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All Cash D Regulations Finalized

On December 18, 2009, Treasury finalized the regulations that address when a transfer of substantially all of its assets by one corporation ("Target") to a corporation controlled by its shareholders ("Acquirer") for any or no consideration, but not for stock of Acquirer, will nevertheless be treated as a section 368(a)(1)(D) reorganization. Reg. 1.368-2(l). The answer is: only when the shareholders of Target and Acquirer are virtually identical and hold their stock in virtually identical proportions. In all other cases, Target will be treated as having sold its assets to Acquirer in a recognition event and liquidated.

The significance of this rule can be illustrated by the two following examples, which bracket the history of the all-cash D reorganization.

Example 1: B owned all the stock of both Target and Acquirer, each of which had been engaged in business for many years. Target sold its operating assets to Acquirer for 34*x* dollars (their fair market value). The remaining assets of Target, which had a fair market value of 33*x* dollars, consisted generally of cash, accounts receivable and investments in stocks and bonds. Following this sale, Target paid its debts, which amounted to 38*x* dollars, and liquidated. *B* received, in exchange for his Target stock (2*x* dollar basis), a liquidating distribution of 29*x* dollars. Acquirer continued to operate the business formerly conducted by Target, in addition to its own existing business. The transfer by Target of its operating assets to Acquirer will be regarded as the acquisition by Acquirer of substantially all the properties of Target. Therefore, it is held that the transaction is a reorganization as defined in section 368(a)(1)(D) of the Code. *B* will be treated as receiving Acquirer stock in exchange for his stock of Target plus a cash distribution of 29*x* dollars. The $27 gain realized by *B* on the exchange is recognized under section 356(a)(1) of the Code to the extent of the cash received (also $27), and is treated as a $27 dividend (as defined in section 316 of the Code) under section 356(a)(2) of the Code, to the extent of the combined earnings and profits of Target and Acquirer.

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As often happens, however, taxpayers found ways to use Rev. Rul. 70-240 and similar case law to their advantage, principally in the foreign arena because a sale of assets by a foreign corporation might not be taxed in the foreign jurisdiction, and particularly when their realized stock exchange gain was little or nothing (as contrasted with the substantial gain in Example 1), as illustrated by these facts based on (but not identical to) LTR 9802030.

Example 2: B owned all of the stock of Target, basis of $100 and value of $100, and of Acquirer, both foreign corporations with substantial earnings and profits. Target sold all of its assets, basis of $10, to Acquirer for $100 and liquidated, distributing the $100 cash received from Acquirer to *B*. Despite the lack of stock consideration paid by Acquirer to Target, the transaction is treated as a Type D reorganization, so section 356 applies to *B*'s receipt of the $100 boot. Because *B* did not realize any gain on exchanging the $100 basis Target stock for $100 cash, *B* will not report any of the $100 as either dividend or gain, and will not reduce or increase its basis in its Acquirer stock (section 358); thus there is not even a theoretically deferred gain in the stock of Acquirer (whose value is unchanged) resulting from the untaxed transaction, although Acquirer will have increased earnings and profits (section 381). If, instead, Acquirer had paid a $100 dividend to *B*, *B* would have included it in ordinary income and would not have reduced its basis in Acquirer stock. And, of course, Target did not recognize the $90 gain in its assets. Therefore the cash owned by Acquirer has been moved onshore to *B*, without tax.

Partial Consideration/No Consideration

Taxpayers often ask: "Can't Target just transfer its assets to Acquirer for nothing and liquidate?" It turns out that the new regulations thought of that, and assume that whole shares of Acquirer, not a nominal share, are deemed issued in such a case. The basis of such shares, like the basis of the nominal share, will be the basis of the shareholder's stock in Target, reduced by the boot received. Where, as in Example 2, the basis is equal to the value, the boot will eliminate the basis and there will be none to transfer to other stock held in Acquirer. However, if there was a loss in the Target stock, and the Target shareholder also owns stock of Acquirer, then the stock actually owned and the stock deemed owned will be deemed recapitalized and the aggregate basis redistributed among the shares actually owned.

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