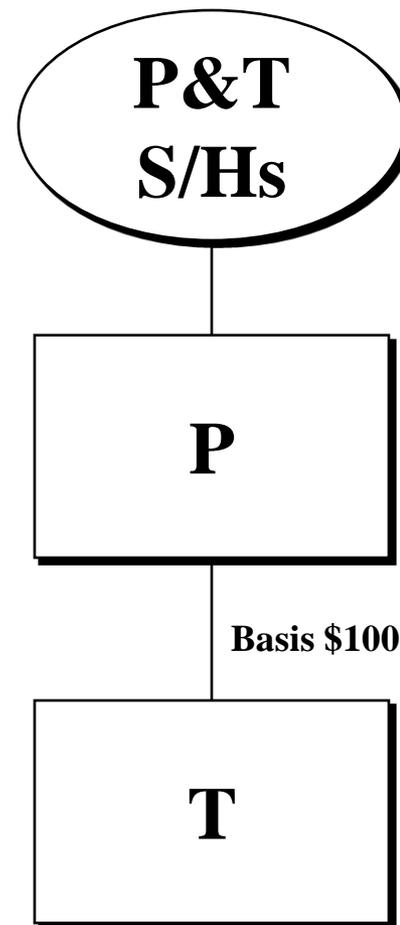
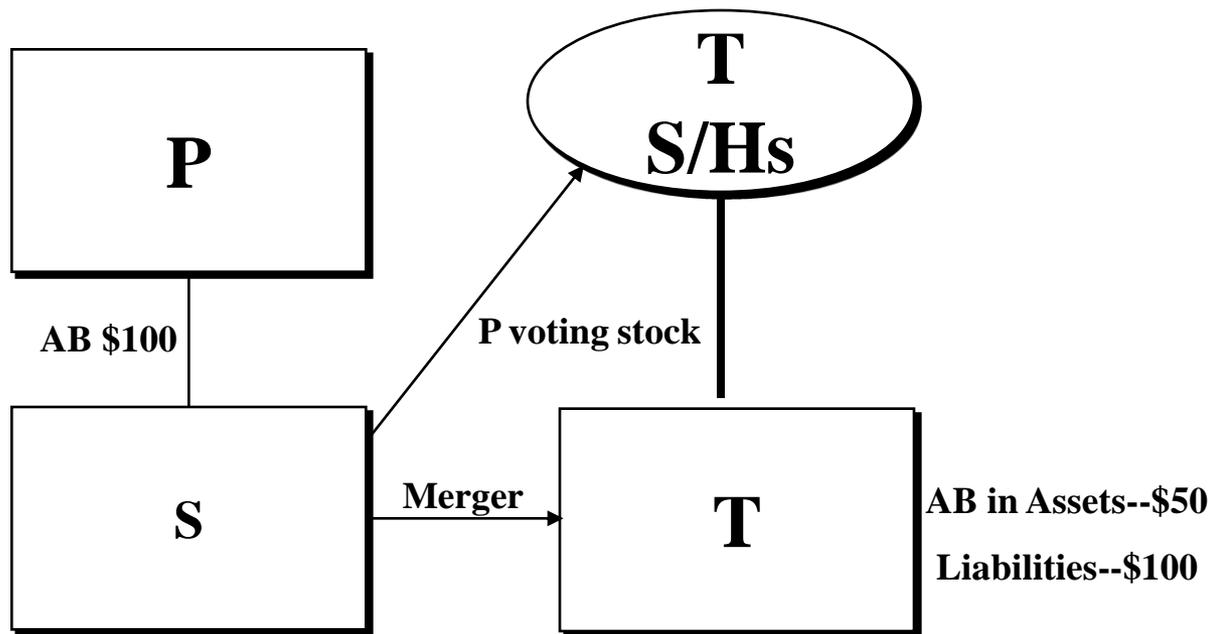
Basis calculation issues in a “reverse triangular” reorganization



- S merges with and into T with T surviving
- S can be a pre-existing entity or could have been newly formed with minimum capitalization



Basis calculation issues in a “reverse triangular” reorganization

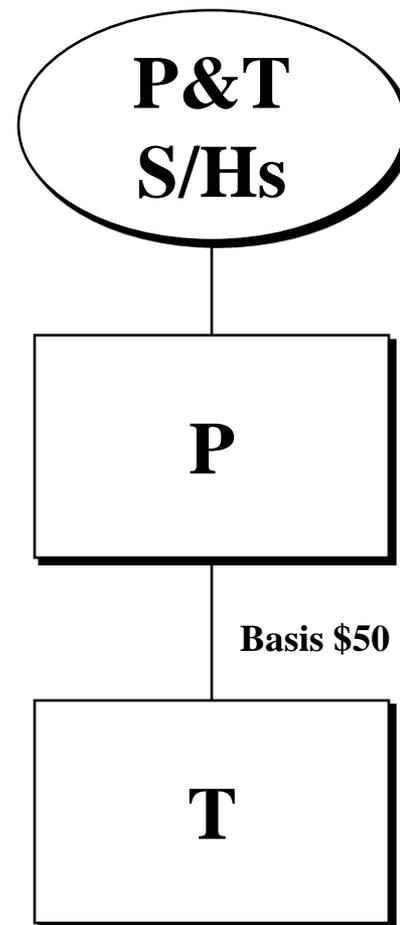
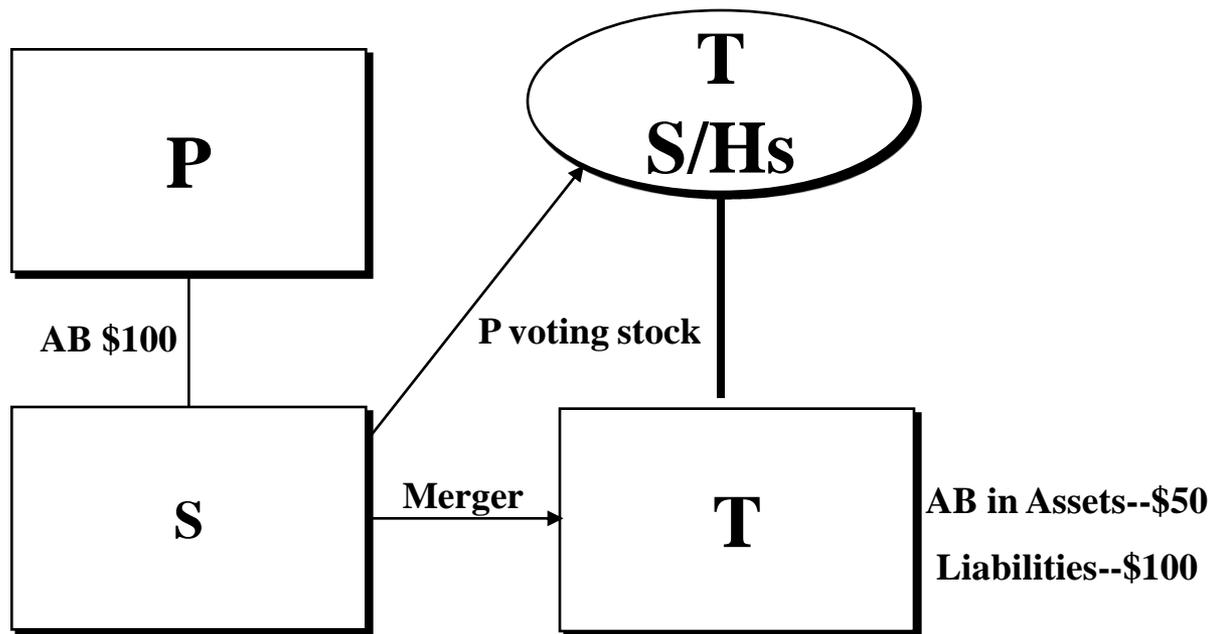


- S merges with and into T with T surviving
- S can be a pre-existing entity or could have been newly formed with minimum capitalization
- The answer would be the same if S had provided consideration in excess of T's adjusted basis in its assets, in that the adjustment would be zero

Basis calculation issues in a “reverse triangular” reorganization

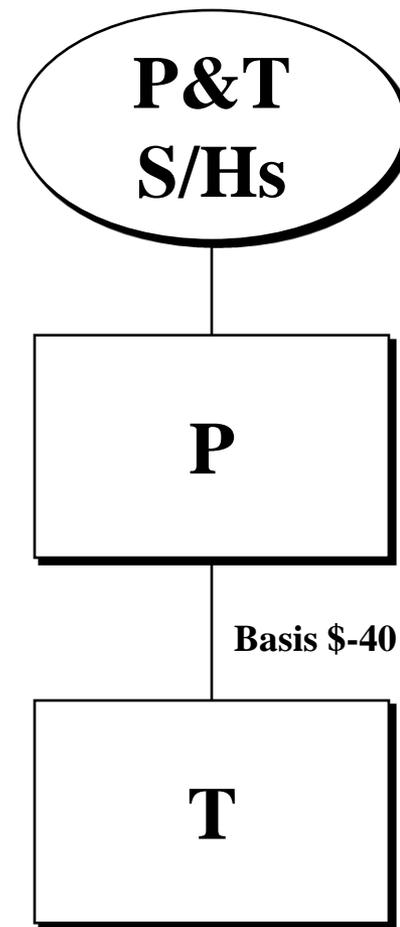
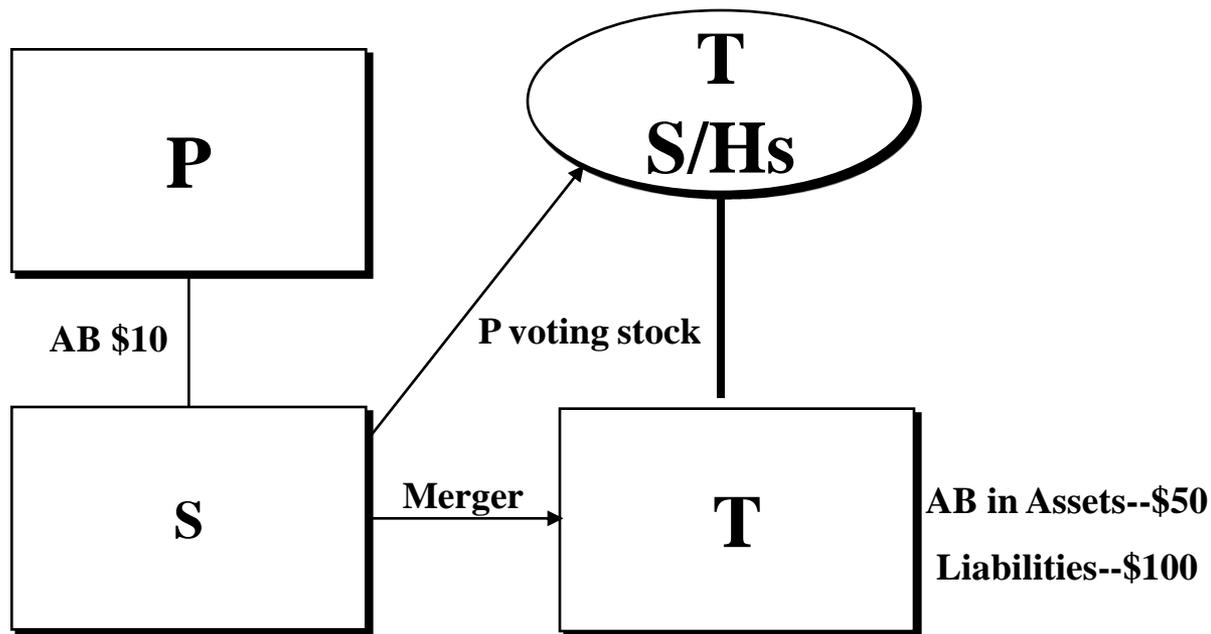
- Exception to the basis limitation rules when T joins a consolidated group
- §1.1502-30 applies to turn off the negative basis consequences when T joins a consolidated group
- Does not need to be a group structure change as described earlier with respect to the B reorganization
- However, the same transferred basis rules with respect to a B reorganization still apply if T is joining a consolidated group

Basis calculation issues in a “reverse triangular” reorganization



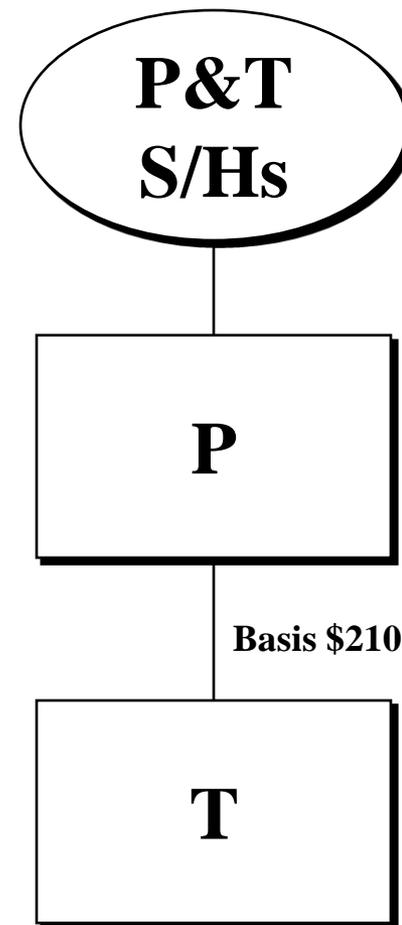
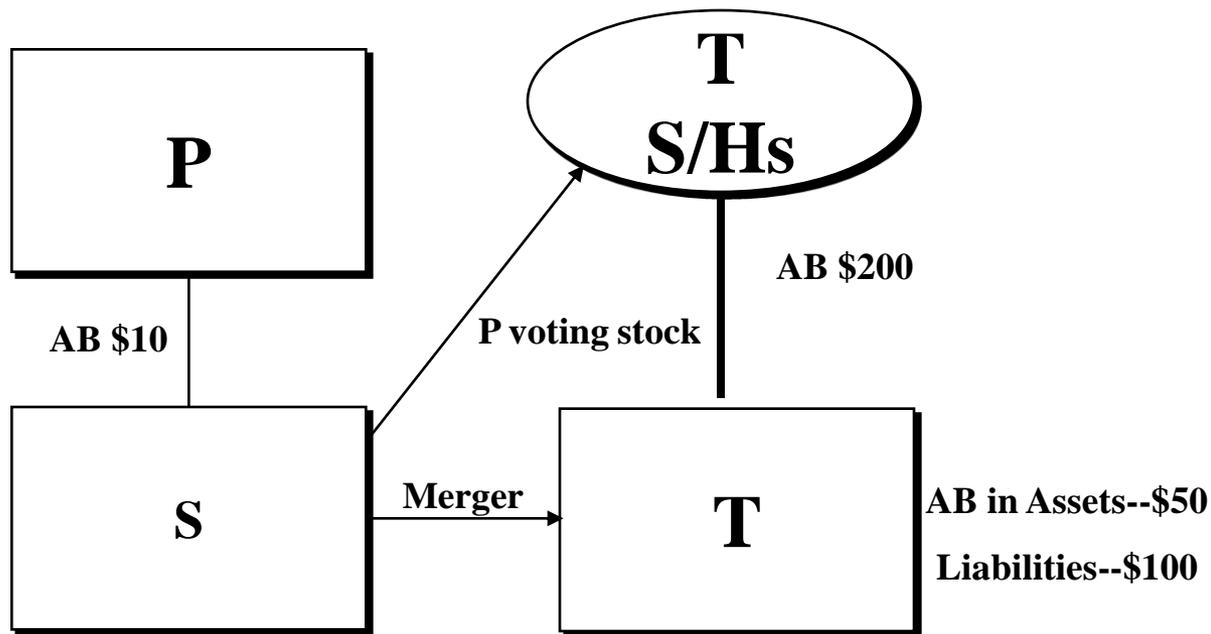
- S merges with and into T with T surviving
- S can be a pre-existing entity or could have been newly formed with minimum capitalization
- The answer would be the same if S had provided consideration in excess of T's adjusted basis in its assets

Basis calculation issues in a “reverse triangular” reorganization



- S merges with and into T with T surviving
- S can be a pre-existing entity or could have been newly formed with minimum capitalization
- The answer would be the same if S had provided consideration in excess of T's adjusted basis in its assets
- P as a result of this transaction has an excess loss in the T stock

Basis calculation issues in a “reverse triangular” reorganization



- S merges with and into T with T surviving
- Transaction also qualifies as a section 368(a)(1)(B) reorganization
- Transferred basis rule of 362(b) can be used and P’s basis in the T stock would be \$210.
- However, if the T shareholders own more than 50% of P, then a net asset basis must be used under §1.1502-31

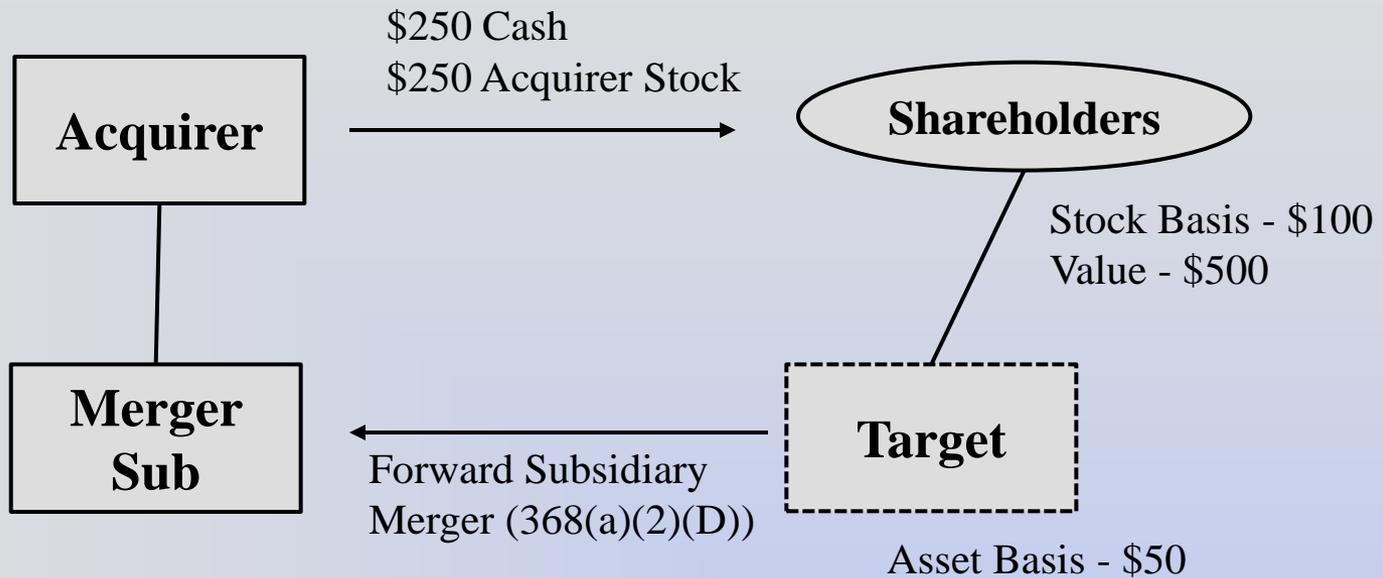
V. Required filings

Required Filings

- §1.368-3—records to be kept and information to be filed with returns
- Each corporation a party to a reorganization must include a statement on or with its return for the taxable year of the exchange
 - “Statement pursuant to §1.368-3(a) by [insert name and employer identification number (if any)], a corporation a party to a reorganization”
- Statement must include:
 - The names and employer identification numbers (if any) of all such parties
 - The date of the reorganization
 - The aggregate fair market value and basis, determined immediately before the exchange, of the assets, stock or securities of the target corporation transferred in the transaction, and
 - The date and control number of any private letter ruling issued by the IRS in connection with this reorganization
- Significant shareholders must also file a similar statement with their return
 - For a publicly traded corporation a significant shareholder is one that owns 5% by vote or value of the total outstanding stock of Target.

Triangular Reorganizations and Net Inside Basis Election

Corporate Basis Rules – Triangular Reorganizations



- Reg. 1.358-6 provides guidance on Acquirer's basis in Target stock following a triangular reorganization.
- Generally an “over-the-top” model is used.

Corporate Basis Rules – Triangular Reorganizations

- Reg. 1.358-6(b) applies to triangular reorganizations of the following types:
 - Forward triangular mergers
 - Reverse triangular mergers (except for certain B reorganizations)
 - Triangular C Reorganizations
 - Triangular B Reorganizations

- Acquirer's basis in the subsidiary's stock is generally determined as if the following steps had occurred: (1) P had acquired the T assets directly from T in a Section 362(b) transaction; and (2) P then contributed those assets, subject to liabilities to new T.

Corporate Basis Rules – Triangular Reorganizations

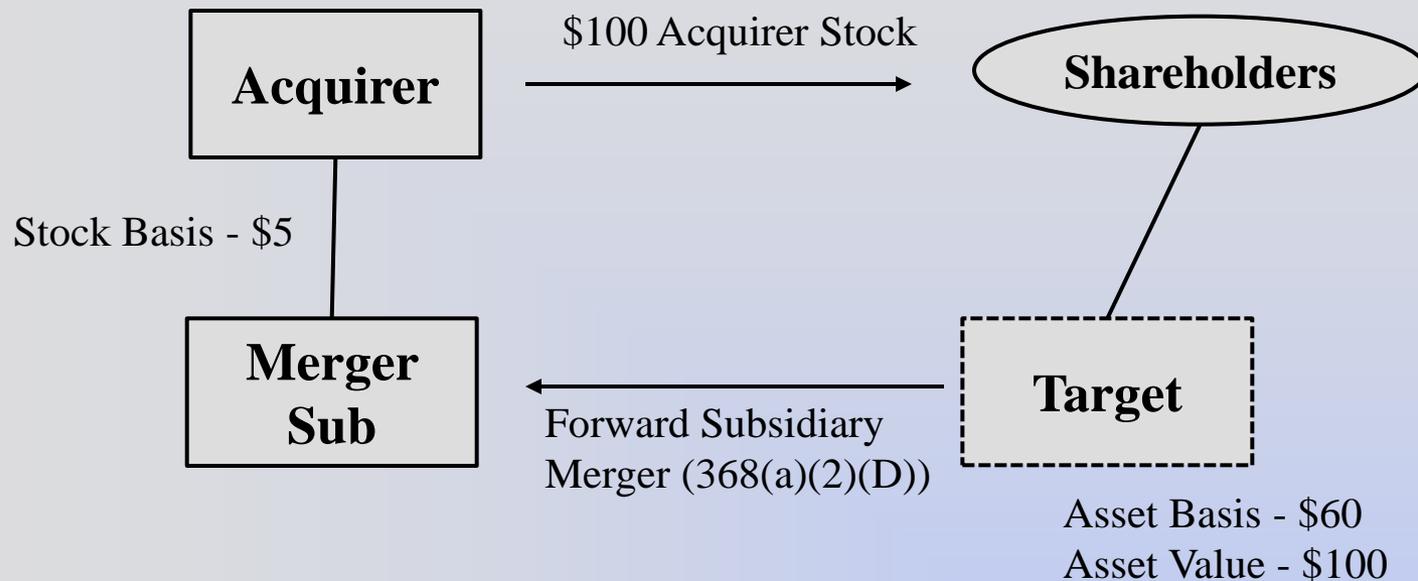
Scope of the rules:

- The over-the-top model applies to all forward subsidiary mergers and triangular C reorganizations.
- It also generally applies to reverse triangular mergers. However, if the reverse triangular merger also qualifies as a Section 368(a)(1)(B) reorganization or Section 351 transaction, P can determine its basis using the over-the-top model, or by applying tracing rule to basis of transferring shareholders' stock in T.
- In a triangular B reorganization, P takes a basis in S as if P acquired T from the shareholders with a carryover basis and then contributed P to S.

Corporate Basis Rules – Triangular Reorganizations

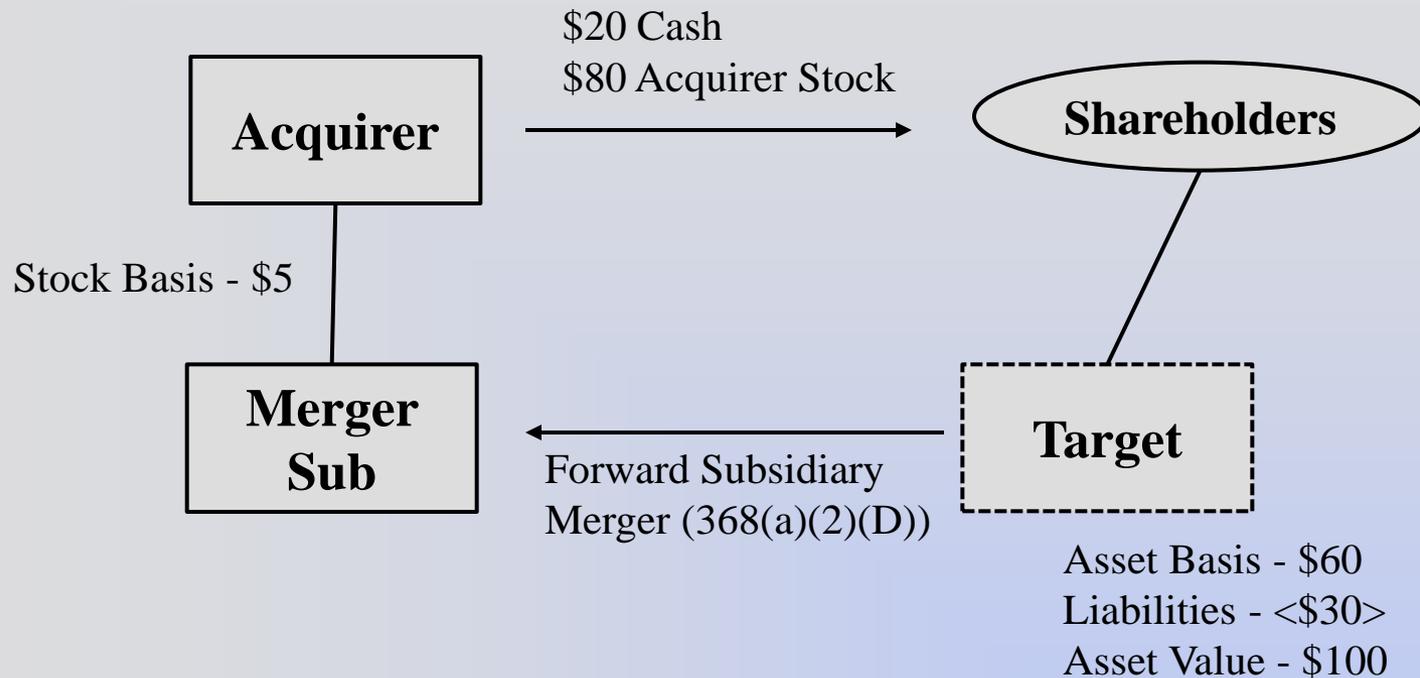
- S's stock may have pre-existing basis (if S is not a new subsidiary formed for the transaction) or if S receives and retains other assets besides those used to pay deal consideration.
- The basis adjustment by P to S's stock is reduced, but not below zero, by any liabilities of S under Section 357(c).
- P's basis in S's stock is reduced, but not below zero, by any portion of the deal consideration furnished by S.

Corporate Basis Rules – Examples of Over-the-Top Model



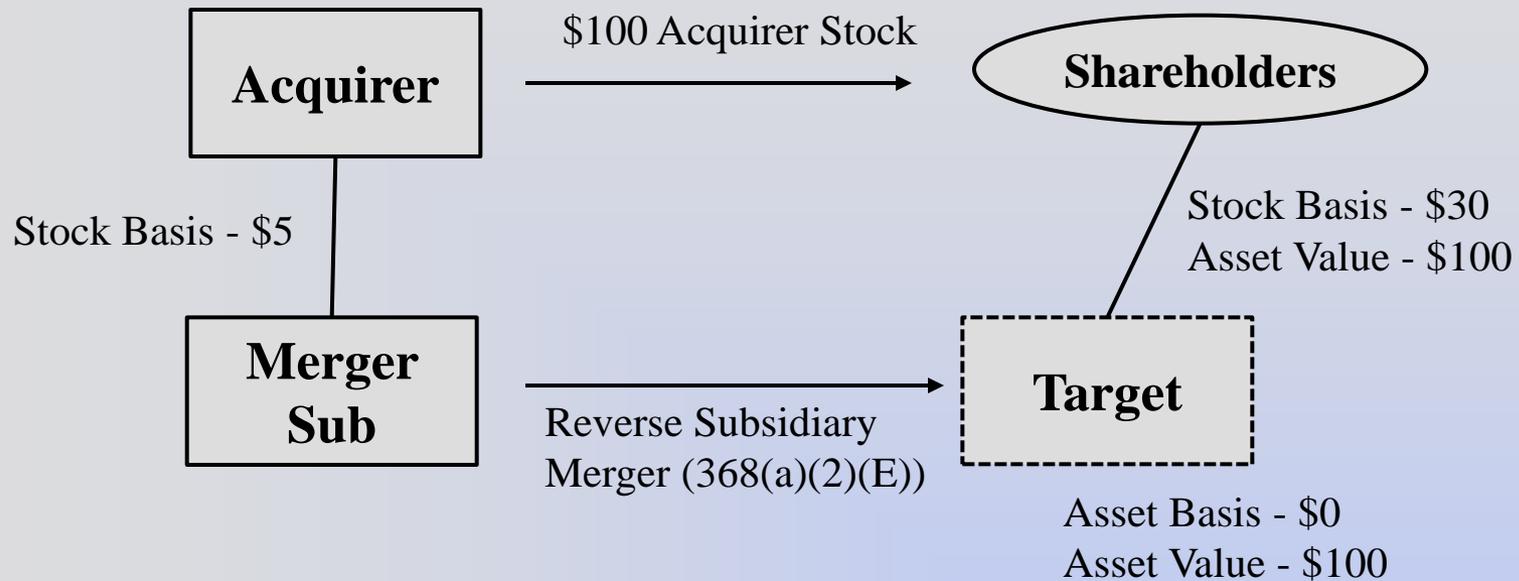
- Acquirer increases basis in Merger Sub's stock by the net asset basis of Target that is deemed to be received by Acquirer and then contributed to Merger Sub.
- Therefore, Acquirer has a basis of \$65 in Merger Sub's stock after the transaction.

Corporate Basis Rules – Examples of Over-the-Top Model



- Acquirer increases basis in Merger Sub's stock by the net asset basis of Target, or \$30, and has a basis of \$35 in Merger Sub's stock.
- Cash from Acquirer to fund the acquisition and shareholders' recognition of gain have no effect on Acquirer's basis in Merger Sub's stock.

Corporate Basis Rules – Examples of Over-the-Top Model



- Reverse Merger is generally subject to “over-the-top” analysis, so that Acquirer basis in Merger Sub / Target remains \$5.
- Under 1.358-6(c)(2)(ii), since acquisition is also a B reorganization, Acquirer could elect to trace to Shareholders’ basis in Target stock (\$30).

Corporate Basis Rules – International Issues

- Sec. 362(e)(1) provides for resetting of tax basis to FMV of assets received in a reorganization or Section 351 transaction that would result in “importation” of built-in-loss into the United States.
- Where Sec. 362(e)(1) applies to the transaction, both built-in-gains and built-in-losses in the transferred properties are eliminated.
- Consider also foreign currency translation of non-USD basis in the Target’s stock following a reorganization in which stock is acquired from non-U.S. individuals who acquired stock with non-dollar currencies (e.g., Euro, Yen). See Chief Counsel Advice 200303021