2011 Annual Income Tax Seminar - Northern

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Mergers & Acquisition of Pass-through Entities: S Corporations, Partnerships & LLCs

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M&A of Passthroughs

- Asset Sales
  - Partnerships
  - S corporations
- Equity Sales
  - Partnership interests
  - S Corporation Stock
  - S Corporation with 338(h)(10) Election
  - Using DEs to achieve asset sale treatment

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M&A of Passthroughs

- Partnerships: Mergers, Divisions and More Exotic Structures
  - Partnership Mergers
  - Partnership Divisions
  - Leveraged Partnerships and Canal Corp.
  - Partnership Mixing Bowls
  - Partnership Exit: Distribution of Newly-Acquired Assets

- S Corporation: Mergers and Divisions and More Exotic Structures
  - S Corporation Mergers
  - Section 351 Structures
  - S Corporation Spin-offs

M&A of Passthroughs

- Using Disregarded Entities to Unite Tax and Business Objectives
  - DE Liquidations
  - F Reorganizations
    - Basic
    - Taxable Asset Sale
    - Taxable Stock Sale
    - Liquidation Merger
    - Acquisitive Merger
  - D Reorganizations
  - Disregarded Entity Mergers

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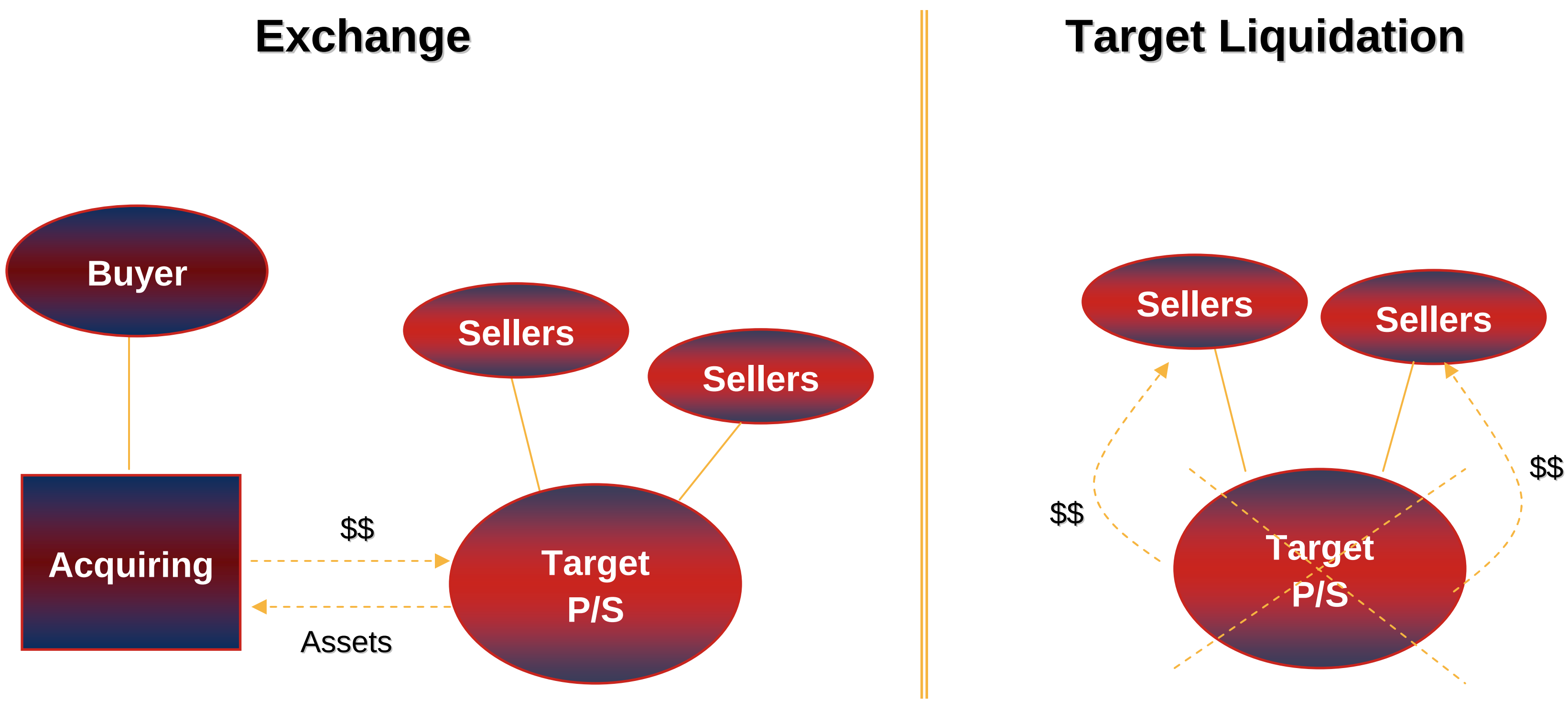
M&A of Passthroughs

- Other Hybrid Structures: Corporate and Partnership Mergers and Divisions
  - Merger of Corporate Partner into Partnership
  - Merger of Corporate Partners
  - Section 351/A Reorganization
  - Partial Morris Trust with Partnership

Taxable Asset Sales: Partnerships, S Corporations & Disregarded Entities

Partnership Asset Sale



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Partnership Asset Sale: Tax Consequences – Sellers

- Generally only one level of tax is paid:
  - Partnership has income on sale of assets that is passed through to partners
  - Income retains its character (capital or ordinary) depending on the type of assets sold
  - Generally no additional tax is due on liquidation because tax basis of partnership interests has been increased by income from sale of assets
  - Installment reporting may be available

- Special allocations of pre-contribution built-in gain may be required if the property sold had been contributed by a partner less than seven years prior to its sale.

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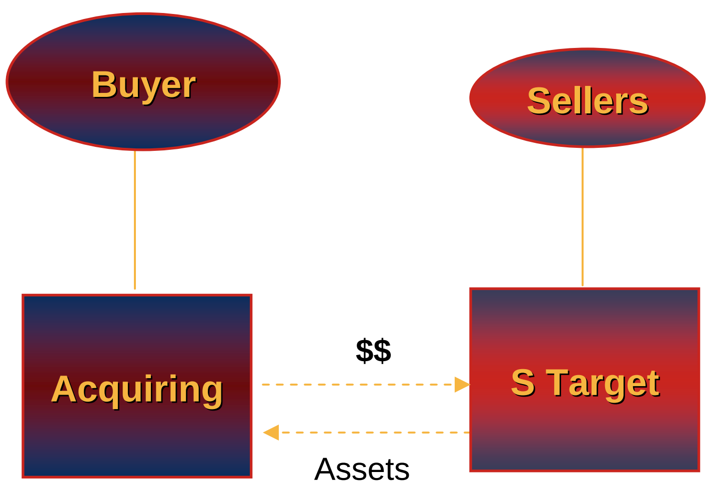
Partnership Asset Sale: Tax Consequences – Buyer

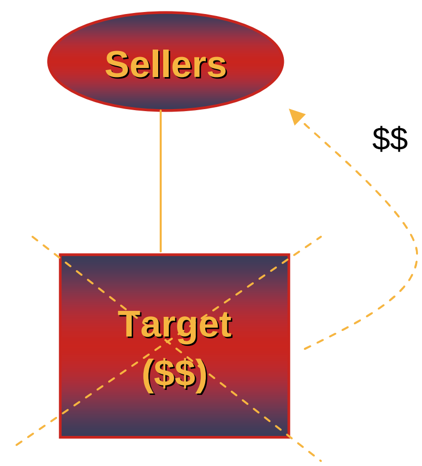
- Buyer takes assets with a (stepped up) fair market value basis
- Buyer would not take Target liabilities in asset sale (subject to bulk sales and similar rules)

S Corporation Asset Sale

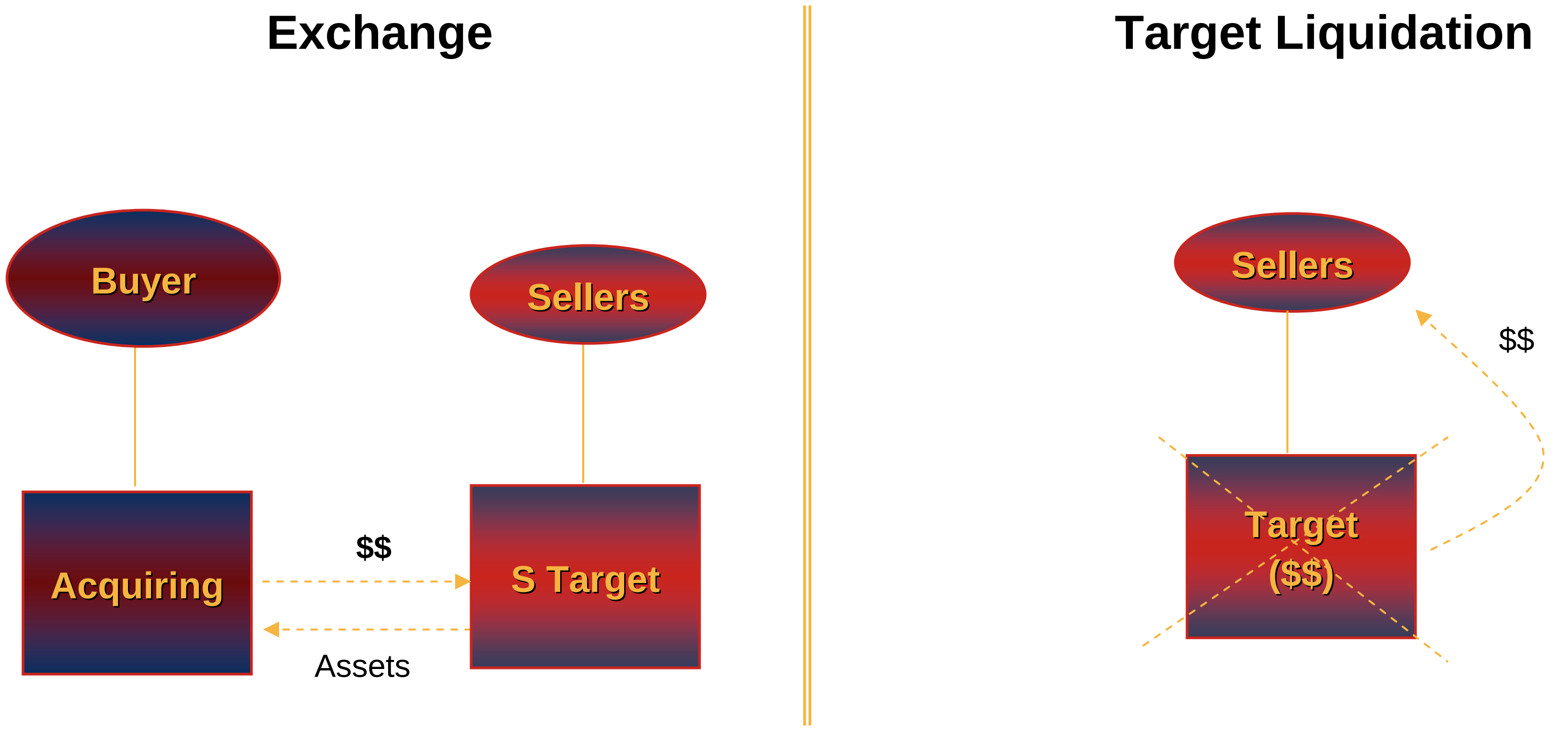
Exchange



Target Liquidation



S Corporation Asset Sale



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S Corporation Asset Sale: Tax Consequences – Seller

- Generally only one level of tax is paid:
  - S corporation has income on sale of assets that is passed through to S corporation shareholders
  - Income retains its character (capital or ordinary) depending on the type of assets sold
  - Generally no additional tax is due on liquidation because tax basis of shares has been increased by income from sale of assets
  - Installment reporting may be available (although technical issue applies if distributed by the S corporation to its shareholders)

- S corporation with C corporation history within 10 years (reduced to 5 years for 2011 sales) will be subject to a second level of tax ("built-in gains tax") imposed at the corporate level.

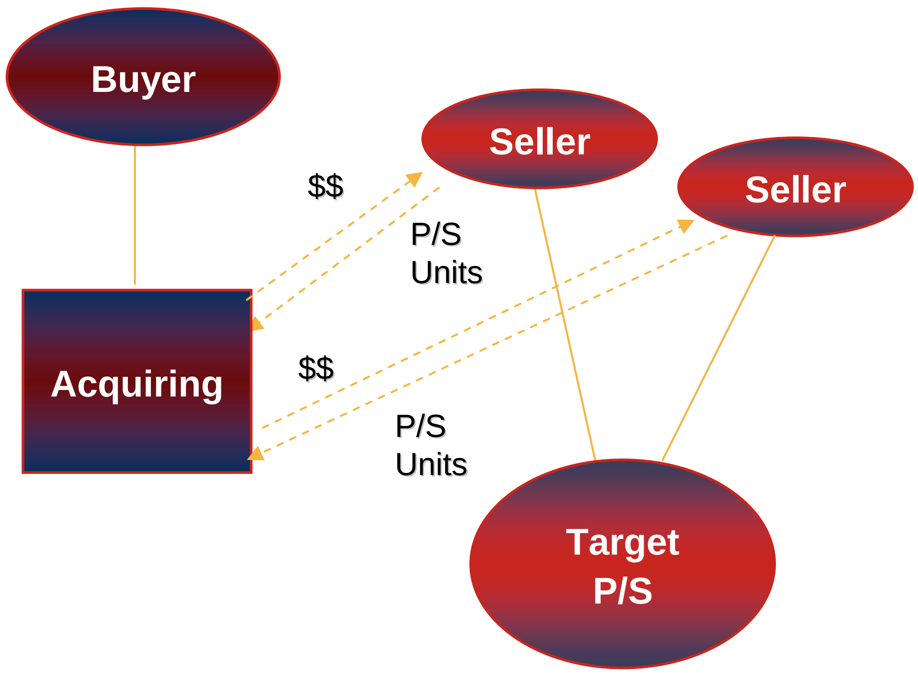
S Corporation Asset Sale: Tax Consequences – Buyer

- Buyer takes assets with a (stepped up) fair market value basis
- Buyer would not take Target liabilities in asset sale (subject to bulk sales and similar rules)

Taxable Equity Sales: Partnerships, S Corporations & Disregarded Entities

Partnership Interest Sale

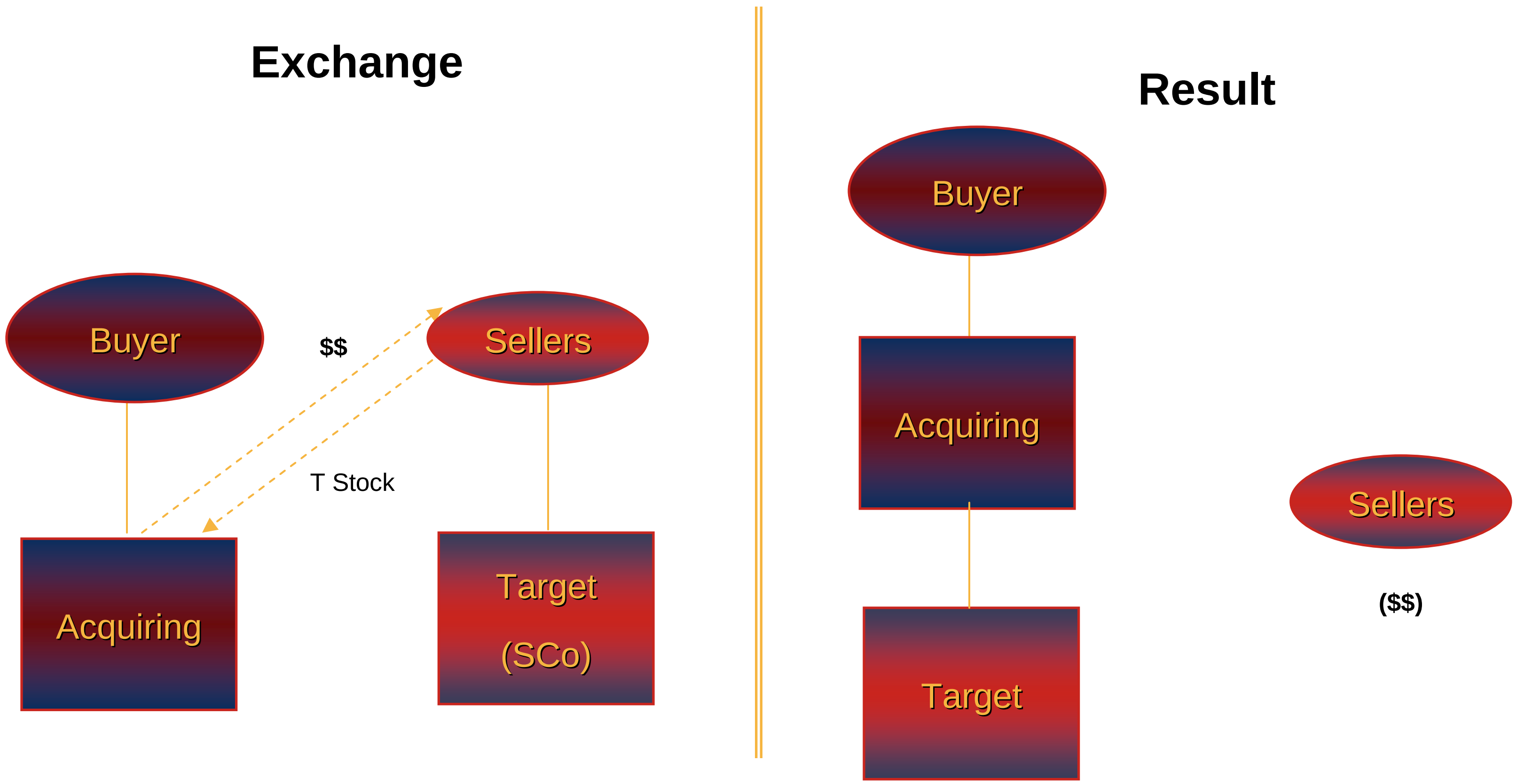
Exchange



Target Liquidation

Transfer of partnership interests from two partners in exchange for cash is treated as a taxable sale of the partnership interests. If there is a single buyer such that Target becomes a disregarded entity in the hands of the Buyer, then the transaction will be treated as an asset purchase by the Buyer.

Taxable S Corporation Stock Sale



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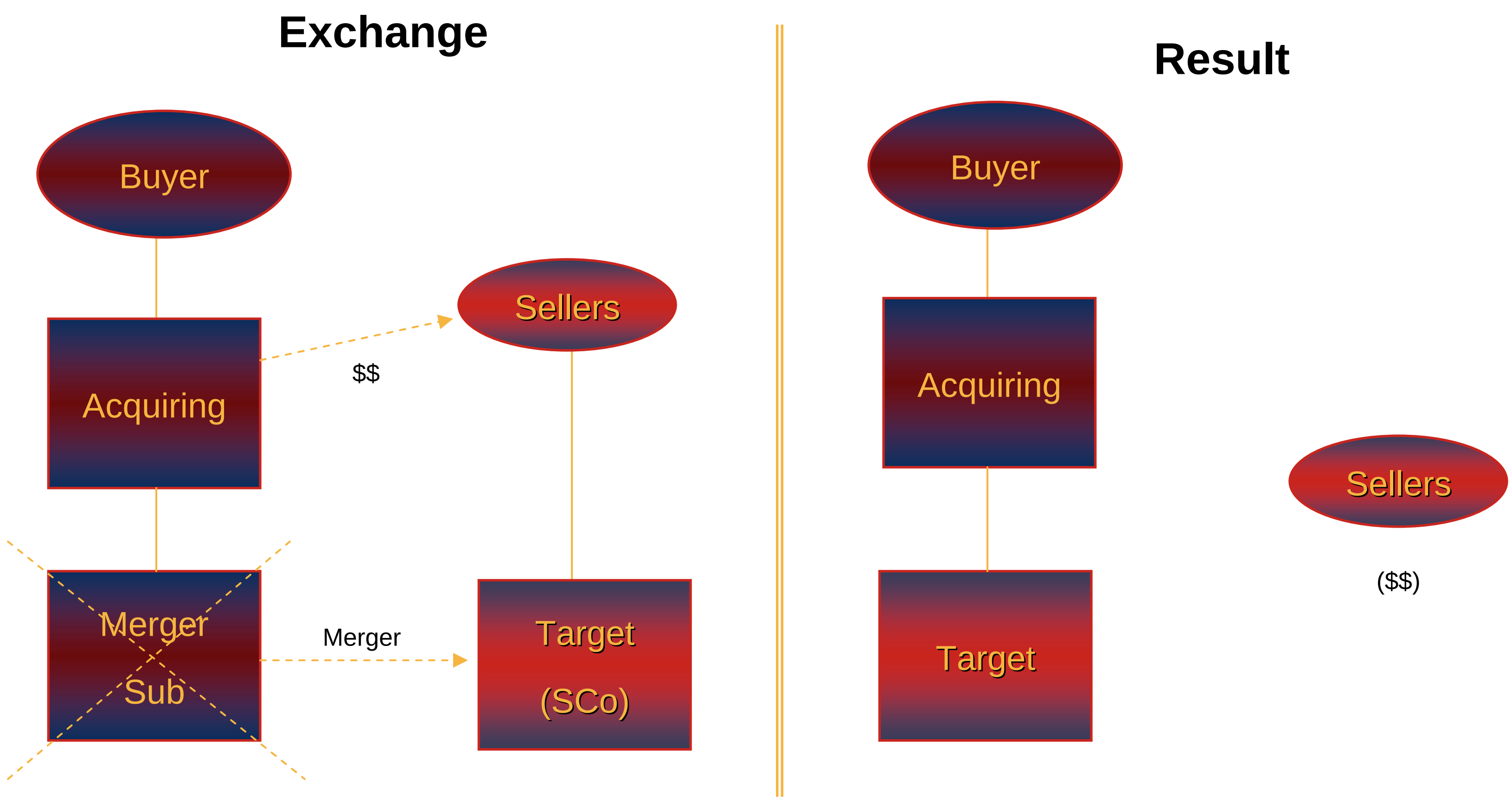
Reverse Subsidiary Cash Merger



S Corporation Stock Sale or Reverse Subsidiary Cash Merger: Tax Consequences – Sellers

Stock Sale or Reverse Subsidiary Cash Merger:

- One Level of Tax - Shareholder taxed on sale of Target stock
    - Income generally will be capital gain (taxed 15% on LTCG)
- Result is generally the same for partnerships (although with partnerships some gain may be recharacterized as ordinary income based on certain “hot assets” and liability shifts must be considered).

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S Corporation Stock Sale or Reverse Subsidiary Cash Merger: Tax Consequences – Sellers

Stock Sale or Reverse Subsidiary Cash Merger:

- Installment reporting is generally available for payments after year of closing
  - Installment obligation cannot be a demand note or readily traded
  - Some uncertainty regarding application to escrowed funds
- Unless there is stated interest, a portion of each deferred payment will be recharacterized under imputed interest rules
- Large installment obligations (over $5 million in the aggregate in one year) are subject to special tax imposed at interest rates (applicable to underpayments).

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Corporation Stock Sale or Reverse Subsidiary Cash Merger: Tax Consequences – Buyer

Stock Sale or Reverse Subsidiary Cash Merger

- Buyer generally does not get a step-up in the basis of the assets of an S corporation. Shares are taken at fair market value but assets retain their historic basis
  - For partnerships, step up is automatic if there is a single buyer. With multiple buyers, a section 754 election can provide buyer with a fair market value in the basis of the partnership assets
  - Section 338(h)(10) election may be available for S corporations but has different consequences for Sellers
- Target will retain its historic tax attributes (but this typically is not meaningful for S corporations since they do not have NOLs)
- If S corporation uses cash basis accounting, conversion to accrual basis accounting may be required (with a four-year income pick-up)

S Corporation Stock Sale Treated as Asset Sale: Section 338(h)(10) Election

Section 338(h)(10) Election – Basic Requirements

- Qualified Stock Purchase
  - Acquiring must be a corporation (can be newly formed but not transitory)
  - Target must be a domestic corporation (S Corporation or C Corporation subsidiary in affiliated group)
  - Acquiring must "purchase" the Target stock (generally means a taxable transaction)
  - The amount of stock acquired must satisfy section 1504(a) (Generally 80% voting power and 80% value)
  - Sellers must not be related to Acquiring
- Joint election, Buyer and Sellers must make a joint section 338(h)(10) election

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SCo Stock Sale Treated as Asset Sale: Tax Consequences – Seller

Section 338(h)(10) Election

- Generally the result is the same as if Target had sold its assets and distributed the sales proceeds in liquidation
  - For S corporation shareholders, liquidation is taxable under section 331 but result generally is still one level of tax (unless S corporation is subject to built-in gains tax)
  - Although there is only one level of tax, the character of the gain will be ordinary income or capital gain based on the deemed asset sale (so result will generally be different from results of a pure stock sale)

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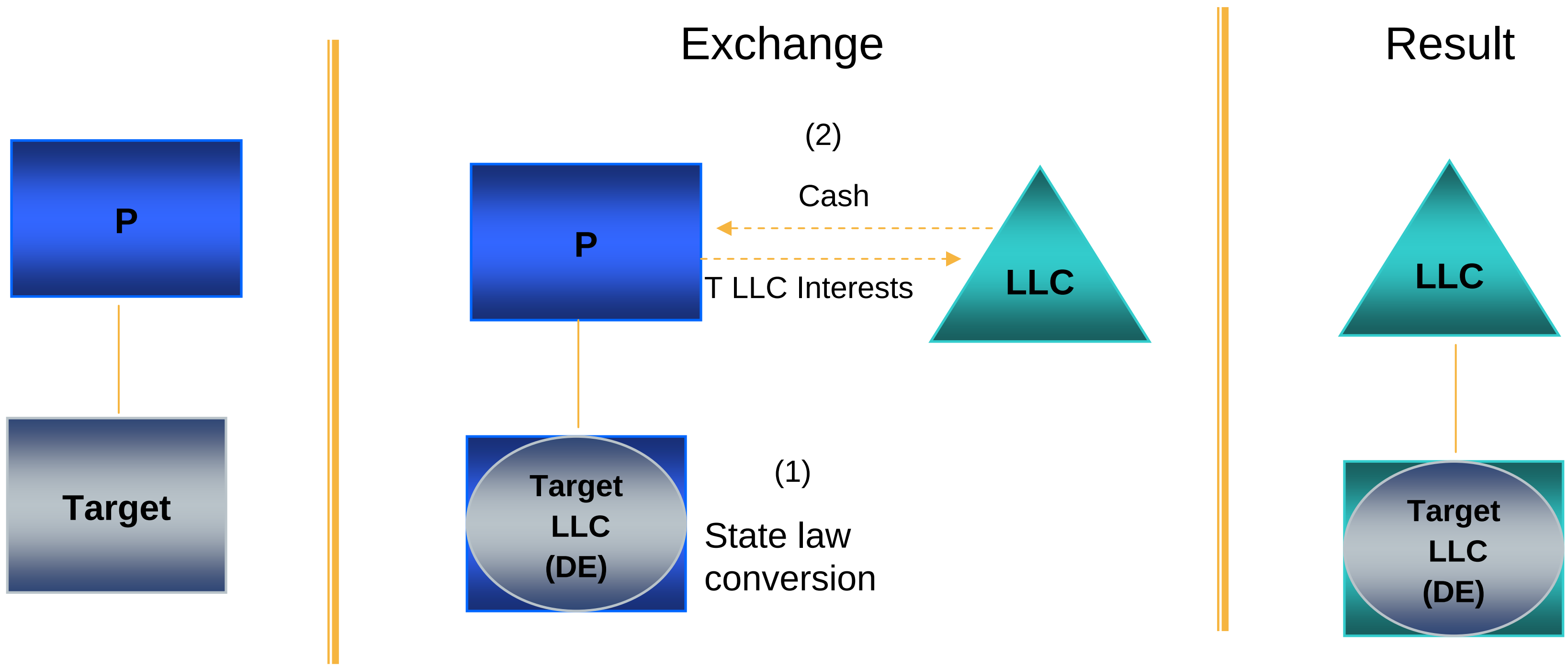
SCo Stock Sale Treated as Asset Sale: Tax Consequences

Section 338(h)(10) Election *(continued)*

- No tax on the sale of Target stock
- Buyer takes fair market value basis in Target's assets as a result of the deemed asset sale, which may result in gain. A Tax Adjustment payment quantifying the additional tax cost to the Seller is generally negotiated
- Contingent liabilities may not be taken into account until fixed and determinable
- State tax differences need to be reviewed: state level corporate tax would figure into any Tax Adjustment payment
- Proposed regulations under section 336(e) may provide an alternative if the rules are ever finalized (but even then may not be available for S corporation targets)

Taxable Asset Sale Using LLC Conversion Statutes



- Parties want an asset sale for tax purposes but for assets cannot be transferred for business reasons.
- Section 338(h)(10) is not available (since buyer is not a corporation). Section 336(e) may be available--but only when regulations are finalized
- Alternative to section 338(h)(10):
  - Step One: Convert Target into a limited liability company
  - Step Two: P sells LLC interests to Buyer
- Taxed as a liquidation of Target (under section 332), followed by an asset sale

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Partnerships: Mergers, Divisions and More Exotic Structures

“Mergers” of Partnerships

- Unlike with corporations, there are no specific forms of merger afforded tax-free treatment
- Is the merger tax-free? Tax treatment is determined under generally-applicable rules of Subchapter K: Sections 721, 722, 723, 752 and 731 play important roles in determining tax treatment of a “merger”
- Which (if any) partnership is the continuing partnership?
- Why is which partnership is the continuing partnership important?
  - Elections remain in place
  - EIN remains the same
  - Determines the “construct” of the transaction for tax purposes, which partnership contributes assets and which distributes the interests in the other partnership received in exchange for the assets

“Mergers” of Partnerships

- The characterization of the form of a merger under state entity law is not determinative for tax purposes. Rev. Rul. 95-27, 1995-1 C.B. 130
- Tax-free treatment would generally result under Section 721, however under Section 752 a deemed cash distribution resulting from a release of nonrecourse debt results in gain if the deemed cash distribution exceeds the partners’ tax basis

“Mergers” of Partnerships

- A partnership terminates on an “actual termination” under Section 708(b)(1)(A).
- A partnership terminates on a “technical termination” under Section 708(b)(1)(B).
- Special rules apply to a partnership merger under Section 708(b)(2)(A); Treas. Reg. Section 1.708-1(c).
- Special rules apply on to a partnership division under Section 708(b)(2)(B); Treas. Reg. Section 1.708-1(d)

“Mergers” of Partnerships

- There is no definition of “merger” under Section 708(b)(2)(A) or in the Regulations.
- There is not necessarily any continuing partnership resulting from a partnership merger, but a partnership continues if its partners own more than 50% of capital and profits of the resulting partnership.
- If a partnership can be treated as a continuation of more than one partnerships, it is considered to be the continuation of the partnership that contributed assets having the greatest fmv of assets (net of liabilities) is the continuing partnership.

“Mergers” of Partnerships

- A mere conversion (for example of a GP to an LP) under state law is not regarded as a merger even though it may be accomplished through a merger under state law.
- There is no terminating partnership and no continuing partnership, for tax purposes the converted entity is the same partnership

"Mergers" of Partnerships

- In a partnership merger, the merger is treated as being accomplished in the assets-over form. Treas. Reg. Section 1.708-1(c)(3).
- A transitory distribution to partners, followed by a recontribution in an assets-up form is respected, despite the transitory ownership. Treas. Reg. Section 1.708-1(c)(3)(ii). But, note, Example 6 of Treas. Reg. Section 1.708-1(c)(6)(ii).
- If certain requirements are met, a sale by a partner in a terminating partnership to a resulting partnership will be respected. Treas. Reg. Section 1.708-1(c)(4).

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“Mergers” of Partnerships

- In a partnership merger, the merger is treated as being accomplished in the assets-over form. Treas. Reg. Section 1.708-1(c)(3).
- In the assets-over form, assets of the terminated partnership is treated as contributing all its assets to the continuing partnership in exchange for an interest in the “resulting partnership,” and immediately thereafter, the terminating partnership is treated as distributing the interest in the resulting partnership to its partners in liquidation of the terminated partnership.

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"Mergers" of Partnerships

- Inter-specie mergers create unique problems (most sophisticated uses are addressed later in this presentation).
- They are tested under the normal reorganization rules of subchapter C and the normal partnership rules under subchapter K.
- Merger of an "S" or "C" corporation into an LLC, with the LLC surviving is a contribution of assets to the LLC and an assumption of the corporation's liabilities by the LLC, in exchange for an interest in the LLC, and a distribution of the interest to shareholders in liquidation of their stock under Section 331; gain or loss is the fair market value of the interest minus the adjusted basis the shareholder has in their shares. The basis of the interests distributed to shareholders is the fair market value of the interest on the date of distribution. PLR 9701029 (C corporation); PLR 9543017 (S corporation).
- Rev. Rul. 68-289, 1968-1 C.B. 314 (mechanics of merger of three partnerships in assets-over form cited by IRS).

“Divisions” of Partnerships

- Which, if any, partnership continues? Treas. Reg. Section 1.708-1(d).
- More than one may continue if more than one resulting partnership is owned more than 50% by partners of the prior partnership.
- There may be no surviving partnerships if no resulting partnership is owned more than 50% (capital and profits interests) by partners of the prior partnership.

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“Divisions” of Partnerships

- Subchapter K contains no special rules as to the tax consequence of a partnership division (other than rules as to continuation rules for the resulting partnership(s)).
- The division is treated as an assets-over form applies if there is at least one continuing partnership or no continuing partnership unless specifically accomplished in the assets up form with all assets distributed to some or all partners in complete liquidation of their interests. If no resulting partnership is a continuing partnership, the prior partnership must liquidate for this form to respected.

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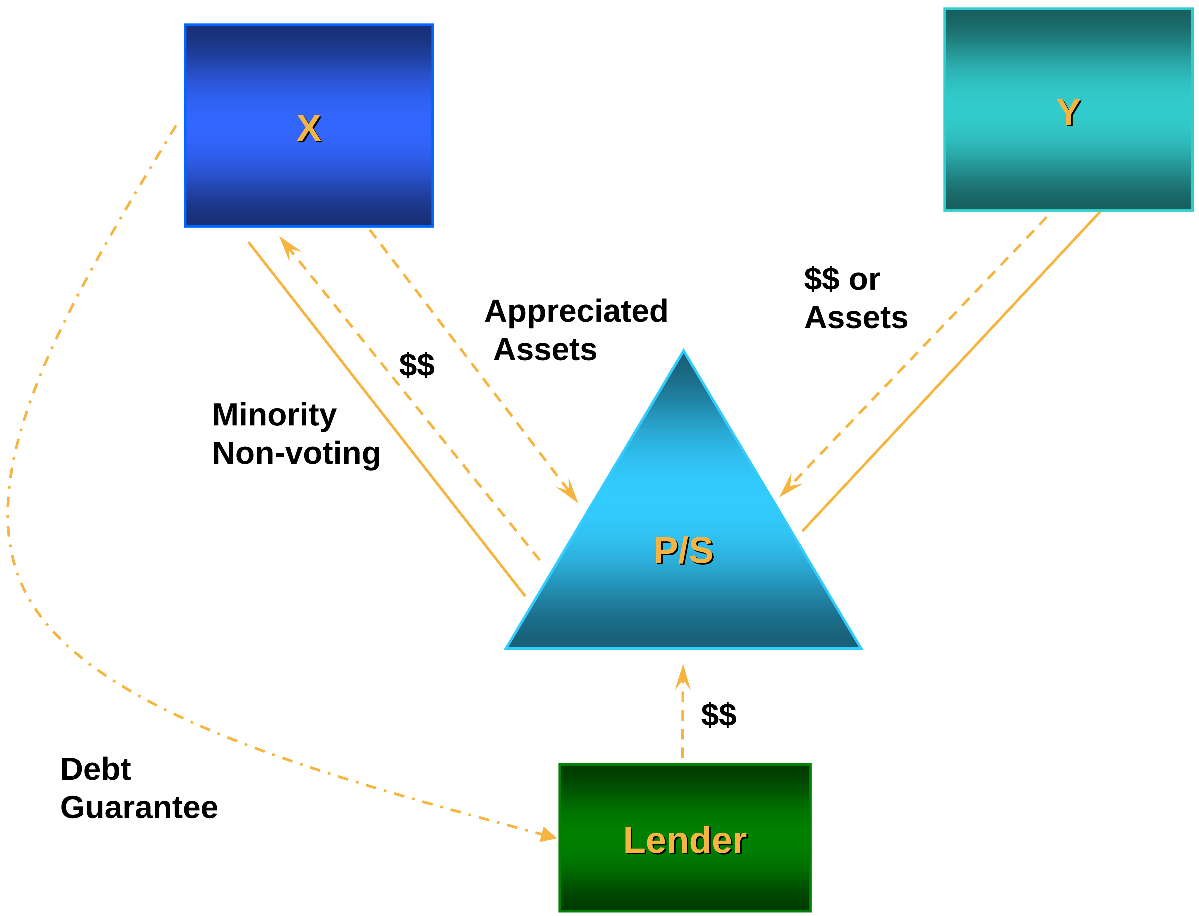
Leveraged Partnership



Leveraged Partnerships and Canal Corp.

- Leveraged partnerships are an exception to the disguised sales rules.
- Treas. Reg. Section 1.707-5(b) sets forth the parameters
  - contributing partner contributes appreciated assets
  - partnership incurs liability
  - all or a portion of the proceeds are distributed to the contributing partner within 90 days

Leveraged Partnerships and Canal Corp.

- Canal Corp. and Subsidiaries v. Commissioner, 135 T.C. No. 9 (August 5, 2010).
- Chesapeake (which was renamed Canal Corp.) owned WISCO which had tissue assets and liabilities. Assets had a very low basis and significant liabilities making a taxable sale a problem (net proceeds would be quite small after tax and providing for liabilities).
- Engaged investment banking firm and PwC.

Leveraged Partnerships and Canal Corp.

- Chesapeake's subsidiary, WISCO contributed its tissue assets worth $775 million, and became a 5% partner in the new LLC; Georgia Pacific contributed its tissue assets worth $376.4 million and became a 95% partner in the new LLC.
- GP guaranteed the debt, and a sub of Chesapeake indemnified the guarantee giving it the "bottom dollar" for purposes of Section 752.
- The LLC borrowed against the assets and the same day distributed $755.2 million to WISCO.

Leveraged Partnerships and Canal Corp.

- PwC issued a “should” opinion for the flat fee of $800,000.
- The Opinion addressed the issue of what amount of value was required to support the indemnification, and noted a 20% safe harbor that did not exist.
- WISCO’s assets to cover the indemnity were a jet worth $6 million and an intercompany note worth $151.05 million; there was no requirement that it retain the note or any minimum capital.

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Leveraged Partnerships and Canal Corp.

- The Tax Court disregarded the indemnification based on the anti-abuse rule of Treas. Reg. Section 1.752-2(b)(6).
- The Tax Court criticized the PwC opinion by saying "looks more like a quid pro quo arrangement than a true tax advisory opinion."
- Tax Court held in favor of the IRS, $183,458,981 deficiency and $36,691,796 penalty under 6662(a), for substantial understatement (no "reasonable cause" in spite of Opinion).

Leveraged Partnerships and Canal Corp.

- Bad facts or attack on leveraged partnership in general: we may never know.
- Case settled for a fraction of the amount due, (but purported 50% of the bankruptcy estate, $2 million) taxpayer was in bankruptcy, there will be no appeal.
- IRS is likely to aggressively pursue leveraged partnerships based on "win."

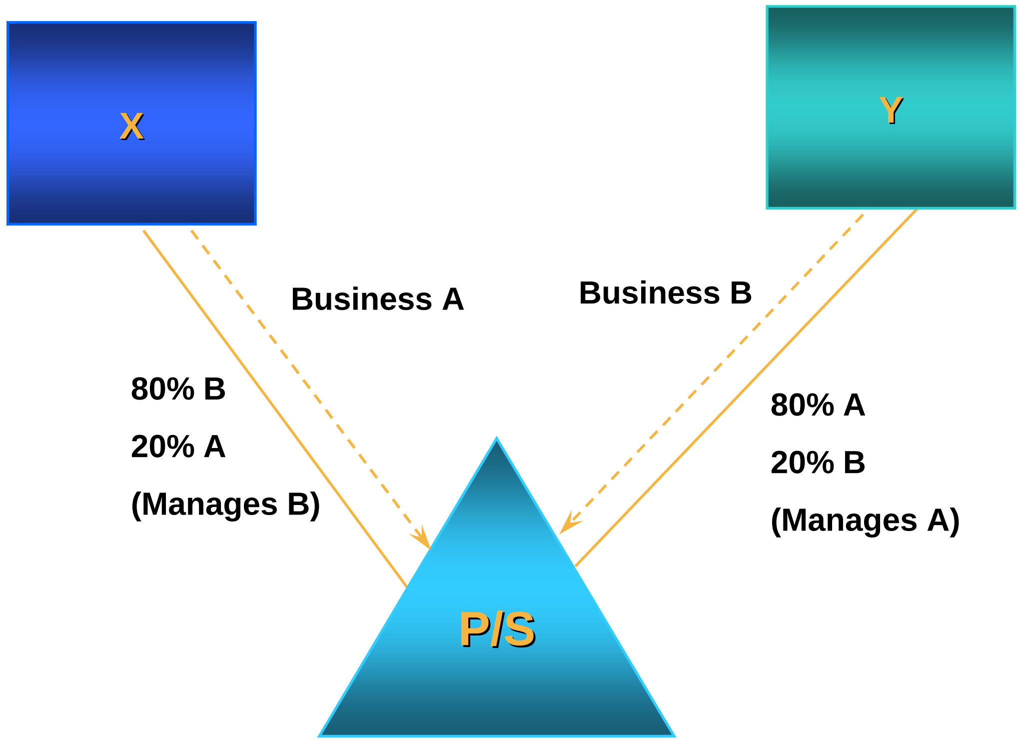
Leveraged Partnerships and Canal Corp.

- Issues to address
  - Sufficiency of guarantee or indemnification for purposes of Section 752, what level of value is needed to support it and must it remain at all times?
  - Opinion, and whether it is for fixed fee or not
  - Continuing use of leveraged partnership transactions
  - Economic substance

Partnership Mixing Bowl

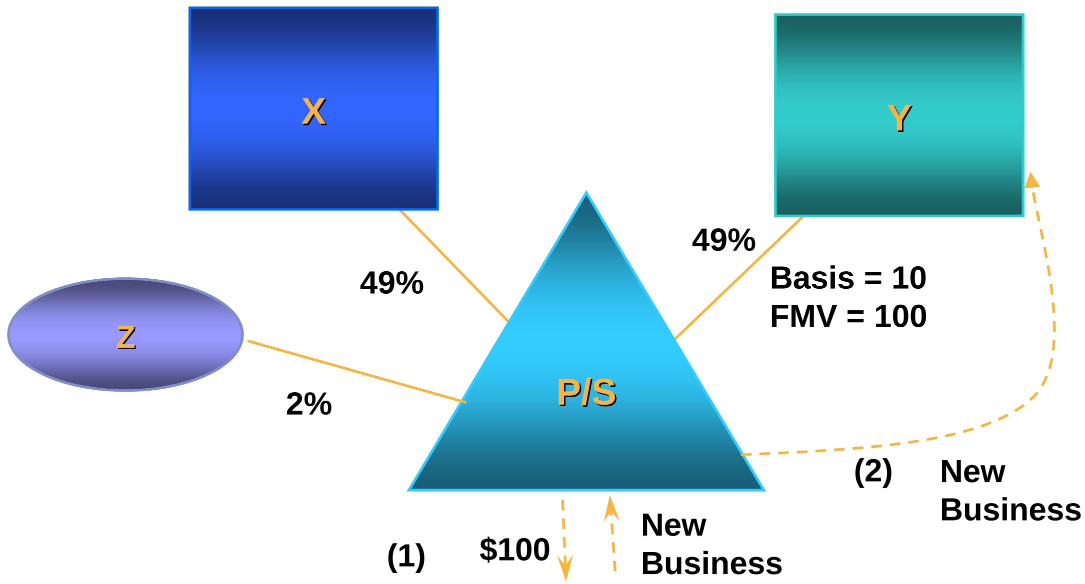
- One party transfers appreciated business assets to partnership
- Second party transfers assets used in a different business to P/S
- Each party gets day-to-day management and operational control of the assets contributed by the other party
- Each party gets a disproportionate allocation of profits and losses from business assets contributed by the other party
  - In general, 80/20 (or even 85/15) allocation may be OK depending on unwind provisions, risk inherent in assets and other factors
  - See Treas. Regs. § 1.707-3(f), *Ex. 8*
- After at least 7 years, partnership may liquidate with each partner receiving assets contributed by the other
  - Book-up would help bring capital accounts in line in part, but not completely. Difference would need to be addressed through distribution of liquid assets, debt assumption or additional contributions.

Partnership Mixing Bowl



- What if Bus A and Bus B are each held in single member LLCs (DEs) under P/S?
- Disguised sale of property rules apply. Do proposed rules for disguised sale of P/S interests also apply?

Partnership Exit:
Distribution of Newly-Acquired Assets



- Assume that X, Y and Z have been partners in P/S for over 7 years and there have been no property contributions during that time. Y wants to be redeemed out of P/S but has a very low basis in its P/S interest.
- If cash (or marketable securities) is distributed to Y, Y will recognize equal to the difference between the cash and Y's basis in its interest in P/S.
- Y does not recognize gain on the distribution of the New Business (but takes a substituted basis in the distributed assets) since § 731(a)(i) and (b) provide that no gain is recognizable to a P/S or a partner upon the distribution of property (i.e., the New Business) to a partner in redemption of the partner's P/S interest.
- If P/S has a § 754 election in place, remaining assets should be entitled to a basis step-up equal to the basis step-down in the distributed assets. (Step-up can be particularly beneficial if retained assets are otherwise subject to §1250 recapture.)
- If Y has a negative tax capital account, highly leveraged assets might be distributed in redemption of Y's interest (in either a successful partnership venture) or to allow workout of P/S debt

S Corporations: Mergers, Divisions and More Exotic Structures

S Corporations: Tax-Free Reorganizations

- Section 1371(a) provides that subchapter C applies to an S corporation except to the extent of any inconsistency with subchapter S.   Section 368 (applying to tax-free reorganizations) generally should apply to S corporation mergers
- To qualify as a tax-free reorganization:
  - Acquiring and target must be corporations (C or S)
  - Continuity of interest must be satisfied: At least 40% of consideration must be buyer's equity
  - Detailed rules may apply depending on the form (e.g., some forms require 80% or even 100% stock consideration)

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S Corporations: Tax-Free Reorganizations

- Generally stock of buyer can be received tax-free (i.e., tax is deferred until the stock is sold)
- Gain is generally recognized to the extent of boot received
  - Boot is generally nonstock consideration.
  - Nonqualified preferred stock can be treated as boot
    - Nonqualified preferred stock is (i) limited and preferred; (ii) does not participate in corporate growth; and (iii) has a special feature such as mandatory redemption, put, call or variable dividend rate
- Buyer gets no step-up in the basis of the assets (even for boot)

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S Corporations: Tax-Free Reorganizations

- In an acquisitive reorganization, the S corporation status of the target will terminate.
  - If an S corporation target is acquired in a reorganization where the target survives, the target generally will have a disqualified (corporate) shareholder and cannot elect S corporation status
- When an S corporation acquires the assets of a C corporation in a tax-free reorganization:
  - The acquiring S corporation generally will retain its S corporation status (as long as target shareholders receiving stock are eligible shareholders and total shareholders are under 100)
  - The built-in gain rules of section 1374 apply to target's assets

S Corporations: Tax-Free Reorganizations

- Where both parties are S corporations:
  - Generally the target SCo will be merged into the SCo acquiring company or a disregarded entity (QSub or DE-LLC) of acquiring (unless target is to be operated as a C corporation subsidiary)
  - The attributes of both S corporations (including built-in gain) are generally combined

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Tax-Free Reorganizations

- A Reorganization
  - Statutory merger or consolidation (so asset transfer in form)
  - Target's stockholders receive stock, cash, debt, property, or a combination
  - Most commonly used because of its relative simplicity
  - Section 368(a)(1)(A)
- B Reorganization
  - Stock for stock exchange (so stock transfer in form)
  - Buyer acquires stock of Target in exchange solely for voting stock of Buyer (or Parent); Buyer has control of Target immediately after
  - Least commonly used because of strict "no boot" requirement
  - Section 368(a)(1)(B)
  - Not used if buyer Buyer and Target are S corporations

Tax-Free Reorganizations

- C Reorganization
  - Buyer acquires substantially all of the assets of Target in exchange for all or part of its own (or it’s controlling parent’s) voting stock, followed by Target’s planned distribution of all of its properties
  - Distribution requirement can be waived by the IRS (but never is)
  - Asset transfer
  - Section 368(a)(1)(C)

Tax-Free Reorganizations

- D Reorganization (acquisitive)
  - Target transfers all or part of its assets to Buyer and, immediately after, Target or one or more of Target shareholders controls Acquiring
  - Asset transfer
  - Used for intercompany transfers, especially cross-border transfers
  - Section 368(a)(1)(D)
  - Rarely used for S corporations

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Tax-Free Reorganizations

- E Reorganization
  - Recapitalization--mere reshuffling of capital structure
  - Section 368(a)(1)(E)
  - Rarely used for S corporations because of single class of stock requirement

- 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)

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Tax-Free Reorganizations

- Reverse Subsidiary Merger
  - Subsidiary of Buyer is merged into Target with Target surviving
  - Would not be used if Buyer and Target are both S corporations
  - Requirements are more difficult than regular A reorganization
    - 80% of consideration must be for voting stock of Parent
    - Parent must acquire “control” of Target
    - Substantially all of the assets must be transferred
  - MergerSub should be newly formed (can be pre-existing)
  - If all stock, may also qualify as a B reorganization (MergerSub must be newly formed)
  - Section 368(a)(2)(E)
  - Useful where a re-titling of assets is impossible or undesirable
  - Also, in the event it doesn’t qualify, one level of tax results, not two

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Tax-Free Reorganizations

- Forward Subsidiary Merger
  - Target is merged into subsidiary of Issuing corporation with MergerSub surviving
  - Would not be used if Buyer and Target are both S corporations
  - Only continuity (40% stock) required
  - Substantially all of the assets requirement
  - MergerSub can be newly formed or pre-existing
  - Section 368(a)(2)(D)

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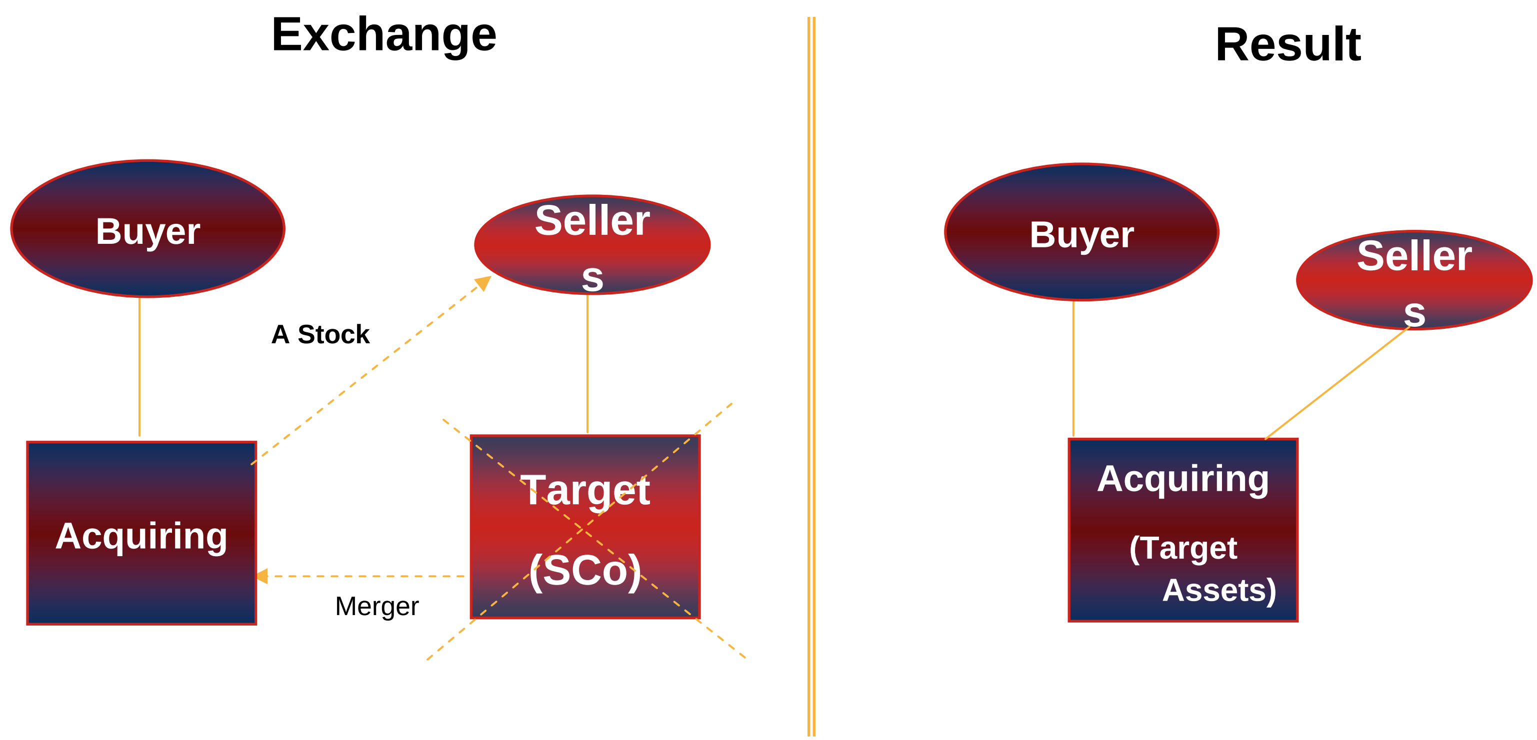
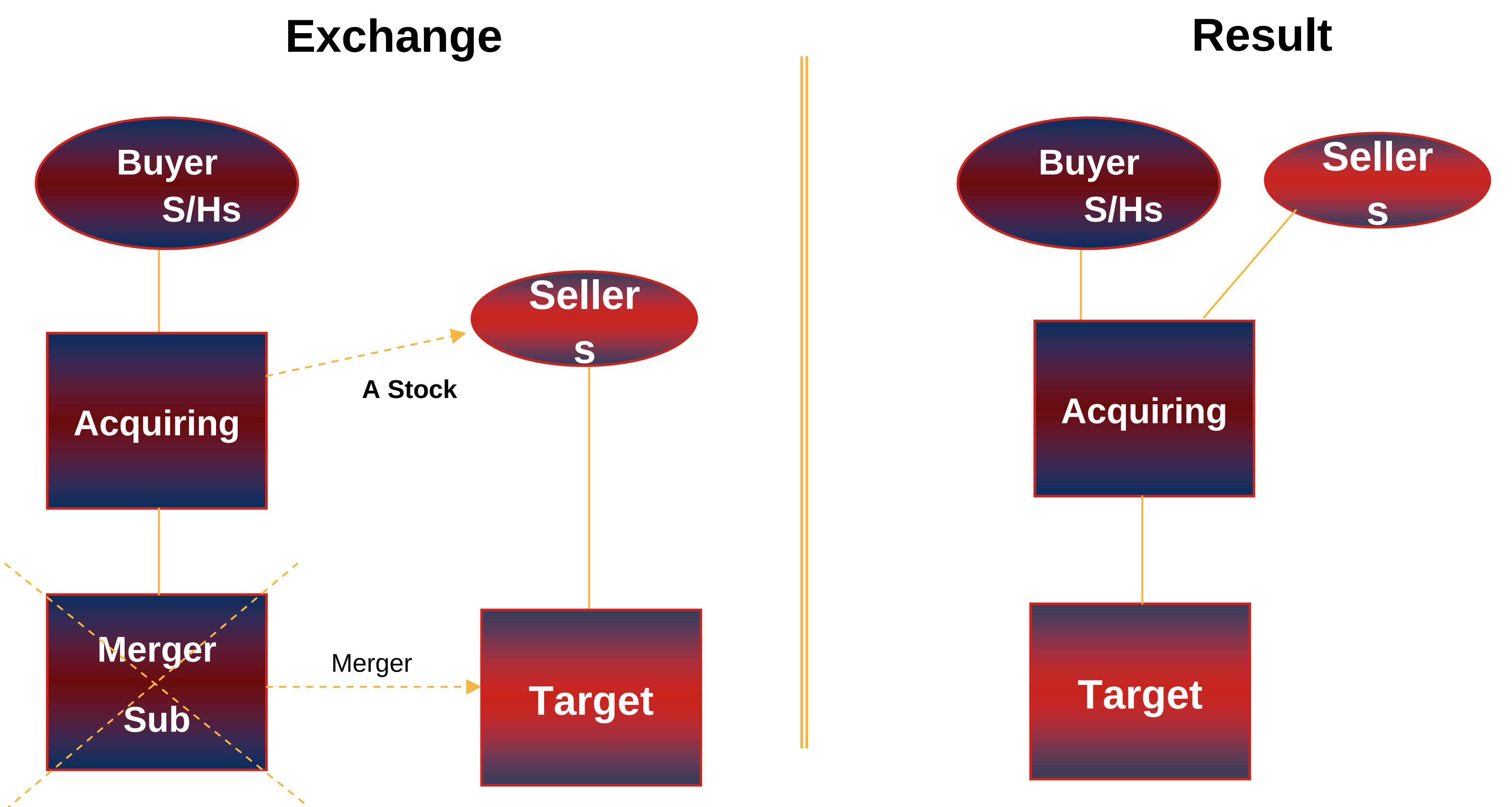
Tax-Free Reorganization (Direct Parent Company Merger)



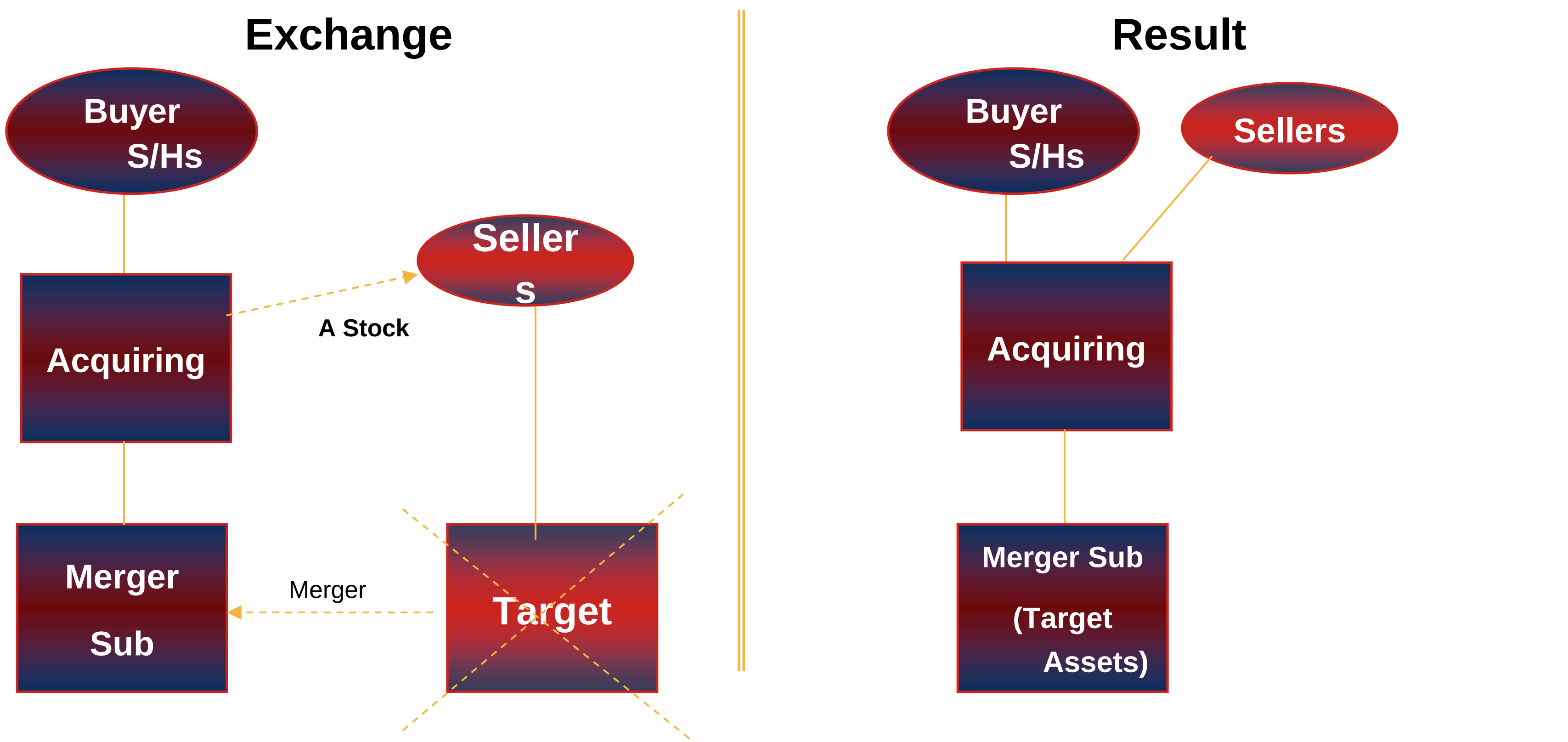
- § 368(a)(1)(A)
- § 368(a)(1)(C) (if by other than statutory merger)

Tax-Free Reverse Subsidiary Merger



- §§ 368(a)(1)(A) & 368(a)(2)(E)
- §368(a)(1)(B) (if merger subsidiary is transitory)

Tax-Free Forward Subsidiary Merger



- §§ 368(a)(1)(A) & 368(a)(2)(D)
- § 368(a)(1)(C) (if by other than statutory merger)

Basic Requirements for Tax-Free Reorganization

- Continuity of Interest
  - IRS ruling standard 50% stock/50% cash
  - IRS regulations indicate that 40% stock is adequate
  - Required for all acquisitive tax-free reorganizations (except section 368(a)(1)(E) and (a)(1)(F) reorganizations)

- Continuity of Business Enterprise
  - Continuation of Target's historic business or use of a significant portion of Target's historic business assets in a business
  - Examples in the regulations indicate that COBE is satisfied by continuing one of three business lines or having an interest in 33-1/3% of the historic business assets
  - Required for all acquisitive tax-free reorganizations (except for section 368(a)(1)(E) and (a)(1)(F) reorganizations)

Basic Requirements for Tax-Free Reorganization

- Solely for Acquiring/Issuing Voting Stock
  - Required for B and C reorganizations
  - Unlike a B reorganization, C reorganizations contain a limited "boot relaxation rule" (i.e., boot plus Target liabilities transferred plus FMV of Target assets not transferred cannot exceed 20% of the FMV of Target's assets)
- Control of Target Immediately After Acquisition
  - Acquiring/Issuing must "control" of Target subsidiary immediately after it is acquired
  - Control defined under section 368(c) as 80% of Target's voting power and 80% of each class of non-voting stock
  - Required for B reorganizations

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Basic Requirements for Tax-Free Reorganization

- Acquisition of Control in Exchange for Voting Stock
  - Required for Reverse Subsidiary Mergers (Section 368(a)(2)(E))
  - Control defined under section 368(c)

- Substantially All the Assets
  - IRS ruling standard 90% of net assets/70% of gross assets
  - D reorganizations case law suggests lesser standard (e.g., operating assets)
  - Required for reverse subsidiary mergers, forward subsidiary mergers, C reorganizations, D reorganizations and G reorganizations

Basic Requirements for Tax-Free Reorganization

- Use of Controlling Corporation Stock
  - Only Controlling/Issuing corporation stock may be issued; no stock of Controlling/Issuing corporation's merger subsidiary
  - Required for subsidiary merger forms (i.e., reverse subsidiary merger, forward subsidiary merger, subsidiary B reorganizations and subsidiary C reorganizations)
- Control of Acquiring Immediately After by Target S/Hs
  - Target or Target shareholders or a combination must control acquiring immediately after Target merges into Acquiring
  - For this purpose, control is defined as 50% of the combined voting power of all classes of stock entitled to vote or 50% of the value of shares of all classes of stock
  - Attribution rules of section 318 apply
  - Required for D reorganizations

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Basic Requirements for Tax-Free Reorganization

Requirement	‘B’	‘(a)(2)(D)’	‘(a)(2)(E)’	‘B’	Subsidiary ‘B’	‘C’	Subsidiary ‘C’	‘D’	‘F’	‘G’
Continuity of Interest	✓	✓	✓	✓	✓	✓	✓	✓		✓
Continuity of Business Enterprise	✓	✓	✓	✓	✓	✓	✓	✓		✓
Solely for Voting Stock				✓	✓	✓	✓			
Substantially All the Assets		✓	✓			✓	✓	✓		✓
Use of Controlling Corporation Stock		✓	✓		✓		✓			
Acquisition of Control			✓							
Control Immediately After (of Target)				✓	✓					
Common Control (of Acquiring)								✓		
Identity of Assets & Shareholders									✓	

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Other Considerations for Tax-Free Reorganization

- Step Transaction Doctrine
  - Related steps viewed together should satisfy requirements for tax-free reorganization
    - Three different tests applied to determine whether steps will be treated as related for purposes of qualifying as a tax-free reorganization
    - See, e.g., Rev. Rul. 2001-26 and 2001-46
  - Applies to all forms of tax-free reorganizations and to section 351 transactions

- Business Purpose
  - Acquiring must have a (commercial) business purpose for acquiring Target.

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Other Considerations for Tax-Free Reorganization

- Escrowed or Contingent Stock
  - No good authority on the treatment of escrowed and contingent shares for purposes of measuring continuity
  - IRS established ruling guidelines but in practice the requirements of the guidelines may not be met

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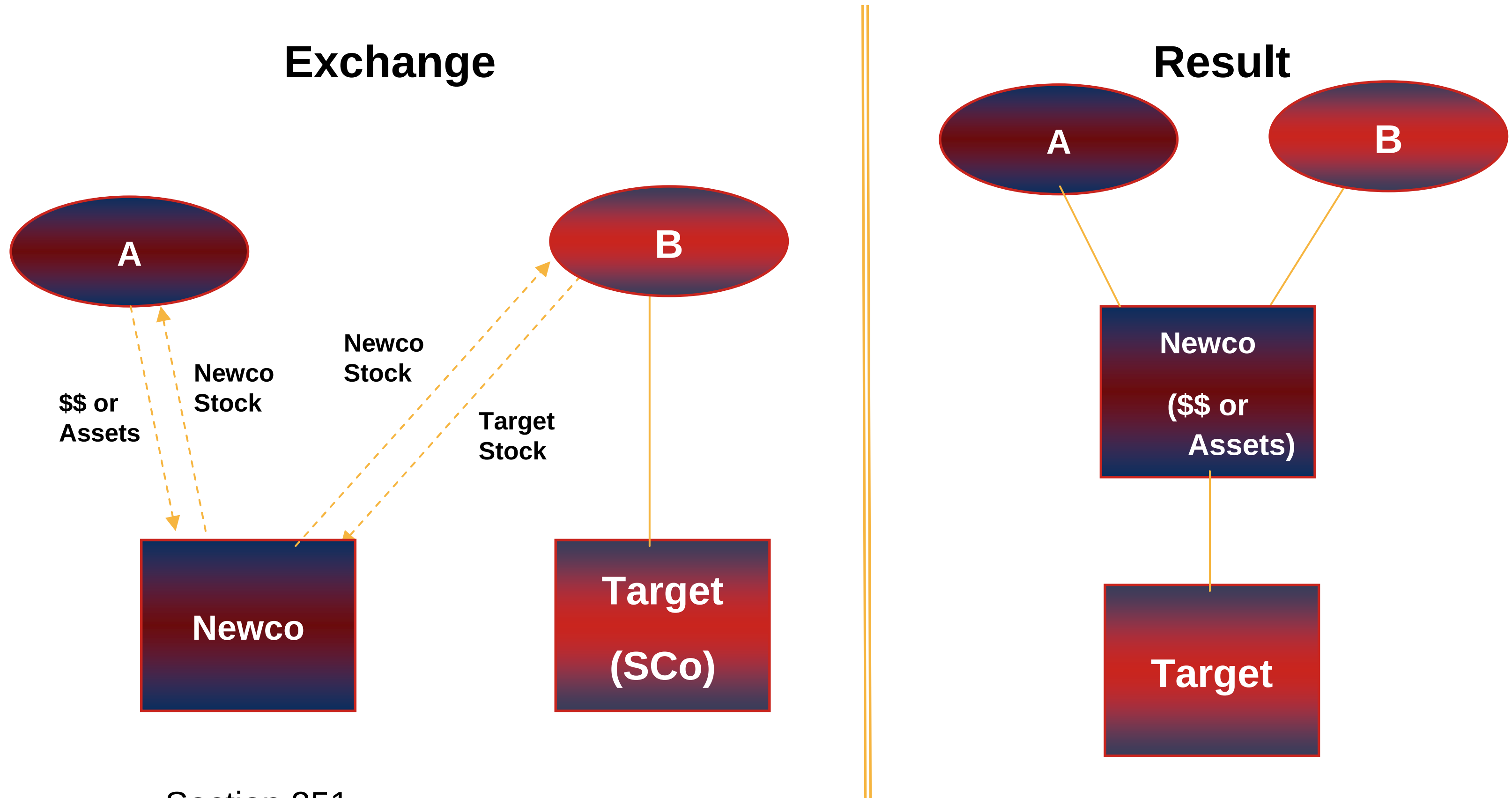
Other Considerations for Tax-Free Reorganization

- **Escrowed or Contingent Stock**
  - IRS ruling guidelines provide contingent and escrowed shares generally not boot if certain requirements met
    - See Rev. Proc. 77-37, §§ 3.03, 3.06; Rev. Proc. 86-42, §§ 2.01, 2.02
    - Requirements include issuance of only stock, business purpose and all shares released/issued within 5 years
    - For contingent shares, at least 50% of shares must be issued initially
    - For escrowed shares, at least 50% of the shares issued initially must not be subject to escrow
    - Guidelines may not apply in employment context

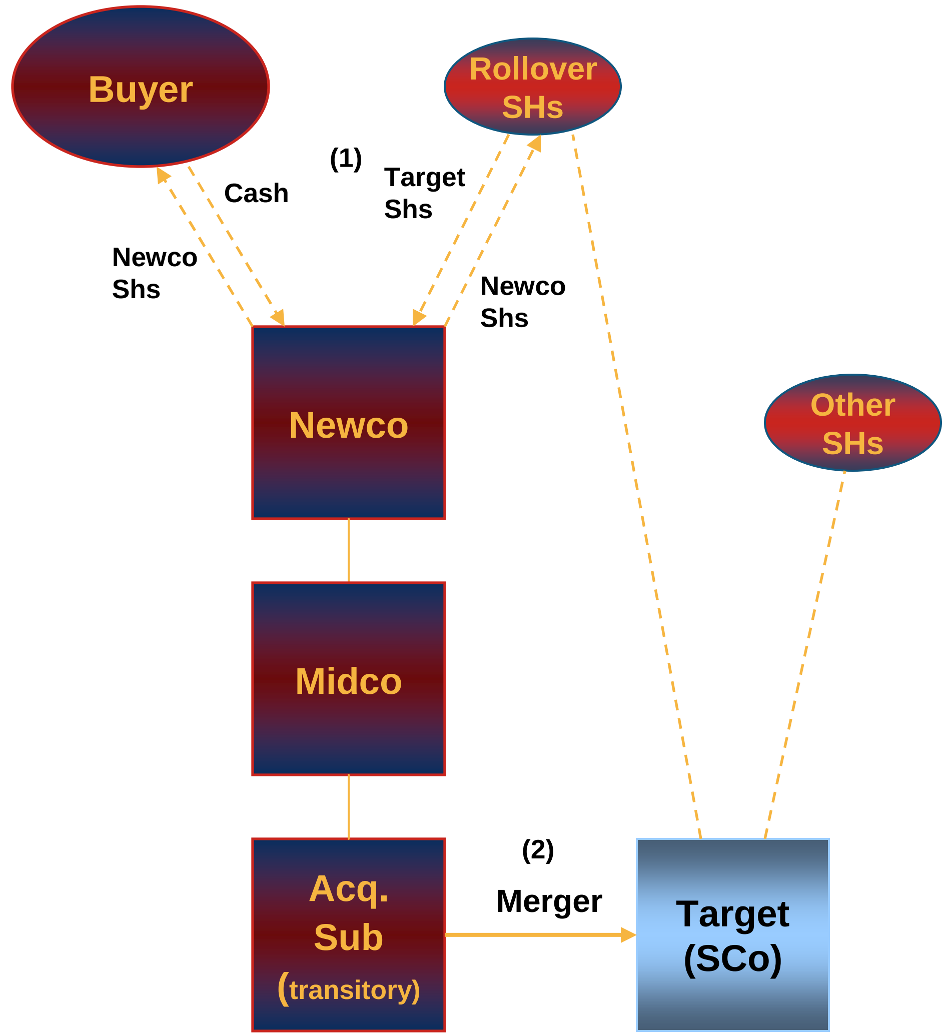
Basic § 351 Acquisition (Tax-free)



- Section 351
- Target's S corporation status terminates (and cash basis targets have income pick-up from conversion to accrual basis)

Section 351 Structure with Cash Merger (National Starch–type Structure)

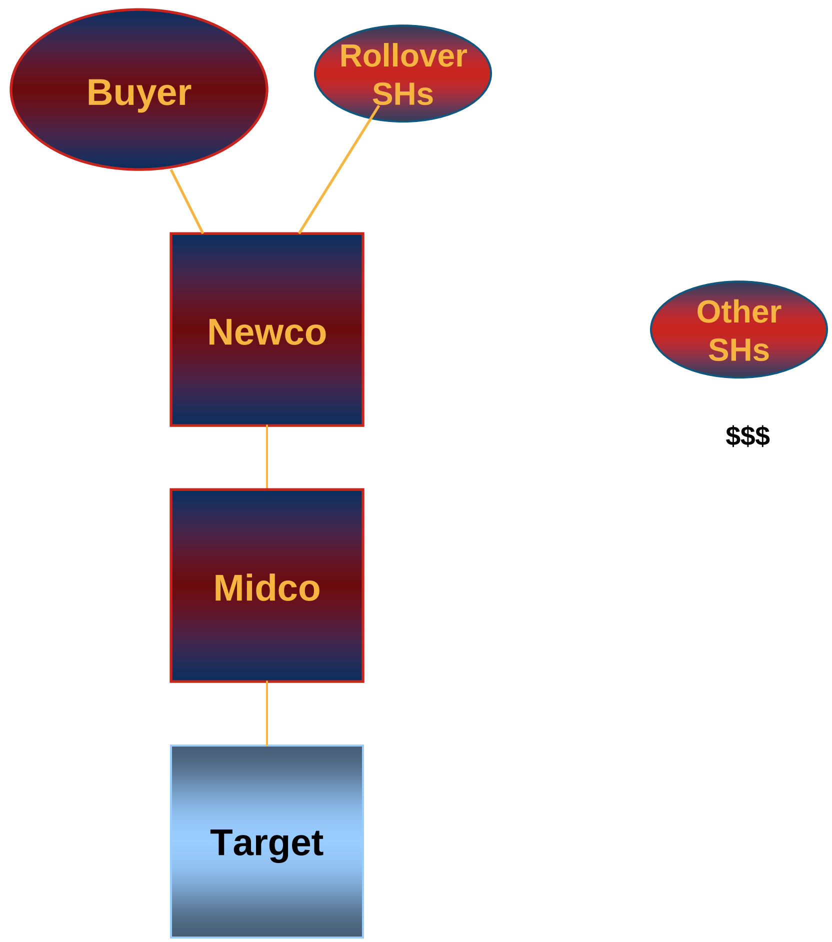
- Newco and Midco are formed. Rollover shares are transferred to Newco in exchange for Newco shares (and sometimes earn-out). At the same time, Buyer transfers the merger consideration to Newco in exchange for Newco shares.
- A newly formed transitory subsidiary of Midco merges with and into Target, with Target surviving. The other Target shareholders receive the merger consideration.



Section 351 Structure with Cash Merger (National Starch–type Structure)

Result

- Exchange of Target shares for rollover shares is tax-free (as long as the rollover shares are not nonqualified preferred stock). Exchange of shares for cash is taxable.
- Typically not used in connection with a section 338(h)(10) election
- Target's S corporation status terminates



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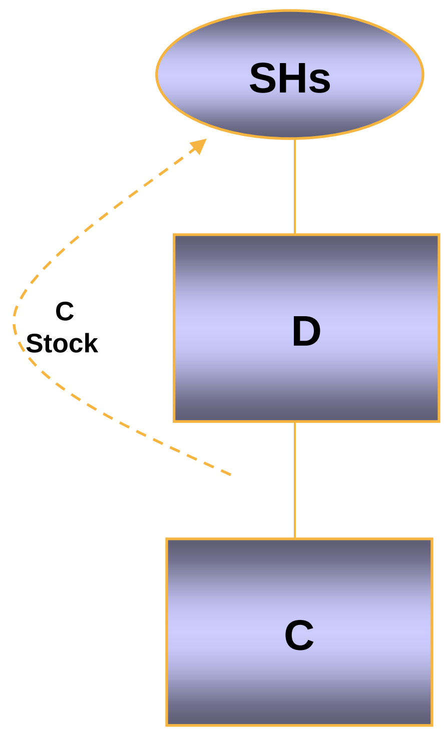
S Corporation Divisions: Spin-offs

- Only section 355 is available to defer tax on a distribution of assets from an S Corporation
- Section 355 takes three forms:
  - Spin-off (in lieu of a dividend)
    - Distributing ("D") distributes Controlled ("C") stock pro rata to D shareholders.
  - Split-off (in lieu of a redemption)
    - D distributes C stock to some or all D shareholders in redemption of all or part of their D stock.
  - Split-up (in lieu of a liquidation):
    - D distributes stock of two or more controlled companies in liquidation of D.

Basic Spin-off

- Tax–free to D and S/Hs
- S/Hs' $100 basis in D is allocated between D and C after spin
- E&P allocated between D and C after spin



D Stock
Basis = $100
FMV = $200

C Stock
Basis = $10
FMV = $100

Spin-Off Requirements

- **Statutory Requirements**
  - Distribution with respect to stock
  - Control immediately before
  - Not a device (device is generally not an issue in split-offs) Rev. Rul. 64-102, 1964-1 C.B. 136
  - Active conduct of a trade or business
  - No related acquisition. Section 355(e).
  - Distribution of all the stock of the controlled corporation
  - Neither D nor C can be a disqualified investment corporation in certain “cash rich” split-off transactions. Section 355(g)(1).

- **Judicial Requirements**
  - Business Purpose
    - IRS ruling position wants both D and C (or neither) to be S corporations after spin-off
  - Continuity of Interest
  - Continuity of Business Enterprise

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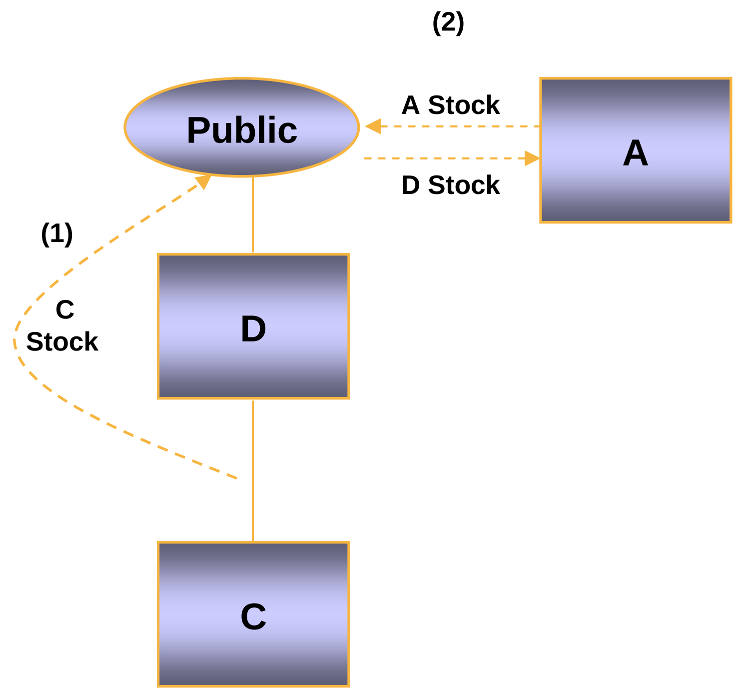
Spin-off Rulings

- Rev. Proc. 2003-48: IRS no longer rules on:
  - business purpose
  - device
  - existence of a plan under section 355(e)
  - See, also, Rev. Proc. 2011-3 for “no rule” and “ordinarily will not rule” areas.
- Instead, representations are required.

Basic Morris Trust - Before Section 355(e)

- As part of a common plan:
  - D contributes unwanted assets to C
  - D distributes C to Public
  - A acquires D from Public
    - Acquisition is a B reorganization (or an A reorganization)
- Prior to 1997, tax-free under Comm. v. Mary Archer W. Morris Trust and Rev. Rul. 68-603



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Section 355(e)

- Section 355(e) applies to a distribution
  - which is part of a plan (or series of related transactions)
  - pursuant to which one or more persons acquire at least 50 percent of the stock (by vote or value) of the distributing corporation (“D”) or the controlled corporation (“C”)
- Statutory Presumption
  - Acquisitions and distributions that occur during the four year period (beginning on the date that is two years prior to the distribution) are presumed to be part of a plan (and extend to predecessors and successors
- Regulations
  - Final regulations provide helpful safe harbors but stock transfers before or after a spin-off must be carefully considered .

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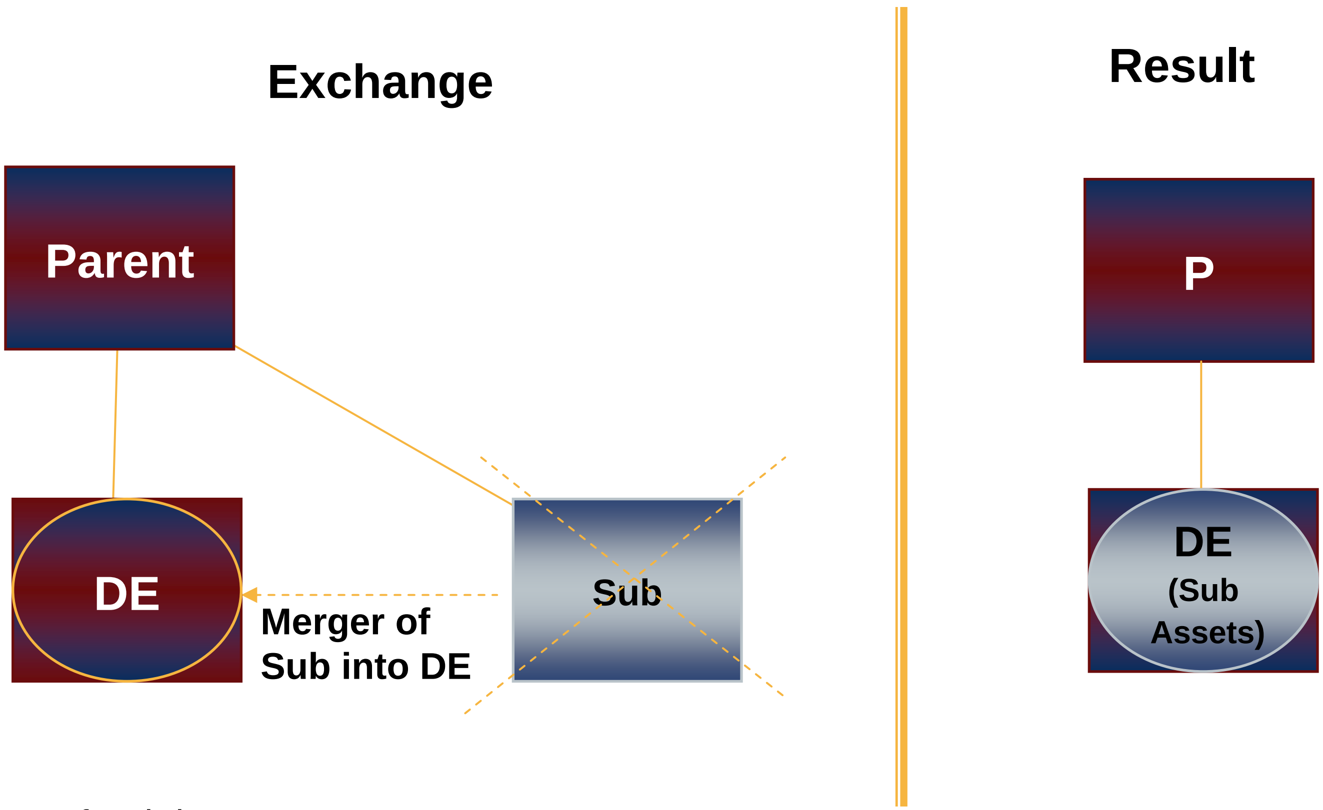
Using Disregarded Entities to Unite Tax and Business Objectives

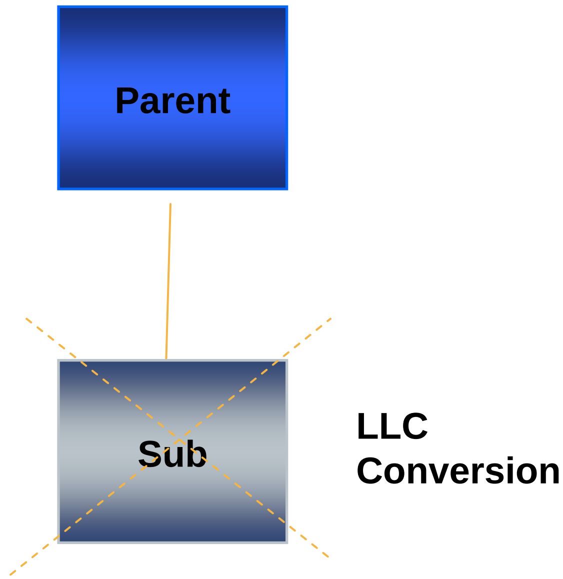
Disregarded Entity Liquidation



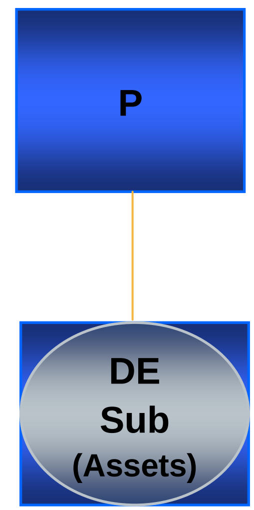
- Merger of Sub into DE
- Treated as liquidation of Sub into Parent
- Like a merger of Sub directly into Parent, this transaction also qualifies as an A reorganization

Disregarded Entity Liquidation

Conversion



Result



- Sub converts into DE pursuant to state law.
- Treated as liquidation of Sub into Parent. Cf. Treas. Reg. § 301.7701-3(g)(1)(iii) (tax election by single member association to be treated as a DE is a liquidation).
- Conversion statutes generally provide that no transfer of assets (for state law purposes) occurs in connection with a conversion.
- Because there is no merger, this transaction (like a regular dissolution) will not also qualify as an A reorganization

Conversions vs. Mergers: State Law Consequences

- Conversion statutes generally provide that the state law existence of a converting entity will survive the conversion process. As a result, consents generally are not required for the assumption of loans or other liabilities, and for the transfer or assignment of contracts, leases, licenses, permits, or other assets.
- Compare to a merger which results in a state law asset transfer.
- Compare to use of a "B" reorganization (which would also keep liabilities remote from Parent and not require consents) which has strict limits on consideration (solely voting stock) and permits no boot.

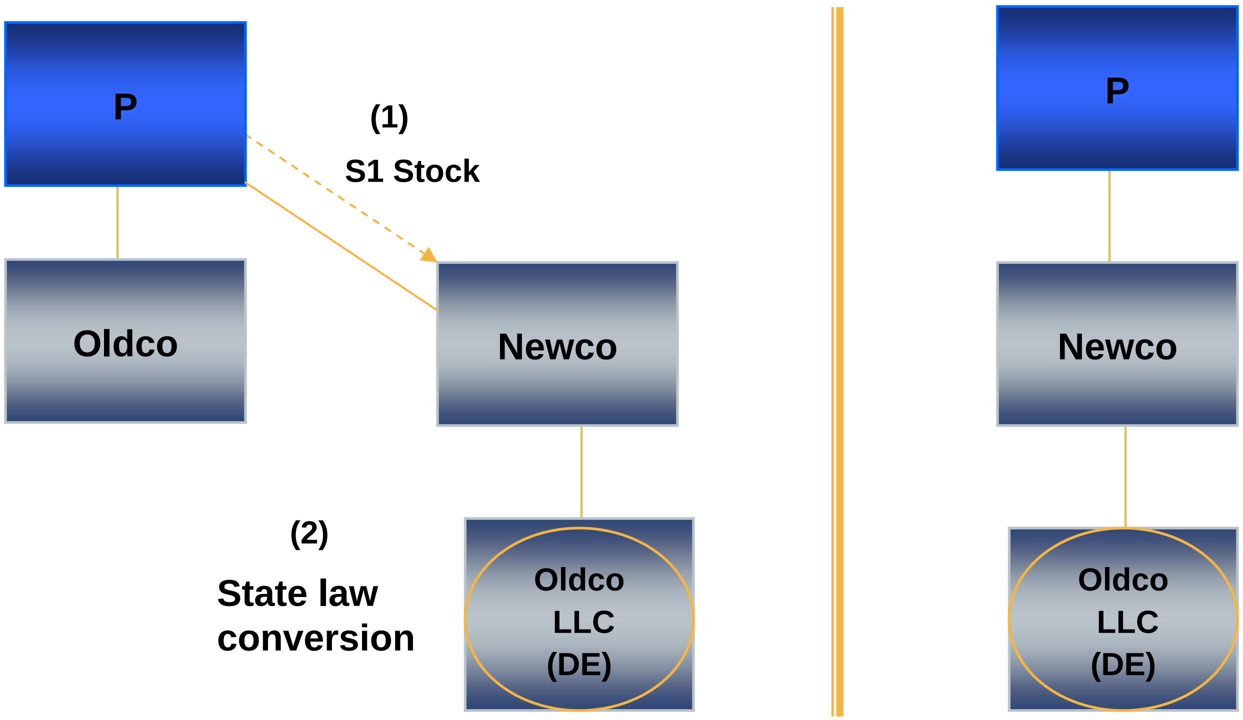
LLC Conversion Statutes

- Typical Conversion Statutes
  - *Delaware:*
    - “When a corporation has been converted to another entity or business form pursuant to this section, the other entity or business form shall, for all purposes of the laws of the State of Delaware, be deemed to be the same entity as the corporation. . . . The rights, privileges, powers and interest in property of the corporation that has converted, as well as the debts, liabilities and duties of such corporation, *shall not be deemed, as a consequence of the conversion, to have been transferred* to the other entity or business form to which such corporation has converted for any purpose of the laws of the State of Delaware.” See Del. Gen. Corp. Law section 266(h) (emphasis added).
    - "Unless otherwise provided in a resolution of conversion adopted in accordance with this section, . . . the conversion shall not constitute a dissolution of [the applicable] corporation.“ See Del. Gen. Corp. Law section 266(f).
  - *California:*
    - “An entity that converts into another entity pursuant to
      this chapter is for all purposes other than [certain provisions of] the Revenue and Taxation Code, the same entity that existed before the conversion. See California Corporations Code section 1158(a).

Merger vs. Liquidation: Tax Consequences

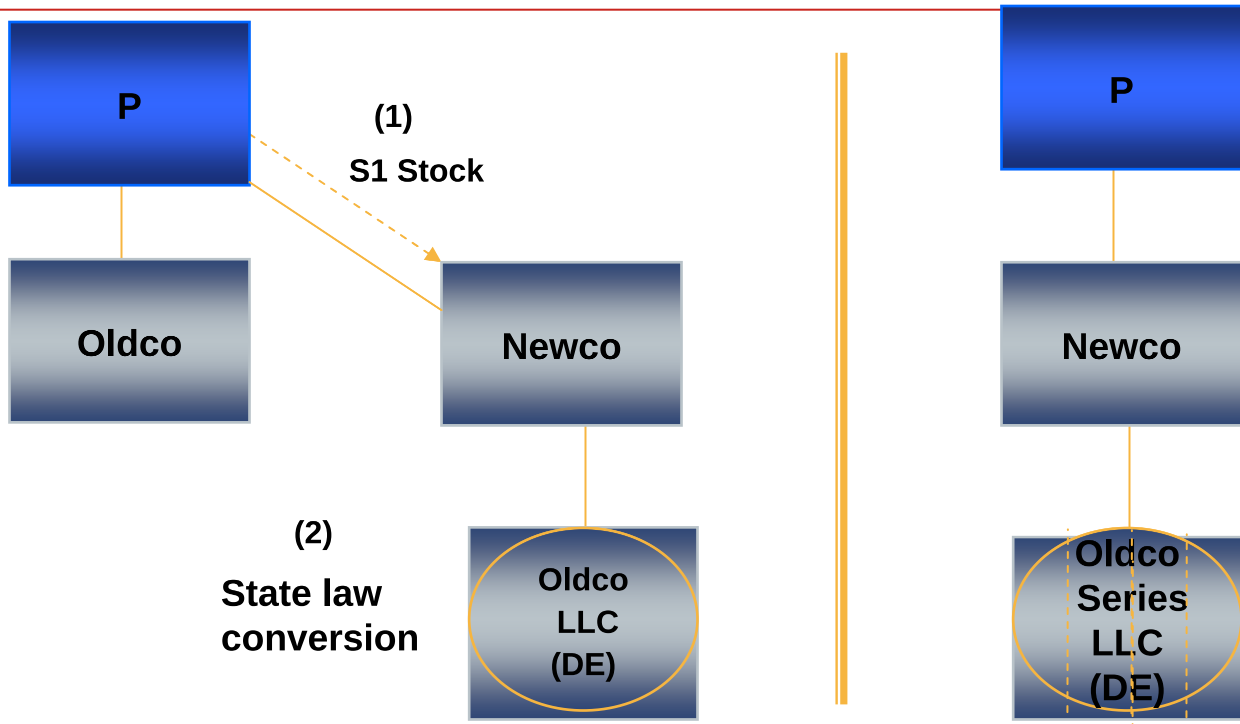
- A transaction can only qualify as an A reorganization if there is a statutory merger or consolidation. Conversion to an LLC does not qualify.
- If a transaction qualifies as both an A reorganization and a § 332 liquidation, then § 332 will apply
- If transaction fails to qualify as a § 332 liquidation (e.g., due to the liquidation/reincorporation doctrine), it can qualify as an A reorganization (assuming the requisite merger)
  - Parent's transfer of some or all of the assets that were received from Sub to controlled subsidiaries of Parent does not disqualify the reorganization. See Rev. Rul. 69-617 and § 368(a)(2)(C)
  - An upstream merger of subsidiary into Parent (or subsidiary into disregarded entity of Parent) will not qualify as a D reorganization because of the special control requirements for D reorganizations. Because there is a merger, however, an upstream merger can qualify as an A reorganization.

Basic F Reorganization



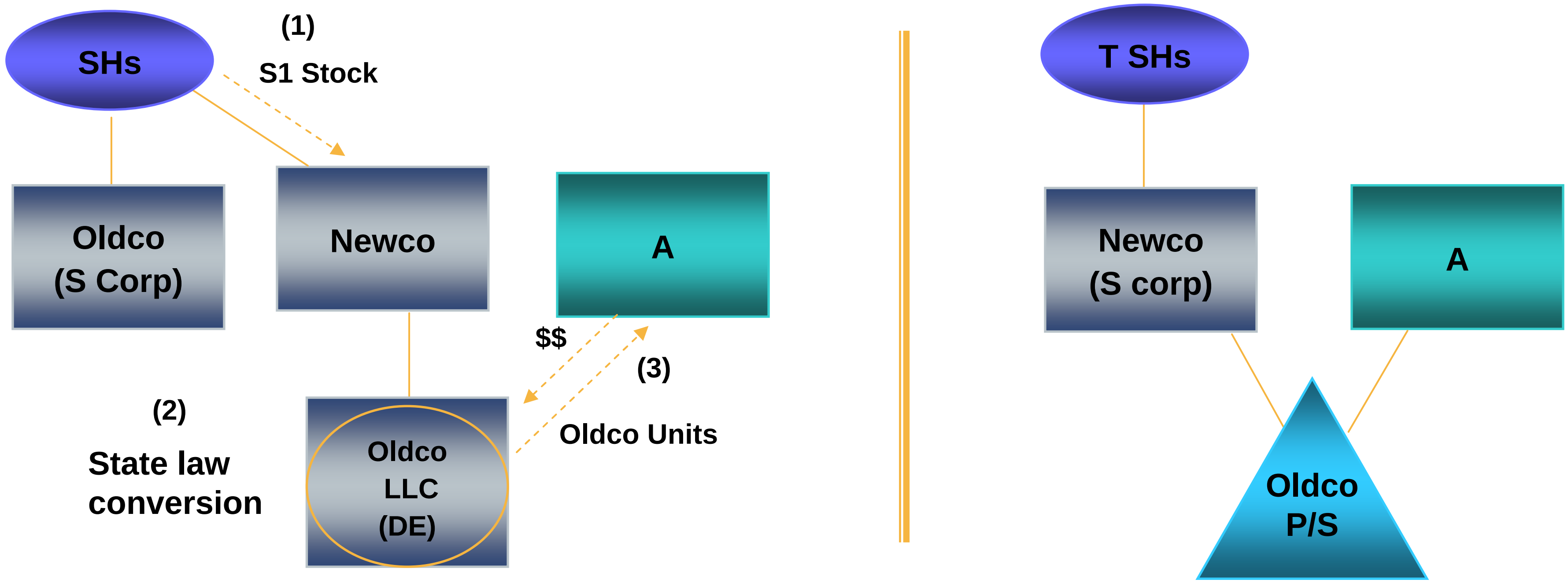
- P forms Newco. P contributes Oldco to Newco. Oldco is converted into an LLC under state law.
- Series of transactions, but result is mere change of one corp. See Treas. Reg. §1.368-2(m)(3)(i) and -2(m)(5), *Example 5* (S1 merges into S2). See FSA 200530023.
- Qualifies as an F reorg. Oldco is treated as transferring assets to Newco in exchange for Newco stock and distributing Newco stock to P in exchange for P's Oldco stock.

Basic F Reorganization into Series LLC



- Basic F Reorganization: P forms Newco; P contributes Oldco to Newco; Oldco is converted into an LLC under state law except that Oldco is converted into a Series LLC.
- Should qualify as an F reorg. as long the Series LLC is initially respected as a DE.
- Sale of interest in a series to another investor may create a P/S with respect to that series (only) *if* each series is treated as a separate eligible entity for tax purposes. See PLR 200803004 (Oct. 15, 2007).

Basic F Reorganization to Preserve S Corporation Status



- Basic F Reorganization: Oldco S/Hs form Newco; Oldco S/Hs contribute Oldco to Newco; Oldco is converted into an LLC under state law. Newco as successor to Oldco inherits status as an S corporation (although a protective S election may be made for Newco).
- A invests directly into Oldco, resulting in deemed formation of a P/S for tax purposes
- Allows investment by corporation or non-resident individual or issuance of "second class of stock" while preserving S status at the Newco level.

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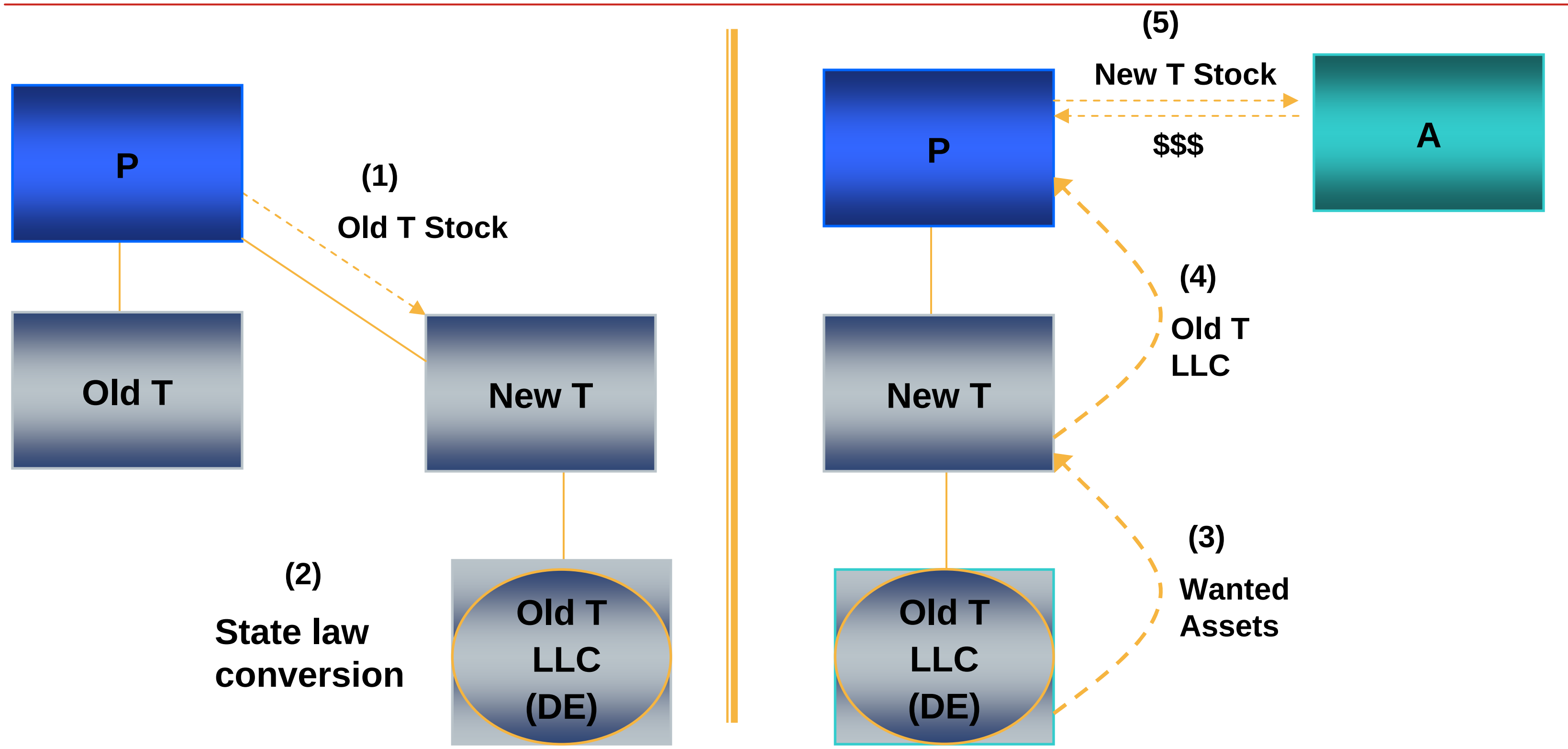
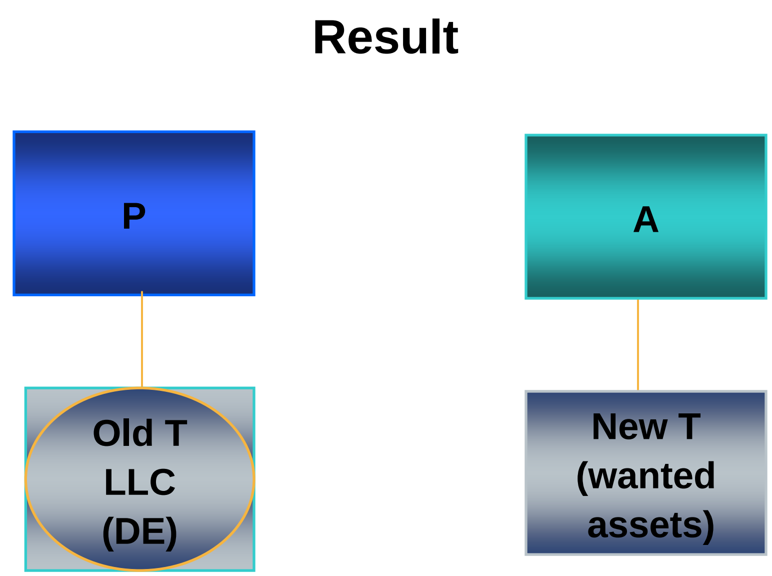
Taxable Stock Sale Using Disregarded Entity to Isolate Liabilities



Parties want a stock sale for tax purposes but want P to retain certain liabilities:

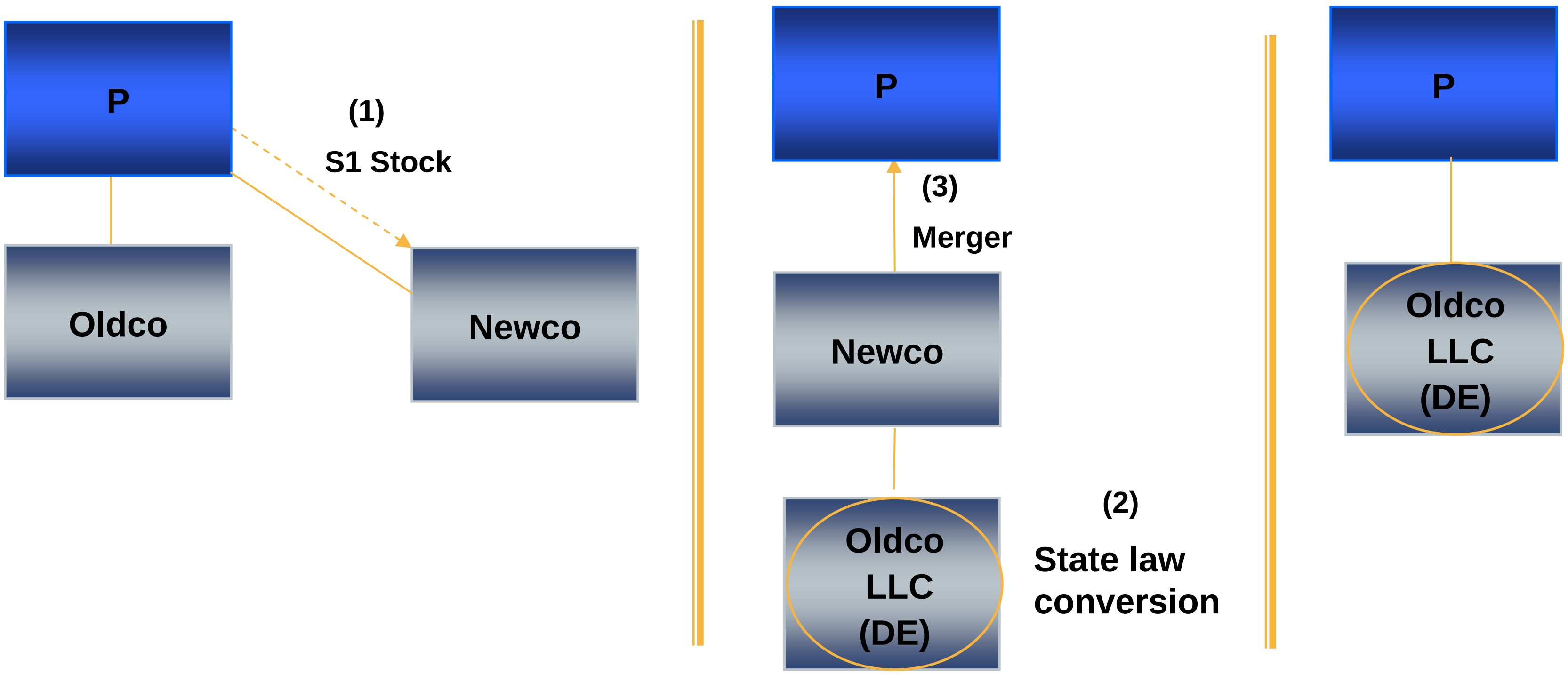
- Step One: P forms New T and transfers Old T shares to New T.
- Step Two: Old T is converted into an LLC
- Step Three: Old T distributes the “wanted assets” to New T
- Step Four: New T distributes the interests in Old T stock to P
- Step Five: P sells New T to A

Taxable Stock Sale



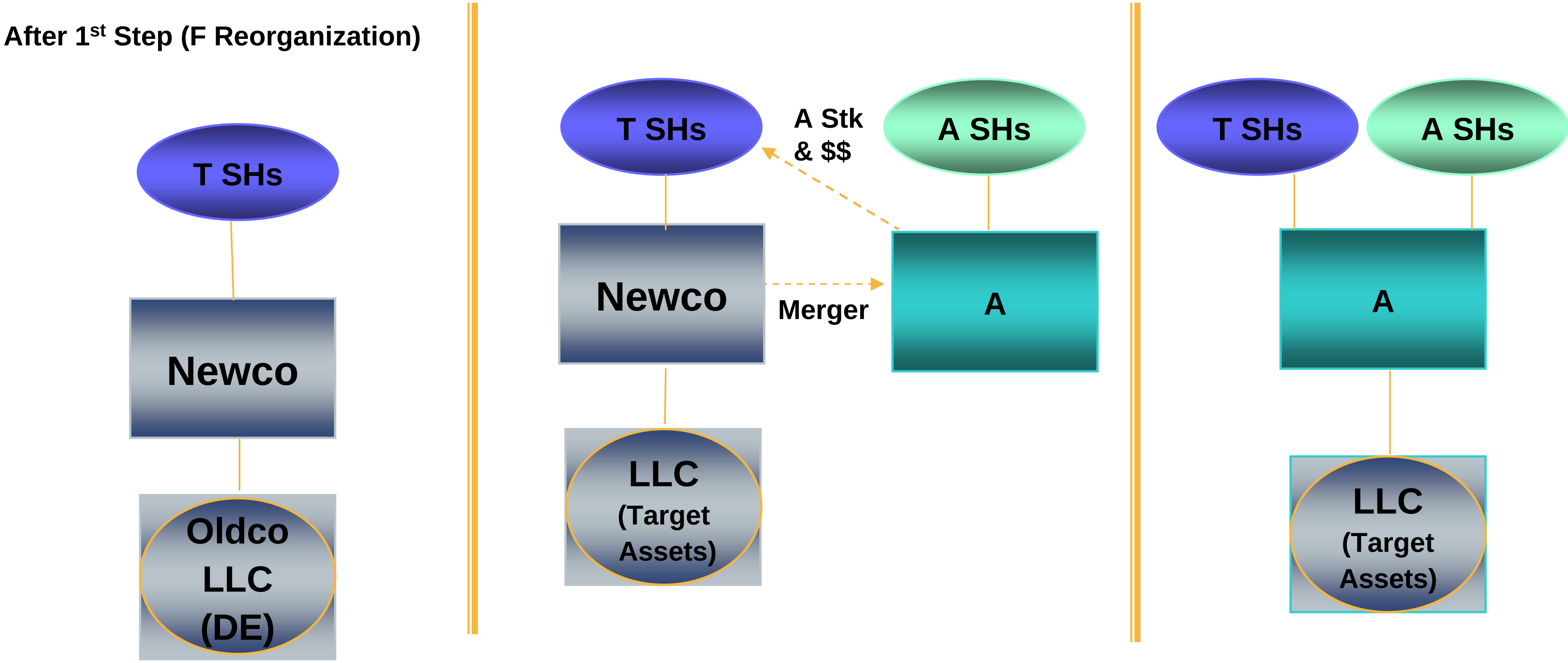
- Result:
  - Initial restructuring should be respected as an F reorganization
  - New T recognizes section 311 gain on the distribution of any unwanted assets retained in Old T LLC

F Reorganization & Liquidation/Merger



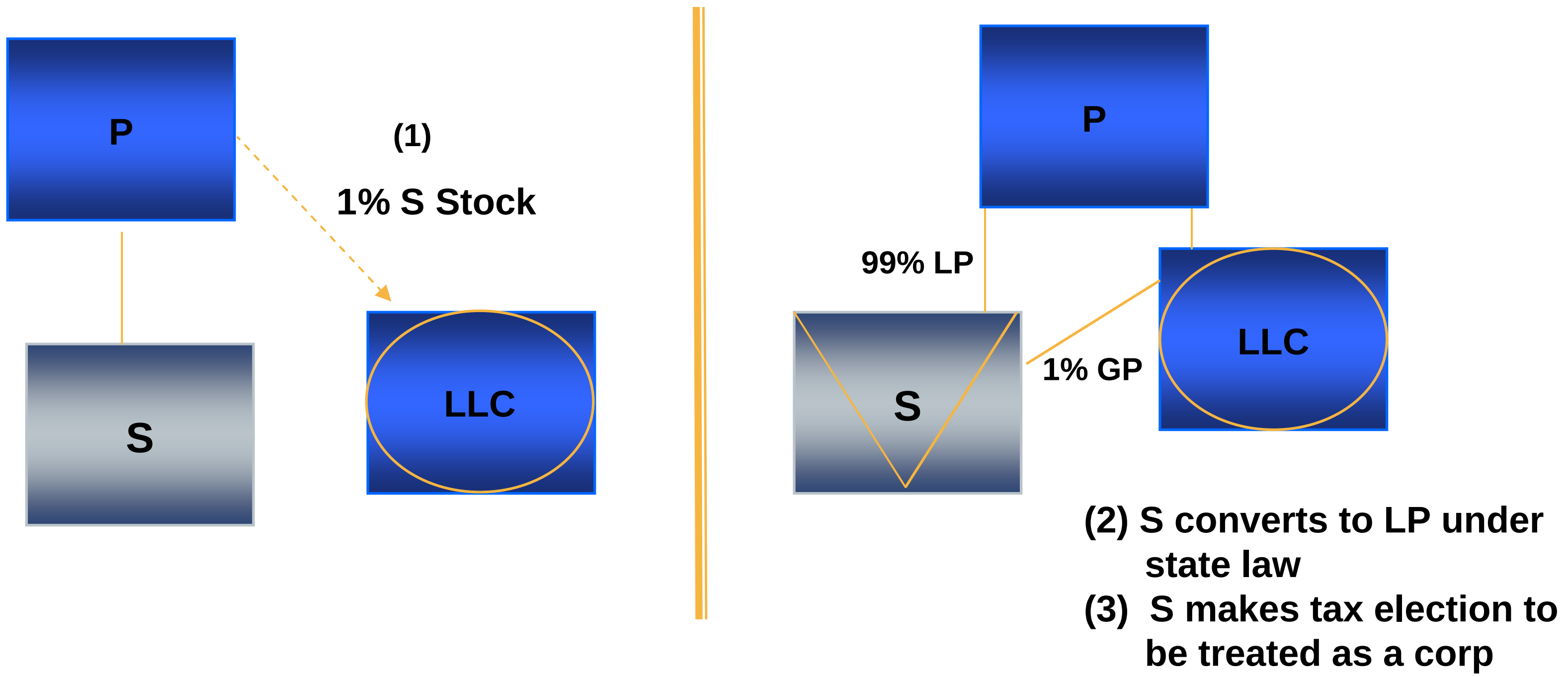
- Start with Basic F Reorganization: P forms Newco. P contributes Oldco to Newco. Oldco is converted into an LLC under state law.
- As part of a common plan, Newco is merged into P pursuant to state law
- Will merger of Newco into P qualify as an A reorg under Rev. Rul. 69-617 (if § 332 doesn't apply)? See Rev. Rul. 69-516 (now obsolete), PLR 200610007 and PLR 200613011.

F Reorganization & Acquisition Merger



- Step One: Target forms Newco and Newco forms LLC (a disregarded entity). Target merges into LLC; Target shareholders receive Newco stock.
- Step Two: Newco merges into A; Newco shareholders receive A stock and cash.
- See Rev. Rul. 69-516 (now obsolete), Rev. Rul. 96-29 and Prop. Treas. Reg. § 1.368-2(m), (REG-106889-04 (Aug 12, 2004). Also see PLR 200610007 and PLR 200613011).

F Reorganization
Prop. Regs. §§ 1.368-2(m)(5), *Ex. 8*



- Step One: T forms new LLC and transfers 1% of S to LLC.
- Step Two: Under statute, S converts to a limited partnership.
- Step Three: S makes tax election to be treated as a corporation for tax purposes
- Valid F reorg. since S's conversion to an LP and tax election are a mere change.

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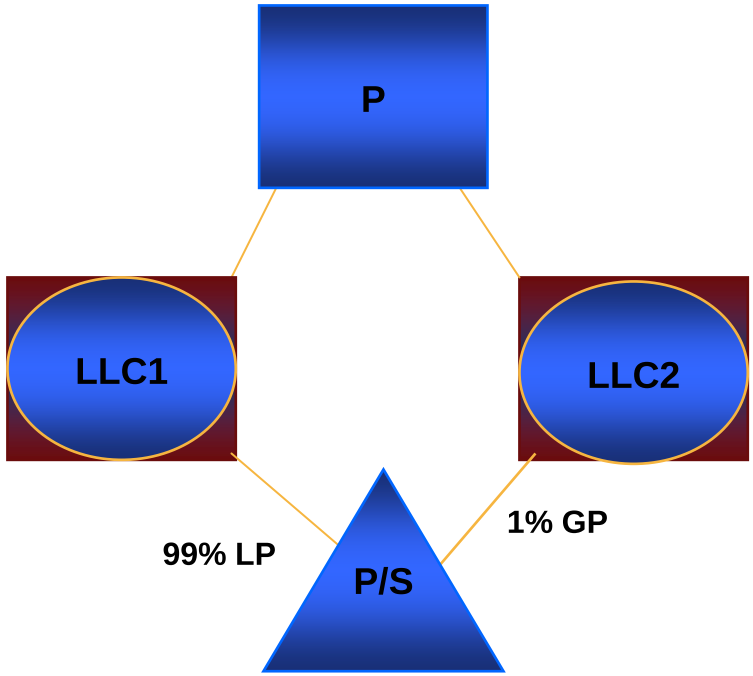
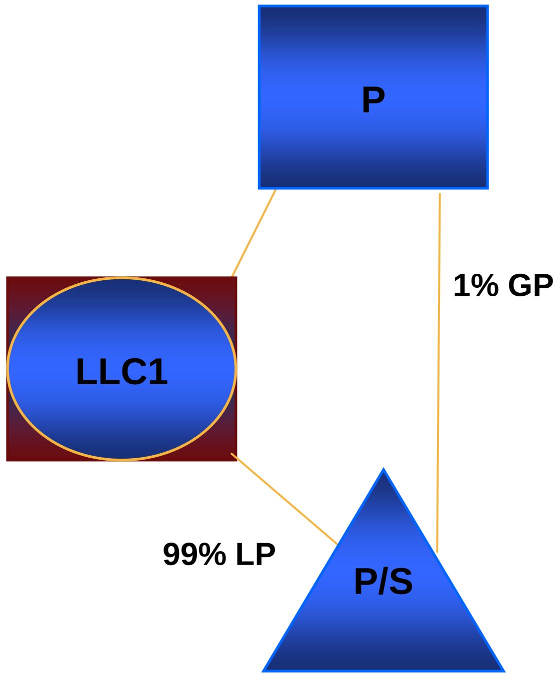
State Law Partnerships



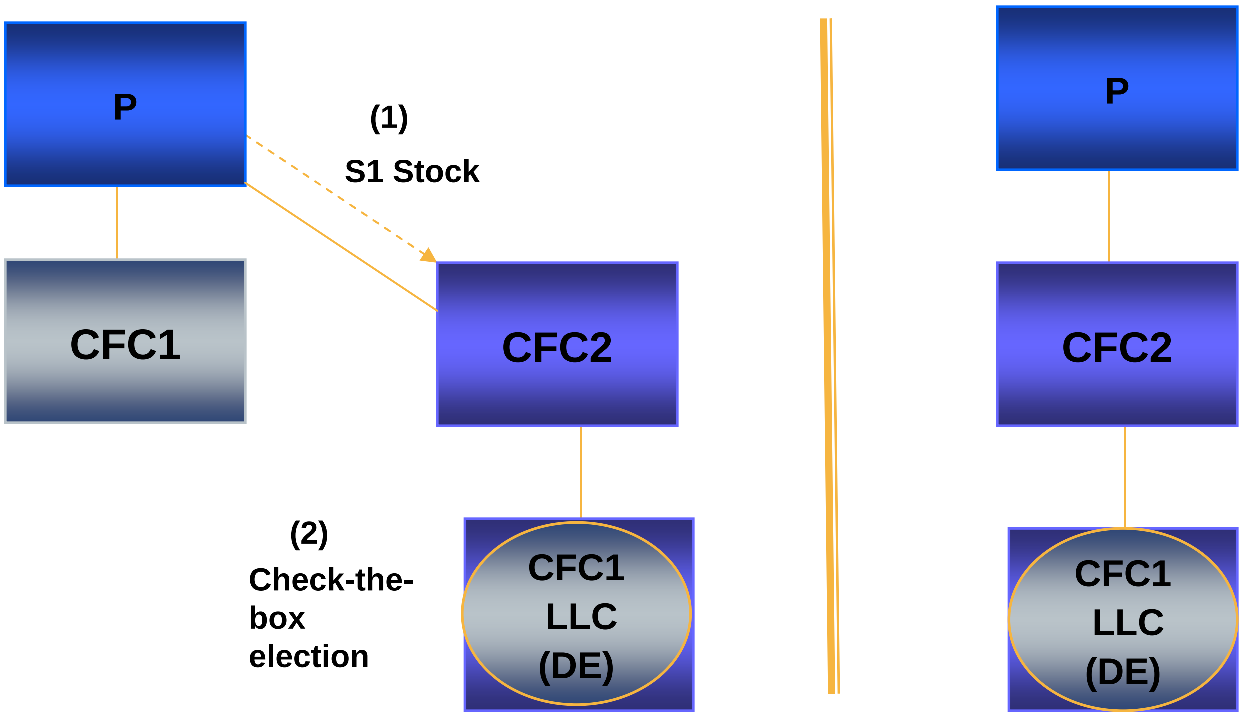
- Assume that it is beneficial for P corp. and its subsidiary, LLC, to have a partnership under state law.
- Step One: P forms a second LLC subsidiary.
- Step Two: LLC1 and LLC2 form P/S.
- Result: P/S for state law but disregarded entity for federal tax purposes.

State Law Partnerships



- P owns 1% of P/S directly and 99% through LLC1, a disregarded entity for tax purposes
- Result: P/S for state law but disregarded entity for federal tax purposes. See Rev. Rul. 2004-77

D Reorganization



- P contributes CFC1 to CFC2, which is an existing subsidiary of P. Tax election is made effective as of two days *after* the stock transfer to treat CFC1 as a disregarded entity (or CFC1 is converted into an LLC under state law).
- Should qualify as a D reorg. See Rev. Rul. 87-66, Rev. Rul. 67-274 and Rev. Rul. 2001-46. CFC1 is treated as transferring assets to CFC2 in exchange for CFC2 stock and distributing CFC2 stock to P in exchange for P's CFC1 stock.

Timing the CTB Election

- Timing of the CTB Election: Regulations provide that the deemed liquidation occurs the day *before* the effective date of the election. *See* Treas. Reg. section 301.7701-3(g)(3)(i).
- In the prior example, if the CTB election is made so that it is effective on the same day as the stock transfer, then the deemed liquidation of CFC1 will occur prior to the stock transfer.
  - In that case, the the transaction would be tested as an upstream "C" reorganization (of CFC1 into P) followed by transfer by P of the CFC1 assets to CFC2. *See* Treas. Reg. section 1.368-2(d)(4).
  - Step transaction doctrine should not apply. Rev. Rul. 69-617.
  - As a consequence, there would be an "all E&P" inclusion with respect to CFC1 and Section 367(a) and/or section 367(d) would apply to P's transfer of the CFC1 assets.
- If CTB election is instead made effective as of two days after the transfer of the CFC1 stock, then the transaction is a foreign to foreign D reorganization (so no E&P inclusion and section 367 does not apply).

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Disregard Entity Mergers

- Statutory Merger or Consolidation Generally - A transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation in which, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction:
  - all non-distributed assets and non-discharged liabilities (or liabilities that are nonrecourse to the distributed assets) of each member of one of the combining units (transferor unit) become the assets and liabilities of one or more members of one other combining unit (transferee unit),
  - the combining entity of the transferor unit ceases its separate legal existence except for limited purposes such as defending or bringing pre-closing lawsuits.
  - See Treas. Reg. § 1.368-2(b)(1)(ii) (and examples that apply to DEs mergers)
  - Applies to mergers of foreign entities and mergers and consolidations under foreign law

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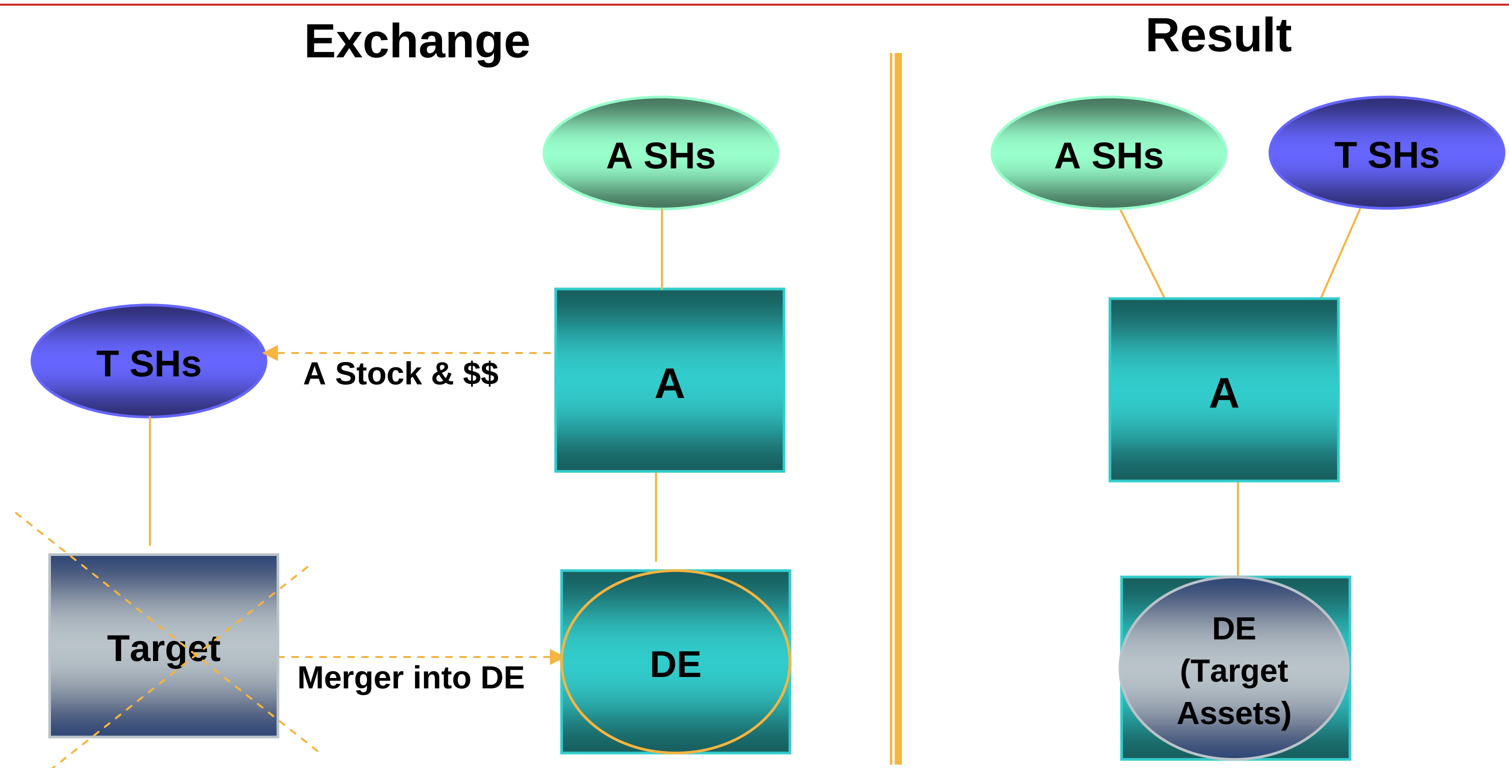
Disregard Entity Mergers

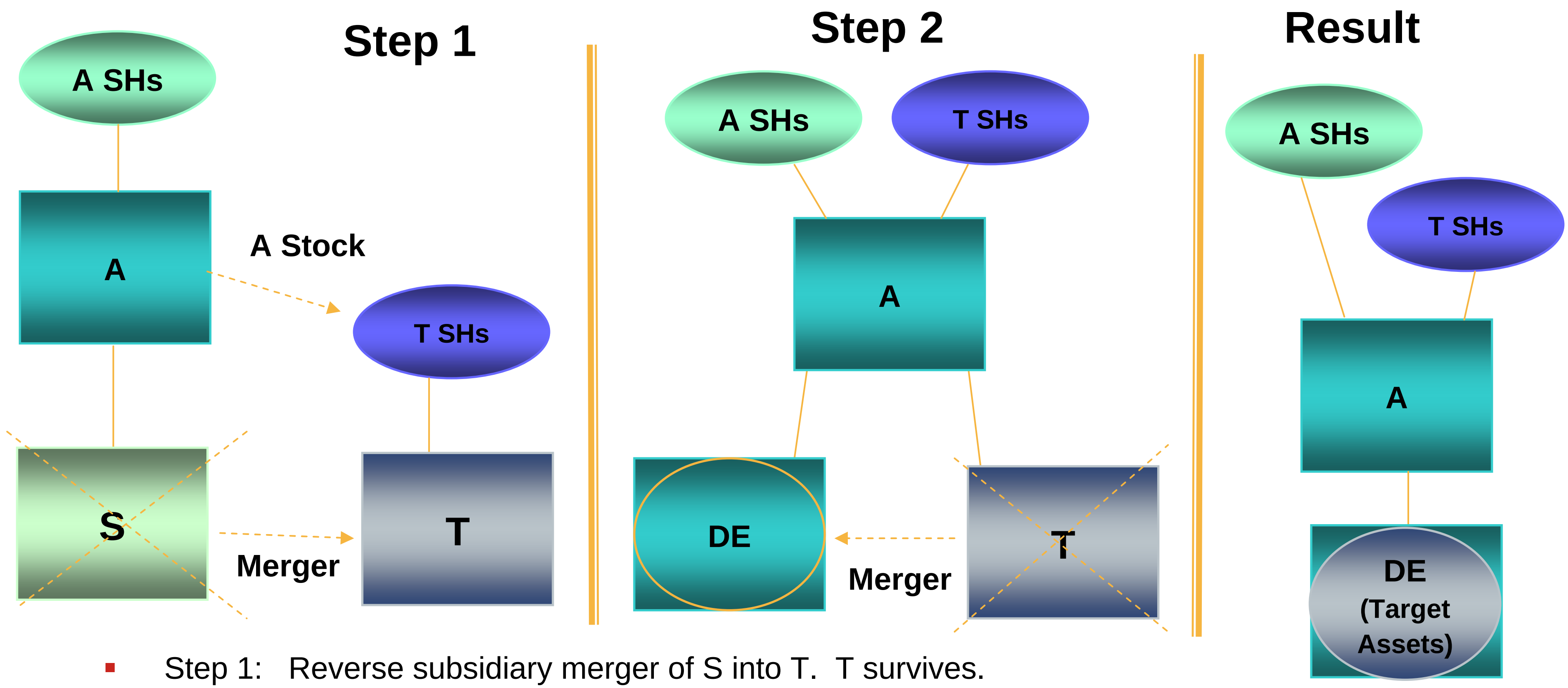
- Disregarded entity ("DE") - Business entity that is disregarded as an entity separate from its owner for federal tax purposes; e.g., domestic single member LLCs that do not elect to be treated as corporations, qualified REIT subsidiaries, and qualified subchapter S subsidiaries. Treas. Reg. § 1.368-2(b)(1)(i)(A).
- Combining entity - Business entity (either Target or Acquiring) that is a corporation that is not a disregarded entity. Treas. Reg. § 1.368-2(b)(1)(i)(B).
- Combining unit - Comprised solely of a combining entity (either Target or Acquiring) and all disregarded entities, if any, the assets of which are treated as owned by the combining entity. Treas. Reg. § 1.368-2(b)(1)(i)(C).
- Transferor unit – Combining unit that is transferring assets and liabilities pursuant to state law
- Transferee unit – Combining unit that receives the assets and liabilities pursuant to state law

Basic DE Merger: ‘A’ Reorganization



- Merger of Target into DE. DE survives.
- T shareholders receive 50% A stock and 50% cash
- Treas. Regs. § 1.368-2(b)(1)(iv), *Ex. 2*
- Tested as an A reorganization
- What if Target distributes unwanted assets to its S/Hs prior to the merger?

Two-Step Acquisition With DE



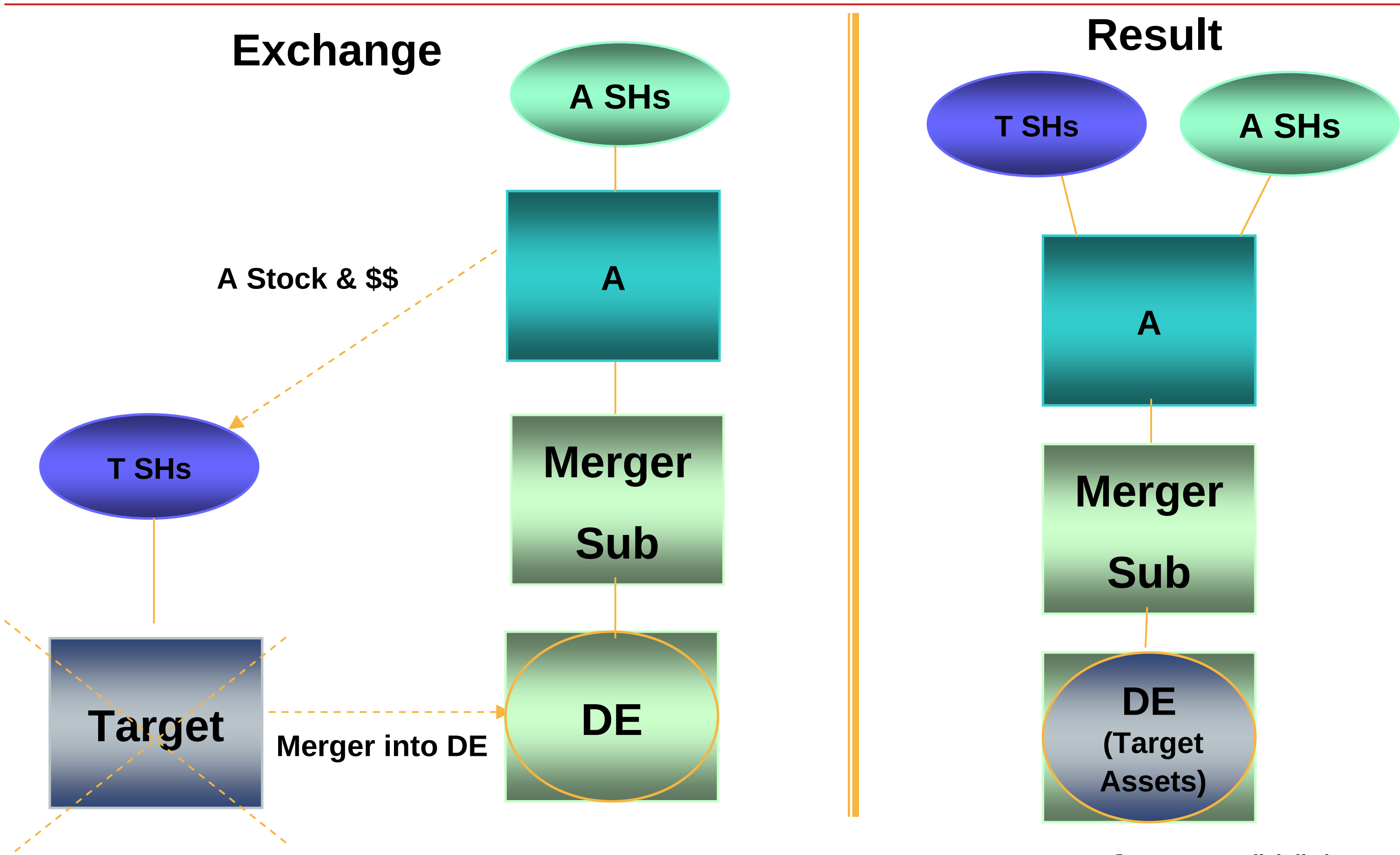
- Step 1: Reverse subsidiary merger of S into T. T survives.
- Step 2: Merger of T into DE (disregarded entity of A). DE survives.
- Tested first as an A reorganization.
- See Rev. Rul. 2001-46 and Treas. Regs. § 1.368-2(b)

Reasons for a "Two-Step" Merger

- In applying the reorganization rules, step transaction rules apply. If after taking into account all of the steps, the target has gone out of existence in a merger into the acquiring company (or a disregarded entity owned by the acquiring company), the transaction can be tested as an "A" reorganization. "A" reorganization rules are the most liberal (e.g., allowing maximum non-stock consideration and the most flexibility as to post-reorganization transfers).
  - See Rev. Rul. 2008-25 as to the importance of an actual merger of target into acquiring.
  - Although the default is to apply step transaction to test for a reorganization, the parties can change this result by making a section 338(h)(10) election for the first step of the transaction. See Treas. Regs. § 1.338(h)(10)-1(c)(2), (e).

- If the combined transaction does not qualify as a tax-free reorganization, step transaction rules will not apply, at least where the first step is a "qualified stock purchase." Accordingly, only the stock transfer will be taxable. (The second step should be respected as a liquidation or upstream merger that is not taxable.) See Rev. Rul. 2008-25.

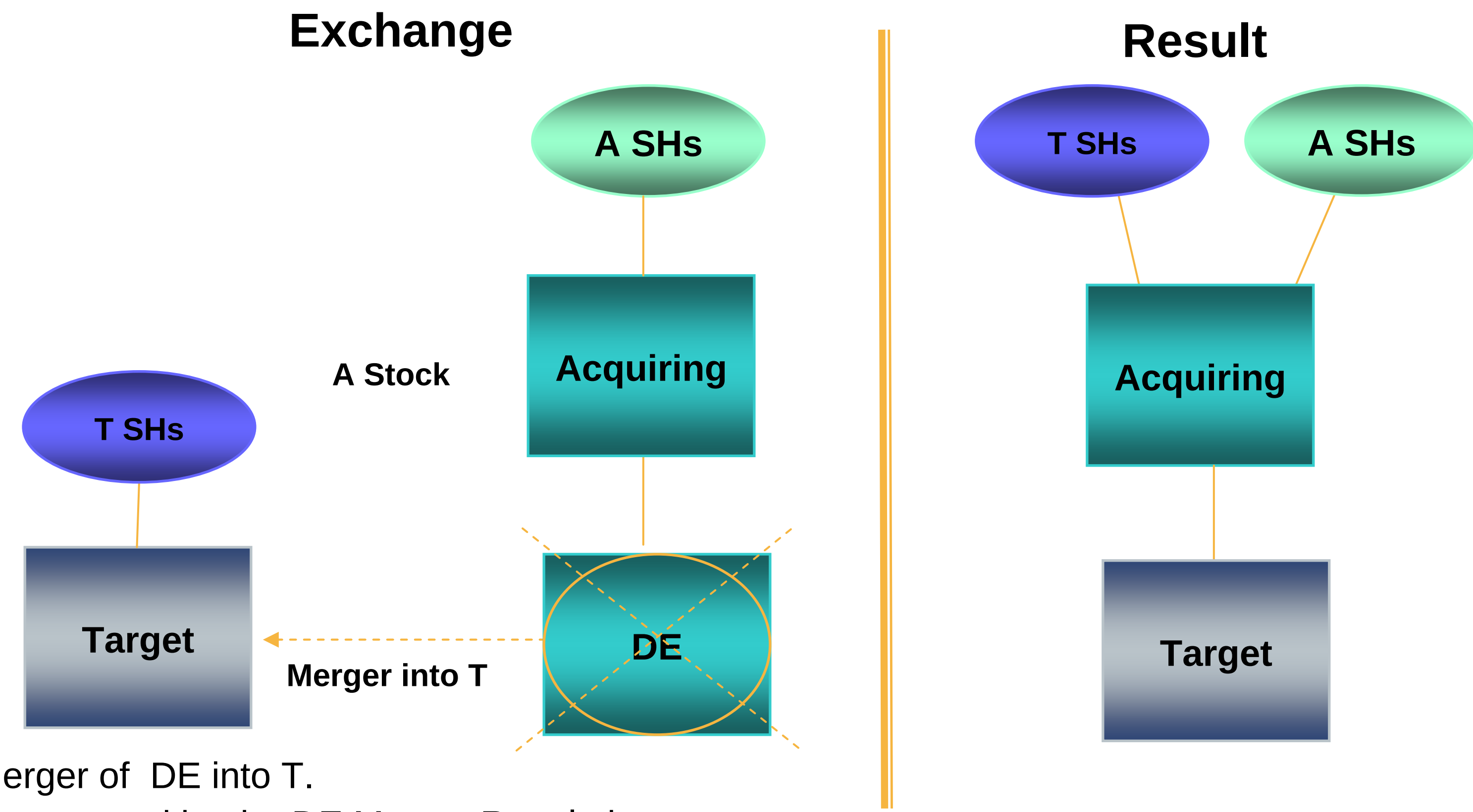
DE Merger: Forward Subsidiary Merger



- Merger of T into DE. DE survives.
- T shareholders receive 50% A stock and 50% cash

- Treas. Regs. §1.368-2(b)(iv), *Ex. 4*
- Tested as a forward subsidiary merger under section 368(a)(2)(D)

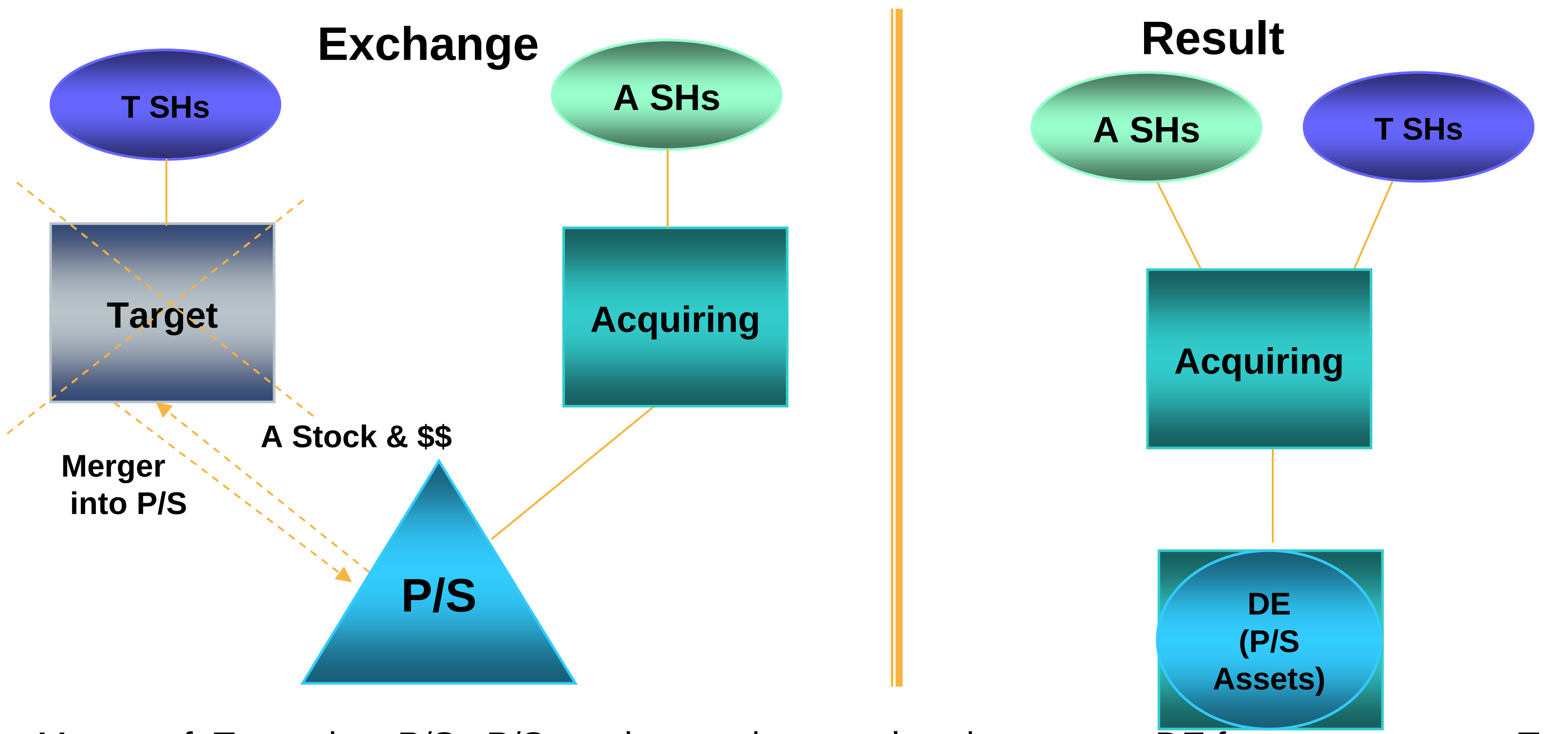
No Reverse Triangular with DE



- Merger of DE into T.
- Not covered by the DE Merger Regulations
- Does not qualify as a good reverse triangular merger under IRC § 368(a)(2)(E)
- Tested as a B reorganization
- What if a retroactive check-the-box election is made to treat DE as a corporation, effective for the time of the merger?

Other Hybrid Structures: Corporate and Partnership Mergers and Divisions

Merger of Corporate Partner into P/S



- Merger of Target into P/S. P/S survives under state law; becomes a DE for tax purposes. T shareholders receive 50% A stock and 50% cash
- Tested as an A reorganization. Treas. Regs. § 1.368-2(b)(1)(iii), *Ex. 11*
- Status of transferee is tested after the merger. See Preamble to Treas. Regs. § 1.368-2(b)(1).
- P/S terminates under § 708(b)(1)(A). Preamble to Treas. Regs. § 1.368-2 ask for comments on whether Rev. Rul. 99-6 should apply.

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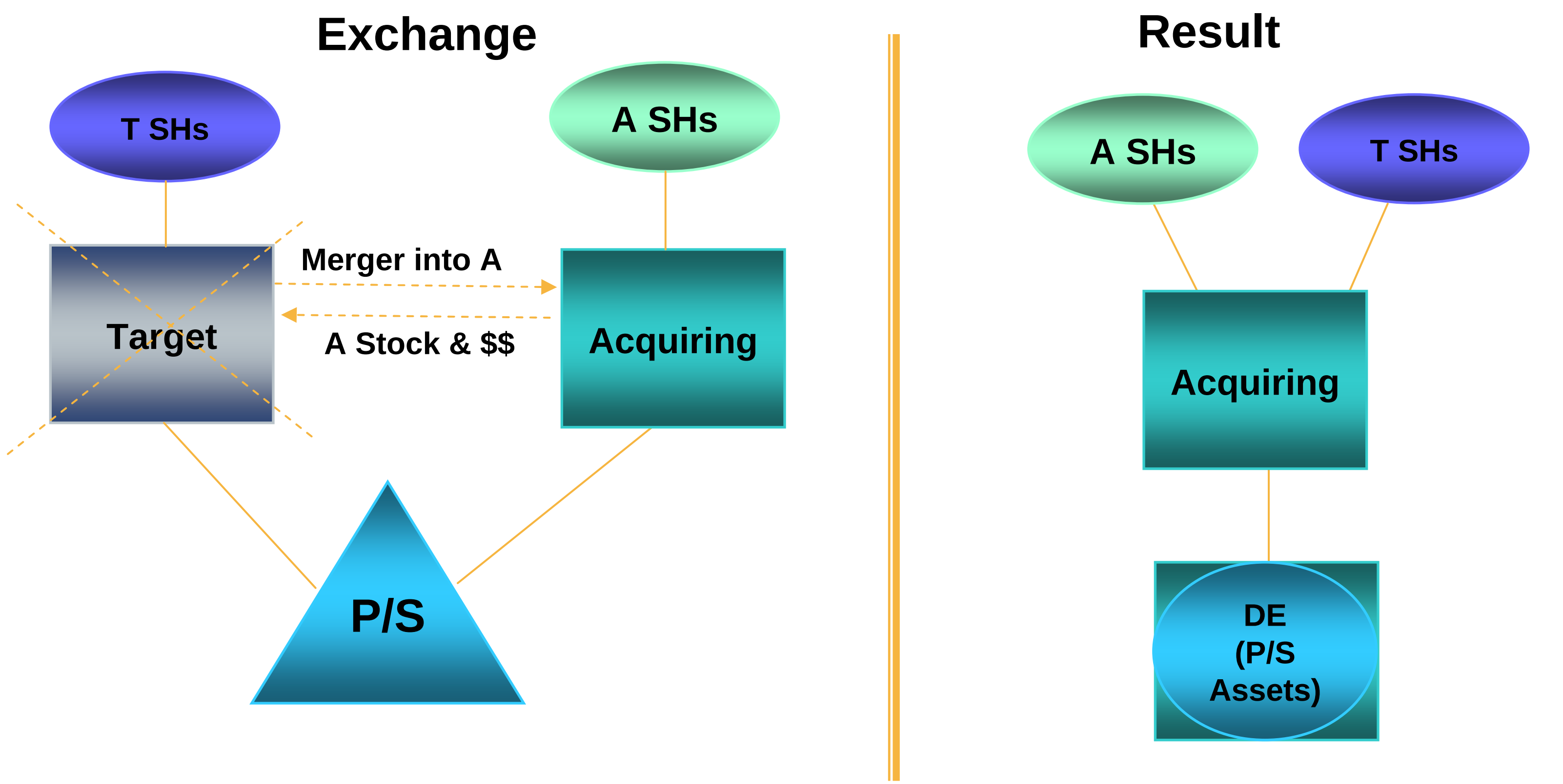
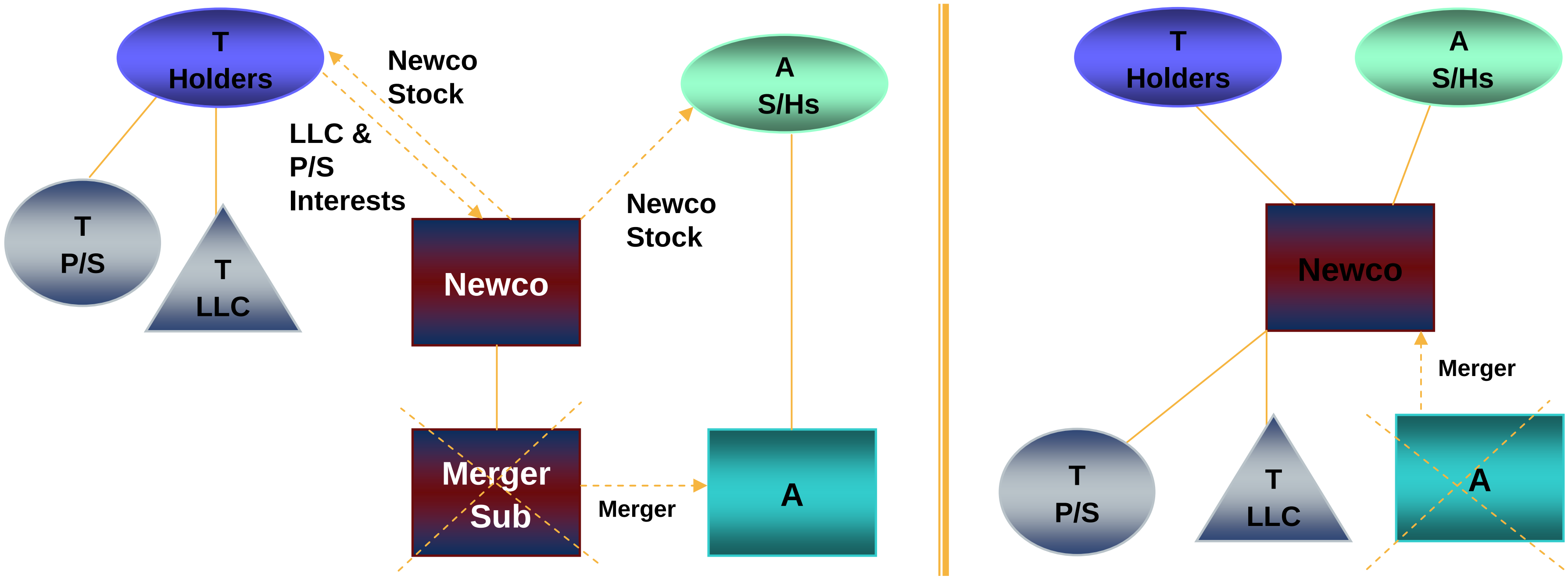
Merger of Corporate Partners



- Merger of Target into Acquiring in an 'A' reorganization. P/S becomes a DE for tax purposes.
- P/S terminates under § 708(b)(1)(A). Do the principles of Rev. Rul. 99-6 apply? Rev. Rul. 99-6 applied to taxable transfers. IRS has requested comments.

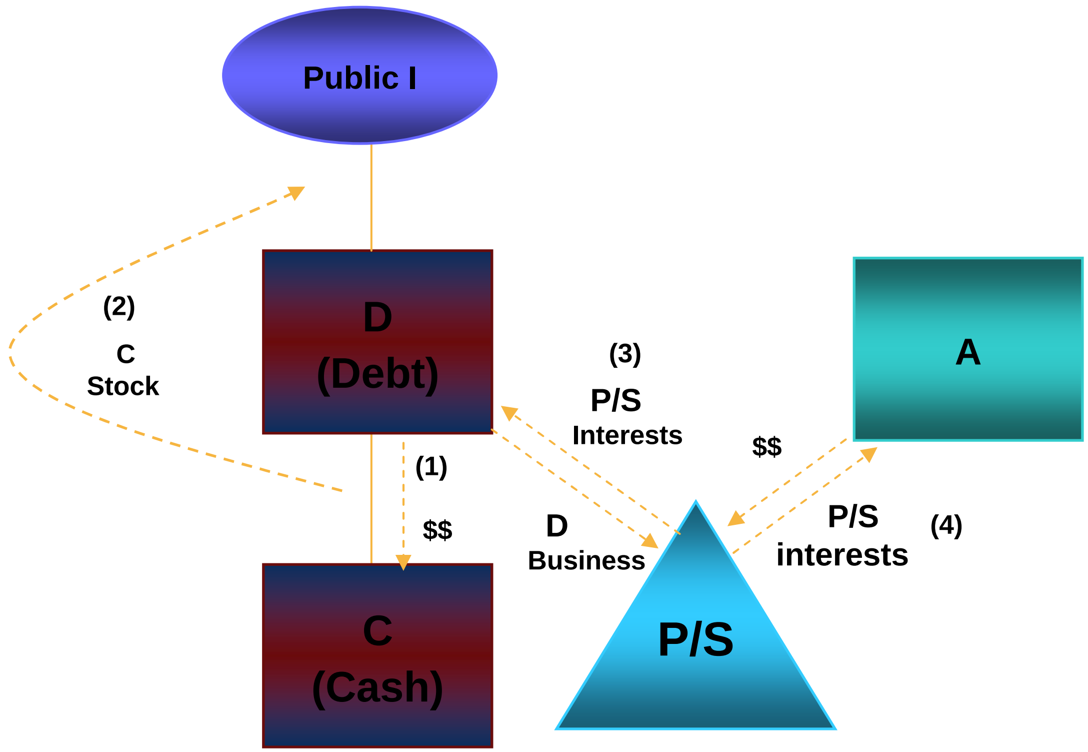
Section 351/ A Reorganization



- Merger Sub merges into A; Newco issues shares to A shareholders.
- T shareholders transfer LLC and Partnership interests to Newco in exchange for Newco shares.
- A merges into Newco.
- A is considered a transferor of property to Newco for purposes of testing section 351. See PLR 200136022.
  - T LLC and T P/S transfer qualify under section 351 because T holders and A shareholders are tested together to determine whether control has been received. See Rev. Rul. 76-123 and Rev. Rul. 68-357. (Newco is not considered a continuation of A.) Compare Rev. Rul. 68-349.
- Merger of Merger Sub into A followed by Merger of A into Newco will qualify as an A reorg. See Rev. Rul. 2001-46, Rev. Rul. 67-274 and Rev. Rul. 72-405.

Partial Morris Trust with P/S

- Step One: D incurs debt and contributes cash proceeds to C (along with unwanted assets)
- Step Two: D distributes C to Public
- Step Three: D transfers some or all of D's assets (and liabilities) to form P/S.
- Step Four: A acquires less than 50% of the vote and value of P/S



Partial Morris Trust with Partnership

- Transfer of D assets to P/S will not effect active trade or business requirement for D as long as D continues to own at least 33-1/3 of P/S (or retains active and substantial management functions for P/S). See Prop. Reg. § 1.355-3(b)(2)(v)(A), (B) and (C). Also see Rev. Rul. 92-17, Rev. Rul. 2002-49 and Rev. Rul. 2007-42
- COBE requirement for D similarly should be satisfied by its interest in P/S
- §355(e) will cause spin-off to be taxable to D if, as part of a plan, 50% or more of the vote or value of C or D (or their successors) is acquired.
  - Is P/S a successor to D? Prop. Reg. § 1.355-8(c)(1) look to whether a § 381 transaction has occurred although the preamble says that the IRS is still considering the issue.
  - In connection with ruling process, IRS assumes that P/S is a successor
  - What if A's interest is a profits interest?