WHO WANTS CAKE? SECTION 368 TAX-FREE REORGANIZATIONS FOR CORPORATIONS

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After making the decision to dispose of a corporation, entrepreneurs and business owners should consider tax consequences and plan accordingly. Often, an exit strategy utilized by a private corporation is the acquisition of the corporation by a public company whose shares are readily saleable because they have a public market. Under this scenario, the target corporation is merged into the acquiring corporation with the target's shareholders receiving the buyer's (or acquiring corporation) stock. The transaction qualifies as a reorganization under section 368(a)(1)(A) of the Internal Revenue Code of 1986 which provides that "the term 'reorganization' means a statutory merger or consolidation."

Code section 368 reorganizations allow target corporation shareholders to exchange target stock for buyer corporation stock without gain recognition. The acquisition would be tax free to the target corporation and its shareholders when the transaction satisfies the requirements of one of the paragraphs of section 368(a). Even though section 368(a) describes several different forms of reorganization, the statutory merger effected under state corporate law is the easiest of the subsections under which to qualify. Furthermore, this statutory merger or consolidation under section 368(a)(1)(A) is commonly referred to as an A Reorganization. The A Reorganization allows the use of up to 60 percent of consideration in the form on non-stock, e.g., cash ("boot"). Additionally, a transaction qualifies for A reorganization treatment irrespective of whether the target corporation retains substantially all of its assets, and whether or not the acquiring corporation issues voting or non-voting stock to the target shareholders.

Similar to an A Reorganization, a B Reorganization under section 368(a)(1)(B) also involves an exchange of stock for stock but prohibits the use of boot altogether. While a C Reorganization (section 368(a)(1)(C)), a stock for assets acquisition, generally limits boot to 20 percent of total consideration. Therefore, the structure of a transaction will determine which particular reorganization provisions are applicable. For example, as just mentioned, the presence of boot would not qualify a transaction as a B Reorganization.

In the merger, shareholders of the merged, or target, corporation, receive their "new" shares from the acquiring company tax free. The shareholders take a basis in the new shares they receive equal to the basis that had in their old shares. Therefore, any tax on the disposition is deferred until sale of those shares.

Target corporation shareholders may determine tax basis in buyer stock using a tracing method. Under the tracing method, shares of new stock may be designated as having been received in exchange for particular blocks of target stock. This allows the target corporation shares purchased at a higher price, than other target corporation shares, to be "traced" to buyer shares received in an exchange. Therefore the higher basis share are sold first. Alternatively, under an "averaging method", a shareholder's basis in target shares would be spread pro-rata to the newly received shares.

The ability to sell the new shares on a piecemeal basis allows the shareholders to have liquidity and diversification in their investment. Also, as mentioned previously, if the target company's shareholders receive some cash (within the statutory constraints to qualify for reorganization treatment), the shareholders will recognize gain to the extent of the cash received.

Since, a shareholder recognizes gain to the extent of cash or property (other than stock or securities), the proper treatment of the boot should be considered. Under 356(a)(2), the recognized gain will be ordinary income (to the extent of the shareholder's undistributed share of the target corporation's earnings and profits), if the boot received has the effect of a dividend.

The IRS in Rev. Rul. 93-61 has stated that it would follow Clark, 489 US 726 (1989) in determining the treatment of boot as ordinary income or capital gain. Specifically, in acquisitive reorganizations, the treatment of the boot as ordinary income or capital gain should be resolved by comparing the interest the shareholder actually receives against the interest that would have been received if only stock and no boot was involved.

Here's some numbers to make things a little simpler. The shareholder of a wholly owned corporation receives an offer, consisting of two choices, by a publicly held corporation to purchase the private corporation. The publicly held corporation offers the choice of 425,000 shares of its stock or 300,000 shares plus $3,250,000 cash. The shareholder chose the stock plus the cash. In Clark, the Supreme Court analyzed the transaction by asserting that, first, the shareholder exchanged all of the shareholder's shares for 425,000 shares of stock in the publicly held corporation. Next, the shareholder is deemed to have had 125,000 shares redeemed for $3,250,000 in cash. The portion of the transaction involving the 125,000 shares has to meet the requirements for a redemption to qualify for capital gain treatment (a meaningful reduction of the shareholder's interest and thus a redemption not essentially equivalent to a dividend). Otherwise, the boot is designated as a dividend and thus, ordinary income to the extent of any accumulated earnings and profit of the target corporation.

Still yet, to qualify as a reorganization under section 368(a), a transaction must satisfy the continuity of business enterprise requirement. Section 1.368-1(d)(1) requires that the acquiring corporation either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business for a reorganization to satisfy the continuity of business enterprise requirement. Nevertheless, the doctrines underlying the continuity of business enterprise requirement are easy to satisfy.

Of the various codified reorganization choices, an A reorganization is a popular way to structure the transaction for income tax planning purposes. The principal benefit of having a transaction meet the requirements of a type A reorganization is the deferral of income taxes. Similar to other exchange provisions of the Internal Revenue Code, a shareholder's existing basis is carried over to the stock received. By utilizing the reorganization exit strategy, business owners are able to sell their business while deferring their gain.