Row Row Row Your Boat Gently … Downstream to Tax Savings

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In LTR 200747006, released on August 22, 2007, the IRS ruled (to the obvious delight of the taxpayer) that the questioned transaction qualified as a tax-free C reorganization. Code Sec. 368(a)(1)(C) provides for tax free treatment of an acquisition by one corporation of substantially all of the properties of another, in exchange for all or a part of the voting stock of the acquiring corporation.

The Target in question was a privately held, personal holding company that sold its operating assets and invested the cash proceeds in marketable securities. Target subsequently sold the securities, using the proceeds to purchase common stock of Acquiring, which at that time was a privately held corporation. After the sale of its operating assets, Target's only assets were a minimal amount of cash and shares of Acquiring common stock.

Steps to the Reorganization

Acquiring conducted an initial public offering and is now a widely held, publicly traded corporation. Acquiring had only one class of stock outstanding (voting common). Target and Acquiring entered into an agreement and plan of reorganization consisting of the following steps:

- Prior to closing, Target would distribute to its shareholders, pro rata, all of its cash, less an amount sufficient to discharge all existing liabilities.
- Target would transfer the remaining assets (primarily consisting of the shares of Acquiring stock) to Acquiring, in exchange for newly issued Acquiring common stock, issued in the names of the Target shareholders. Acquiring would not assume any of Target's liabilities.
- Within 30 days of the asset transfer, Target would distribute the newly issued Acquiring common stock to its shareholders.
- Target would then dissolve within 180 days of the asset transfer.

Acquiring planned to acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by Target immediately prior to the transaction.

Downstream Deal

The IRS ruled that this transaction qualified as a C reorganization. Thus, Target and Acquiring avoided recognition of gain on the exchange of old Acquiring shares for new Acquiring shares. Plus, Target avoided recognition of gain on the distribution of the new Acquiring shares to its shareholders. However, the Target shareholders will recognize gain to the extent of the cash received when they exchange their Target shares for new Acquiring shares. [Code Sec. 356(a)(1).]

This all sounds appropriate. Yet, for all intents and purposes, the facts of this letter ruling evidence a private company that sold all of its operating assets (essentially a sale of the business) and invested the proceeds in another private company. Soon after Target purchased shares in Acquiring, Acquiring (quite fortuitously) went public.

The alternative would presumably have been for Target to sell its old Acquiring shares, paying tax on the appreciation. Thereafter, Target would dissolve, distributing the proceeds from the sale of the old Acquiring shares to its shareholders in redemption of their Target shares. The Target shareholders would, of course, be taxed on the dissolution proceeds.

Conclusion

By swapping out its old and rusty Acquiring shares for new and shiny Acquiring shares, the Target here avoided taxation on what would otherwise have been a simple redemption of the Acquiring stock. As an additional benefit, the Target shareholders now hold stock in a publicly traded company.