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F Reorganizations: "Tax Nothings" in a Bubble

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To a tax person, the term "reorganization" has a special meaning. The definitions in Code Sec. 368 can get tricky, especially when there's a subsidiary involved. But defining an F reorganization is simplicity itself: "a mere change in identity, form, or place of organization of one corporation, however effected." [Code Sec. 368(a)(1)(F).]

The original definition was even simpler—Congress did not think it necessary to say "of one corporation" until 1982. The ancestor of today's F reorganization was introduced way back in 1924. For decades, it was generally understood that the statute was talking about a *single* corporation changing its identity, form or place of organization.

Inevitably, however, aggressive tax planners started to treat the lack of an explicit limitation to one corporation as license to merge multiple affiliated corporations. In fact, in one case, the tax plan was to merge 123 of them and to report the whole thing as a mere change of form under Code Sec. 368(a)(1)(F). [*See Home Construction Corp. of America*, CA-5, 71-1 USTC ¶9267, 439 F2d 1165.] The courts did not want to draw the line, so Congress amended the statute in 1982 to make clear that an F reorganization must involve only a single corporation.

Stakes Under Code Sec. 381(b)

Keep in mind, there was nothing to prevent 123 corporations, affiliated or not, from merging or otherwise combining their assets in a tax-free reorganization under Code Sec. 368(a)(1)(A) or (C). There still isn't. So why were those tax planners of yore pushing to get their transactions into Code Sec. 368(a)(1)(F)?

The goal was to circumvent two inconvenient restrictions on carry-overs in asset acquisitions. Code Sec. 381(b)(1) closes the tax year of the acquired corporation (the transferor). Sticking the transferor with a short tax year can reduce the value of the transferor's NOLs, to which the acquiring corporation (the transferee) succeeds under Code Sec. 381(c).

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Then, there's Code Sec. 381(b)(3). This blocks the acquiring corporation from carrying back its post-acquisition losses to offset income and gain reported in the transferor's pre-acquisition tax years.

F reorganizations, however, are exempt from these limitations. So when carryovers were an issue, tax planners were eager to drop the "F" bomb to combine affiliated corporations. But that game ended in 1982.

A Reorganization About Nothing

Why are F reorganizations exempted from Code Sec. 381(b) in the first place? The answer is implicit in the concept of an F reorganization as a mere change in identity, form or place of incorporation of one corporation (a "Mere Change").

In legal form, of course, a transaction that implements a Mere Change will typically involve *two* corporations, each a distinct legal person under nontax law. Whether effected by bill of sale or by operation of law (merger), the movement of assets from one corporation to another is a disposition of property. *Prima facie*, we expect the transferor to realize and recognize gain under Code Sec. 1001.

The premise in an F reorganization, however, is that the substantive effects of the inter-corporate transfer are so modest that we should view the formally distinct transferor and transferee as simply two phases or aspects the *same* corporation. Stepping back from the form and concentrating on the substance, we see the "acquired" corporation transferring assets *to itself*.

A taxpayer's transfer of property to itself is not a disposition of ownership, and it does not result in realization of gain or loss under Code Sec. 1001. [*Cf. J. Dobson*, 1 BTA 1082 (1924) ("since one cannot sell things to himself, the sale was nugatory").] From a tax perspective, the purported transfer is a nonevent—a transactional "tax nothing."

A transaction between a taxpayer and his single-member LLC provides a familiar analogue. If the LLC is disregarded as an entity separate from the taxpayer, the taxpayer is actually dealing with himself. The transaction is a nullity for tax purposes.

The term "tax nothing" is generally applied to disregarded *entities.* But the idea is equally applicable to disregarded *transactions*. In a Mere Change, neither the transferor nor the transferee corporation is disregarded in favor of the other. Instead, they are recognized as two aspects of the same corporation.

The bottom line, however, is the same. The two corporations are only formally distinct, so the purported transaction between them is a "nothing" for tax purposes. There is no real disposition of property in a Mere Change, so there is no realization of gain to attract tax.

The reorganization provisions date from an era long before the proliferation of disregarded entities and disregarded transactions. So they take a less direct approach. The transfer of assets between the two corporate shells is taken at face value, which means that gain and loss are technically realized in an F reorganization. But the transfer is then run through the nonrecognition and basis-preservation rules of Code Secs. 354–362.

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This deprives the transfer of any substantive effect, as if the transaction had simply been disregarded. Viewing the two corporations as identical also explains why F reorganizations are exempt from the limitations of Code Sec. 381(b). Despite the formal transfer from transferor to transferee, the "one corporation" that undergoes the Mere Change *doesn't do anything* for tax purposes.

The corporation is just sitting there. Hence, there is no reason to terminate its tax year or to limit its ability to carry back its future losses. Consistently with this, Code Sec. 381(b) does not apply to an F reorganization.

Defining "Mere Change"

Historically, tax professionals have been confident that they know what constitutes a change in a corporation's identity, form or place of organization. But there has been uncertainty about what counts as a "mere" change. If a corporation changes its identity, form or place of organization, what *other* changes (if any) may occur, either before, during or after the change? At what point does the change stop qualifying as a Mere Change?

Six Requirements

On September 21, 2015, the Treasury and the IRS issued final regulations adding new Reg. §1.368-2(m) ("Qualification as a reorganization under section 368(a)(1)(F)"). [T.D. 9739, IRB 2015-41, 528.] The 2015 regulations set out six basic requirements.

The first four were part of proposed regulations that date back to 2004. Their thrust is to ensure that the transferee corporation will be what the preamble calls the "functional equivalent" of the transferor corporation. The fifth and sixth requirements were added in 2015 to address an unusual scenario devised by a commenter.

Shareholders Before and After

The first two requirements focus on whether the transferor and transferee corporations have essentially the same stockholders. Under Reg. §1.368-2(m)(1)(i), all of the stock issued by the transferee (which the regulations call the "resulting corporation") must be distributed in exchange for stock of the transferor. There is a *de minimis* exception for directors' qualifying shares and stock issued to non-shareholders to meet legal requirements.

The second requirement, set forth in Reg. §1.368-2(m)(1)(ii), demands that the same person or persons to own all the stock of the transferor and the resulting corporation. What's more, they must do so "in identical proportions." That sounds like strong stuff. [*Cf.* Rev. Rul. 66-284, 1966-2 CB 115 (approving public company's reincorporation in a new jurisdiction as an F reorganization where *less than one percent* of shareholders dissented and were cashed out).]

But the regulation turns out to me much less stringent. First, the shareholders are permitted to exchange their shares of the transferor for a different class of shares of the resulting corporation. They just need to receive equivalent value. So, combining an asset transfer with an equity recapitalization should not prevent the transaction from qualifying as a Mere Change.

Second, the regulations permit the existing shareholders to redeem some or all their stock for cash or property, provided that at least one shareholder hangs on. This is striking because redemptions can transform the composition of a corporation's shareholder body almost beyond recognition.

However, the change is all in one direction—a reduction in the interests of *existing* shareholders. The introduction of *new* shareholders is still prohibited, except for the *de minimis* exceptions mentioned above.

To account for these rather liberal exceptions, the preamble to the 2015 regulations observes that some courts have held that even a significant redemption is consistent with an F reorganization. [*See Reef Corp.*, CA-5, 66-2 USTC ¶9716, 368 F2d 125 (approving transaction in which 48 percent of stock was redeemed).] The preamble also refers to the IRS's prior rulings, which have permitted an F reorganization to be combined with a recapitalization. [*See* Rev. Rul. 2003-48, 2003-1 CB 863.]

The preamble to the 2015 regulations also contends that permitting redemptions and recapitalizations is the right thing to do. After all, it says, "one corporation could effect the transaction without undergoing an F reorganization." True enough.

But if that is the principle, why is there a strict prohibition against introducing new shareholders? A corporation can certainly issue stock to a new shareholder without undergoing an F reorganization. The Treasury's justification is something of a puzzle.

Assets Before and After

The regulations' third requirement is that the resulting corporation must not hold any property or have any tax attributes immediately *before* the transaction. [Reg. §1.368-2(m)(1)(iii).] The transferee is supposed to start as an empty corporate shell with no tax history. There are limited exceptions for assets required to facilitate the organization of the transferee and for pre-transaction borrowings in connection with the F reorganization.

The fourth requirement is that the transferor must completely liquidate. This means "liquidate" in the tax sense—the transferor need not formally dissolve and it can even retain a *de minimis* quantity of assets to preserve its legal existence. [Reg. §1.368-2(m)(1)(iv).]

The third and fourth requirements accomplish two purposes. First, they ensure that everything that the resulting corporation has when the transaction is complete will be traceable to the transferor. Second, they ensure that the transferor will not hold back any significant assets and will terminate for tax purposes.

Notably, this still leaves room for almost unlimited "leakage" of corporate assets out to the existing shareholders. Even so, the regulations accept this as consistent with a Mere Change.

Preventing Overlapping Successors

The fifth and sixth requirements address an unusual scenario described in a comment on the 2004 proposed regulations. Suppose that Parent owns all the stock of Sub-1. Sub-1 operates two separate business, which are worth $297 and $3, respectively. Parent organizes new Sub-2 and causes Sub-1 to merge into it. This should qualify as an F reorganization, with Sub-2 as the transferee succeeding to Sub-1's tax attributes pursuant to Code Sec. 381(a)(2).

But suppose that, as part of the transaction, Parent *also* receives the business worth $297. Reg. §1.368-2(m)(1)(ii) permits almost unlimited redemptions. Thus, the fact that Parent ends up with 99 percent of Sub-1's assets will not prevent Sub-2's acquisition of what's left of Sub-1 from qualifying as an F reorganization.

However, because 99 percent of Sub-1's historic business assets are distributed to Parent for its stock of Sub-1, the transaction might *also* qualify as a liquidation of Sub-1. Parent controls Sub-1, so the liquidation would be governed by Code Sec. 332. Under Code Sec. 381(a)(1), Sub-1's tax attributes would pass to Parent.

This means that *both* Parent and Sub-2 would have a statutory claim to be the successor to Sub-1. This overlap, the preamble observes, would create "unintended complexities."

Reg. §1.368-2(m)(1)(v) avoids these complexities by providing that a transaction does not qualify as a Mere Change if any *other* corporation (in this example, Parent) receives property of the transferor such that it would succeed to the transferor's tax attributes under Code Sec. 381. Reg. §1.368-2(m)(1)(vi) provides a similar rule directed at situations in which the resulting corporation might be viewed as a successor following the combination of the transferor with another corporation.

"However Effected"

Code Sec. 368(a)(1)(F)'s commitment to substance over form is clearly reflected in its declaration that it applies to a Mere Change "however effected." The regulations spell this out, observing: (1) that a *series* of transactions extending over time can still add up to a Mere Change; and (2) that it is irrelevant that certain steps in the series, viewed in isolation, would be subject to other provisions of Subchapter C. This includes Code Sec. 331, which ordinarily requires shareholders to recognize gain in a corporate liquidation. [Reg. §1.368-2(m)(3)(i).] But "however effected" means, well, *however* effected.

Reorganization in a Bubble

F reorganizations are often undertaken to pave the way for other transactions. A corporation may, for example, change its place of organization to Delaware to take advantage of some feature of Delaware corporate law that will facilitate a reorganization under some other provision of Code Sec. 368(a)(1).

Historically, tax practitioners have worried that an intended F reorganization might be treated as a transitory step in a larger transaction that effects more than a Mere Change. The 2015 regulations, however, largely eliminate this concern.

Under Reg. §1.368-2(m)(3)(ii), transactions that precede or follow a potential F reorganization generally will *not* cause it to fail to qualify under Code Sec. 368(a)(1)(F), even if the transactions are related to the intended F reorganization. This user-friendly suspension of the step-transaction doctrine is sometimes called the "reorganization in a bubble" principle. The preamble justifies it with the observation that "F reorganizations involve only one corporation and do not resemble sales of assets."

Besides protecting intended F reorganizations, the reorganization-in-a-bubble principle ensures that qualification of a transaction under Code Sec. 368(a)(1)(F) will not alter the character of *other* transactions in the vicinity. [Reg. §1.368-2(m)(3)(ii).] Interestingly, the step-transaction doctrine continues to apply to the other transactions, and it may take account of steps that are included in an F reorganization. The "bubble," it turns out, is at least semi-permeable.

Conclusion

There is, of course, more to say about F reorganizations. But even this brief account reveals that transactions implementing a Mere Change can be surprisingly flexible, particularly in their treatment of existing shareholders. And by embracing the "bubble" principle, the 2015 regulations allow tax planners to deploy F reorganizations with confidence that the transactions will do no more—and no less—than intended.