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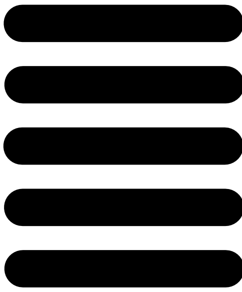

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When Stock Issuances Are Meaningless

By Patrick Hoehne • Wood & Porter • San Francisco

If one shareholder owns 100 percent of the stock of two corporations, and one of those corporations purchases assets from the other corporation in exchange for stock (and control), does the shareholder's ownership change? Clearly, the shareholder owns 100 percent of the two corporations before and after. The structure of the corporations may change, because one corporation has more assets than it did, and one corporation has control of the other corporation, but the shareholder's ownership interest remains unchanged. The transaction is meaningless as to the shareholder's interest.

What are the tax implications where one corporation distributes assets to the other, but no stock is issued or distributed? Just as in the previous example, the shareholder's ownership remains unaffected since he owns 100 percent of the corporations before and after. In fact, the IRS issued temporary and proposed regulations on December 19, 2006, that allow transactions to qualify as D reorganizations even though no stock and/or securities of the acquiring corporation are issued and distributed, as long as the same shareholder owns all of the stock (directly or indirectly) of the acquiring and distributing corporation. [Temporary Reg. §1.368-2T.] That means the transaction between the shareholder's two corporations qualifies as a tax-free reorganization even though the transaction does not necessarily meet the literal requirements of the Internal Revenue Code.

D Is for Distribution

Code Sec. 368(a)(1)(D) describes as a reorganization a transfer by a corporation (transferor corporation) of all or a part of its assets to another corporation (transferee corporation) if, immediately after the transfer, the transferor corporation or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the transferee corporation;

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but only if stock or securities of the controlled corporation are distributed in pursuance of a plan of reorganization in a transaction that qualifies under Code Sec. 354, 355 or 356.

Although Code Sec. 368(a)(1)(D) explicitly states that stock or securities must be distributed in a transaction to qualify as a tax-free reorganization, the IRS and the courts have not required the actual issuance and distribution of stock and/or securities of the transferee corporation in circumstances where the same person or persons own all the stock of the transferor corporation and the transferee corporation. In fact, the IRS and the courts have viewed an issuance of stock in such a case to be a "meaningless gesture" not mandated by Code Secs. 368(a)(1)(D) and 354(b).

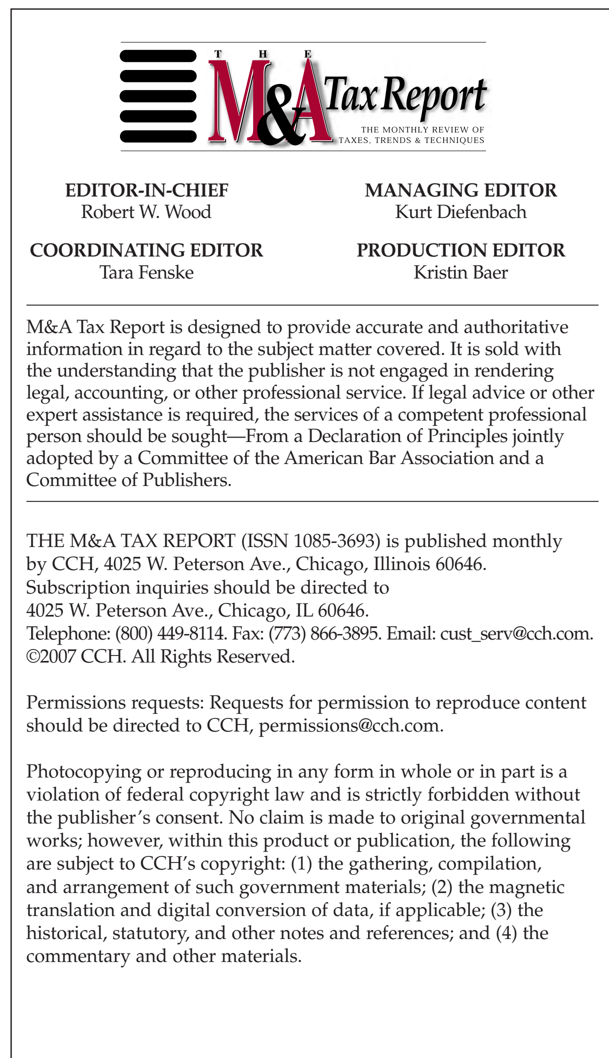
Not Your Father's Meaninglessness

There's some history to the meaningless gesture doctrine. For example, in Rev. Rul. 70-240, 1970-1 CB 81, B owned all of the stock of both corporation X and corporation Y. X sold its operating assets to Y for $34x dollars, representing the fair market value of X's assets. X had $33x of other assets, consisting generally of cash, accounts receivables and investments in stocks and bonds, so that the assets sold by X to Y constituted approximately 51 percent of X's total assets.

Following the sale to Y, X paid its debts, which amounted to $38x, and then liquidated, distributing $29x to B, while Y continued to conduct the business formerly operated by X. The IRS concluded that "although no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all the stock of Y." Accordingly, the IRS ruled that the sale of the operating assets by X to Y, followed by the liquidation and distribution of X's assets to B, was a good D reorganization, despite the absence of an actual issuance and distribution of Y stock. The actual issuance and distribution of Y stock was meaningless.

This meaningless gesture doctrine has generally applied only when there is identical shareholder identity and proportionality of interest in the transferor corporation and the transferee corporation. For example, in *Warsaw Photographic Associates, Inc.*, 84 TC 21, Dec. 41,822 (1985), there was no issuance of stock by the transferee corporation to the transferor corporation, and the stock ownership in the two corporations was not identical. The Tax Court concluded that the stock distribution would not be a mere formality and refused to apply the meaningless gesture doctrine. Accordingly, the transaction failed to qualify as a D reorganization.

In cases where the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions, Temporary Reg. §1.368-2T provides that the distribution requirement will be treated as satisfied even though no stock is actually issued in the transaction. To determine whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, the temporary regulations provide that an individual and all members of his family (spouse, children, grandchildren and parents) are treated as one individual.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Wiggle Room

De minimis variations in ownership, however, are OK. The temporary regulations also provide that the distribution requirement will be treated as satisfied in the absence of any issuance of stock and/or securities where there is a *de minimis* variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations. For example, if Parent owns all of the stock of both S1 and S2, and if S1 owns all of the stock of S3 and S2 owns all of the stock of S4, then an asset transfer from S3 to S4 for all cash followed by dissolution of S3 will qualify as a D reorganization.

The IRS and the Treasury generally follow the plain meaning of the Code and the regulations to assess whether a transaction qualifies as a tax-free reorganization. But, that's not always true. Here, the IRS and the Treasury have disregarded the plain meaning of the statute to conclude that subscribing to the literal meaning of the regulations would be meaningless in the context of a D reorganization involving two corporations wholly owned by a single shareholder.