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The M&A Tax Report

JUNE 2012 VOLUME 20, NUMBER 11

The Monthly Review of Taxes, Trends & Techniques

Debt Pushdowns in Overlapping Transactions: Part I

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When Code Sec. 304 applies to the sale of stock of corporations under common control, it creates a tax fiction—a deemed redemption that is subject to Code Sec. 302. If the deemed redemption fails to satisfy the requirements for exchange treatment, the stock sale is recharacterized as a distribution. Code Sec. 304 was originally passed as a backstop to Code Sec. 302. It was intended to prevent shareholders of corporations under common control from bailing out earnings through sales of stock of controlled corporations.

Unfortunately, Code Sec. 304 is a notoriously complex code section. What's more, Code Sec. 304 transactions sometimes overlap with Code Sec. 351 transactions and acquisitive "D" reorganizations under Code Sec. 368(a)(1)(D). This article compares the effects of falling into one or the other of these three code sections in an acquisition when Acquirer assumes a liability of the transferor. In Part II of the article, I will discuss a recent letter ruling addressing the allocation of assumed liabilities in an overlapping Code Sec. 304/351 transaction.

Primer on Code Sec. 304

When it applies to the sale of stock of a controlled corporation, Code Sec. 304 treats the receipt of property from Acquirer as a deemed redemption. Code Sec. 304 applies in two different contexts:

1. A brother-sister transaction when a shareholder or group of shareholders control both Acquirer and Target.
2. The parent-subsidiary context when the parent controls a subsidiary and the subsidiary acquires parent stock.

This article focuses on the brother-sister transaction. If the deemed redemption is not treated as an exchange under Code Sec. 302, tested by reference to Target stock, the transaction is recast as (1) a fictional Code Sec. 351 contribution of Target stock to the Acquirer

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in exchange for deemed Acquirer stock, followed by (2) a redemption of this fictional Acquirer stock. The deemed redemption will be treated as a distribution. And the deemed distribution will be treated as a dividend, first to the extent of the earnings and profits of Acquirer and second to the extent of the earnings and profits of Target.

Example 1. Shareholder P owns all T stock with basis of $70 and T has $5 of E&P. P also owns all A stock, with a basis of $20. A has $50 in E&P. A purchases all of P's T stock for $100.

Result. Under Code Sec. 304, the purchase is treated as a Code Sec. 351 contribution of the T shares to A in exchange for fictional A stock, followed by a redemption of the fictional A stock. Under Code Sec. 302, the deemed redemption will be treated as a distribution. Under Code Sec. 301(c)(1), the distribution will be treated as a dividend of $55 (A's E&P and then T's E&P), and a $45 return of basis under Code Sec. 301(c)(2). P's basis in A stock will be increased from $20 to $45. [*See* Reg. §1.304-2(a).]

The M&A Tax Report
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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Code Sec. 304 and Code Sec. 351 Overlap

When a shareholder controls Acquiring and Target both for purposes of Code Sec. 351 (80 percent of vote and value) and Code Sec. 304 (50 percent of vote or value), and Acquiring assumes a shareholder liability, the assumption of the liability will be subject to both Code Sec. 304 and Code Sec. 351. If the assumption of the liability were treated as part of the Code Sec. 351 transaction, the debt assumption would be entirely tax-free under Code Sec. 357(a), unless the assumed liability exceeded the transferor's basis in Target stock.

However, if the transaction were to fall under Code Sec. 304, the debt assumption would be recast as a distribution.

Example 2. Shareholder P owns all T stock with basis of $70 and T has $5 of E&P. P also owns all A stock, with a basis of $20. A has $50 of E&P. P borrows $90 and pledges T stock. P contributes T stock to A, and A assumes P's liability of $90.

Result. Under Code Sec. 351, P would have $20 of capital gain under Code Sec. 357(c), because the assumed liability exceeds P's basis in T stock. Under Code Sec. 304, P would have $55 of dividend income and a $35 return of basis. P's basis in A stock would increase to $55.

History Lesson

Before the 304/351 overlap was addressed by Code Sec. 304(b)(3) in 1982, courts were split over which should take priority. Not surprisingly, the IRS took the position that Code Sec. 304 should prevail. [*See* Rev. Rul. 73-2, 1973-1 CB 171, declared obsolete by Rev. Rul. 95-71, 1995-2 CB 323.] If Code Sec. 351 took precedence, taxpayers could circumvent Code Sec. 304 and bail out earnings by borrowing against their controlled corporation stock and then contributing the stock to another controlled corporation, which would assume the debt.

In 1982, Congress gave priority to Code Sec. 304 over Code Sec. 351. Under Code Sec. 304(b)(3)(A), when a shareholder transfers stock of controlled Target to controlled Acquiring and Acquiring assumes a shareholder liability, the shareholder will be treated as receiving "property" from Acquiring in exchange for Target stock. However, Congress also created an exception to the overlap: Under Code Sec. 304(b)(3)(B), Code Sec. 304 will not apply to the assumption of a liability if the liability "was incurred by the transferor to acquire the stock."

According to the legislative history of the Code Sec. 304(b)(3)(B) exception, Code Sec. 304 will not apply to acquisition debt. After all, "assumption of such debt is an alternative to a debt-financed direct acquisition by the acquiring company." [P.L. 97-248, Conference Committee Report, 97 H. Rpt. 760 (1982).] Congress intended the acquisition debt exception to be available regardless of whether there was a plan to transfer the liability at the time the liability was incurred.

Congress explained that Code Secs. 357 and 358 would apply to an assumption of acquisition indebtedness by an acquiring corporation, except for Code Sec. 357(b). In exempting these transactions from Code Sec. 357(b), Congress apparently believed that there would always be a business purpose to transferring acquisition indebtedness in a Code Sec. 304(b)(3)(B) transaction.

Before the acquisition debt exception was passed in 1982, the IRS ruled in favor of a similar result in narrower circumstances. In Rev. Rul. 80-240, 1980-2, CB 116, individual A incurred a liability to purchase all of the stock of corporation X. The amount of the liability was equal to 90 percent of the fair market value of the stock of X.

As part of a pre-arranged plan, A then transferred the newly acquired stock of X to newly formed corporation Y in a Code Sec. 351 transaction, and Y assumed A's liability. The IRS ruled that the transaction would not be subject to Code Sec. 304, because A was acting as a mere agent that was never the beneficial owner of the stock and had never incurred the liability. Because A had never incurred the liability, there was no assumption of a liability for US federal income tax purposes.

Therefore, neither Code Sec. 304(a)(1) nor Code Sec. 357(a) had any application to the transaction. While this revenue ruling reached the same result as in Code Sec. 304(b)(3)(B), it depended on the existence of a pre-arranged plan by A to transfer the newly acquired stock and the liability.

Pushdown of Acquisition Debt Does Not Produce Income

According to the Conference Committee Report, the justification for the acquisition debt exception was that the controlling shareholder could have structured the acquisition as a direct debt-financed acquisition of Target stock by Acquirer, instead of as a debt-financed acquisition of Target stock followed by a Code Sec. 351 contribution of Target stock and debt pushdown. Of course, many transactions *could have been* structured differently. But Congress does not generally pass new laws giving taxpayers the more desired tax treatment after the fact.

For example, in Example 2 above, P would have a deemed dividend of $55 (A's E&P and then T's E&P) and a return of basis to the extent of $35. Compare that result to Example 3.

Example 3. Shareholder P owns all T stock with basis of $70 and fair market value of $100. T has E&P of $5. P also owns all A stock, with a basis of $20. A has $50 in E&P. In Year 1, P contributes T stock to Newco, a newly formed corporation, in a Code Sec. 351 transaction. Newco has no assets except for T stock and T does not make any distribution to Newco. Newco borrows $90 against its T stock and distributes $90 to P. In Year 2, P contributes Newco to A. A then liquidates Newco and assumes the Newco liability of $90.

Result. Assuming the step transaction doctrine does not apply to integrate the distribution by Newco in Year 1 with the contribution of Newco stock to A in Year 2, P will have a $70 return of basis under Code Sec. 301(c)(2) and capital gain of $20 under Code Sec. 301(c)(3) in Year 1. The Year 2 contribution is treated as a tax-free Code Sec. 351 transaction followed by a tax-free liquidation (or as an integrated D reorganization).

In Example 3, the beginning and end result is exactly the same as in Example 2. However, assuming the form of Example 3 is respected, P has capital gain of $20 instead of dividend income of $55. Therefore, it is difficult to see the possibility of reaching a better tax result through a different structure as a compelling justification for the acquisition debt exception.

If the possibility of structuring an acquisition debt pushdown as a direct debt-financed acquisition is not a compelling justification for the acquisition debt exception, then what is the justification? The exception is probably best viewed as a concession to a harsh result for taxpayers that want to structure a pushdown of acquisition debt.

Part II of this article will appear in the July 2012 issue of THE M&A TAX REPORT.