Exit Strategies and Techniques for the Business Owner

Stephen L. Owen
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Stephen L. Owen, Esq.
Piper Rudnick LLP
Baltimore, Maryland / Washington, D.C.
Phone: (410) 580-4230
(202) 861-6240
Fax: (410) 580-3230
E-mail: stephen.owen@piperrudnick.com
THE FACTS

Senior, age 80, owns all of the stock of Cashcorp, Inc., a company engaged in the manufacturing of widgets as well as in the sale of used cars. Cashcorp was a C corporation until 2001 when Senior finally listened to the advise of his CPA, Mr. Fudge, and made an S election for Cashcorp. The value of Cashcorp at the time of the S election was $10 million, based upon the independent appraisal of Mr. Lowball. Cashcorp has $5 million of C corporation earnings and profits. Cashcorp is now worth at least $25 million. Senior has built the business of Cashcorp through his extraordinary efforts. Senior’s compensation was $2 million a year prior to the S election, but, once the S election was effective, Fudge advised Senior to reduce his compensation to $200,000. Cashcorp has no debt and generates $5 million of taxable income and cash flow per year.
Senior owns all of the interests in Real Estate LLC. Real Estate LLC owns the land and buildings that Cashcorp uses in its manufacturing operations. Real Estate LLC has an arm’s length lease with Cashcorp for 40 years. Real Estate LLC receives $500,000 per year in rent.

Senior has $20 million in other assets including a marketable securities portfolio and a beach house. Senior is divorced and is dating Nancy, age 33. Nancy was Senior’s nurse after his second heart attack in 2001. Senior has one son, Junior, age 55. Junior has worked for Cashcorp for 30 years, although Junior can usually be found on the golf course most afternoons. Junior has 3 children, none of whom is expected to work in the family business.

Senior, based upon the advice of Fudge and his attorney, Jim Shark, Esquire, has finally decided to transfer equity in the business to Junior. However, Senior would like to retain control because he does not believe Junior is mature enough to take over the reins of the business.
S Corporation Discounting

- Suppose that Senior wishes to gift stock to Junior.
- Senior transfers nonvoting stock to Junior, either as an outright gift or as a transfer to a GRAT or as an installment sale to a defective grantor trust ("IDGT"), or some combination. Senior retains control with the retention of the voting common.
- Senior, relying on an independent valuation expert, takes a 40% discount from NAV on the transfers. Part of the discount is attributable to the potential BIG tax. See A.D. Davis Est., 11 T.C. 530 (1998); Eisenberg, 98-2 USTC ¶60, 322 (2nd Cir. 1998). See also W.L. Gross 78 TCM 201 (1999) (whether S corporation earnings can be "tax affected").
S Corporation Discounting

- Discounting for lack of marketability and minority interest is available just as in the case of limited partnership and LLC interests.

- Note that, unlike in the partnership context after Strangi II (85 TC Mem 1331 (5-20-03)), there should be no attack under Section 2036(a)(2). See Rev. Rul. 81-15, 1981-1 C.B. 457. As long as the corporate formalities are observed, Section 2036(a)(1) should not apply.

- Note that S corporations have negative features compared to partnerships and LLCs taxed as partnerships, such as (i) limitations on stockholder basis for corporate debt, (ii) deemed taxable sale on distribution of appreciated assets, and (iii) limited permitted stockholders, etc.
Senior has a low basis in his stock. As a succession plan, Cashcorp will redeem Senior with cash. The parties will allocate a portion of the payments to a 3-year noncompete. Senior will remain with Cashcorp as an employee, officer and director.
Succession Planning: Corporate Redemptions

- For a C corporation or an S corporation with C corporation earnings and profits, the redemption of Senior's stock will be treated as a dividend under §301 (to the extent of E&P), because of the §318 attribution rules. Under prior law, this would have been a tax disaster because dividends were taxed at ordinary income tax rates. As a result of recent legislation, dividends are now taxed the same as long term capital gains (15% plus state and local taxes). Note that sale or exchange treatment could be achieved if Senior and Junior waive family attribution under §302 (this could only be done if Father completely terminated his relationship with Corp including as an employee, officer and director).

- If Senior dies, the estate will want to take advantage of its step up in basis. If the redemption is a dividend, the estate will not be able to use its basis. See Treas. Reg. §1.302-2(c), Ex 2; Prop. Reg. §1.302-5. If Junior is a beneficiary of the estate, entity attribution (which cannot be waived) will prevent Section 302(b) complete termination. Thus, the stock basis would not be available and the entire redemption would be taxed at 15%. Note: Under existing regs. unclear what happens to basis. Under proposed regs., basis will be available when the facts that caused 301 treatment no longer exist.
Succession Planning:
Corporate Redemptions

➢ The same analysis will apply to an S corporation to the extent it has C corporation E&P and the redemption exceeds the redeemed stockholder’s AAA.

➢ Assume Senior is redeemed for $10 million in a transaction that does not satisfy §302(b). Senior has AAA of $1 million and Cashcorp has E&P of $5 million. Senior has a basis in his stock of $2 million. The first $1 million is nontaxable return of AAA. The next $5 million strips out all of Cashcorp’s E&P - taxable to Senior at 15%. The next $1 million is a nontaxable return of basis. The next $3 million is 15% capital gain. If Senior died and his estate has a $10 million basis, the $3 million layer described above would not be taxable and Senior’s estate would have $5 million of remaining basis suspended.

➢ Note if Senior has a low stock basis and E&P dividends are taxed at capital gains rates, Senior might try to have §301 treatment (including bypassing AAA under §1368(e)(3)) to strip out all E&P to avoid §1375 problem.

➢ For an S corporation with no C corporation E&P, satisfying §302(b) will not matter. If the redemption has deferred payments, §302(b) will permit installment sale reporting, while §301 dividend treatment would not.
Succession Planning: Corporate
Redemptions/Noncompete

➢ Can the covenant not to compete be amortized over the three-year period?
  • No. The amount allocated to the covenant must be amortized over 15 years because the redemption transaction is an acquisition of an interest in a trade or business under §197(d)(1)(E). Frontier Chevrolet v. Commissioner, 116 T.C. 289 (2001).
  • But see §162(k) – no deduction in connection with a redemption?

➢ There is always an issue whether the allocation will be respected. What about Martin Ice Cream Company, 110 TC 189 (1998)? See also Norwalk, 76 TC Mem 208 (1998).
Gift Stock to Charity/Redemption

- Senior wishes to make a substantial charitable contribution. His tax advisors recommend using appreciated property. Senior transfers 10% of his Cashcorp stock to a 501(c)(3) organization. After a "respectable" waiting period, Cashcorp agrees to redeem the stock from the charity.

- Note that 501(c)(3) organizations are permitted S corporation stockholders. But see §512(e) which provides that all income from S corporation is UBTI. Gain from the redemption would also be UBTI. If Cashcorp were a C corporation – no UBTI.

- Note that the redemption will strip out proportionate E&P.

- As long as there is no binding obligation on the part of the charity to redeem at the time of the gift, Senior succeeds in attaining a full charitable deduction with no gain recognition. See, e.g., Rev. Rul. 78-197, 1978-1 C.B. 83; Gerald Rauenhorst, 119 T.C. 157 (2002).

- Note valuation risks.
ESOPS with an S Corporation

> Senior wants to sell half of his Cashcorp stock but still retain voting control of Cashcorp.
ESOPS with an S Corporation

- What if Senior sells half of his Cashcorp stock to a third party?
  - Senior must pay capital gains.
- What if Cashcorp forms an ESOP and the ESOP purchases one-half of Senior’s Cashcorp stock?
  - An ESOP is a permitted S corporation stockholder. §1361(c)(6).
  - Senior must pay capital gains on the sale to the ESOP.
- If the ESOP borrows money in order to fund the acquisition of Senior’s stock and Cashcorp makes contributions to the ESOP to be used to repay the loan, Cashcorp will be able to deduct its contributions to the ESOP to cover interest on the ESOP loan and will be able to deduct contributions to cover principal in an amount equal to 25% of the total eligible pay of the ESOP’s participating employees.
ESOPS with an S Corporation

- Cashcorp could increase its cash flow by making a tax distribution to its shareholders, to the extent the ESOP (a tax-exempt entity not subject to the unrelated business income tax) uses its distribution to purchase additional shares of Cashcorp.

- Senior (and his family members) cannot receive stock allocations from the S corporation ESOP. §409(p).

- What if Cashcorp distributes to Senior his AAA, converts to a C corporation, and then recapitalizes and issues to Senior shares of Super Common Stock in exchange for 50% of his common stock. Cashcorp thereafter purchases Senior’s Super Common Stock. Senior can defer paying capital gains tax on the sale of C corporation stock to the ESOP under §1042, if he purchases qualified replacement property (QRP) within 12 months after the sale (or 3 months before it).

- Senior could "monetize" the QRP and then use the proceeds to purchase securities or investments of his choice. Senior could set up a family limited partnership and then contribute these securities to it to obtain a valuation discount on transfer to his children. Note: If the securities are the QRPs then a contribution to a partnership will be considered a taxable event. See Rev. Rul. 2000-18, 2000-1 C.B. 847.
ESOPS with an S Corporation

➢ To receive tax-free roll-over treatment under §1042 on the sale of C corporation shares, Senior and his family members will not be able to receive allocations of the Super Common Stock from the ESOP. However, Senior (and his family members) could receive incentive stock options or non-qualified stock option from Cashcorp outside of the ESOP, provided that the price paid by the ESOP for the Super Common Stock is determined on a fully diluted basis.

➢ Cashcorp could convert back to an S corporation in 5 years (after the loan has been repaid), however it may be subject to BIG tax and LIFO recapture tax. Any accumulated E&P distributed after the S election would be taxed as a dividend.
Senior wishes to shift future appreciation in the QSUB 2 business to Junior. QSUB 2 converts to LLC. Junior contributes cash to LLC 2 in exchange for a “common” interest. Cashcorp receives a “preferred” interest (preference on cash flow and on sale refinancing, etc.) with a 5% residual share.
THE FREEZE PARTNERSHIP

➢ Partnerships between a corporation and its stockholders and/or family members have been respected. But what is the business purpose?
  ➢ Watch “sham” argument
  ➢ Watch §701 anti abuse regs.

➢ Valuation must be accurate to avoid constructive dividend
  ➢ §704(c) will apply
  ➢ §482 could apply
  ➢ Chapter 14 could apply
Pope & Talbot Planning

Cashcorp will convert QSUB 2 into an LLC. Junior will then become a member of LLC. After a respectable waiting period, Cashcorp will sell minority nonvoting interests in the LLC to Junior. Over a period of several years, the LLC interest will be completely sold by Cashcorp to Junior. What happens on audit?
Pope & Talbot Planning

- The government prevailed and discounting was rejected where the formation of the LLC and a spinoff of LLC interests occurred pursuant to one plan. See Pope & Talbot, Inc. v. Com'r, 162 F.2d 1236 (9th Cir. 1999). See also TAM 200443032 (7-13-04); TAM 200239001 (1-22-02); Ltr. Rul. 200214016 (12/21/01).

- Different facts may lead to a more favorable result based upon well respected valuation discounting principles.

- What about Section 1239? Is there a look through? While not crystal clear, the better view is that there is no look through. See Section 386 (repealed in 1988); Holiday Village Shopping Center v. U.S., 84.2 USTC ¶9549 (Cl. Ct 1984), aff'd 773 F2d 276 (Fed Cir. 1985) (look through); Petroleum Corp of Tex. Inc. v. U.S., 939 F2d 1165 (5th Cir. 1991) (no look through).

- What about Section 701 partnership anti-abuse regs.?
QSUB Election

- Cashcorp is an S corporation that wants to acquire all of the stock of Target.
- Target is a C corporation that owns land with a basis of $2 million and a value of $10 million.
- Cashcorp wants Target to be a QSub.
QSUB Election

1. Assume Cashcorp purchases all of the stock of Target for $10 million. What if Cashcorp makes a QSub election for Target?
   ➢ If a QSub election is made for Target, it will be treated as liquidating under §332 and §337. See Treas. Reg. §1.1361-4(a)(2)(ii), Ex. 1. Target, as a QSub, would be disregarded for income tax purposes and its operations would be treated as if it were a division of Cashcorp §1361(b)(3).

2. What is Cashcorp’s basis in Target’s assets?
   ➢ Cashcorp’s $10 million basis in the Target stock will evaporate forever and the $2 million basis in the land will survive “in Cashcorp’s hands.” §334(b)
Cashcorp sells 21% of the QSUB stock to Purchaser.
1. What are the tax consequences?
2. What if Purchaser contributes cash to QSUB in exchange for 21% of QSUB?
3. What if S Corp. sells 100% of QSUB stock to Purchaser?
QSUB Termination

➢ The QSUB election for QSUB will terminate by selling 21% of the QSUB stock to Purchaser.

➢ QSUB is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from Cashcorp in exchange for "new" QSUB stock immediately before the termination. The deemed exchange by Cashcorp of assets for QSUB stock does not qualify for non-recognition under §351 because Cashcorp is not in "control" (80%) of QSUB immediately after the transfer. Treas. Reg. §1.1361-5(b)(3), Ex. 1.

➢ Cashcorp must recognize the full gain on the transaction (as if all of QSUB had been sold).

➢ What if Purchaser contributes cash to QSUB in exchange for 21% of QSUB stock?

➢ QSUB is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for QSUB stock immediately before the termination. Because Cashcorp and Purchaser are co-transferors that control QSUB immediately after the transfer, the transaction qualifies under §351. Treas. Reg. §1.1361-5(b)(3), Ex. 3.

➢ What if Cashcorp sells 100% of QSUB stock to Purchaser?

➢ This is treated as a sale of all of QSUB’s assets followed by Purchaser’s contribution of those assets to QSUB in exchange for QSUB stock. Treas. Reg. §1.1361-5(b)(3), Ex. 9.
Use of SMLLC in Lieu of QSUB

- Cashcorp forms a single member LLC and does not check-the-box.
- QSUB merges into LLC with LLC surviving.
- Cashcorp sells 21% of its ownership interest in LLC to Junior.
Use of SMLLC in Lieu of QSUB

- The merger of QSUB into the LLC is disregarded. The sale by Cashcorp of 21% of its ownership interest in LLC is treated as a sale of a 21% undivided interest in each of LLC’s assets. Cashcorp will recognize gain (note potential application of §1239). Immediately thereafter, Cashcorp and Junior are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership in a §721 asset transfer. Treas. Reg. §1.1361-5(b)(3), Ex. 2.

- What if Junior contributes cash to the LLC in exchange for a 21% ownership interest in LLC?
  - The LLC is converted from an entity treated as a disregarded entity to a partnership when Junior contributes cash to the LLC. Junior is treated as contributing cash and Cashcorp is treated as contributing all of the assets of the LLC to the partnership. No gain or loss is recognized or under §721(a). Rev. Rul. 99-5, 1999-1 C.B. 434. Caveat: The investment company rules of §721(b).

- In either case, note application of §704(c).
Use of SMLLC in Lieu of QSUB

➤ What if Cashcorp sells 50% of its ownership interest in LLC to Junior?
➤ The LLC is converted from an entity treated as a disregarded entity to a partnership when Junior purchases a 50% ownership interest in the LLC. Junior’s purchase of 50% of Cashcorp’s membership interest is treated as the purchase of a 50% undivided interest in each of the LLC’s assets. Cashcorp will recognize gain under §1001 on the deemed asset sale. Rev. Rul. 99-5, 1999-1 C.B. 434.
Tax-free Spin-off

- Cashcorp distributes 100% of QSUB 2 stock pro rata.
- QSUB 2 is no longer a QSUB. It can make an S election. Reg. §1.1361-5(c)(3).
Tax-free Split Off

- Cashcorp distributes 100% of QSUB 2 stock to Junior in exchange for Junior’s Cashcorp stock.
- QSUB 2 is no longer a QSUB. S election can be made.
Tax-free Split Up

- Cashcorp distributes 100% of stock of QSUB 1 to Senior and 100% of QSUB 2 to Junior.
- Cashcorp liquidates.
- QSUB 1 and QSUB 2 are no longer QSUBs. An S election can be made.
§355 Requirements

- §355 – no gain or loss to Cashcorp, Senior or Junior where stock in a controlled corporation is distributed with respect to stock of the distributing corporation. Other property (“boot”) will trigger gain.
- Spin-off is a pro rata distribution.
- Split-off is a non pro rata distribution in exchange for stock in the distributing corporation.
- Split up is a separation of ownership of two businesses via a liquidation of the distributing corporation.
- Controlled corporation must be controlled (§368(c)) by distributing corporation immediately before distribution.
- Each corporation must satisfy the “active conduct of a trade or business” test. Five year look back. §355(a)(1)(C).
- Distribution must not be a “device” for the distribution of E&P. Spin off puts more pressure on this issue. §355(a)(1)(B).
- The distribution must have a corporate business purpose. Treas. Reg. §1.355-2(b).
- Continuity of interest. Treas. Reg. §1.355-2(c).
**Taxable Asset Deal**

Senior -> Cashcorp

Cashcorp -> Cash

Cashcorp -> Assets

Cashcorp -> BIG CORP

**Alternative Structure - Triangular Cash Merger**

Senior -> Cashcorp

Cashcorp -> Cash

Cashcorp -> Merger

Merger -> LLC

[Survivor]

LLC -> BIG CORP

QSUB

QSUB 2

QSUB

QSUB 2
Taxable Asset Sale

- Cashcorp has a Built-In Gains ("BIG") tax. §1374.
- Senior and Junior have a shareholder level tax.
- BIGCORN gets a stepped-up basis in the assets.
- Cashcorp cannot avoid the BIG tax on receipt of payments under the installment note. Reg. §1.1374-4(h). If there is a BIG tax, the liquidation of Cashcorp will accelerate it.
- There may be a §1375 problem because the note bears interest, stated or imputed.
- To the extent no BIG problem, Cashcorp qualifies for non-recognition at the corporate level. §453B(h). Stockholders receive installment sale treatment on liquidation.
S Corp Installment Sale: Basis Problem

- Stock Basis $0
- Asset Basis $0
- Asset Sold for $1000: $100 cash and $900 note
- Gain Recognized Up Front: $100
- Liquidation of Cashcorp: New stock basis of $100 allocated $10 to cash, $90 to note resulting in $90 gain Up Front
- SOLUTION: take back SHORT TERM NOTE (due shortly after liquidation) instead of cash
Taxable Sale of QSUB Stock

- The sale of 100% of the QSUB 2 stock is treated as a sale of assets.
- The basis of the QSUB 2 stock to Cashcorp is irrelevant. BIGCORP gets stepped up basis.
Taxable Sale of Stock – No 338(h)(10)
Alternative Structure Reverse Triangular Cash Merger

Senior → Cashcorp [Survivor] → QSUB 1

Cashcorp [Survivor] → Junior → BIGCORP

Junior → Cashcorp [Survivor] → QSUB 2

BIGCORP → Cashcorp [Survivor] → LLC

Stock

Cash

Merger
Taxable Sale of Stock – No §338(h)(10)

➢ The sale of S corporation stock where there is no §338(h)(10) election produces capital gain to Senior and Junior (Note: only look through rule is on 28% collectables; collapsible corporation rules of §341 have been repealed).

➢ Bigcorp does not get a basis step up in Cashcorp assets.
Taxable Sale of Stock - §338(h)(10)

Form

Senior → Cashcorp

Junior → BIG CORP

Stock → Cash

Tax Treatment

Senior → Cash

Junior → Cash

Cashcorp → Assets

Cash corp → New Cashcorp

QS SUB 1 → Cashcorp

QS SUB 2 → Cashcorp

QS SUB 1 → Big Corp

QS SUB 2 → Big Corp
Taxable Sale of Stock
§338(h)(10) Election

➤ Same result to Senior and Junior as an asset sale.
➤ Purchaser must be a corporation.
➤ Purchaser gets a stepped up basis in assets.
➤ What if stock sale in exchange for a promissory note with a balloon payment in 2018? Regulations allow the use of installment sale treatment in a §338(h)(10) election. Reg. §1.338(h)(10)-1(d)(8). Again, the BIG tax cannot be avoided and would be triggered by a §338(h)(10) election. Stockholders get installment sale treatment.
S Stock Sale with Different Consideration

Senior

80%

Note

20%

Junior

Cashcorp

Cash

Stock

BIG CORP

Stock
S Stock Sale with Different Consideration

- Assuming no §338(h)(10) election, does this allocation of consideration create a prohibited second class of stock that would blow the S election? No, because the transaction does not involve differing shareholder rights as to distribution or liquidation proceeds from Cashcorp Reg. §1.1361-1(l)(1).

- Does this result change if a §338(h)(10) election is made? No, the IRS has ruled that this does not create a second class of stock. See Ltr. Rul. 9821006 (Feb. 5, 1998).

- Suppose there is no §338(h)(10) election and Senior and Junior agree to split the purchase price equally (Senior is agreeing to overpay Junior to induce Junior to vote in favor of the deal). This should not create a second class of stock problem. First, there is no distribution or liquidation from Cashcorp. Second, buy-sell agreements and redemption agreements among the shareholders are generally disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights. Reg. §1.1361-1(l)(2)(iii); see Ltr. Rul. 9433024 (May 20, 1994). However, a buy-sell or redemption agreement will be considered if (i) a principal purpose of the agreement is to circumvent the one class of stock requirement and (ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess or below the FMV of the stock.
S Stock Sale with Different Consideration

➤ Does this result change if Senior and Junior split the proceeds equally and a §338(h)(10) election will be made? Cashcorp will be deemed to have distributed 50% of the consideration to Junior even though Junior only owns 20% of Cashcorp stock.

➤ There is a risk of creating a second class of stock. Reg. §1.1361-1(l)(2)(v) provides: “If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10), the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.” The trouble here is that Bigcorp will not care how the price is divided. Senior and Junior will be the ones who cut any special deal. A preliminary cross purchase between A and B relying on Reg. §1.1361-1(l)(2)(iii) might avoid this problem.

➤ Also, what about assignment of income and gift tax problems?
Avoiding Corporate Tax: Martin Ice Cream

- Goodwill could be a stockholder asset rather than a corporate asset.
- Senior receives capital gain on sale of goodwill, Bigcorp amortizes the cost under §197.
- Avoids corporate level tax (C corporation or S corporation with §1374 BIG).
Tax-Free Reorganizations

To be a reorganization, a transaction must:

1. Satisfy extra-statutory requirements which are applicable to all acquisitive reorganizations.

2. Be one of the specific forms of reorganization prescribed by the Code.

3. Satisfy other requirements (which vary depending on the specific form).
Extra-statutory Requirements

- Continuity of interest
- Continuity of business enterprise
- Business purpose
Continuity of Interest

- A “substantial part” of the value of the proprietary interests in the target must be preserved.
- In practice, at least 40% - 50% of the total value of the consideration must be stock.
Continuity of Business Enterprise

The acquiror must either

- Continue a significant line of the target’s historic business; or
- Use a significant portion of the target’s historic business assets in any business.
Tax-Free “A” Reorganization

**Diagram:**
- **Senior**
- **Junior**
- **Cashcorp**
  - **QSUB 1**
  - **QSUB 2**
- **BIGCORP**
- **Merger**

**Alternative Structure:**
- **Senior**
- **Junior**
- **Cashcorp**
  - **QSUB 1**
  - **QSUB 2**
- **BIG CORP**
- **Merger**
- **LLC**
- **Stock**
Forward Triangular Reorganization [(a)(2)(D)]

Alternative Structure
“(a)(2)(D)” Reorganization

- Forward triangular merger (merger sub survives)
- Merger sub must be a direct subsidiary of the acquiror
- Acquisition subsidiary must acquire substantially all of target’s assets
- No subsidiary stock may be used
QSUB Target – Stock Deal

Cashcorp → Stock → BIGCORP

QSUB → QSUB 2 → LLC
QSUB Target – Stock Deal

- This transaction will not qualify as a tax-free reorganization. Cashcorp is treated as owning the assets of QSUB 1 and QSUB 2. Therefore, the transaction would be treated as an asset sale by Cashcorp to BIGCORP of the QSUB 2 assets. This prevents the application of §368(a)(1)(A).

- §368(a)(1)(C) would not apply because Cashcorp did not transfer "substantially all of [its] properties" to BIGCORP. The IRS's present safe-harbor position is that “substantially all” of an entity’s assets means 90% of the fair-market value of its net assets and 70% of the fair-market value of its gross assets. Rev. Proc. 77-37, 1977-2 C.B. 568. If this safe-harbor is not satisfied, a facts and circumstances test, based on the nature (business asset or passive asset) and amount of the assets retained, might be applied to determine whether the acquirer has acquired "substantially all" of the acquirer’s assets. See Rev. Rul. 57-518, 1957-2 C.B. 253.

- If S Corp. owns at least 80% of BIGCORP stock immediately after the transaction, §351 would apply because Cashcorp transferred its assets solely for stock in Bigcorp.

- If QSub 2 were a C corporation, this transaction would qualify as a merger under §368(a)(1)(A).
Tax-Free C Reorganization

- Cashcorp must transfer "substantially" all of its assets and Bigcorp must assume Cashcorp's liabilities. See Rev. Proc. 77-37, 1977-2 C.B. 568 (90% net assets and 70% of gross assets).
- Bigcorp voting stock must be used.
- Cashcorp must liquidate and distribute Bigcorp voting stock to Senior and Junior.
- Note: If Cashcorp receives at least 80% control of Bigcorp then §351 could apply.
Tax-Free B Reorganization

- Senior and Junior exchange their Cashcorp stock solely for Bigcorp stock.
- Not a popular deal structure. No room for "error."
Tax-Free Reverse Triangular Reorganization

- Bigcorp Sub merges into Cashcorp with Cashcorp surviving.
- Senior and Junior receive Bigcorp voting stock (there can be up to 20% other property).
- Treated as an acquisition of Cashcorp stock.
“(a)(2)(E)” Reorganization

- Reverse triangular merger (target survives)
- Merger Sub must be a direct subsidiary of the acquiror
- Target must hold “substantially all” of its assets
- Acquiror must acquire control (80% of voting power + 80% of each non-voting class) target in the transaction in exchange for voting stock
- If (i) no target stock is already owned, (ii) target has only one class of stock, and (ii) all shareholders receive the same mix of consideration, this means that 80% of consideration must be voting stock
National Starch Structure

- Bigcorp wants to acquire Cashcorp. Senior wants cash; Junior wants a tax-free stock deal.
- Bigcorp and Junior form Holding Corp. Bigcorp contributes cash and Junior contributes his Cashcorp stock in a §351 transaction.
- Holding Corp forms transitory subsidiary, Shell Corp.
- Shell Corp is merged into Cashcorp with Cashcorp surviving. Senior receives cash. Junior ends up with illiquid stock.
Sale of Potential Dealer Property to Related S Corporation

- Land LLC holds a substantial tract of land that is almost at record plat.
- If subdivided, the land will be "dealer property, generating ordinary income."
Sale of Potential Dealer Property To a Related S Corporation

- What result if Land LLC sells the undeveloped land to a controlled S corporation in exchange for notes? Gain is capital gain as long as the form of the transaction is respected. The determination will turn on whether the corporation pays FMV rather than an inflated price. If the purchase price is paid by issuing an installment note, the determination hinges on the FMV of the property and whether the corporation has sufficient capital to pay the obligation. See, e.g., Aqualane Shores Inc. v. Commissioner, 269 F.2d 116 (5th Cir. 1959); Bradshaw v. United States, 683 F.2d 365 (Ct. Cl. 1982); Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992).

- The tendency in this situation is to inflate the purchase price to maximize capital gain and minimize ordinary income after the property is developed. If this occurs, the transfer by a controlling shareholder may be treated as a contribution of capital to the corporation rather than a sale. See Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th Cir. 1966), cert. denied, 385 U.S. 1007 (1967).
Sale of Potential Dealer Property To a Related S Corporation (cont’d)

➤ What steps can be taken to bolster the taxpayer’s position?
  ➤ Have unrelated stockholders.
  ➤ Have some equity contribution.
  ➤ Make sure S Corp. is held out to the public as the developing entity and not merely serving as A’s agent.

➤ If sell interests in Land LLC, be aware of the bifurcated holding period rules. Reg. §1.1223-3(b).
Tax-Free Reorganization
Converting LLC to S Corporation

- Senior and Junior want to “sell” Real Estate LLC to Bigcorp in exchange for Bigcorp stock.
- Real Estate LLC can “check the box” to be taxed as a corporation and it can make an S election.
- Alternatively, Real Estate LLC could convert to a state law corporation and make an S election.
- Either approach needs to satisfy the requirement of §351 including the 80% control requirement. If the reorganization occurs shortly after the incorporation, §351 may not be satisfied.
- Is there a binding obligation at the time of conversion?
Using Disregarded Entities Under Section 1031

- Buyer proposes to purchase the membership interests in Real Estate LLC from Senior and Junior to avoid transfer taxes. Senior and Junior want to do a like-kind exchange.

- §1031(a)(2)(D) provides that an interest in a partnership does not qualify as good like-kind property. Even though Rev. Rul. 99-6, 1999-1 C.B. 432, provides that Buyer would be treated as acquiring the assets of Real Estate LLC (because Real Estate LLC would be disregarded in the hands of Buyer), Senior and Junior are treated as selling partnership interests.
Using Disregarded Entities Under Section 1031

- What if Senior and Junior contribute their membership interests in Real Estate LLC to a newly formed limited liability company, LLC II, and then have LLC II sell 100% of its membership interest in Real Estate LLC to Buyer?

- Under the revised two-tier structure, Real Estate LLC is now a disregarded entity. The sale by LLC II of 100% of the interest in Real Estate LLC will be treated as a sale of the Real Estate LLC assets, thus teeing up the deal for a good §1031 exchange on both sides.

- What about the “holding for investment” issue?

- Under the partnership merger rules, LLC II is considered a continuation of Real Estate LLC, thus LLC II should be treated as” holding” the property for the same investment purpose that Real Estate LLC held it.
LLC Cross Purchase

- Senior agrees to sell Junior all of his LLC interest in Real Estate LLC.
- Senior receives capital gain treatment except (i) ordinary income recapture and (ii) 25% depreciation recapture. What about application of §1239?
- Junior is treated as purchasing Senior's undivided interest in Senior's share of Real Estate LLC assets and Real Estate LLC becomes a disregarded entity. Rev. Rul. 99-6, 1999-1 C.B. 432.
- If Junior did not want to end up with a disregarded entity, Junior could first admit an S corporation or a family member as a 1% member. In this case, Junior will have a basis in the LLC interest purchased from Senior equal to cost. If Real Estate LLC makes a §754 election, Junior will get a basis step up in the assets as well.
LLC Redemption

- Senior structures his exit as a redemption instead of a cross purchase. Senior still has potential ordinary income recapture. However, Senior does not have 25% depreciation recapture. Reg. §1.1(h)-1(b)(3)(ii). What about §1239?
- Real Estate LLC gets a basis step up under §734 assuming a §754 election is in effect.
Contribution to UPREIT in Exchange for OP Units

- Senior
- Junior
- Real Estate LLC
  - Property
  - OP Units
- UPREIT OP
- REIT
  - LPs
Contribution to UPREIT in Exchange for OP Units

- Contribution is tax-free under §721.
- A direct contribution to the REIT would not satisfy §351 (control test problem).
- OP Units are convertible into REIT shares, but conversion is a taxable event. Transaction permits diversification and liquidity.
- Watch liabilities in excess of basis.
- Watch §704(c) allocation traps.
- Negotiate lockups, debt levels etc. to avoid tax problems.
- Watch disguised sale issues. §§707, 704(c)(1)(B), 737.