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Reincorporation and Related Problems

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It is a pleasure to be here with you and to speak to you on a subject that I think is very important and one that we certainly need an awareness of. We spent most of the day today giving some consideration to the tax consequences involved in the sale of a corporate business. You see that these tax consequences vary depending upon whether we have a sale of the assets, whether we instead have a sale of the stock, or whether the transaction takes the form of some type of liquidation.

The problem is intensified since we do not have the luxury of merely giving consideration to each one of these things in isolation, because as soon as we do, some revenue agent is going to appear on the scene, take his long arms and aggregate together two or more of the transactions which we thought unquestionably were separate transactions.

This is the very essence of the liquidation-reincorporation theory advanced by the Internal Revenue Service. It is very important for us to be aware of the problems that can arise in connection with a liquidation-reincorporation so that we can take action in the planning stages to structure the transaction in such a way to get it outside the possible application of this doctrine. However, in the event we feel we can't restructure, but that we must proceed with the transaction as we have received it, we can outline for our client the possible tax consequences so that he does not, at some later date, find that a revenue agent has clobbered him in the head with the liquidation-reincorporation club when he thought his transactions were perfectly legitimate, separate, distinct transactions.

The problems in the area of liquidation-reincorporation generally arise in one of three circumstances. You could have the situation in which you have a group of stockholders owning all the stock in Corporation A. They can engage in what they think is a liquidation of Corporation A, complying with all the laws of the state which were set with respect to liquidating Corporation A. Then they can turn around and take a portion of those properties received from Corporation A and transfer them to Corporation B, retaining whatever properties they desire. This is the classic liquidation-reincorporation situation.

The transaction can become somewhat more subtle, however, if it is structured in the following way: Assume that you have a group of individuals owning all the stock of Corporation B. Corporation B may be a corporation with an operating history or it may be a brand new corporation which was incorporated to receive assets from Corporation A. Following through the transaction we have Corporation A making a sale of its property to Corporation B, receiving back some form of consideration—maybe cash, maybe notes, maybe some combination of the two plus stock in Corporation B. Then Corporation A, which was the transferor corporation sitting over here engages in a liquidation which the stockholders assume to be a transaction goverened by section 331.

The third form in which the transaction may be structured again involves two corporations, Corporation A and Corporation B. You have the same stockholders owning the stock of both corporations. Instead of having Corporation A make an asset transfer over to B, Corporation A liquidates the property in kind and its stockholders transfer property up to Corporation B.

Still, another form of the transaction involves ownership of A and B by the same group. Instead of having an asset transfer, that is instead of liquidating A initially, you have the stockholders transferring some of the stock in Corporation A, maybe all of it, to Corporation B. So you see that here you have no direct asset transfer between the corporations prior to the sale of stock. Then following through with the transaction, Corporation B over here, if it desires the assets, can liquidate Corporation A, since it now owns a controlling interest in the corporation.

Well, you may say, why go to all that trouble? That sounds like a lot of trouble. Why not just step through the transactions in a more simple way?

Well, there are several hoped for tax advantages to structuring a transaction to make it look like a liquidation, or maybe it is in fact a liquidation but you have this desire on the part of the stockholders to continue to receive the economic benefits of operating in corporate form. But they hope to get some tax advantages out of structuring the transaction at least in part as a liquidation.

Well, what are these tax advantages? What possible good could come out of this part of the transaction? Probably the one that comes to mind most readily is the opportunity to withdraw liquid assets from the corporation at capital gain rates or maybe at no tax cost at all. If Corporation A continued to operate and made an operating distribution of liquid assets, you know that the tax consequences flowing from that transaction would be subjection to section 301-C of the Code with the resultant dividends to the extent of earning and profits. On the other hand if these transactions in the form of a liquidation-reincorporation are recognized as separate transactions you know that under section 331 the stockholders get capital gain treatment on the liquidation, then when they make the transfer of those properties to B Corporation you have a new basis for those transferred properties to the new corporation under section 362 of the Code.

Well, that brings us to a second possible hoped for tax advantage as a reward for going to all this trouble. It may be that the stockholders of Corporation A, although they want to continue to operate in corporate form would like to have a stepped up basis. They would like to have a stepped up basis at least in part at capital gains rates. I know you talked earlier in the day about the application of sections 1245 and 1250 to this part of the transaction. But as you saw from your discussion there is still a lot of room for paying a capital gain rate to converting over to an ordinary depreciation deduction. So this may be one of the hoped for tax advantages, and we don't have to worry about the application of section 1239, because if a liquidation is recognized there is not going to be any gain on that subsequent transfer to the new corporation.

Another hoped for advantage of going to all this trouble might be the elimination of the earnings and profits account of the first corporation. Of course, you know that section 301-C doesn't hurt us at all if there are no earnings and profits. Therefore, if we can liquidate a corporation in such a manner that we will continue to get the benefits of operating in corporate form simply by changing our corporate structure and as a fringe benefit eliminate the earning and profits account the result is well worth the trouble. It is also well worth the cost of a capital gain to eliminate the corporation's dividend paying capacity at a point in time.

Still another hoped for tax benefit might be the interjection of preferred stock into the capital structure of the corporation, if we do not wish to go to the trouble of liquidation-reincorporation. Of course, we can interject preferred stock into our capital structure on a non-taxable basis under Section 305. But, if we do that, the preferred stock becomes Section 306 stock so that when we later dispose of it we're going to have noncapital gain, even if we sell to a third party. However, if we can have our liquidation-reincorporation recognized as separate transactions, the new corporation has no earnings and profits at the time the capital structure is formulated. The result is that Section 306 is stopped in its tracks because Section 306, as you know, has no application if there are no earnings and profits at the issue date. Analogous to that, you may have a desire to introduce into the capital structure some debt. This cannot be done in the context of one operating corporation because the distribution of the debt obligation would constitute a distribution of property, taxable again under that terrible Section 301-C. On the other hand, a liquidation-reincorporation would permit the introduction of debt into the capital structure. It's a very simple matter for you to decide that you want part of the new corporation's capital to be in the form of long term debt. Long term debt would eliminate any possible non-security applications under Section 351.

And then another reason—and the last one I'm going to call to your attention—for going to this trouble is that we may be holding stock in a corporation which has not been profitable—we're not willing to junk it, we still think it has hope, but we would like to go ahead and write off our loss. However, we know we can't do that unless we have some identifiable event, some realization. So liquidation-reincorporation looks like a chance to do that. We'll liquidate the loss corporation—that'll be our realizable event, and then we'll go ahead and continue to get the economic benefits of the corporation simply by starting another one and transferring the liquidated properties under Section 351.

Well, those are the reasons that we might be willing to go to the trouble of liquidation-reincorporation.

But the revenue service is also willing to go to trouble. They're willing to go to the trouble to show us that we can't operate within this liquidation-reincorporation framework at our whim. So what might they do about it? What are the possible governmental attacks? We need to be aware of them because if we're not aware of them we may operate along, oblivious to the dangers thinking we've really pulled one off on the Internal Revenue Service because, while we've structured this transaction to get maximum tax benefits, it doesn't fit under any of the unsympathetic code sections. But we'll see that the court, on many occasions, will shock us back to cold, brutal reality by aggregating these transactions. So what weapon might be used against us by the revenue service? And just how good is their artillery.

Well, the first one, and the one that's probably obvious, would be application of the form versus substance theory in the situation where we have the liquidation and the transfer of the property to a second corporation. The revenue service may very well take the position that we have to look at the substance of the transaction; you all know that that's something the government always says when they think the substance of the transaction is in their favor. If it's not in their favor they say to look at what you did and don't worry about the substance of the transaction. But here, the Internal Revenue Service says let's look at the substance of the transaction. We can't just look at step number one in isolation and then move to step number two. And the revenue agent will say if we put these steps together and see what really happened we can see that the liquidation, the transfer to the second corporation—in net effect-was nothing more than a corporate distribution from an operating corporation: you were operating in corporate form before, you're still operating in corporate form, you're carrying on the same business, you have the same stockholders, the only thing different is that you have some cash in your pocket. And having some cash in your pocket or some marketable securities is O.K., but you have to pay the cost says the revenue agent. Therefore, if he can sustain his position of bringing those transactions together, then Section 301 would apply. The regulations at Section 1.331-1(c) takes the position that you better not try this—that we know what you're out there trying to do and if we have a situation in which there is a liquidation of a corporation followed by OR PRECEEDED by a transfer of some of those properties to another corporation, we're going to put the liquidation-reincorporation gun on you. We're going to put you under a microscope and see if these steps were interdependent and if they were, Section 301 applies.

To further foster that position the government issued ruling 61-156 which reaches a similar result in a very surprising fashion —you might want to take a look at that ruling. But substance versus form is not the only weapon, and that one may not work because we may have a more sophisticated transaction.

For example, consider the type of transaction that I mentioned earlier involving a sale of the assets. Well that just doesn't seem to fit the classic type of transaction. So the government has come up with an argument that would seem to fit in those circumstances, too. They'll say, well, we can't think of anything else, so that must be a reorganization. And we know that the reorganization statutes are so complicated that that would scare us whether they have any basis for it or not. We're really going to have to get out the book and analyze this. We do this and make a prefunctory analysis and say, well, there's really no way they can get a reorganization out of this because some of these essential elements of a reorganization are missing.

This is the point to which I wish to speak now. Although some of those elements may appear to be missing the court may supply them for the government. The type of reorganization with which the government has had most success is the type "D" reorganization. That is the one that they seem to be using to fit these liquidations and reincorporations into. I think before we talk about the mechanics of a type "D" reorganization we should remember that, in order to have a reorganization the court has said that we must do more than follow the exact letter of the statute. There are certain things that Congress intended to put in that statute, but they didn't put them there so we're going to put them there for them concludes the court. That is, there must be a business purpose for the transaction, there must be continuity of proprietary interest, and there must be a continuity of business enterprise. Now of course all of those judicially imposed requirements came up in the context of the revenue service saying this is not a reorganization, hence your transaction is a recognition transaction. The government was imposing these requirements to protect the revenue. But now maybe you can turn the tables and use those same requirements to say this can't be a reorganization because there is no business purpose. There's no continuity of proprietary interest, or there's no continuity of business enterprise. So we want to keep those things in mind as possible back doors to the reorganization treatment. As I said, generally, the approach would be that this is a type "D" reorganization.

What is necessary in order to have a type "D" reorganization? You need to know these requirements to see if they would really fit your transaction that you worked so hard over into a type D reorganization. Well, section 368(a)(1)(D) which defines this type D reorganization says, in order to have a type D reorganization you must have a transfer, an intercorporate transfer of property, *i.e.*, part or all of the property from Corporation number 1 over here to Corporation number 2. Secondly, you must have control, which 368(c) defines as 80% of the voting power and 80% of each other class of stock. You must have control resting in the transferor corporation, its stockholders and people who were stockholders before we made the transfer. And then a very important requirement—the third requirement—that there must be a distribution or an exchange which qualifies under Sections 354, 355, or 356. Now keep that in mind—because that is a problem as far as the government's use of type D reorganization in our particular stock situation.

Alright, going back now and thinking about the transaction, that second type of transaction that I told you can present a problem for us. That is where we have a sale of property from one corporation to the other. Well, what are the taxpayers trying to do in that case. Think about it, we have Corporation A making a sale of property to Corporation B; receiving back money, notes, maybe some stock, and Corporation A then liquidates. The hoped for results are first of all, that the sale up here at the corporate level will qualify for nonrecognition treatment under Section 337. This should be easy since after all we've adopted a plan of complete liquidation, we're going to carryout the mechanics of getting this corporation liquidated within the 12 month period and certainly the sale of operating assets is a sale of property. Normally what we'll do is sell our operating assets, retain our nonoperating liquid assets, because that's what we're trying to get out of the corporation anyway. Then if Corporation B, receiving in properties has made a purchase of the properties, it's going to get a basis equal to their cost which would be a stepped up basis. Now, when we liquidate over here at Corporation A, we're going to have a capital gain or loss.

Well, let's see if that type of transaction can be fit into the requirements of D reorganization, because this is what the government would have to do. Alright, we said in order to have a D reorganization we have to have a transfer of some or all of the property. We certainly have that, don't we? We have a transfer of all the operating assets, from Corporation A over to Corporation B. So the government is O.K. there. We've also got to have the control feature. We've got to have 80% control in the transferor—no problem there, we own it all so we have this control feature. And then the last requirement that we either have an exchange or a distribution by the transferor corporation, which qualifies under Sections 354, 355 or 356. Do we have that? That may be the government's problem because normally, we have no exchange of stock involving the transferee corporation at all. You see, once the sales proceeds have been received back by the first corporation those assets do not consist of stock in the transferee corporation. So there's no way really that there can be an exchange in the usual situation involving stock of the transferee corporation. Well, the taxpayer's got it made then, hasn't he! Well, one taxpayer thought he did. The tax court considered this question in the case of *James Armour,* 43 TC 95. In that particular case you had a group of individuals that owned two corporations. They owned a construction corporation and an excavating corporation. They decided that they would have the excavating corporation make a sale of its operating assets to the construction corporation. The operating assets consisted of about 51% of the total properties of the excavating corporation. They would receive back full fair market value in cash and notes. Then the excavating corporation liquidated. Of course, they reported on their return that the sales of property by the excavating corporation qualified under section 337. Incidentally, they had made some sales of properties to outside parties too. So they had two things in issue so far as the 337 question: whether or not the sales to the contracting company, a related party, qualified for nonrecognition; also whether or not the sales to the outside party qualified. They treated these sales as qualifying under Section 337 and the liquidation as qualifying under Section 331 reporting capital gain.

The revenue service came in and said the transaction was a type D reorganization. The taxpayer said that it could not be a type D reorganization since one of the essential elements was missing, and you know how touchy you are about these elements,–if one's missing you tell us tough luck! Well the government said, well, we might make an exception in your case!! Here's what we're going to do. There is no question but that we have a transfer of property. We also have control as required by 368(c). The taxpayer says we've got you now because there was no exchange of stock in the transferee corporation, by corporation number one. Therefore, how are you going to fit this transaction under Section 354 or 355 anyway?

Well, you know from what's been said earlier that Section 355 is a very technical Section of the Code, one that has some specific requirements. Two of them are very important in the context of liquidation-reincorporation. One requirement being, as you recall, in order to have Section 355 operative, you have to have the transferee or the distributing corporation in control, so it itself would have to have 80% of the stock. Also, you know, you've got this five year business history that has to be present on the part of both corporations, the transferee and the transferor. And in the context of these liquidation-reincorporations you will not have the five year operating history. So Section 355 has no application, in this area. Of course, Section 356 operates only in tandem with 354 or 355. If you don't have one of them applicable first you can go home, because Section 356 is inoperative. That means in most of these cases, *if not all of them,* that the government is going to have to base its argument for a D reorganization on the theory that Section 354 applies.

The problem with this theory is that Section 354 normally has no application to a type "D" reorganization. The reason is that Congress restricted its application to non-divisive type "D" reorganizations thereby forcing divisive D reorganizations to be subjected to Section 355's restrictions. Section 354(b) provides that a type D reorganization falls under Section 354, if, first of all we have a transfer by the transferor of substantially all the property to the transferee—that could be a problem in our situation. Secondly, Section 354(b) invisions a complete liquidation of the transferor corporation as a part of the exchange and it does require that there be an exchange of the stock of the transferee for stock of the transferor. So the taxpayer in *Armour* said you can't classify this a type D reorganization for those two reasons.

The court said well, let's think about that. It pondered the intent of Congress when it said "substantially all" of the assets had to be transferred before Section 354(b) is applicable.

The court reasoned that the "substantially all" requirement was just to be sure Section 354 wasn't used to get a divisive "D" reorganization outside Section 355's stringent requirements. The court next considered the distribution of stock requirement under Section 354(b). It determined that had there been a distribution that after the transaction was over, this group of people would have owned all the stock of the transferee. Well, since you didn't have that, how much do they own? Well, they own it all. In other words, to go through a distribution would have been meaningless. Therefore, the court held that in effect there was a distribution because the end result was the same and found a "D" reorganization.

To give you some idea of the flexibility of the Tax Court in dealing with Section 354(b) when they want to find a D reorganization, I call your attention to the case of *David Grubbs* 49 TC 42. That case involved a little variation on the above facts. The facts were about the same as in the *Armour* case with one exception which the taxpayer thought was really an important distinction. The transferor corporation was not liquidated in *Grubbs*. Instead, all of the stockholders' stock was redeemed except for one stockholder who continued the corporation as an investment. The taxpayer argued no D reorganization had occurred because there was no 354(b) required liquidation. The taxpayers argued that they qualified for capital gain treatment on the redemption because they withdrew from the corporation and proved that the redemption—when applying constructive ownership—was substantially disproprotionate under Section 302(b) because of this remaining stockholder.

The court overcame the problem by holding that there was a constructive exchange. It held that there was a constructive liquidation of the transferor corporation. And that this one stockholder who continued then transferred his properties back, in effect, in a Section 351 exchange.

You can see that Section 354(b) can be applied rather flexibly in the liquidation-reincorporation area, although it might not be applied so flexibly if the taxpayer was the one that was arguing for such elasticity.

The government could run into a bit of a problem in applying D reorganization principles in the liquidation-reincorporation area, if instead of a sale of property, the transaction took the following form—the same situation as above, except that instead of having the corporation make the sale of properties, that is from A to B, that the assets are liquidated to A's stockholders and then the assets are transferred up to B corporation. The classic reorganization situation I mentioned to you earlier results in a government attack under Section 301. However, if the government wants to argue that the liquidation-reincorporation is a D reorganization they have the problem of the lack of an intercorporate transfer. What they've argued in those situations is that the stockholders who received the properties and moved them into the second corporation were simply acting as agents or as conduits for an intercorporate transfer, and if they can get past that then they have all the arguments we just mentioned in favor of a D reorganization.

If, on the other hand, the mechanics of the transaction are such that we have two corporations having their identical stockholders making a sale of their stock in A to B in order to draw off liquid assets, the government has an argument in addition to what we've talked about up to this point. The transaction may very well fall under Section 304. You recall that Section 304 provides that where a group of individuals having control of two corporations, and the control feature is dropped down to 50% instead of 80%, and the stockholders sell their stock in one of the controlled corporations to the other controlled corporation that the sale is a transaction that falls under Section 302. When we look to Section 302 you'll remember that unless the transaction fits into one of those four exceptions in Section 302(b) (that it's not essentially equivalent to a dividend, that it is a substantially disproportionate redemption, that it is a complete termination of interest, or that it is a railroad reorganization) then we drop down to Section 302(d) which says go directly and apply the principles of Section 301(c). So you're right back to a dividend to the extent of earnings and profits. Section 304 says that the sale of the A corporation stock to B by this stockholder would be treated as a contribution to B's capital. Furthermore, in determining whether or not one of the Section 302(b) exceptions apply we look to the situation with respect to the issuing corporation. You see, even though we're making a sale to the second corporation, to see whether or not we have a Section 302(b) exception, we must look to the corporation which issued the stock. If we find no exceptions so that we're going to apply the dividend rules of Section 301(c); Section 304 says you base the amount of your dividends on the earnings and profits of the transferee corporation, that is, the corporation to which the sale was made. Therefore, you will have a dividend in an amount equal to your pro rata share of the earnings and profits of the second corporation.

These are all arguments that can be used to have a liquidation and a subsequent incorporation treated as one transaction rather than giving recognition to the individual transactions. You know if we do collapse the two transactions we lose many of the advantages that we had hoped for and we are back under dividend treatment, we don't get our stepped up basis and we can't alter the capital structure of the corporation. We may have thought Section 337 applied. It now doesn't because we have no liquidation and there can be no application of Section 337 except in the context of a liquidation.

It is apparent that if we fall into a situation in which the way we've outlined a transaction is not accepted—that the steps are considered to be interdependent—we have very unfavorable tax results. There's not too much we can do about it except fight it when the situation comes up. But I will just call a couple of things to your attention.

Taxpayers have been successful in some cases where the liquidation and the subsequent incorporation were separated by a period of time. I know your question is, well, how long? Well, again, it varies, but the courts say there's no magic period of time, it's just that they are going to look at each case, look at the facts on a case by case basis and see whether or not the steps were interdependent. Of course, you know the more time between the liquidation and the incorporation, the better the chance of having the transactions condisered independent. This point is significant since in order to have a reorganization there must be a continuity of business operation. If you can separate the business of the first corporation from the business of the second by some period of time and then present an agrument that this is indicative of a lack of continuity of business enterprise, then there should be no type D reorganization treatment.

There is another possibility as follows. As I mentioned to you in connection with the transfer of property from one corporation to another, in order to have D reorganization there must be a situation in which there is 80% continuity of ownership. It may very well be that we can structure the transaction where there's not 80% continuity. To my knowledge, the government has won no cases, and you may have one right in your back pocket, in which continuity dropped below 80%. Of course, I'm talking about this in the context of a type D reorganization. There have been arguments in this liquidation-reincorporation area that the transaction was an E reorganization or an F reorganization.

In those cases, we do not have a fixed control percentage as we do in the D reorganization. In revenue ruling 61-156, under facts similar to what I've outlined for you, the government found an E reorganization where there was only 45% continuity and a sale of 55% of the stock on the open market. So I'm not going to tell you that if you get ownership continuity below 80% you have it made, but you have a much better chance because apparently the courts have responded more favorably to the government's D reorganization argument than they have to the other arguments *including* the Section 301 step transaction argument.

What I have tried to do this afternoon is outline for you the problems in the liquidation-reincorporation area. Remember that you may think we don't have a problem when you really do. You are never operating in a situation where you can't be hammered later by the government. You must determine, to the extent that you can, how to shield yourselves and how to protect your taxpayers. If we have done that today, I think our time was well spent. I hope you agree that the liquidation-reincorporation area is a very subtle area of tax problems. In closing, let me say that I do not want any of these revenue agents here today to get the wrong idea about anything I've said.