Can Humanity Find the Meaning of Life in the Final Cash D Reorganization Regulations?

By William M. Funk[*]

William M. Funk tracks the development of the "meaningless gesture" doctrine that has evolved in D reorganizations and explains how final regulations set guidelines for this doctrine.

If, as of late, you have had a heightened awareness about meaninglessness, there is a good chance you have been thinking about cash D reorganizations. With the issuance of T.D. 9475 and the final regulations addressing the qualification of certain transactions as "D" reorganizations, the IRS has completed the journey of the "meaningless gesture" doctrine in the context of D reorganizations.

As sometimes happens, a recharacterization that was originally used for anti-abuse purposes has become a planning rule for a discrete set of transactions. Gradually but surely, the IRS dispensed with the requirement of issuing stock in exchange for transfers of substantially all assets of a corporation in nondivisive D reorganizations where there is no more than a *de minimis* change in beneficial ownership.

D Reorganizations Background

What we have come to call D reorganizations are those reorganizations described in Code Sec. 368(a)(1)(D) of the Internal Revenue Code of 1986, as amended ("the Code"). This section provides that a tax-free reorganization includes a transfer by a corporation of all or part of its assets to another corporation if afterwards the transferor or one or more shareholders thereof control the transferee corporation, but only if the stock or securities of the transferee is distributed pursuant to Code Sec. 354, 355 or 356.

D reorganizations can be divided into two categories: divisive reorganizations that qualify under Code Sec. 355, and nondivisive reorganizations that qualify under Code Sec. 354 or 356. In a divisive reorganization, which will not be discussed at length in this article, the result will generally be that afterwards, at least two separate corporations will conduct active trades or businesses that had previously been conducted by a single corporation.[1]

In nondivisive reorganizations, the transferee corporation must acquire substantially all the assets of the transferor corporation.[2] The stock, securities and other property received by the transferor corporation from the transferee must then be distributed to its shareholders in pursuance of the plan of reorganization.[3] The shareholders have tax-free treatment under Code Sec. 354 if the only property they receive is stock or securities.[4] If the shareholders receive "boot" (other property including money), then the shareholders may recognize gain on the exchange. This gain, however, is limited to the value of money and other property received.[5] For exchanges that have "the effect of a distribution of a dividend," this gain may be reclassified as a dividend to the extent of the shareholder's share of earnings and profits with gain in excess of that treated as gain from the exchange of property.[6] Determining whether the exchange has the effect of a dividend requires "examining the effect of the transaction as a whole."[7]

For these nondivisive D reorganizations, the control requirement is relaxed, which is what makes nondivisive D reorganizations favorites of tax advisors. Under the general rule of D reorganizations, one or

William M. Funk, Law Office of William M. Funk, New York, NY, provides tax assistance to individuals, businesses, funds and nonprofit organizations.

©2010 W.M. Funk

CCH a Wolters Kluwer business

more shareholders of the transferor from prior to the reorganization must control the transferee corporation under Code Sec. 368(c). This general provision requires ownership of 80 percent of total combined voting power of all voting classes of stock *and* 80 percent of total shares of all other classes. In contrast, in nondivisive D reorganizations, "control" is defined by Code Sec. 304(c), which requires only 50 percent of voting power of all voting classes of stock *or* 50 percent of total value of all classes of stock.[8]

The change from the conjunctive 80-percent test to the disjunctive 50-percent test in 1984 (late in the *General Utilities* era) reflects the history of the overall structure of U.S. corporate tax law and the role of the nondivisive D reorganization.[9] Prior to *General Utilities* repeal, when a corporation could liquidate without incurring gain on distribution of appreciated property,[10] tax advisors would make use of liquidation followed by reincorporation to bail out earnings and profits. Specifically, under the old rules, the liquidation of a corporation and distribution of assets to shareholders would result in shareholders recognizing capital gains income while the liquidating corporation did not recognize any income and paid no tax on the distribution of its assets. Earnings and profits inherent in the liquidating corporation, which if distributed in a nonliquidating distribution as a dividend, normally would be taxed at ordinary income rates that often exceeded 50 percent. But this consequence was avoided in a liquidation. So if a taxpayer could distribute out the earnings and profits in a liquidating distribution subject to capital gains tax and then continue the profitable business of the liquidated corporation in a new corporation, that would be the checkmate for the taxpayer. Thus a chess match was played by taxpayers (and their advisors) and the IRS for decades.

Therefore, requiring 80-percent control by shareholders before a transaction could be deemed a reorganization made it easier for taxpayers to avoid unwanted classification as a reorganization and so deflect attacks on liquidation-reincorporation transactions.[11] Lowering the threshold to 50 percent and making the test disjunctive made classification by the IRS as a reorganization much easier and classification as a liquidation more difficult.

In using Code Sec. 304(c) in this way, Congress also brought in the constructive ownership rules of Code Sec. 318 as part of combating perceived abuses. These rules deem stock owned by family members or related partnerships, estates, trusts or corporations as being owned by the individual.[12] The result of this would be that a taxpayer need not actually own any stock in a corporation to be considered an owner to whom control could be attributed in a D reorganization.

Where the statute regarding D reorganizations was written to allow the government flexibility in determining reorganization status, the regulations were written with an eye towards taxpayers who actually intended to engage in tax-free reorganizations. The original regulations under Section 368 of the Internal Revenue Code of 1954 stated, "The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways described in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms."[13] Accordingly, reorganizations, explicitly including D reorganizations, were required to have several common elements. The regulations required (1) continuity of business enterprise, (2) continuity of interest, (3) a plan of reorganization, and (4) a nontax business purpose. Later regulations were adopted to add greater flexibility, for instance, by explicitly permitting assets that were transferred in a reorganization to be transferred again to a subsidiary and still qualify as a tax-free reorganization.

D Reorganizations Without Physical Exchange of Stock in the *General Utilities* Era

Current doctrines regarding D reorganizations without physical exchange of stock, which have come to be called "cash D reorganizations," originated in anti-avoidance cases. In *W.M. Liddon,*[14] which was decided under Section 112(g)(1)(D)[15] of the Internal Revenue Code of 1939, the predecessor of modern Code Sec. 368(a)(1)(D), Liddon Motors Inc., an auto dealership, was owned 80 percent by Mr. and Mrs. Liddon and 20 percent by R. H. Davis. When Davis became ill, he wanted to sell his stock to Mr. and Mrs. Liddon, but this was rejected. Instead, the shareholders adopted a plan of liquidation. Within days, they also formed a new corporation, Liddon Pontiac Inc., and decided that Liddon Motors would sell all assets to Liddon Pontiac at book value. Liddon Motors would then redeem Davis' stock and make liquidating distributions to Mr. and Mrs. Liddon. The

CCH a Wolters Kluwer business

Tax Court concluded that these steps must constitute a plan of reorganization, focusing particularly on the substance of the transactions in addition to the provisions of Code Sec. 112(g)(1)(D). With respect to the requirement of an exchange of stock under Code Sec. 112(b)(3) and the lack of an actual exchange of stock in this transaction, the Tax Court stated that "all of the transactions, when viewed as one plan of reorganization, culminated in an exchange of stock for stock plus some money." The Sixth Circuit agreed with this determination with little discussion on this particular point.

In *W.L. Morgan*,[16] which was also decided under the Internal Revenue Code of 1939, the court now focused on the requirement of a transfer of stock. The taxpayer in this case was the sole shareholder of Wellington Corporation, an investment advisory firm, and W.L. Morgan and company, which engaged in the promotion and distribution of securities for a mutual fund. The shareholder liquidated the investment advisory firm by transferring its assets to the other corporation. The surviving corporation then distributed cash and bonds to the sale shareholder. No stock was transferred to the liquidating corporation. The shareholder attempted to classify the distribution to him as long-term capital gain. The IRS argued that the transaction was a reorganization under Section 112 of the Internal Revenue Code of 1939. The Tax Court had held that the transaction could not be a reorganization because there was no actual exchange of stock. The Third Circuit Court of Appeals overruled the Tax Court, stating that this type of transaction, distributing as capital gains what are in effect dividends out of earnings and profits, was targeted by the legislative history of the 1924 Act. Because a single shareholder wholly owned all the corporate parties, the issuance of stock would have been a meaningless gesture.

Then in *J. Armour, Inc.*,[17] a similar situation arose, with the difference that the brother-sister corporations were owned by a husband and wife in the proportions of 98 percent and two percent. The shareholders owned one corporation that engaged in the business of heavy construction and another corporation that engaged in excavating activities. The shareholders, after a change in insurance coverage rendered the need for two separate corporations unnecessary, liquidated the heavy construction corporation by having it sell assets to the excavating corporation at fair market value and then make liquidating distributions to the shareholders. The IRS attacked this transaction, now under the Internal Revenue Code of 1954, as a reorganization. The Tax Court focused on the "continuity of enterprise" and the "continuity of proprietary interest" in concluding that the substance of the transactions was a reorganization. Because the proportions of the corporations owned was the same and proprietary interests were maintained, the court followed *Morgan* in declaring that the step of issuing stock in such situations would be a meaningless gesture and stated "we cannot conclude that the statute requires such a vain act." Another case would be decided two years later on similar facts, but with the main difference being that a father and son were equal owners of the transferor and transferee corporations.[18]

This is to be contrasted with *Warsaw Photographic*. In this case, a group of 10 investors owned all of one corporation and 20 percent of another corporation in a related business. The 20-percent owned corporation transferred its assets to the wholly owned corporation and received cash, which it distributed. No new stock was issued or distributed. This was ruled not to be a D reorganization. Because the ownership was not identical, the distribution of stock would not have been a meaningless gesture.

By 1970, the IRS had sufficient experience with cash D reorganizations that it issued a revenue ruling on point.[19] B was the owner of corporations X and Y. B liquidated X and transferred assets to Y. Y then transferred $34x cash, equivalent to the fair market value of the assets to X; X then made a liquidating distribution to B. Because B already owned all the shares of Y, B was deemed to have received a distribution of Y shares, and the cash distribution was deemed to be a dividend.

This could be extended to situations where corporations were deemed to have common ownership by operation of the constructive ownership rules of Code Sec. 318. In a situation where shareholder A contributed 25 percent of the stock of wholly owned corporation X to corporation Y, wholly owned by B, and received cash from Y, this was deemed to have caused no change in ownership, and the transaction was treated as a dividend to A.

Cash D Reorganizations Post–*General Utilities* Repeal

After *General Utilities* repeal, when the chess match was decidedly won by the IRS (or rather, by

CCH® a Wolters Kluwer business

Congress), the game lived on and taxpayers started to request rulings specifically making use of this rule to confirm that their transaction was a valid D reorganization and get comfort in such areas of tax law as cross-border transactions, consolidated corporations and conversions of corporations to limited liability companies while extracting cash tax-free, at least on a limited basis, using Code Sec. 356(a). For example, in LTR 9111055, a U.S. resident owned a foreign holding company that owned two subsidiaries. The taxpayer proposed a domestication transaction in which the stock of the foreign corporations would be contributed to a new S corporation in exchange for stock. The taxpayer would then liquidate the foreign subsidiary corporations and transfer their businesses to new corporations, which would be subsidiaries of the S corporation in exchange for cash equal to the fair market value of the businesses transferred. The foreign corporations would then make liquidating distributions. The IRS ruled that the continuity of interest and Code Sec. 354(b) requirements were deemed satisfied even without the issuance of new stock, citing *Armour* and Rev. Rul, 70-240. Therefore the transaction was a tax-free reorganization, although the taxpayer would be required to include 1248 amounts in income, but only to the extent that the fair market value of the notional stock exceeded the adjusted basis.[20]

In LTR 9336029,[21] the proposed transaction was a possible transfer of assets of a business from one chain of corporations in a consolidated group to another chain.[22] In this transaction, a holding corporation ("Holding") owned corporation A, which in turn owned corporation B, which then owned two chains of corporations. One chain was corporation C, its subsidiary E, and that corporation's subsidiary "Target." The other chain was corporation D, which owned "Acquiring." It was represented that assets of Target would be transferred to Acquiring for constructive exchange of Acquiring shares, which would then be distributed up one chain to corporation B and contributed to corporation B. The IRS ruled that this would be a valid D reorganization.

In LTR 200252005, the proposed transaction involved a parent corporation ("Parent") that wholly owned an acquiring corporation ("Acquiring"). Parent and Acquiring owned x and y percentages of a target corporation ("Target"). It was proposed that Parent contribute its target stock to Acquiring and that Target then convert to a single-member limited liability company, a disregarded entity. The IRS ruled that in effect Target transferred its assets to Acquiring and was deemed to receive and distribute Acquiring stock in a D reorganization.

The final stage of evolution came with the issuance of temporary regulations on cash D reorganizations in response to requests for guidance on nondivisive D reorganizations where no stock is issued.[23] The proposed regulations looked to *Warsaw Photographic* and required that these transactions result in identical ownership before and after the reorganization, although *de minimis* differences will be ignored. These temporary regulations took the approach of deeming a single nominal share as being issued by the transferee and distributed to the shareholder or shareholders.

In doing so, the temporary regulations enshrined the "meaningless gesture" doctrine. The doctrine will apply to situations in which the net value of assets transferred to a corporation equals or exceeds the cash received.

The Final Regulations on Cash D Reorganizations

The final regulations then made refinements to explain the effect of the issuance of nominal stock such as questions of basis calculation and allocation and the effect on consolidated groups.[24] The IRS considered an approach of mere deemed satisfaction of the distribution rules of Code Sec. 354(b)(1)(B) but preferred the nominal share approach as being conducive to tracking the basis of nonrecognition property under Code Sec. 358(a). The basis of the stock would be equal to the excess of the fair market value of the assets surrendered over the consideration received by the shareholder. This preserves basis pursuant to the substituted basis rules of Code Sec. 358.

The regulations clarified that the deemed nominal issuance would not apply to certain triangular reorganizations under Reg. §1.358-6(b)(2) or to G reorganizations under Code Sec. 368(a)(2)(D).[25] This responds to the concern that many reorganizations could potentially qualify as D reorganizations, be subject to the cash D reorganization rules and then fail under these rules based on the fact that stock or securities of a controlling corporation is used instead of the transferee corporation.[26] Therefore, this rule protects those other transactions.

The final regulations provide examples to illustrate the operation of these rules and track

CCH a Wolters Kluwer business

the development of case law and administrative guidance. In Example 1, which echoes *Morgan*, a shareholder has one subsidiary transfer all its assets to the transferee, who pays $100, the value of the assets in return. The $100 is distributed to the shareholder. This is a valid cash D reorganization and one nominal share is deemed to have been transferred to the transferor and then distributed to the shareholder. This also is the classic cash D reorganization.

In Example 2, the corporation that owns the transferor is owned by one shareholder and the transferee corporation is owned by her son. As in the first scenario, one subsidiary transfers all its assets to the transferee, who pays $100, the value of the assets. This is also a valid cash D reorganization through operation of the constructive ownership rules of Code Sec. 318. With this example, a late statutory change enacted as a way of broadening the anti-abuse authority of the IRS now broadens the ability of taxpayers to use the cash D reorganization structure even when the actual ownership of the transferor and transferee corporations vary considerably.

In Example 3, a single shareholder owns two chains of corporations, each with three tiers of corporations. The transferor corporation, the lowest subsidiary of one chain, transfers substantially all of its assets to a transferee corporation that is the lowest subsidiary of the other chain in exchange for $70x, the value of the assets. A nominal share is deemed to have been transferred to the transferor and then distributed up the chain to the ultimate shareholder. With this, the IRS permits taxpayers to rely on the rule implied by LTR 9336029, but which as a private letter ruling was not authority taxpayers could rely on.

In Example 4, the transferor corporation is owned equally by three shareholders and the transferee corporation is owned 99 percent by the three shareholders equally and one percent by an unrelated shareholder. This *de minimis* difference in the ownership of the two corporations will not prevent this transaction from having the same result as the other nondivisive D reorganizations. This example presents *R.C. Wilson, Sr.* with a minor twist. *Wilson* was a case of multiple shareholders in control of the corporations rather than a single shareholder. Although the shareholders were father and son, the case was decided before the constructive ownership rules of Code Sec. 318 were incorporated through the reference to Code Sec. 304(c), confirming that a group of unrelated shareholders may be considered to have control of the corporations. The minor twist is the confirmation that *de minimis* differences will not disrupt the cash D reorganization.

In Example 5, three shareholders own the common stock of two corporations in equal proportions. An unrelated shareholder in the transferee corporation holds all of the stock that is defined as preferred stock under Code Sec. 1504(a)(4). Because preferred stock under Code Sec. 1504(a)(4) is not "stock," the corporations are considered owned in identical proportions despite the presence of the preferred shareholder. Here, *Wilson* is presented with the twist of preferred stock ownership in one corporation, confirming that preferred stock is really not stock. This also presents additional planning opportunities. In the context of foreign transactions, it may occasionally be useful to have a corporation issue preferred stock, particularly for shareholders who are not required to include "preferred stock original issue discount" in income, such as foreign persons.[27]

In Example 6, the transferor corporation is owned by the first and second shareholders in equal proportions while the transferee corporation is owned 90 percent by the second shareholder and 10 percent by an unrelated shareholder. If no stock is physically issued by the transferee corporation and distributed, the transaction will not qualify as a D reorganization because the issuance of stock would not be a meaningless gesture. This example is *Warsaw Photographic* in essence.

There is also an example in the consolidated corporation context: in Example 4 under Reg. §1.1502-13(f)(7)(i), a parent corporation owns two corporations, M, which owns subsidiary S and B. S sells its assets to B for $100, the fair market value, and liquidates. B is deemed to have issued a nominal share to S, who distributes the nominal share and cash to the parent corporation. This brings the example of LTR 9336029 to the consolidated corporations regulations in addition to the corporate reorganization regulations.

Conclusion

The final regulations, in addition to bringing to an end a half-century sojourn of corporate reorganization law from anti-avoidance to planning tool, provide useful guidance to advisors involved with private

CCH® a Wolters Kluwer business

equity clients, particularly those private equity clients with foreign investments. Though the circumstances in which these rules can be used is limited, the ability to modify an ownership structure tax-free without the issuance of stock, while extracting cash and property may be particularly useful when state or foreign country rules render other structures infeasible and should be kept in mind for that rainy day.

ENDNOTES

* The author would like to thank his colleague Solomon Steiman for his ongoing assistance in the preparation and review of this article.

1 *See* Code Sec. 355.

2 Code Sec. 354(b)(1)(A).

3 Code Sec. 354(b)(1)(B).

4 Code Sec. 354(a)(1).

5 Code Sec. 356(a)(1)

6 Code Sec. 356(a)(2).

7 *D.E. Clark,* SCt, 89-1 USTC ¶9230, 489 US 726.

8 Code Sec. 368(a)(2)(H)(i).

9 H.R. REP. NO. 861, 98th Cong., 2d Sess., 846–48 (1984).

10 *General Utilities & Operating Co.*, SCt, 36-1 USTC ¶9012, 296 US 200 (1935).

11 General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, at 192. ("The Congress believed that many of these transactions should be treated as D reorganizations. However, in some instances, the control requirement that applied in the case of a D reorganization prevented the service from successfully asserting that these transactions constituted D reorganizations.") Once Code Sec. 336 was adopted in its current form, requiring recognition of gain or loss on distribution of property, the motivations for transactions changed.

12 Code Sec. 318, of course, also can deem stock owned by an individual to be owned by other family members or by related partnerships, estates, trusts or corporations.

13 T.D. 6152 (Jan. 1, 1955).

14 *W.M. Liddon*, CA-6, 56-1 USTC ¶9268, 230 F2d 304.

15 This was originally Section 112(g)(1)(C).

16 *W.L. Morgan*, CA-3, 61-1 USTC ¶9317, 288 F2d 676.

17 *J. Armour, Inc.,* 43 TC 295, Dec. 27,071 (1964).

18 *R.C. Wilson, Sr.*, 46 TC 334, Dec. 27,987 (1966).

19 Rev. Rul. 70-240, 1970-1 CB 81.

20 LTR 9111055 (Dec. 19, 1990), citing prior Reg. §7.367(b)-7(c)(1)(i).

21 LTR 9336029 (June 14, 1993).

22 The LTR also noted an alternative transaction where the stock of Target would be sold to an unrelated party. This alternative is not germane to this article.

23 T.D. 9303, 2007-1 CB 379.

24 T.D. 9475, IRB 2010-4, 304.

25 *Id.*

26 *See* 72 FR 9284.

27 *See* Code Sec. 305(c) and regulations thereunder.

This article is reprinted with the publisher's permission from the TAXES–THE TAX MAGAZINE, a monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the TAXES–THE TAX MAGAZINE® or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.

CCH®

a Wolters Kluwer business