14 Tax-Free Acquisitions of Freestanding Corporations

14.1 Basic Types of Tax-Free Reorganizations: In this Chapter, we will consider four different ways (with triangular variations) of combining corporations on a tax-free basis. Note that there are other ways of combining corporations in a tax-free manner, but these are the principle ways such combinations are accomplished. Three of the techniques are in §368(a)(1): the "A" (§368(a)(1)(A)), the "B" (§368(a)(1)(B)), and the "C" (§368(a)(1)(C)). The fourth technique uses §351, a provision that also applies to simple corporate formations. A comparison of the techniques is in Table 14.1 (p. 14-3).

14.2 Section 368 "A" Reorganization: Statutory Merger: A tax-free reorganization under §368(a)(1)(A) must be accomplished by satisfying the terms of a merger statute under applicable state or federal law. But not all statutory mergers qualify under §368(a)(1)(A) for tax-free treatment: the courts have imposed additional requirements, discussed below. Because the target corporation ceases to exist after a statutory merger, all of its outstanding stock necessarily is cancelled. As consideration for their cancelled target shares, the former target shareholders will receive some combination of stock of the acquiring corporation, cash, property, and debt of the acquiring corporation.[1] Note: the merger can be structured with either corporation as the surviving entity. Of course, if the target corporation survives, the acquiring shareholders will acquire shares sufficient to represent majority ownership of the surviving corporation.

14.2.1 Requirements to Qualify for Tax-Free Treatment under Section 368(a)(1)(A): The courts have imposed three requirements on statutory mergers if they are to qualify as "A" reorganizations: (1) continuity of proprietary interest; (2) continuity of business enterprise; and (3) business purpose.

14.2.1.1 Continuity of proprietary interest requires that a significant portion of the consideration received by the target shareholders be equity in the acquiring corporation. For our purposes, a "significant portion" is at least 40% of the total consideration. The stock may be common or preferred and may be voting or nonvoting, but debt interests will not satisfy the requirement. Note that this requirement looks only at the total consideration used. For example, 60% of the purchase price may be paid in cash to some group of shareholders while 40% of the consideration can be stock given to a different group of shareholders.

14.2.1.2 Continuity of business enterprise requires that the acquiring corporation continue the target corporation's business in some form. For our purposes, that means it continues to use the target's assets in any business.

14.2.1.3 Business purpose is a general gloss on all the reorganization forms and is not discussed in the text.

[1] Debtholders of the target shareholders must also exchange their debt instruments for new consideration, but that is not discussed.

14.2.2 Tax Consequences of a Section 368 "A":

14.2.2.1 There is no tax imposed on the target corporation participating in an "A" reorganization.

14.2.2.2 If the target shareholders receive only stock of the acquiring corporation in exchange for their cancelled shares of the target corporation, the exchange is tax-free to the shareholders. But to the extent a shareholder receives consideration for the cancelled shares other than stock of the acquiring corporation, the shareholder recognizes gain equal to the *lesser of* (1) the shareholder's realized gain on the exchange and (2) the value of the property (other than stock of the acquiring corporation) received in the exchange. The realized gain on the exchange is the excess, if any, of the value of the shareholder's cancelled shares over the value of shareholder's basis in the cancelled shares. Any gain recognized by shareholders is capital gain, and we will assume it is taxed at 20% as long-term capital gain (and so we are assuming the target shareholders are not C corporations). Property other than stock of the acquiring corporation usually is called "boot." Note that loss cannot be recognized by the shareholder on the exchange.

14.2.2.3 There is no tax imposed on the acquiring corporation unless the consideration it furnishes to the target shareholders includes appreciated property. We will assume that the acquiring corporation uses only cash and its own stock, so that the acquiring corporation does not recognize gain or loss on the transaction. The acquiring corporation takes a carry-over basis in the target's assets.

14.2.2.4 Look at Table 14.2 (p. 14-5). The first column shows the tax consequences of an "A" reorganization. Note that this example assumes the consideration furnished by the acquiring corporation is 60% stock and 40% cash so that there is gain recognition to the shareholders. If the consideration had been entirely stock, there would be no gain recognition to any participant, and target shareholder's after-tax wealth would equal $685.00. Note that any target shareholder realized gain that is not recognized on the exchange is deferred but not exempted from taxation[2] unless the shareholder dies without selling the acquiring corporation shares. The example assumes all acquiring stock received by the target shareholders will be held until death.

14.2.3 Nontax Issues Associated with the Section 368 "A" Structure:

[2] The target shareholders push their basis from their cancelled stock into the stock of the acquiring corporation received in the exchange.

14.2.3.1 Because a statutory merger is treated as an asset acquisition, target assets that are difficult or expensive to transfer can present problems.

14.2.3.2 To the extent that target shareholder gain is deferred, it is because the target shareholder's receive stock of the acquiring corporation. That imposes a risk on the target shareholders unless they sell their newly-acquired stock, but to the extent they do that, they trigger recognition of the deferred gain. Of course, this risk is assumed by all shareholders of the acquiring corporation, and offsetting this risk is the possibility that the stock will increase in value over time.

14.2.4 Triangular Mergers: A statutory merger requires the affirmative vote of the shareholders of both the target corporation and the acquiring corporation. If the acquiring corporation is publicly traded, seeking approval of the shareholders generally will be prohibitively expensive.

14.2.4.1 To avoid this cost, the reorganization is structed as a merger of the target corporation into a controlled subsidiary of what otherwise would be the acquiring corporation. This is called a "forward triangular merger," and the allowable equity interests in a forward triangular merger is stock of the subsidiary's parent (that is, the corporation that would be the acquiring corporation if the triangular structure were not used).

14.2.4.2 Alternatively, the reorganization can be structured as a merger of a controlled subsidiary into the target, reversing the direction of the merger. This is called a reverse triangular merger, and it can be important if the target corporation has assets that difficult or expensive to transfer. As part of the reorganization, the target shareholders agree to give up their shares in the target corporation in exchange for stock of the parent of the acquiring corporation (possibly with some boot). The Internal Revenue Code imposes additional restrictions on the consideration that can be furnished to the target shareholders in a reverse triangular merger.

14.3 Section 368 "B" Reorganization: Stock-For-Stock Acquisition: A "B" reorganization is an exchange by the target shareholders of their target stock for voting stock (common or preferred) of stock of the acquiring corporation. Alternatively, the reorganization be structured by having the shareholders transfer their target stock to the acquiring corporation in exchange for stock of the acquiring corporation's parent corporation: that is, it can be structed as a triangular reorganization. Note that the target corporation does not participate in the reorganization other than by seeing its ownership change.

14.3.1 Requirements to Qualify for Tax-Free Treatment under Section 368(a)(1)(B): In a "B" reorganization, the acquiring corporation must end up owning at least 80% of the outstanding target shares, and the only consideration that can be used is its own voting stock or voting stock of its parent. Note that the acquisition cannot be structured using both stock of the acquiring corporation *and* stock of the parent.

14.3.2 Tax Consequences of a Section 368 "B": There is no gain or loss recognized to the acquiring corporation, the target corporation, or the target shareholders. The target's asset basis continues unchanged, and the acquiring corporation's basis in the target stock it acquires equals the basis of that stock in the hands of the target shareholders immediately prior to the reorganization.

14.3.3 Nontax Issues Associated with the Section 368 "B" Structure: Because the target's assets remain with the target corporation, difficult to transfer assets present no complication. As in an "A" reorganization, the target shareholders will lose their deferral to the extent they sell the acquiring corporation stock received in the exchange.

14.4 Section 368 "C" Reorganization: Stock for Assets Acquisition: A "C" reorganization is often called a "de facto merger" because it is an asset transfer in exchange for stock of the acquiring corporation in which the acquiring corporation acquires at least substantially all of the target's assets and the target liquidates as part of the reorganization. Note that there is no requirement that the reorganization comply with any state or federal merger statute. And there is a triangular version in which the controlled subsidiary acquires the target's asset but the target shareholder's receives stock of the parent corporation. In either case, the stock must be voting stock.

14.4.1 Requirements to Qualify for Tax-Free Treatment Under Section 368(a)(1)(C): Because most companies borrow against their assets, the consideration furnished in a "C" reorganization invariably includes assumption by the acquiring corporation (or by the parent of the acquiring corporation in a triangular "C" reorganization). If the only consideration furnished by the acquiring corporation is voting stock of the acquiring corporation, then the amount of the target's liabilities is irrelevant. But if the acquiring corporation uses any consideration in addition to its voting stock and assumption of the target's liabilities, then the voting stock must equal at least 80% of the total consideration including the assumed liabilities. Because most companies have liabilities in excess of 20% of their value, in practical terms this means the acquiring corporation cannot use any consideration other than its own voting stock (or the voting stock of its parent in a triangular "C").

14.4.2 The Statutory Explanation for Liabilities and Boot in a "C" Reorganization: Liabilities of the target corporation in a tax-free reorganization were disregarded until the Supreme Court's decision in *United States v. Hendler*, 303 U.S. 564 (1938). In that case, the Court held that target liabilities assumed by the acquiring corporation should be treated as if cash were furnished by the acquiring corporation to the target corporation equal to the amount of the liabilities, a treatment consistent with general tax principles. However, Congress quickly overruled the *Hendler* decision, providing in §357(a) that (subject to certain exceptions) liabilities in reorganizations (including reorganizations under

§351) would be ignored. This anti-*Hendler* applies to all reorganizations including "A" reorganizations. However, in a provision applicable only to "C" reorganizations (§368(a)(2)(B)), Congress retreated on the anti-*Hendler* rule, providing that liabilities of the target corporation must be treated as cash consideration furnished by the acquiring corporation if the acquiring corporation actually furnishes any consideration other than qualifying stock.

14.4.3 Tax Consequences of a Section 368 "C"

14.4.3.1 If the acquiring corporation furnishes nothing but its own voting stock for all of the target's assets (along with assumption of the target's liabilities), and then the target immediately liquidates, there is no recognized gain or loss to the target corporation or to its shareholders. The acquiring corporation carries over the target's basis in the target assets.

14.4.3.2 If the acquiring corporation uses cash in addition to its own voting stock (along with assumption of the target's liabilities), then gain will be recognized to the target shareholder's equal to the lesser of (1) the gain realized on their exchange and (2) the amount of cash received. Note that there still is no tax imposed on the target corporation itself.

14.5 Tax-Free Reorganizations Under Section 351: Section 351 can be used to combine two corporations by using a holding company. The shareholders of both the acquiring corporation and the target corporation contribute their shares to the new company (usually called NewCo) in exchange for stock of NewCo. At that point, NewCo holds the stock of both the target and the acquiring corporations so that the two corporations have been combined into a brother/sister pair with a common parent. It is not unusual for the new corporate group (NewCo, acquiring corporation and target corporation) to form a consolidated group. Note that in this form of the reorganization, the acquiring corporation does not in fact acquire anything.

14.5.1 Requirements for Tax-Free Treatment under Section 351: The former shareholders of target and of acquiring must end up owning at least 80% of the stock of NewCo, and that rarely is a problem (they usually end up owning 100%).

14.5.2 Tax Consequences of a Section 351 Merger: For those shareholders who receive only NewCo stock in the exchange, no gain or loss is recognized. But for those shareholders who receive boot in addition to stock of NewCo, gain will be recognized equal to the lesser of (1) gain realized on the exchange and (2) the value of the boot received. Note that some shareholders are permitted to received only boot. Because neither the target's assets nor the acquiring corporation's change hands, their bases do not change.

14.6 Comparison of Tax-Free Acquisition Structures

14.6.1 The "A" reorganization offers the most flexible possible consideration.

14.6.2 The "B" reorganization offers the least flexible possible consideration (only voting stock).

14.6.3 The “C” reorganization offers the possibility of some flexibility in the consideration used by the acquiring corporation, but as a practical matter it is in effect an “A” reorganization that does not need to comply with a merger statute and in which the consideration is limited to voting stock.

14.6.4 The Section 351 form of a reorganization is similar to the “A” reorganization in that both voting and nonvoting stock can be used, and it is similar to the “B” reorganization in that it is accomplished using a stock-for-stock exchange.

14.6.5 Looking at Table 14.2 (p. 14-5), it is important to note that if no boot is used, the various forms of the reorganization are all tax-free. Table 14.1 (p. 14-3) compares the various reorganization forms.

14.7 Limitations on Target Firm Tax Attributes: Section 382 limits the use of a firm’s NOLs if there is a 50% or greater ownership change. When §382 applies, the post-ownership change of NOLs is limited annually to the federal tax-exempt interest rate (published by the US government) times the net value of the firm as of the date of the ownership change. Note in particular that if the firm is insolvent at the time of the ownership change, then this rule limits future use of the NOLs to $0 per year. The §382 limit also applies to losses recognized after the ownership change to the extent they represent unrealized losses that accrued prior to the ownership change (so-called “built-in” losses). In a taxable asset sale, there is no ownership change and so §382 does not limit the target corporation’s ability to use its own NOLs against the sale gain or at a later date. In a taxable stock sale without a §338 election, there is an ownership change and so §382 applies. In a taxable stock sale with a §338 election, the target is treated as if it sold its assets so that any target NOLs can be used against the sale gain. But because the stock acquired in the transaction is treated as stock of a new corporation (“new T”), any NOLs unused by the target (“old T”) on its final return are lost. Do not forget that S Corporations cannot have NOLs, so the discussion above is relevant only to target corporations that are C corporations.

14.7.1 How Much Are the Target Firm’s NOLs Worth? To compute the potential worth of a target’s NOLs to the acquiring firm, we estimate the §382 limitation, we estimate the firm’s future tax rate, and we discount the estimated savings to present value.

14.7.2 General Limitations on a Firm’s NOLs and NOL Poison Pills: Note that §382 may be triggered by a new stock offering if the new investors obtain control of the corporation. Similarly, if enough shares are traded in the market to reach the 50% trigger, §382 can apply. In these cases, there can be a §382 limitation even without a corporate reorganization. Under the detailed rules of §382, transfers of less than 5% of the corporation’s stock are ignored.

14.8 Comparison of Taxable and Tax-Free Acquisitions of Freestanding C Corporations; Table 14.4 (p. 14-18) nicely summarizes the requirements and consequences of various forms of corporate reorganizations of free-standing C corporations, both taxable and tax-free.

14.9 Questions (p. 14-19):

14.9.1 Question 2: Leaving the target as a controlled subsidiary insulates the rest of the acquiring corporation's assets from liabilities of the target. For example, if the target owns real estate, potential CERCLA liability is always a concern. Isolating each business in a separate controlled subsidiary ensures the liabilities of any one business cannot jeopardize the assets of any other business.

14.9.2 Question 4: Because a cash merger triggers both a corporate-level tax and a shareholder-level tax, the target shareholders presumably will insist on a higher price than if either (or both) level of taxes were avoided.

14.10 Problems (p. 14-20):

14.10.1 Problem 8: Here are the constraints: (1) the assets of Baja cannot be transferred; (2) the 70% shareholder (Calegari) insists on cash; (3) the 30% shareholder (Smith) insists that the transaction be tax-free to him; (4) the acquiring corporation's shareholders are unwilling to see significant dilution of their vote.

14.10.1.1 Could Calstar acquire Baja in an "A" statutory merger? An "A" reorganization includes the requirement that at least 40% of the consideration include equity in the acquiring company (or in its parent). That is inconsistent with constraint (2).

14.10.1.2 Could Calstar acquire the stock of Baja in a "B" reorganization. A "B" reorganization requires that the consideration for the target's stock consist exclusively of voting stock if the acquiring corporation (or its parent). This is inconsistent with constraints (2) and (4).

14.10.1.3 Could Calstar acquire the stock of Baja in a "C" reorganization? A "C" reorganization requires that at least 80% of the consideration consist of voting stock of the acquiring corporation (or of its parent). This is inconsistent with constraint (2).

14.10.1.4 Could Calstar obtain effective control of Baja using §351? Calstar, Smith and Calegari would jointly form NewCo, with Calstar contributing $70,000 of cash and Smith and Calegari contributing their stock of Baja. Calstar would receive voting stock of NewCo worth $70,000, Smith would receive $30,000 of nonvoting (common or preferred) of NewCo, and Calegari would receive cash. Alternative, Calstar and Smith could form NewCo and then Calstar could then purchase Calegari's stock for cash. In either event, NewCo could eventually be merged into Calstar, moving Smith's equity interest from NewCo to Calstar.

14.10.1.5 Could the transaction be structured as a merger of Calstar into Baja, with Calegari cashed out as part of the transaction? This leaves the assets in place (constraint (1)), but violates constraint (4) unless the consideration furnished to Calstar shareholders is high-voting stock.

14.10.2 Problem 9:

14.10.2.1 Part (a): Carryover of $3 billion.

14.10.2.2 Part (b): Variation 1: No change in basis, so asset basis equals $5 billion.

14.10.2.3 Part (c): Because the taxable shareholders received nothing but coting stock of the acquiring corporation, they recognize no gain.

14.10.2.4 Part (d): In the aggregate, the taxable shareholders receive cash of $1.875 billion as well as stock worth $5.625 billion of stock, for a total of $7.5 billion in total consideration (three-quarters of the total consideration). Because they have an aggregate basis of $2 billion, the gain recognized equals $5.5 billion. Because the value of the boot they receive is only $1.875 billion, that is the amount of the gain recognized by the taxable shareholders, yielding a tax liability of $375 million. The exempt shareholders do not recognize taxable gain because they are exempt.

14.10.2.5 Part (e): The asset basis is not increased by any gain recognized to the target shareholders (the only way to increase corporate-level basis is to trigger a corporate-level gain), so the asset basis remains at $5 billion.

14.10.2.6 Part (f): None: because asset basis does not change, there is no step-up in the basis of the goodwill (which have a zero basis prior to the transaction). If the acquiring corporation wants to step-up the basis of corporate assets, it must trigger gain at the *corporate* level.