

Mastering Section 368 Tax-Free Reorganization Reporting for Maximum Tax Benefits

THURSDAY, JUNE 4, 2015, 1:00-2:50 pm Eastern

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Mastering Section 368 Tax-Free Reorganization Reporting for Maximum Tax Benefits

June 4, 2015

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Understanding Tax-Free Reorganizations under Section 368

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Webinar

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Emphasis:

International Tax

Tax Planning

Tax Controversy

Corporate/Transactional Tax

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Overview –

- Overview of Tax-Free Reorganizations
- Review of A, B and C Reorganizations and Forward / Reverse Subsidiary Mergers
- Non-Statutory Reorganization Requirements

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).

Elements of a Reorganization

- Transaction must be described within one of the six categories described in Section 368(a)(1).
- Transaction must satisfy the non-statutory requirements of a reorganization:
 - Non-tax business purpose (*Gregory v. Helvering*)
 - Continuity of interest (COI)
 - Continuity of business enterprise (COBE)

Note – both the Target and Acquirer must be corporations for tax purposes for Section 368 to apply.

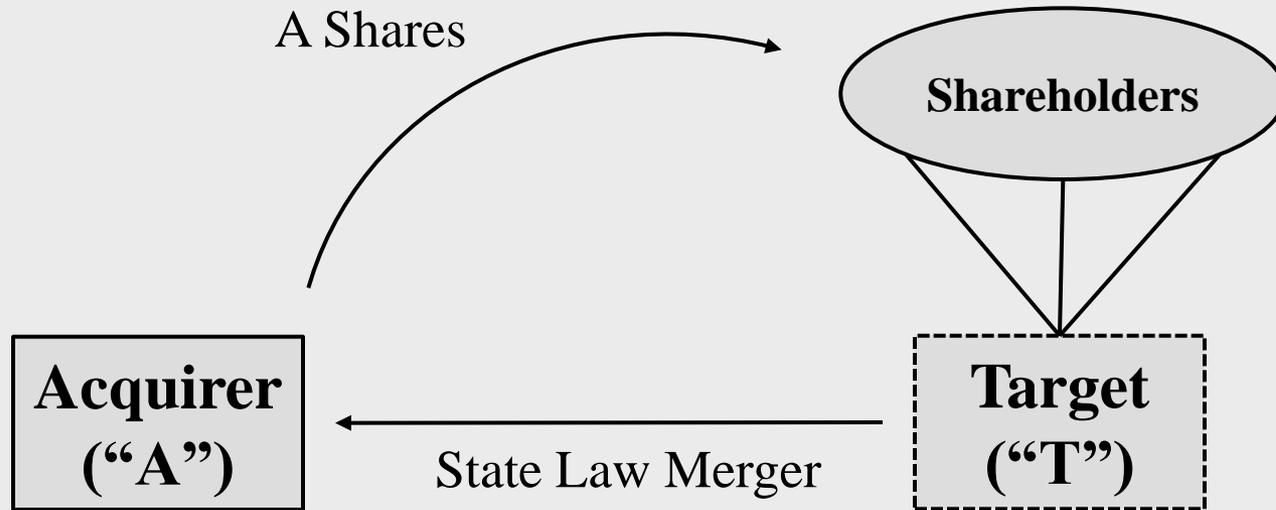
Types of Reorganizations

- Statutory Merger (“A” Reorganization):
 - Merger into the Acquirer (i.e., straight A Reorganization)
 - Merger into a subsidiary of Acquirer (i.e., a forward triangular merger)
 - Merger of Acquirer’s subsidiary into Target (i.e., a reverse triangular merger)

- Exchange of Stock for Stock (“B” Reorganization)

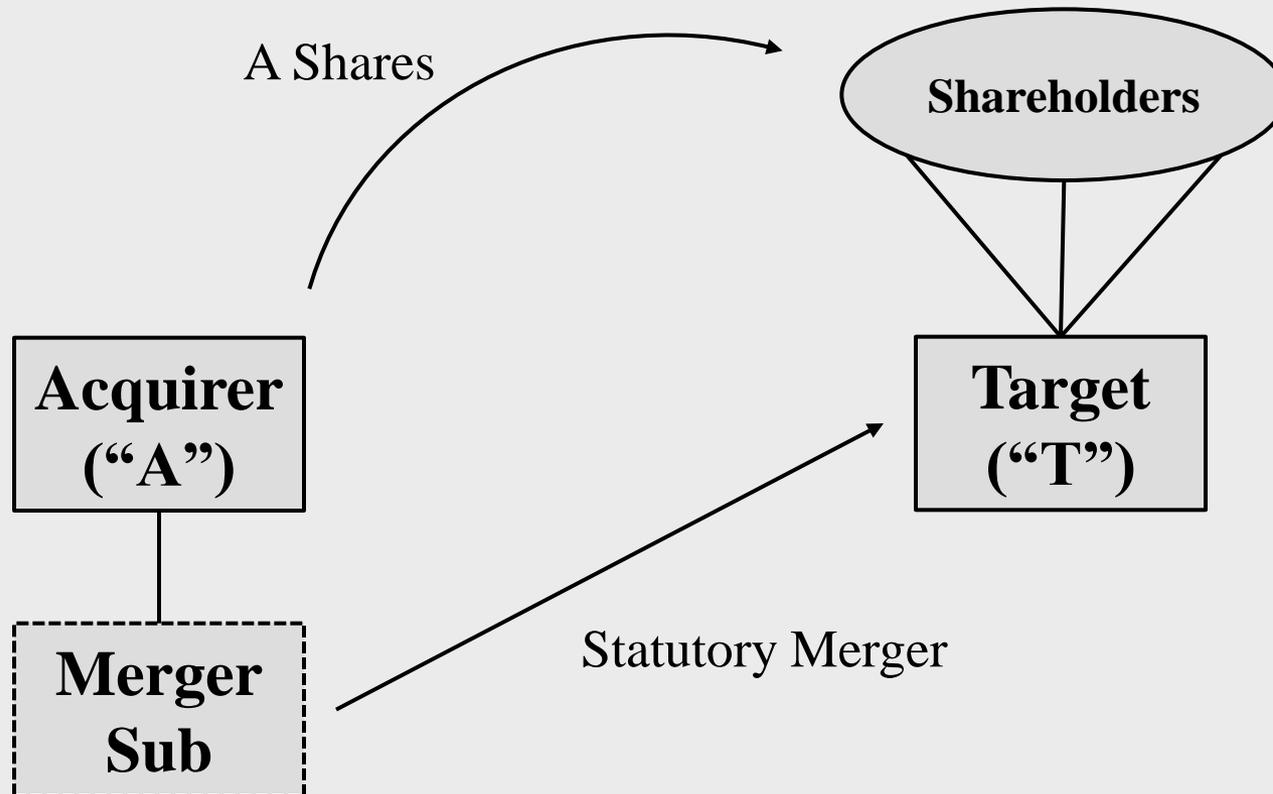
- Acquisition of Assets for Stock (“C” Reorganization)

Asset Reorganization: Straight A Reorganization



- T's merger into A through a statutory merger is treated as if (1) T transferred its assets to A in exchange for merger proceeds and (2) T dissolved and distributed the proceeds to its shareholders.

Stock Reorganization: Reverse Subsidiary Merger



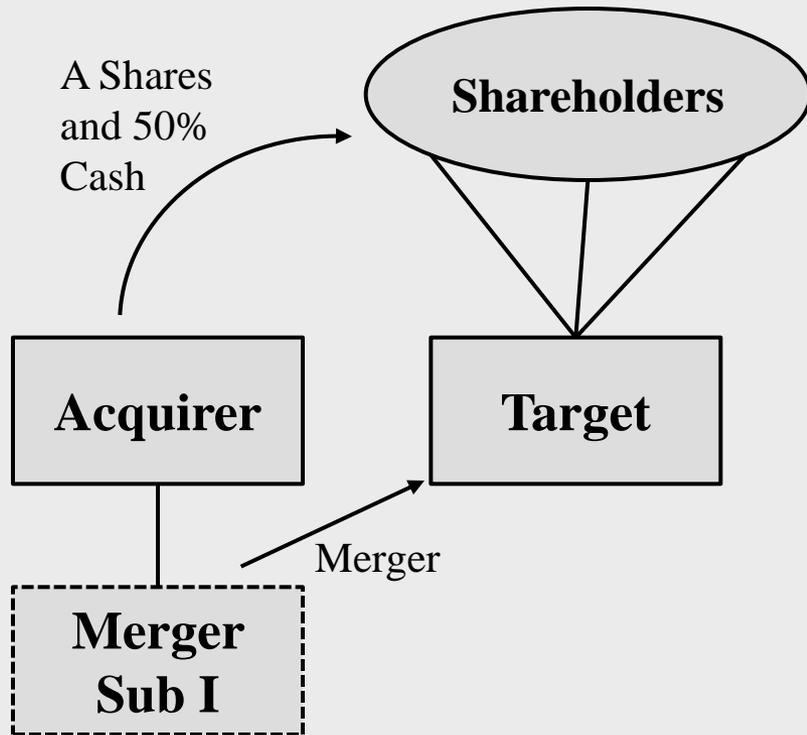
- Merger Sub's merger into T is treated as if shareholders exchanged their T shares for A shares by operation of law.

Integrated Transaction Doctrine

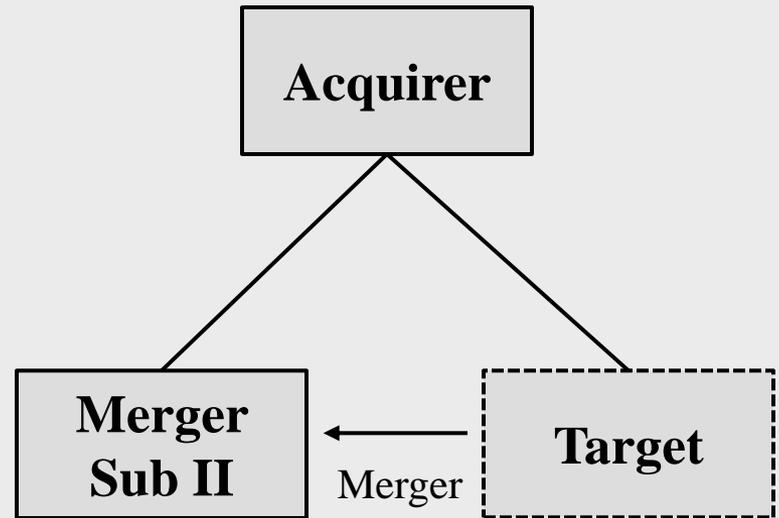
- IRS has issued a series of revenue rulings clarifying role of step-transaction in context of a stock acquisition followed by a merger or liquidation.
 - Rev. Rul. 90-95 – cash reverse merger for 100% of Target’s stock, followed by a merger or liquidation of Target, will be treated as a separate qualified 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.

Integrated Transaction Doctrine – Recent Developments

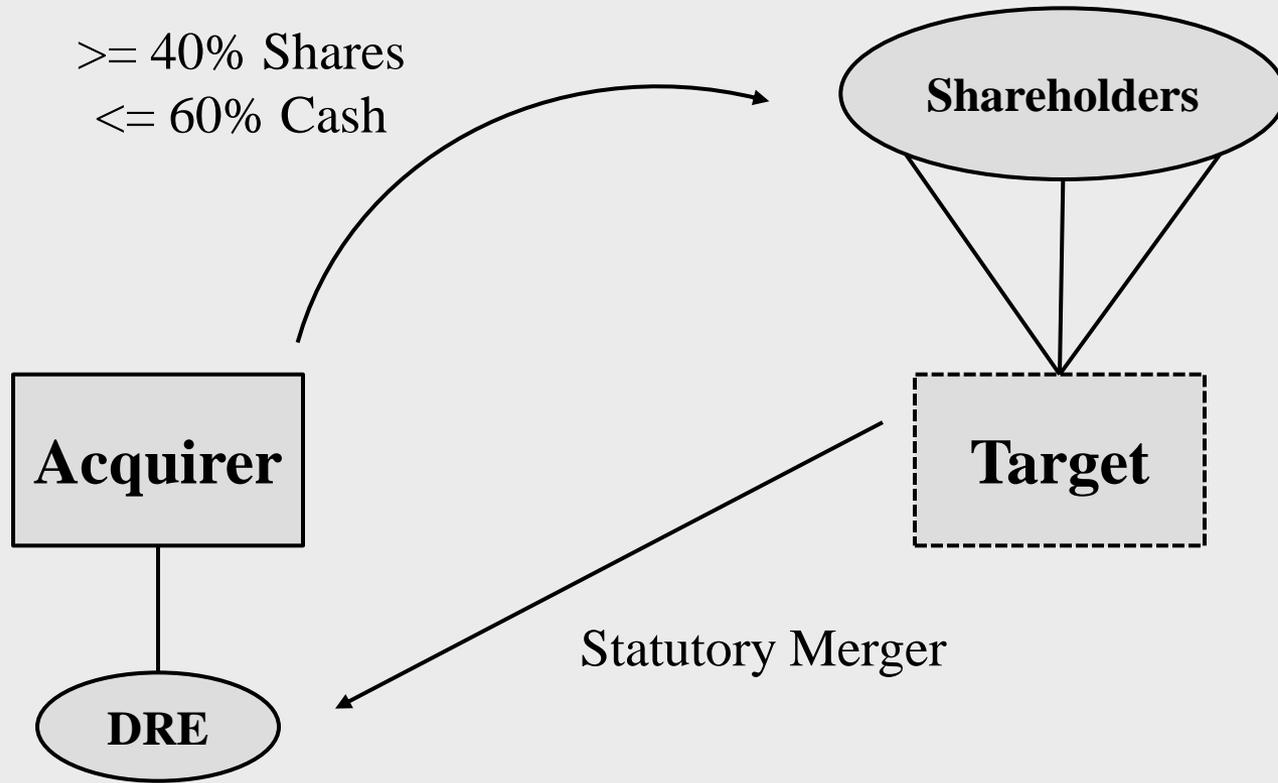
- Rev. Rul. 2008-25 –
 - P acquired all of T's stock (via reverse merger) for 90% P stock and 10% cash. P then liquidated T (not via a statutory merger). The amount of T's liabilities and 10% cash exceeded permitted boot under C reorganization requirements.
 - IRS ruled that integrated transaction did not qualify as a forward merger because second step was a liquidation. First step would be treated as a taxable stock purchase, followed by a separate Section 332 liquidation.
- Rev. Ruls. 2015-9 and 2015-10 – IRS ruled that cascading Section 351 transfers, followed by a check-the-box liquidation, would be treated as (1) Section 351 transactions, followed by a (2) D reorganization.

Review of A, B and C Reorganizations and Forward / Reverse Subsidiary Mergers

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

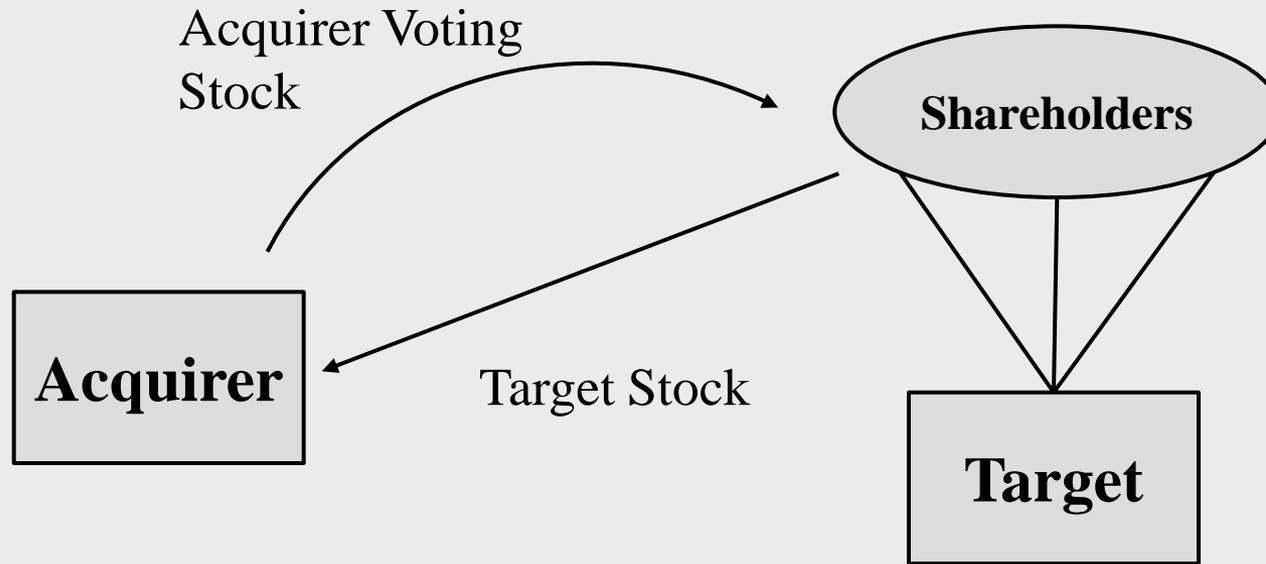


- Target's merger into Acquirer's DRE is treated as a statutory merger into Acquirer's "combining unit." This is tested as a Sec. 368(a)(1)(A) reorganization.

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

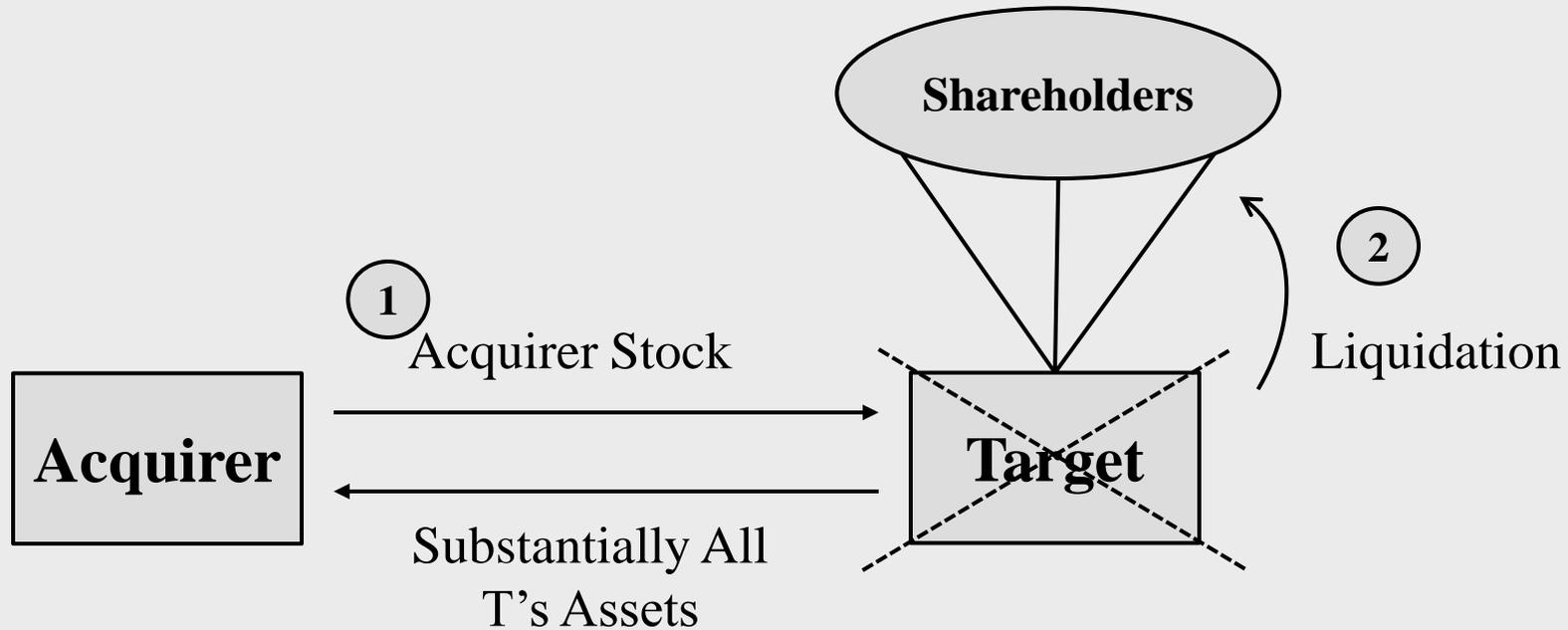


- Alternatively, under parenthetical, Acquirer's first-tier, wholly owned subsidiary could acquire target in a triangular B reorganization.
- A reverse merger involving a transitory merger sub also may lead to a "forced" B reorganization. *See Rev. Rul. 74-564.*

Section 368(a)(1)(C) Reorganizations

- Section 368(a)(1)(C) applies to the acquisition by one corporation of substantially all of the assets of another corporation solely in exchange for its voting stock (or that of a corporation in control of it), disregarding any assumption of liabilities.
- Boot relaxation rule (§ 368(a)(2)(B)). If acquirer exchanges money or other property, this will not disqualify the exchange so long as at least 80% voting stock consideration is used (taking into account assumed liabilities for this purpose).
- Distribution requirement (§ 368(a)(2)(G)). Target must distribute all of the consideration received, and its other properties, as part of the plan of reorganization.

Example of a C Reorganization

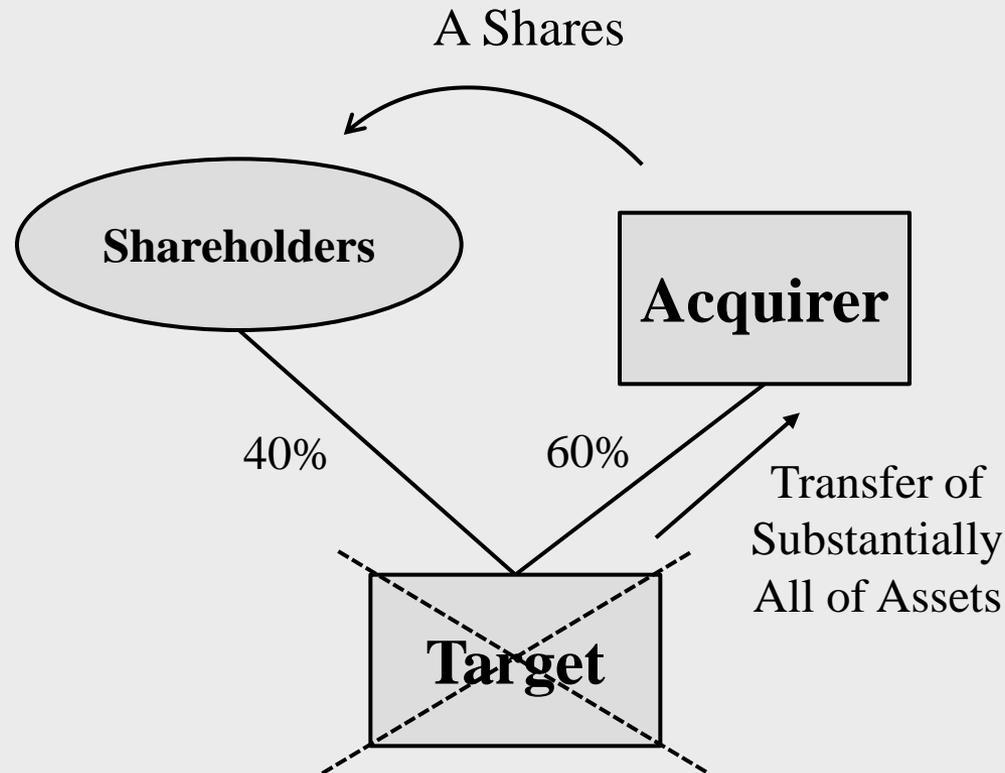


- Alternatively, Target's assets could be acquired by Acquirer's first-tier subsidiary in a Triangular C reorganization.

Section 368(a)(1)(C) Reorganizations

- “Substantially all” of the assets is a case law test that applies on the facts and circumstances, looking both to the amount of gross and net assets acquired and nature of the assets (i.e., passive vs. operating).
- Rev. Proc. 77-37 safe harbor deems substantially to be met if buyer acquires at least 90% of the net assets and 70% of the gross assets.
- Upstream C Reorganizations (Reg. § 1.368-2(d)(4)). Acquirer’s prior ownership of Target’s stock does not prevent the solely for voting stock requirement from being met.

Example of an Upstream C Reorganization



- Transaction may qualify as a C reorganization so long as Acquirer does not acquire more than 20% of the value of Target's assets for Acquirer stock. *See* Reg. § 1.368-2(d)(4), Example 1.

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.

Non-Statutory Reorganization Requirements

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).

Continuity of Interest (COI)

- COI generally requires a minimum of 40% of T's shares to be exchanged for stock in the issuing corporation. *See* Treas. Reg. § 1.368-1(e)(2)(v), Example 1.
- COI is measured as to T's shareholders as a whole; thus, particular shareholders may be cashed out while others maintain continuity of interest.
- COI is not affected by sales of stock by Target shareholders before the reorganization (i.e., there is no historic continuity requirement). COI is also unaffected by sales of stock after the reorganization the acquirer or a related person to the acquirer makes the acquisition. *See* Treas. Regs. §§ 1.368-1(e)(1) and 1.368-1(e)(6).

Continuity of Interest (COI) – The Signing Date Rule

- Signing date rule – COI generally is determined by valuing stock and other property to be delivered on the last business day before there is a binding contract providing for a fixed consideration. Treas. Reg. § 1.368-1(e)(2)(i).
- A contract provides for fixed consideration if the amount of stock and other property to be delivered is specified. Contingent adjustments to the consideration are disregarded, however, unless the adjustments prevent the target shareholders from having the benefits and burdens of owning P's stock from the signing date.
- Customary escrows do not prevent the signing date rule from applying.

Continuity of Interest (COI) – The Signing Date Rule cont.’

- Modifications. If the contract is modified after the initial signing date, the modified contract is generally treated as a new contract if it provides more cash, less shares or both to the target shareholders.
- Shareholder elections of cash / stock do not affect application of the signing date rule so long as the stock price used for the election is set on the signing date.
- 2011 Proposed Regulations would adopt favorable rule for certain collar provisions, where the amount of cash / stock does not exceed / fall below a floor or ceiling and the floor / ceiling would preserve continuity based on the signing date value of P’s stock.

Continuity of Interest (COI) – Examples of the Signing Date Rule

- Examples 1 and 2 – P and T enter a merger agreement that provides for 60% cash and 40% P stock (based on signing date values), with half of the P stock placed in escrow.
Holding: signing date rule applies, so that movement in P's stock price between sign and close does not affect COI.

Note: signing date only is used to *value* P shares, not determine COI. Thus, if P escrow shares are forfeited, COI may be failed in the above example.

Continuity of Interest (COI) – Examples of the Signing Date Rule

- Example 10 – shareholders enter into a contract whereby they will receive additional P shares and cash to the extent P's stock price declines between signing and closing.
Holding: the signing date rule does not apply and P shares must be valued as of closing.

Continuity of Interest (COI) – Contingent / Escrowed Stock

- Case law has generally rejected the IRS’s arguments that the right to contingent stock is “boot.” *See, e.g., Carlberg*, 281 F.2d 507 (8th Cir. 1960).
- Rev. Proc. 84-42, § 2.01, sets forth IRS ruling guidelines for contingent stock and escrowed stock, including:
 - No more than 5 year term
 - Maximum number of shares is known
 - No more than 50% of total shares are contingent
 - Contingent payment rights only payable in shares, not cash
- Sellers generally prefer the use of escrowed stock in a reorganization due to imputed interest on contingent / deferred shares. *See* Reg. § 1.483-4(b), Example 2.

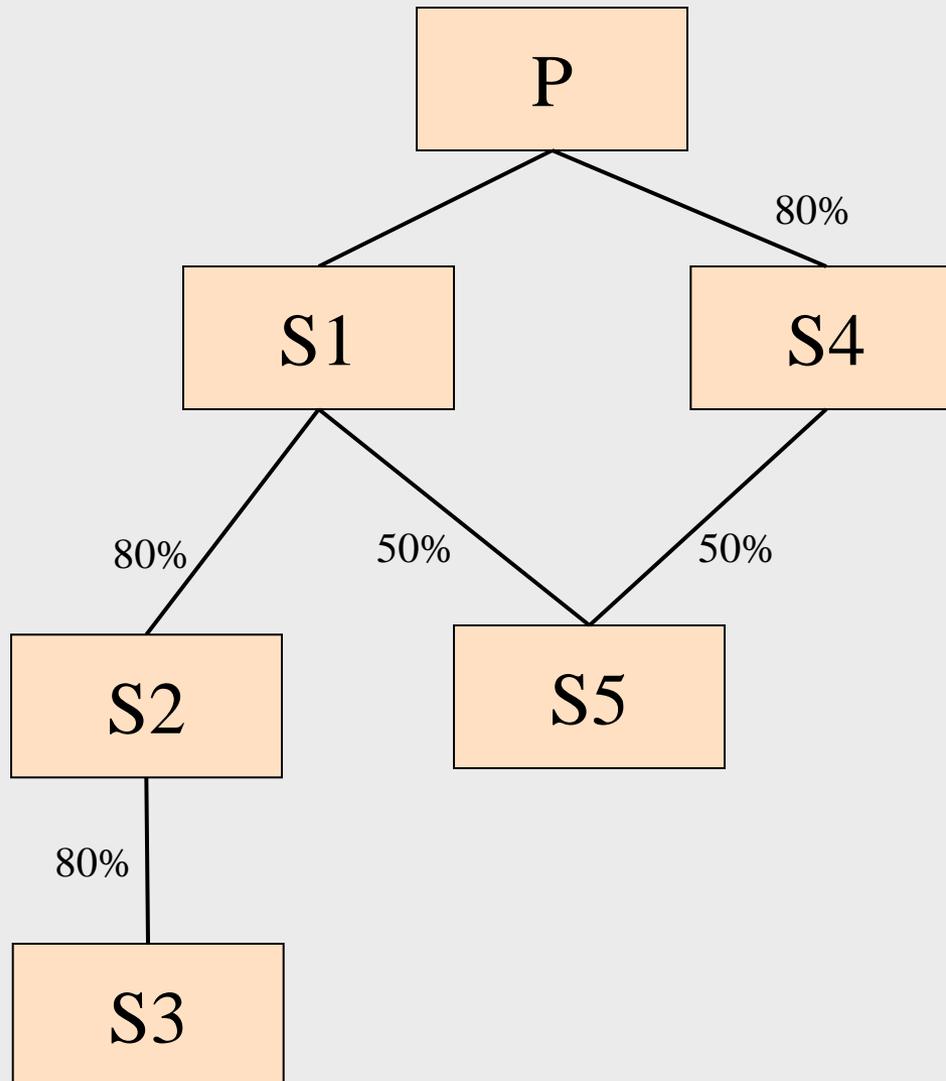
Continuity of Interest (COI) – Redemptions and Other Distributions

- Redemptions of Target or Acquirer stock in connection with the merger by Acquirer or a related person to acquirer will affect COI. *See* Treas. Reg. § 1.368-1(e)(3).
- COI generally will not be affected by the following:
 - Redemptions or distributions by Target prior to closing funded by Target’s own assets – *see* Treas. Reg. § 1.368-1(e)(8), Example 9.
 - Certain open market stock buyback programs– *see* Rev. Rul. 99-58
 - Dividends paid by buyer to all shareholders post-closing – *see*, e.g., PLR 200752014.
- Distributions of T assets as part of plan of reorganization also can pose issues under the “substantially all” test

Continuity of Business Enterprise (COBE)

- COBE requires the issuing corporation to continue T's historic business or use a significant portion of T's historic business assets.
- The issuing corporation can maintain historic business assets or conduct business activity anywhere within the “qualified group.”
- Qualified group includes one or more corporations connected to Issuing corporation through chains of Section 368(c) control. Qualified group also includes partnerships in which corporation owns a “significant interest” or conducts active and substantial management functions as a partner.

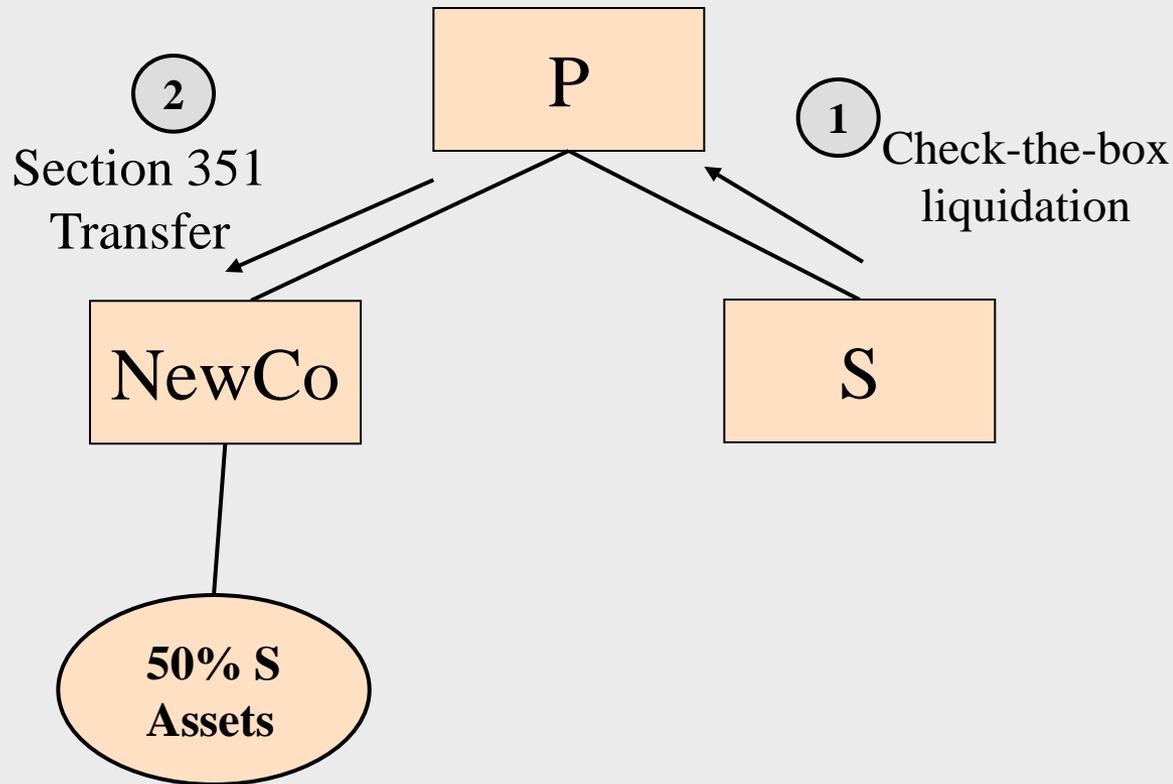
Continuity of Business Enterprise (COBE) – Example of a Qualified Group



Subsequent Drop Downs

- Section 368(a)(2)(C). A transaction described in Sections 368(a)(1)(A), (B) or (C) shall not be disqualified by reason of the fact that the assets are transferred to a controlled corporation.
- The IRS has interpreted the section also to allow drop-downs following D reorganizations. See Rev. Rul. 2002-85.
- Treas. Reg. § 1.368-2(k) provides that a Section 368 reorganization shall not be disqualified or re-characterized as a result of certain distributions or certain subsequent transfers within the qualified group.

Example of a Subsequent Drop Down



- The subsequent transfer to a controlled corporation does not disqualify or recharacterize S's upstream C reorganization under Treas. Reg. § 1.368-2(k)(1).

Proposed Net Value Requirement

- Prop. Reg. § 1.368-2(f) (2004) would require both a surrender of net value and receipt of net value in a reorganization.
- When finalized this would cause certain reorganizations involving insolvent corporations to become taxable transactions.
- Pending finalization, taxpayers are required to determine the impact of insolvency on reorganization status based on case law.

Examples of M&A Tax Provisions

- Parties' agreement to treat the transaction as a reorganization and treat merger agreement as the “plan of reorganization.”
- Representations & warranties or covenants as to specific matters that could affect reorganization status.
- General representations / covenants that parties know of no facts or will not take action that could cause transaction to fail to qualify.
- Tax opinion as a condition to closing of the deal.

Strafford Publications Webinar

Understanding Tax-free Reorganizations Under Section 368

June 4, 2015

**ROSE WILLIAMS
EY
WASHINGTON, DC**

Section 368(a)(1)(D)

Acquisitive D Reorganizations

- Section 368(a)(1)(D) provides:
 - Transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred, but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356 are transferred.
 - Focus is on acquisitive D reorganizations—focus on the 354 requirement

Section 368(a)(1)(D)

Acquisitive D Reorganizations

➤ Statutory requirements:

➤ *Assets*

➤ Section 354(b)(1)(A)

- The corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets
- Has the same meaning as substantially all for C reorganizations

➤ *Control*

➤ Section 368(a)(2)(H)(i)

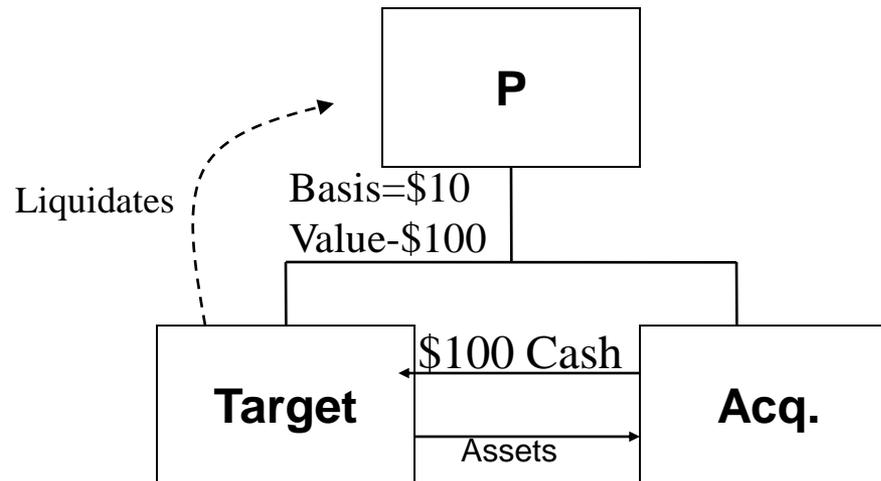
- For this purpose control has the meaning contained in section 304(c)
- Section 304(c)
 - Control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes of stock
 - Constructive ownership rules in section 318 apply with some modifications

Section 368(a)(1)D)

Acquisitive D Reorganizations

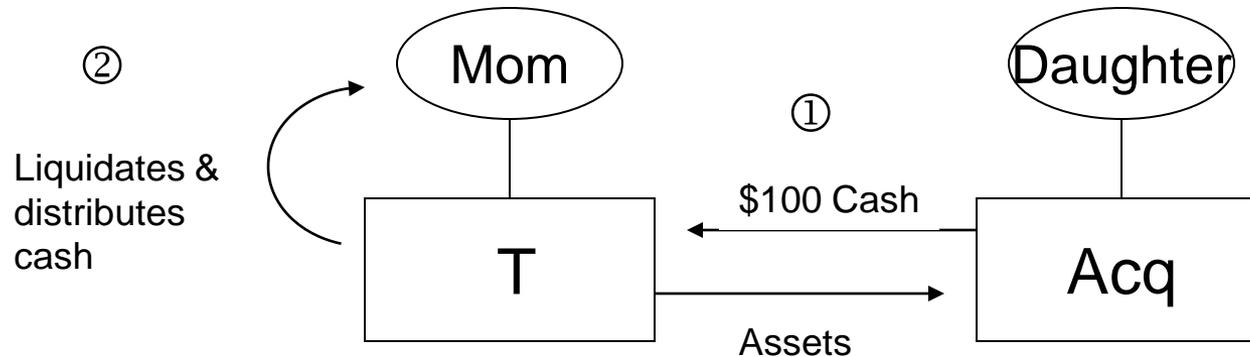
- Statutory requirements continued:
- *Distribution/Liquidation*
 - Section 354(b)(1)(B)
 - The stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.
 - Target corporation must liquidate.
 - *Meaningless Gesture*---Treas. Reg. §1.368-2(1)
 - A transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding that there is no actual issuance of stock and/or securities of the transferee corporation if the same person or persons own directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions.
 - In such cases, the transferee corporation will be deemed to issue a nominal share.

Base Case



- All cash asset acquisition qualifies as a D reorganization under the right circumstances
- Rev. Rul. 70-240 and Rev. Rul. 2004-83
- and Treas. Reg. §1.368-2(l)

Identical ownership through attribution

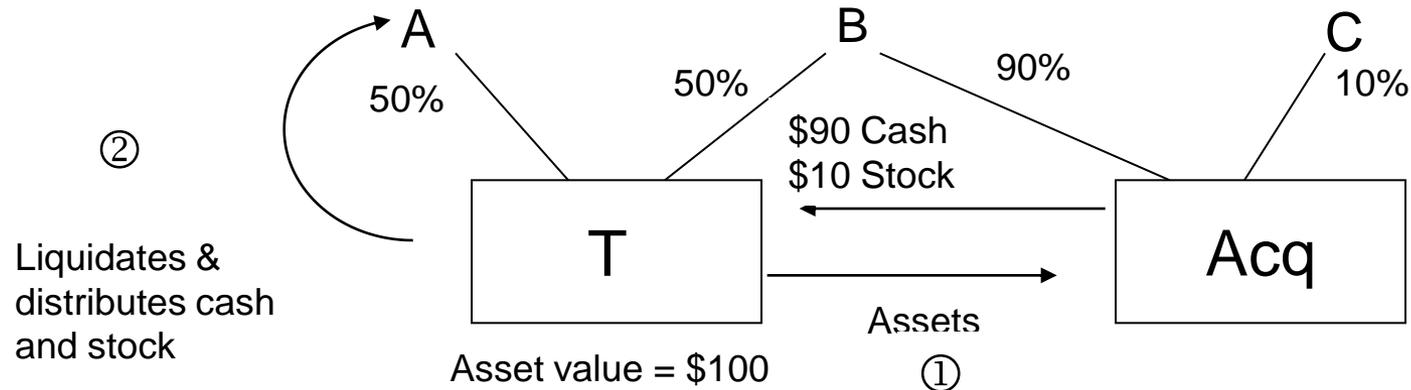


- Transaction qualifies as an “Acquisitive D” reorganization.
- Attribution applies for distribution and control requirements
 - Mom and daughter have identical ownership in T and Acq as a result of the attribution rules.
- COI implications?
- See, PLR 9111055.

No identity of shareholders

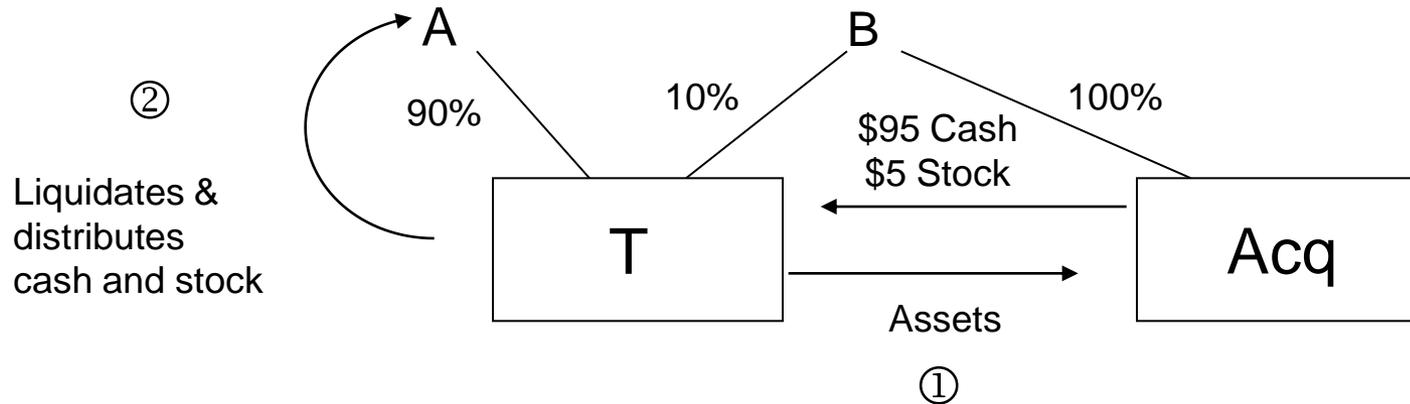
But

T Shareholders control both T and Acq.



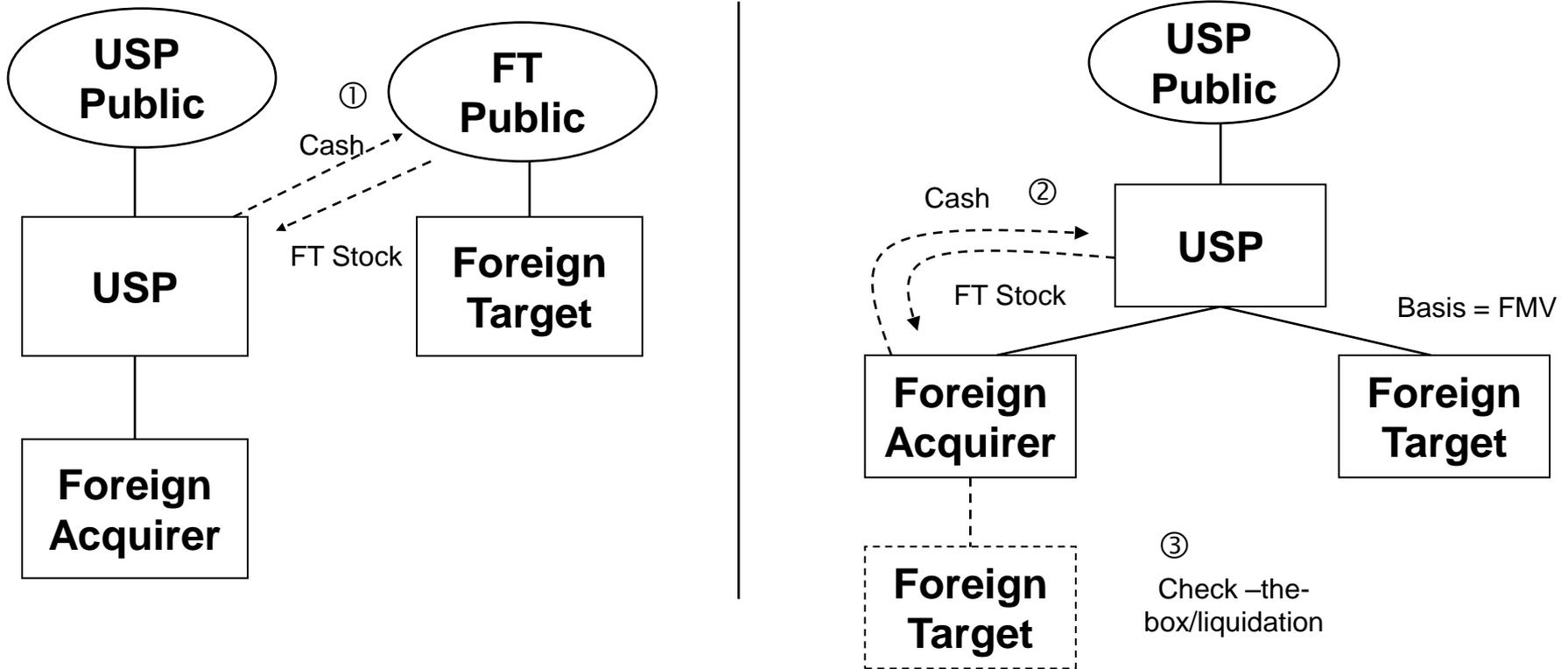
- A and B unrelated.
- In liquidation: \$50 cash to A; \$40 cash and \$10 stock to B.
- Is this a D reorganization?
 - – Distribution and control requirements satisfied.
 - – Role of COI?

Control immediately after



- A and B are unrelated.
- In liquidation: \$90 cash to A; \$5 cash and \$5 stock to B.
- Is this a D reorganization?
 - Distribution and control requirements satisfied.
 - Role of COI?

All Cash D – No Gain



- Steps 2 & 3 constitute a Type “D” reorganization
 - See Rev. Rul. 67-274 and Rev. Rul. 70-240
- Under §356(a)(2), dividend is limited to gain, then reduction of basis

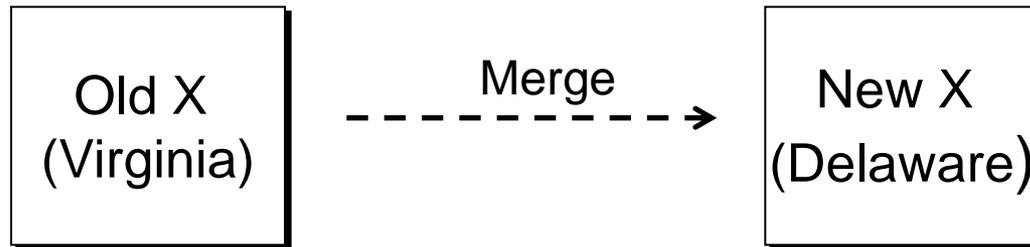
Tax-Free Reorganizations

- E Reorganization
 - Recapitalization--mere reshuffling of capital structure
 - Section 368(a)(1)(E)
- F Reorganization
 - Mere change in identity, form, or place of organization of a corporation
 - Often used to preserve entity from a legal standpoint but allow for an asset transfer for tax purposes
 - Section 368(a)(1)(F)
- G Reorganization (reorganization in bankruptcy)

Section 368(a)(1)(E)--Recapitalizations

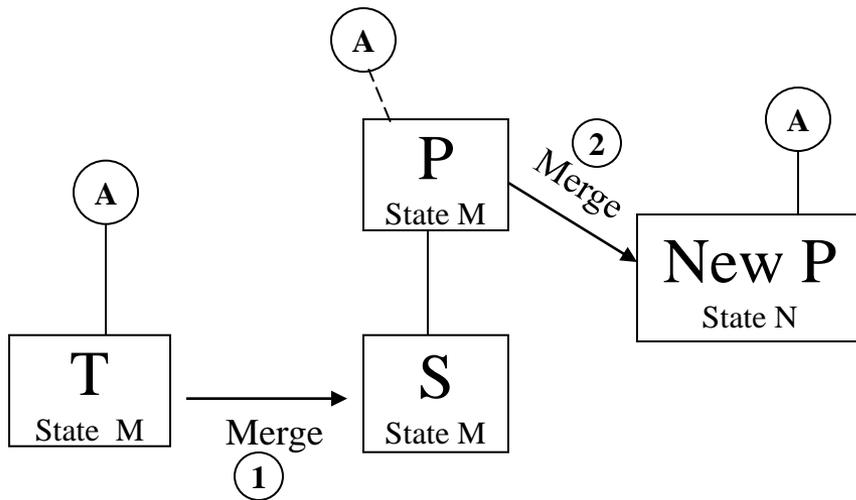
- Includes any changes to the capital structure
 - Stock splits, reverse stock splits
- Stock for stock exchanges
 - Common for common
 - Common for preferred stock
 - Preferred stock for common stock
 - Overlap in some instances with Section 1036
- Stock for security or debt exchanges
- Debt for stock exchanges
 - Consider application of Section 108

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

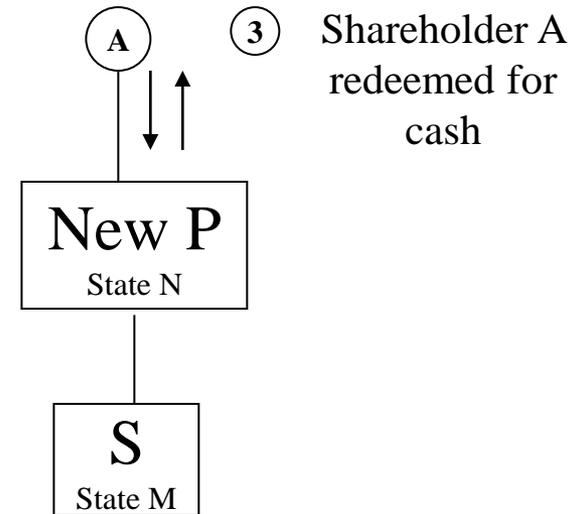


- §368(a)(1)(F): “a mere change in identity, form, or place of organization of one corporation, however effected”
- Limited application of the step transaction doctrine; see Rev. Rul. 96-29
- New X may carry back Old X’s NOLs to prior years
- No year end for Old X

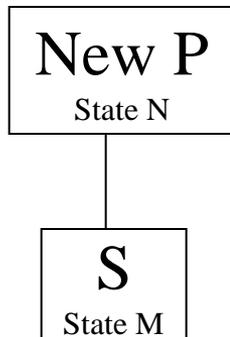
F Reorganization Inserted in the Middle of a Transaction



Shareholder A receives P stock in the merger of T into S. The merger is intended to be a forward triangular reorganization



Result:



Does the F reorganization act as a blocker for integrating the first and the third step.

F Reorganizations & Step Transaction

- Rev. Rul. 96-29, 1996-1 CB 50.
 - *Situation 1* of that ruling involved the merger of a target corporation into a newly formed corporation (the F reorganization) which was respected as an F reorganization and treated separately from a subsequent prearranged public offering of shares equal to 60% of the target company's value and a redemption of nonvoting preferred stock of the target corporation equal to 40% of its value prior to the offering. The ruling noted that the step transaction doctrine would not apply because of the “unique status” of F reorganizations.
 - In *Situation 2* of the same ruling, after a corporation acquired the stock of a target corporation for stock of the acquiring corporation (in a B reorganization), the target changed its state of incorporation by merging into a new corporation. The ruling held that the reincorporation transaction was separate from the B reorganization even though the reincorporation transaction only took place because of the acquisition.

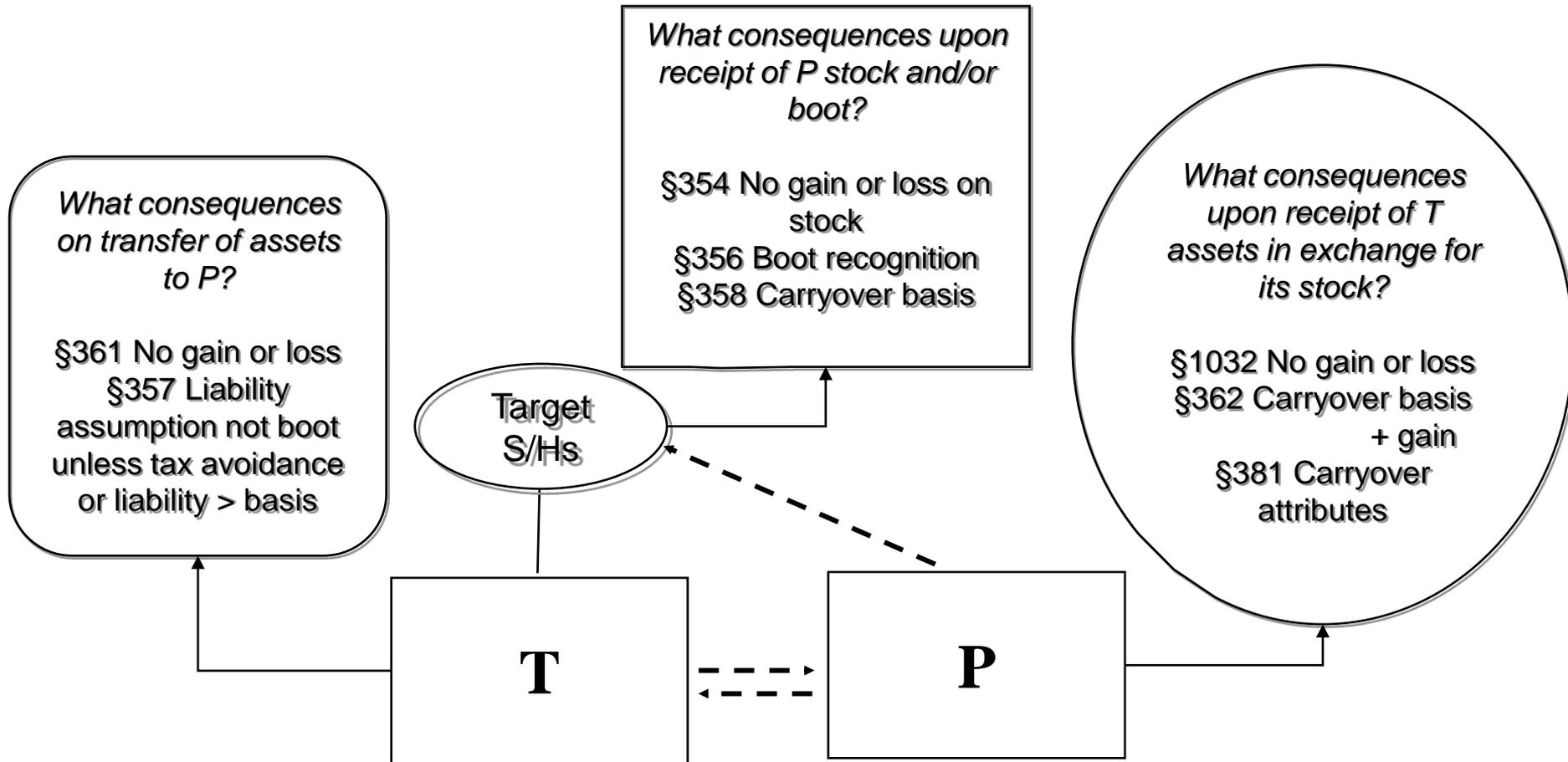
F Reorganizations & Step Transaction

- Preamble to proposed regulations issued in Aug. 2004 states the related events preceding or following the transaction or series of transactions that constitute a mere change do not cause that transaction or series of transactions to fail to qualify as an F reorganization.
- The qualification of the mere change as an F reorganization does not alter the treatment of the larger transaction.
- For example, if a redemption of stock occurs in a transaction that qualifies as an F reorganization and the F reorganization is part of a plan that includes a subsequent merger, the step or series of steps constituting the F reorganization will not alter the tax consequences of the subsequent merger.

Judicial requirements for Section 368(1)(E) and 368(1)(F) reorganizations

- As illustrated the step transaction has a limited role in the context of a Section 368(a)(1)(F) reorganization.
 - The “Bubble” theory
- Continuity of shareholder interest
 - Not applicable to either reorganization
- Continuity of business enterprise
 - Not applicable to either reorganization

Tax Consequences of Asset Reorganizations



Tax Consequences of Asset Reorganizations

- The acquiring corporation
- No gain or loss on use of its stock to acquire assets of target—Section 1032
- Basis in the acquired target assets is carryover basis—Section 362
- Carryover of Target's attributes with some limits
- If the asset reorganization is a triangular reorganization
 - S takes carryover basis in assets transferred
 - “Over-the-top” model provides basis adjustment to P basis

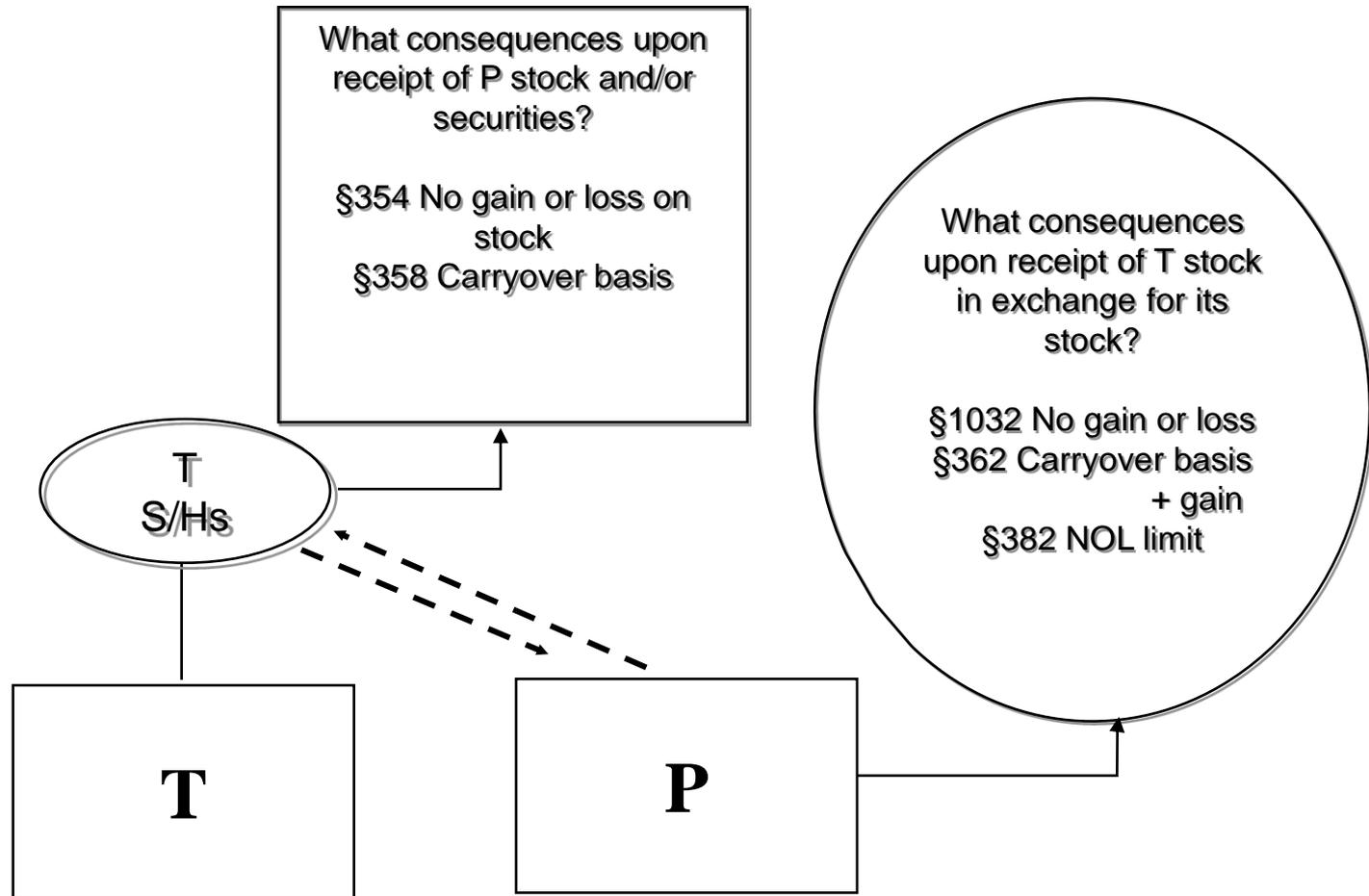
Tax Consequences of Asset Reorganizations

- Target Corporation
- Boot
 - No gain or loss on receipt of P stock or securities
 - No gain recognized upon receipt of boot when distributed to shareholders
 - Gain recognized on distribution of retained appreciated property
- Liabilities
 - Assumption of Target liabilities not boot unless tax avoidance purposes

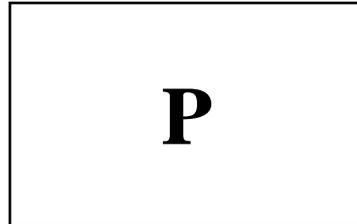
Tax Consequences of Asset Reorganizations

- Target Shareholders
- No gain or loss upon receipt of P stock or securities
- If boot received, gain is recognized to the extent of the lesser of
 - Gain realized
 - Boot received
- Character of gain determined under Rev. Rul. 93-61 and *Clark* fiction
- Basis of P stock received = (Basis of T stock) – (boot received) + (gain recognized)
- Basis of other property received = FMV

Tax Consequences of Stock Reorganizations

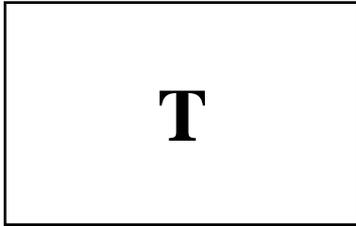


Tax Consequences in Stock Reorganization

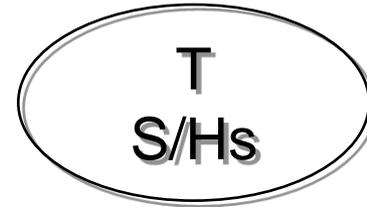


- No gain or loss on use of its stock to acquire stock of T
- Carryover stock basis
 - May be difficult in determining P's basis in T stock
 - Rev. Proc. 81-70

Tax Consequences in Stock Reorganization



- Attributes remain with T



- No gain or loss on receipt of P stock and/or securities (except NQPS and excess securities)