St. John's Law Review

Volume 44, Spring 1970, Special Edition Article 80

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Recommended Citation

Wintrub, Warren G.; Graichen, Raymond E.; and Keidan, Harry W. (1970) "Tax Aspects of Corporate Acquisitions," *St. John's Law Review*: Vol. 44 : No. 5 , Article 80.
Available at: https://scholarship.law.stjohns.edu/lawreview/vol44/iss5/80

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TAX ASPECTS OF CORPORATE ACQUISITIONS

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Tax considerations are of critical importance in the structure of a merger agreement. Maximization of after-tax benefits requires careful preliminary analysis and planning. This article will explore many of the tax considerations which should be taken into account in the negotiating process. If each party is sufficiently aware of the various tax limitations and available opportunities, the parties will have a greater chance of fulfilling their objectives.

NON-TAXABLE TRANSACTIONS

Generally, the Internal Revenue Code provides that transferors of appreciated property incur a taxable gain on the sale or exchange of property where the consideration received exceeds the tax basis of the property surrendered. Exceptions are made for sellers of corporate assets or stock where the exchange is made for stock of the acquiring corporation and the transaction qualifies as a corporate "reorganization." In this event, some or all of the gain will not be presently taxable to either the selling corporation or its shareholders.[1] The recognition of gain (or loss) will be postponed until the stock of the acquiring corporation received by the sellers is ultimately disposed of in a taxable transaction.

There are three non-taxable routes by which one corporation may acquire the ownership of the assets and business of another unrelated corporation:

(1) The selling corporation is acquired by means of a statutory merger with the acquiring corporation.[2]

(2) The purchasing or acquiring corporation issues voting stock in exchange for the outstanding stock of the selling corporation ("stock-for-stock").[3]

(3) The purchasing or acquiring corporation issues voting stock in exchange for the assets of the selling corporation ("stock-for-assets").[4]

The underlying theory for non-recognition in each instance relates to the fact that the described exchanges merely effect a continuing interest in property under a modified corporate form.[5] Therefore, continuity of in-

* Lybrand, Ross Brothers & Montgomery.

1 I.R.C. §§ 354, 361, 368.

2 *Id.* § 368(a)(1)(A).

3 *Id.* § 368(a)(1)(B).

4 *Id.* § 368(a)(1)(C).

5 Treas. Reg. § 1.368-1(b) (1955).

terest in the assets of the selling corporation on the part of its shareholders through stock ownership in the acquiring corporation is an essential requirement in each.

STATUTORY MERGER

A statutory merger is the combination of two or more corporations into one in strict compliance with the merger or consolidation provisions of the particular corporate statutes which govern the transaction.[6] The transaction may take the form of a combination of two or more existing corporations into a newly-formed corporation or the absorption of one corporation into another existing corporation. The outstanding characteristic of a statutory merger is a greater degree of flexibility in the choice of the consideration to be paid or property to be acquired than is permissible under the rather strict requirements of the stock-for-stock or stock-for-assets acquisition. The acquiring corporation may issue nonvoting common or nonvoting preferred stock as well as voting stock (or any combination thereof) in the transaction.

In addition to its stock, the acquiring corporation may pay, as part of the consideration, a substantial amount of cash or other property to the acquired corporation. In order to be consistent with the underlying policy of nonrecognition accorded to "mere corporate readjustments," the Treasury Regulations require that the owners of the absorbed concern retain a continuing interest in its assets through the receipt of a significant equity interest in the acquiring or surviving corporation.[7] No minimum percentage of continued stock interest is required by the Code or Regulations.

For the purpose of advanced rulings, the stockholders of the absorbed corporation, in the aggregate, must receive a stock interest in the surviving corporation equal in value to at least 50 percent of the value of the total stock interest in the disappearing corporation.[8] Where none of the shareholders of the selling corporation dissent from the merger and all of its assets are acquired, if the acquiring or surviving corporation issues shares of its stock equal in value to at least 50 percent of the total consideration to be paid, it may use cash, debentures or other property, or any combination thereof, as the remainder of the consideration. It should be noted that if the smaller of the two corporate parties has a desirable attribute, such as a listing on a national stock exchange, the transaction may be arranged so that the smaller corporation is the survivor.

ACQUISITION OF STOCK IN EXCHANGE FOR VOTING STOCK

Generally, this is considered to be the simplest type of acquisition. The participating stockholders of the selling corporation merely exchange their

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6 I.R.C. § 368(a)(1)(A); Treas. Reg. § 1.368-2(b) (1955).

7 *See* Treas. Reg. 1.368-1(b) (1955).

8 Rev. Proc. 34, 1966-1 CUM. BULL. § 3.02, at 1233.

stock for voting stock (common or preferred, or any combination thereof) of the purchasing corporation or of its parent company. However, a combination of stock of both the acquiring corporation and its parent may not be used; all of the shares issued must either be stock of the acquiring corporation or stock of its parent corporation.[9]

Immediately after the transaction, if it is to qualify as non-taxable, the acquiring corporation must own (i) at least 80 percent of the total combined voting power of all classes of outstanding stock of the acquired corporation entitled to vote, and (ii) at least 80 percent of the outstanding shares of each class of nonvoting stock.[10] Outstanding preferred as well as common stock must be taken into account. Thus, in the case of a selling corporation with only one class of stock outstanding, a purchasing corporation owning none of the selling corporation's stock prior to the exchange must acquire at least 80 percent in the exchange. Should the purchasing corporation own 50 percent, then an additional 30 percent would have to be acquired. If 80 percent was already owned, then all or any part of the remaining 20 percent may be acquired.

No gain or loss is recognized by the shareholders of the selling corporation upon the transfer of their stock in exchange for stock of the acquiring corporation or its parent in a transaction which meets the stock-for-stock requirements.[11] Where shares are received in the future in a contingent price transaction, imputed interest is applicable and some portion of the shares received will be taxed as interest income.[12]

The tax basis to be assigned to the shares of stock of the acquiring corporation received without recognition of gain (*i.e.*, other than the shares treated as inputed interest) will be the same as the tax basis of the shares of stock of the selling corporation given in the exchange.[13] Therefore, the gain inherent in the transaction, measured by the difference between the value of the stock of the acquiring corporation received and the tax basis of the stock of the selling corporation surrendered, will be postponed until the ultimate disposition of the stock of the acquiring corporation in a taxable transaction. Under present law, the gain or loss may never be taxed if the recipient of such stock makes no disposition during his lifetime. At the date of the shareholder's death, the stock receives a new tax basis determined with respect to its fair market value on that date.[14]

The holding period of the stock of the acquiring corporation received by a shareholder of the selling corporation will include the period during which the shares surrendered were held.[15] As a result, some of the shares of

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[9] *Cf.* Treas. Reg. § 1.368-2(d)(1).
[10] Rev. Rul. 259, 1959-1 CUM. BULL. 115-16.
[11] I.R.C. § 354.
[12] Treas. Reg. § 1.483-1(b)(6) (example 7) (1966).
[13] I.R.C. § 358.
[14] *Id.* § 1014.
[15] *Id.* § 1223(1).

the acquiring corporation received in the transaction can be sold immediately to third parties at long-term capital gain rates.

Meaning of "Solely Voting Stock"

Because of the requirement that the exchange involve solely voting stock of the acquiring company or its parent, cash and other forms of consideration may not be used. Where cash or other forms of consideration are employed, the nontaxability of the exchange may be completely destroyed, making the exchange wholly taxable to each of the selling corporation's stockholders (even as to those who received solely stock in the exchange).[16]

The payment of cash by the acquiring corporation to the shareholders of the acquired corporation as consideration for their shares will disqualify the non-taxable status of the transaction. Accordingly, it is imperative that the acquiring corporation make no payments in cash for items such as the reorganization expenses of the shareholders of the acquiring corporation, since such payments may well be construed as indirect consideration for the stock. On the other hand, the payment of cash by the acquiring corporation for items which are clearly separable from the stock of the acquired corporation, such as payments made to shareholders of the acquired corporation under bona fide employment contracts entered into concurrently with the acquisition, should have no adverse effect on the non-taxable status of the transaction.

The requirement that the acquiring corporation issue *solely* voting stock in the exchange has received a strict construction by the courts.[17] Stock rights and stock warrants are not considered "stock," and, if issued by the acquiring corporation for the stock-acquired corporation, would upset an otherwise tax-free exchange.[18]

As to the requirement that the stock issued by the acquiring corporation be "voting stock," it is not necessary that the voting power per share of the stock issued be equal to that of other classes of stock. For example, if an acquiring company has outstanding a single class of common stock with a market value of $10, it might issue shares of $100 par value voting preferred. Assuming each share has one vote, and the market value of the preferred equals par value, a share of preferred would have only one-tenth the voting power of a share of common.

The important point is that each share issued must have present voting power although diluted when compared to the voting power of other classes. If the stock issued carries only contingent voting rights, as in the case of nonvoting preferred which acquires voting status upon the non-payment

16 *See, e.g.*, Turnbow v. Commissioner, 368 U.S. 337 (1961), *affirming* 286 F.2d 669 (9th Cir. 1960).

17 *See, e.g.*, Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

18 *Cf.* Treas. Reg. § 1.354-1(e) (1955); *see also* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

of dividends, the tax-free aspect of the stock-for-stock exchange will be destroyed.

Step Transactions

The solely-for-voting stock requirement cannot be obviated by what appear to be separate transactions which are linked together as steps of a single plan. For example, if a corporation acquires 30 percent of the second corporation's stock for cash, and soon afterward acquires the remaining shares solely in exchange for voting stock of the first corporation, it is likely that both acquisitions will be construed as parts of a single transaction. Since cash has been used to acquire a portion of the stock, the transaction will not satisfy the solely-for-voting stock requirement. On the other hand, if it is clear that the subsequent acquisition for voting stock is not part of the same plan as the earlier cash acquisition, the subsequent acquisition can be viewed separately to determine whether it qualifies for non-taxable treatment.[19]

The step transaction doctrine is also invoked to determine whether the acquiring corporation is in control of the acquired corporation "immediately after the acquisition." This occurs where the acquiring corporation issues solely voting stock in a series of exchanges for stock of the acquired corporation. The earlier exchanges will qualify for nonrecognition treatment, even though the acquiring corporation does not thereby attain control of the acquired corporation, where the earlier exchanges are in pursuance of the same plan as the later exchange by which control is achieved. The Treasury Regulations permit all such exchanges in a series of transactions to qualify for nonrecognition treatment where the exchanges occur over a relatively short period of time.[20]

The step transaction doctrine may also be invoked where, in pursuance of a plan, one corporation acquires all of the outstanding stock of a second corporation and then causes the acquired corporation to be liquidated. In that event, the transaction may be viewed as the direct acquisition of the assets of the acquired corporation.[21] In order to qualify for nonrecognition treatment, this transaction would have to satisfy the requirements of a stock-for-assets type acquisition.

Continuity of Interest

The shareholders of a selling corporation will not lose any continuity of equity interest in a stock-for-stock acquisition since the only consideration is voting stock. However, redemptions of stock of the selling corporation prior to the transaction and sales of stock of the acquiring corporation received by the shareholders of the selling corporation after the transaction

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[19] *See* Treas. Reg. § 1.368-2(c) (1955).

[20] *Id.*

[21] Rev. Rul. 274, 1967-1 CUM. BULL. 141-42.

may be considered in determining whether the shareholders of the selling corporation had a sufficient continuing equity interest to justify the nonrecognition treatment. For advance ruling purposes, the shareholders of the selling corporation could plan to sell up to 50 percent of the stock of the acquiring corporation on the open market immediately after the transaction, provided it is clear that no further dispositions are planned for the foreseeable future.[22]

Exchange of Voting Stock for Assets

Where the acquisition is not consummated pursuant to applicable state or federal merger laws, the selling corporation must transfer substantially all of its assets to the acquiring corporation in exchange solely for voting stock of the acquiring corporation or its parent corporation.[23] Liabilities of the acquired corporation which are assumed by the acquiring corporation are disregarded in determining whether the assets are acquired solely for voting stock.[24]

There is one limited exception to the solely-for-voting stock requirement in a stock-for-assets reorganization. If the transaction otherwise qualifies, the acquiring corporation may give consideration other than voting stock if it acquires, solely for voting stock, property of the selling corporation having a fair market value which is at least 80 percent of the fair market value of the seller's gross assets.[25] This exception applies only if all assets are acquired. However, for purposes of this exception, all liabilities assumed by the acquiring corporation will be treated as the equivalent of cash payment. Thus, the cash or other property paid, plus the amount of liabilities assumed by the acquiring corporation, cannot in the aggregate exceed 20 percent of the fair market value of the gross assets of the selling corporation.

The latter exception is rarely used inasmuch as the amount of liabilities of most commercial corporations will usually exceed 20 percent of the fair market value of gross assets. Accordingly, with respect to the solely-for-voting stock requirement of a stock-for-assets acquisition, the basic nontaxable status of the transaction will be destroyed if either (a) the amount of liabilities assumed equals or exceeds 20 percent of the fair market value of the gross assets of the selling corporation and the acquiring corporation pays any consideration other than solely voting stock, or (b) the amount of liabilities assumed does not exceed 20 percent of the value of the gross assets, but the sum of such liabilities and the cash or other consideration paid is greater than 20 percent of the value of the gross assets of the selling corporation.

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22 Rev. Proc. 34, *supra* note 8.
23 I.R.C. § 368(a)(1)(C).
24 *Id.*
25 *Id.* § 368(a)(2)(B) (no reference to the 80 percent though).

Except for purposes of the limited 20 percent exception to the solely-for-voting stock requirement, the assumption of liabilities of the selling corporation by the acquiring corporation is generally disregarded as consideration paid in the transaction. There is no limitation on the amount of liabilities that may be assumed in relation to the value of the assets acquired. However, it is possible that the transaction will fail to qualify under the non-taxable provisions if the excess of the value of the assets transferred is so insignificant that only a de minimis amount of stock of the acquiring corporation is issued.[26] The character of the transaction might then be viewed as more in the nature of an acquisition of assets in exchange for the mere assumption of liabilities rather than a true "reorganization."

The assumption of liabilities — the character and amount of which are fixed and determined as part of the transaction — will not be disregarded under the general rule as consideration paid in addition to voting stock.[27] Therefore, the assumption of an obligation to make payments to equity holders of the selling corporation who dissent from the proposed plan will disqualify the transaction from nontaxability where other liabilities equal or exceed 20 percent of the value of the gross assets of the selling corporation. Similarly, for advance ruling purposes, the Service is likely to treat the assumption by the acquiring corporation of the selling corporation's expenses incurred in connection with the transaction, such as legal and accounting fees, as consideration paid in addition to voting stock. Court decisions do not necessarily concur.[28]

Substantially All of the Properties of the Selling Corporation

Where the selling corporation retains a portion of its assets, a determination of whether substantially all of its properties have been transferred requires an examination of the nature of the properties retained by the transferor, the purpose of the retention and the amount thereof.[29] Thus, both qualitative and quantitative tests are imposed. Generally, the retention of cash, liquid assets or other non-operating assets by the selling corporation will satisfy the qualitative test where the retained assets are to be used to pay its liabilities or distributed in complete liquidation to the shareholders of the acquired corporation.[30]

For advance ruling purposes, the Service has set forth a two-part quantitative test which must be satisfied in addition to the qualitative test.[31] The assets transferred should constitute at least 70 percent of the fair market value of the gross assets and at least 90 percent of the fair market value

[26] *Cf.* Treas. Reg. § 1.368-2(d)(1) (1955).

[27] *See, e.g.,* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

[28] *See, e.g.,* Roosevelt Hotel Co., 13 T.C. 399 (1949).

[29] Rev. Rul. 518, 1957-2 CUM. BULL. 321-22.

[30] *Id. See also* Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937); James Armour, Inc., 43 T.C. 295 (1964).

[31] Rev. Proc. 34, 1966-1 CUM. BULL. § 3.01, at 1232-33.

of the net assets of the selling corporation immediately before the transaction. In other words, the selling corporation may retain assets representing up to 30 percent of the fair market value of its gross assets, but the value of the assets retained after reduction of liabilities retained cannot exceed 10 percent of the value of its net assets before the transaction. For this purpose, the amount of the assets retained is not reduced by those liabilities arising from the transaction such as obligations to dissenting shareholders and for legal and accounting fees.

TAXABLE TRANSACTIONS

Taxable transactions have the disadvantage of requiring an immediate payment of tax on gains. Because of the tax, the seller is immediately faced with a partial and often substantial dissipation of his proceeds. Where the corporate assets and business are sold, there is the possibility of a double tax on the gain, one tax to the corporation and a second to the stockholder, unless the transaction is properly arranged. Losses on stock are deductible, but usually only under the limitations of the capital loss provisions of the Internal Revenue Code.[32]

A taxable transaction usually contemplates a pay-out of cash funds or the use of convertible debentures or nonvoting stock. Although the purchaser may have to part with cash, the taxability of the transaction permits him to step-up the bases of low tax basis depreciable assets to the price paid. This is not possible in the case of a nontaxable transaction.

A taxable transaction may be disadvantageous to a purchasing corporation where the selling corporation has an unused net operating loss carry-over and a high depreciable tax basis which substantially exceeds the price to be paid for the selling corporation's business. In this situation, the purchasing corporation is not entitled to the unused loss carry-over or the high depreciable tax basis if it purchases assets rather than stock. Even if stock is purchased, the benefit of loss carry-over and high basis depreciable property may be denied if the acquired company is liquidated shortly after acquisition.[33] Similarly, even though the acquired company is kept alive as a subsidiary, its loss carry-over may be forfeited if the acquired business is not continued in substantially the same manner as before the transaction,[34] and if the company was acquired for the principal purpose of avoiding taxes.[35]

There are several possible methods to transfer ownership of corporate assets and business in a taxable transaction, each with potentially different tax consequences:

(1) Sale of stock of the selling corporation.

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32 *Cf.* I.R.C. § 1244.
33 *Id.* § 334(b)(2); *see also* Treas. Reg. § 1.381(a)-1(b)(i) (1960).
34 *Cf.* I.R.C. § 382(a).
35 *Id.* § 269(a)(1).

(2) Sale of assets of the selling corporation by its shareholders after liquidation of the corporation.
(3) Sale of assets by the selling corporation before liquidation.
(4) Sale of assets by the selling corporation without liquidation.

A brief general discussion of the tax consequences of each method follows. It should be noted that if the selling corporation is a "collapsible corporation," the general rules may not apply, or if they do, gains realized by the stockholders which would otherwise qualify as capital gain may be treated as ordinary income.

Sale of Stock of the Selling Corporation

The sale of stock is the simplest procedure for selling ownership of a corporate business in a taxable transaction. The selling stockholder is relieved of all contingencies attaching to the corporation (unless an idemnification warranty is given) and he does not bear the costs and expenses of liquidating the selling corporation. Assuming that the corporation was not a small business corporation which had elected to have its profits taxed to its shareholders, this method also avoids any possible recapture of depreciation or investment credit by the selling shareholder.

A purchasing corporation has the option of liquidating or continuing the acquired corporation. If the purchase price of the stock is substantially greater than the underlying tax basis of the assets in the corporation, and the purchase of stock constituting control (80 percent or more) occurred within a 12-month period, the acquiring corporation may cause the acquired corporation to adopt a plan of complete liquidation (at any time within two years after the stock purchase) and, as a result of the liquidation, obtain a stepped-up basis for the assets equal to the cost of the stock.[36] In that event, however, the purchasing corporation does not succeed to any unused net operating loss carry-over or any other tax attributes which may exist in the acquired corporation.[37]

A step-up in tax basis requires an actual liquidation of the acquired corporation. A liquidation cannot be accomplished by a downstream merger of the parent corporation into the newly acquired subsidiary. Moreover, if it is necessary that the business of the acquired corporation be continued in subsidiary form, extreme care should be taken in planning the form of the acquisition. For example, if the stock acquired by the parent corporation is transferred to another wholly-owned subsidiary of the parent as a contribution to its capital, there is doubt that the benefits of the stepped-up basis will be available upon the liquidation of the acquired corporation into such subsidiary.[38] Similarly, if the assets of the newly acquired cor-

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[36] *Id.* § 334(b)(2).
[37] *See id.* § 381; Treas. Reg. § 1.381(a)-1(b)(i) (1960).
[38] The contribution to capital will not technically qualify as an acquisition by purchase by the distributee of the subsequent liquidation. I.R.C. § 334(b)(3)(A-C).

poration are distributed in complete liquidation to the parent corporation which in turn immediately transfers such assets to another subsidiary corporation, the transaction could be viewed as a mere reorganization of the acquired corporation and not as its liquidation.[39] This potential problem can be avoided if a newly-formed or existing subsidiary of the parent corporation is the actual buyer of the stock of the acquired corporation.[40] The acquired corporation could then be liquidated into such subsidiary.

Where a purchase is followed by a plan of liquidation within two years, recapture of depreciation and investment credit occur with respect to the liquidating company.[41] Recapture may result in gain and tax even though there was no sale or similar disposition of any assets. Recapture in this instance represents an exception to the rule that a corporation generally has no recognized gain on a liquidating distribution of its assets.[42]

If the purchase price of the stock is substantially less than the total of the tax basis of the underlying assets and tax benefits which might accrue from an unused net operating loss carry-over and other tax attributes, the acquired corporation may be kept alive to utilize those benefits. But if the business of the acquired corporation is discontinued or otherwise substantially altered within the two taxable years following the change of ownership, or if the acquisition was made for the principal purpose of evading or avoiding tax, those benefits may be denied.[43]

After two years have elapsed, the acquired corporation can be liquidated without penalty. The tax basis of the assets of the acquired corporation, its unused loss carry-overs and all other underlying tax attributes should carry over intact to the purchasing corporation.[44] However, this will be the result only if the liquidation is not an integral part of a plan of tax avoidance existent at the date of purchase of the stock[45] and there has been no prior forfeiture of the tax attributes. No depreciation or investment credit recapture would result in such a liquidation. However, the plan of liquidation clearly must be adopted after the two-year holding period has expired — otherwise a step-down of basis and a forfeiture of other underlying tax attributes will occur.[46]

Sale of Assets by the Shareholders after Liquidation of the Corporation

Stockholders may liquidate their corporation before they sell its assets and business, and thereby avoid at least the tax at the corporate level. The liquidation gain generally represents capital gain except in the case of a collapsible corporation. The property, as a result of the liquidation, takes

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39 *See, e.g.*, Estate of James F. Suter, 29 T.C. 244 (1957).
40 Rev. Rul. 262, 1960-1 CUM. BULL. 114-15.
41 *See* I.R.C. §§ 47, 1245, 1250.
42 *See id.* § 336.
43 *Id.* §§ 269, 382(a).
44 *Id.* §§ 334(b)(1), 381(a).
45 John B. Stetson Co., 23 CCH Tax Ct. Mem. 876 (1964).
46 I.R.C. § 334(b)(2).

a stepped-up basis[47] and no gain or loss will ordinarily be realized upon its immediate sale. Such a liquidation is not necessary where one corporation owns 80 percent or more of the stock of another corporation since no gain or loss is recognized to the parent corporation upon the liquidation of the subsidiary,[48] and no double tax can result.

The liquidating company has no gain on the distribution of its assets in liquidation except with respect to installment obligations where gain has been deferred,[49] or where there has been depreciation and investment credit recapture.[50] The corporation may, however, realize unsuspected income in the year it liquidates if its regular method of accounting does not accurately reflect income in the final year, (*e.g.*, where a corporation on the completed contract method distributes uncompleted contracts, or where a distribution of a right may constitute a taxable anticipatory assignment of income).

Where a liquidation is effected in order that the stockholders rather than the corporation may sell the corporate property and business, care must be taken that the sale is not consummated prior to the liquidation. If the corporate officers have substantially consummated the sale, the gain may be taxed to the corporation despite the liquidation.[51] However, this can generally be avoided if the stockholders make it clear during negotiations that the corporation is not a party to the transaction and that the assets are to be sold by the shareholders after liquidation of the corporation.[52] Where there is any danger of taxation to the corporation, it is advisable to consider the applicability of the 12-month liquidation provisions.

Sale of Assets by Corporation before Liquidation

If a corporation adopts a plan of complete liquidation and thereafter completely liquidates within 12 months, no gain or loss will be recognized to it on the sale of certain of its assets after the date of adoption of the plan.[53] Thus, a 12-month liquidation which may eliminate double taxation may also eliminate the recognition of losses sustained by the corporation. In some instances, the courts have allowed the recognition of loss on a sale of the property prior to the adoption of the plan of complete liquidation.[54] If the loss property is sold before the adoption of the plan of liquidation, the liquidation should be completed within 12 months after the first sale of loss property. In that event, even if the loss is not recognized, the benefits of the 12-month provision will not be forfeited. Notwithstanding the non-

[47] *Id.* § 334(a).
[48] *Id.* § 332.
[49] *Id.* § 453(d).
[50] *See id.* §§ 47, 1245, 1250.
[51] *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
[52] *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).
[53] I.R.C. § 337.
[54] *See, e.g.*, City Bank, 38 T.C. 713 (1962); Virginia Ice and Freezing Corp., 30 T.C. 1251 (1958).

recognition provisions, the depreciation and investment credit recapture rules apply to the disposition of property in a 12-month liquidation.[55]

The 12-month liquidation provisions are not elective. They apply to any liquidation which is completed within 12 months of the adoption of the plan to liquidate. Accordingly, taxpayers may inadvertently fall under the nonrecognition provisions. To avoid such application once a plan of liquidation has been adopted, the liquidation of the corporation should be deferred by retaining a significant portion of the assets to be distributed until after the 12-month period has expired.

The property on which no gain or loss will be recognized is all corporate property other than (1) inventory or stock in trade (exclusive of inventory or stock in trade, substantially all of which is sold in one transaction to one purchaser during the 12-month liquidation period), (2) installment obligations acquired with respect to sale of inventory or stock in trade (exclusive of installment obligations acquired with respect to a bulk sale of inventory or stock in trade during the 12-month liquidation period), and (3) installment obligations acquired prior to the adoption of the plan of complete liquidation, in connection with the sale or exchange of property other than inventory or stock in trade.[56]

Sale of Assets by the Corporation Without Liquidation

When the selling corporation continues its existence it realizes a taxable gain or deductible loss, as the case may be, and the depreciation and investment credit recapture provisions are applicable. An instance in which the stockholders may wish to have their corporation sell its assets and continue in existence might occur where the corporation has a substantial loss carry-over. This loss carry-over might be used to offset gain from the sale of the assets, and also to offset future income from the reinvested proceeds of the asset sale. Where the corporation is continued, the personal holding company provisions of the Code may be applicable.[57]

OPEN-END TRANSACTIONS

In negotiating an equitable amount of stock of the acquiring corporation to be issued in exchange for stock of the selling corporation, the parties may in good faith be unable to agree upon a present value of either corporation. In such a case, the acquiring corporation may subsequently agree to issue additional shares based upon the occurrence or nonoccurrence of future contingencies related to the uncertainty. For example, the subsequent earnings or absence of additional liabilities of the acquired corporation may be used as an indicator of the present value of the acquired corporation. Similarly, the market value of the stock of the acquiring cor-

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55 *See* I.R.C. §§ 47, 1245, 1250.
56 *Id.* § 337(b).
57 *Id.* §§ 541-47.

poration at a future date may be used as an aid in determining the present value of the stock, even though the shares are listed and actively traded on a national exchange.[58]

The Service has announced that it will issue advance rulings with respect to the use of contingent shares in a reorganization where six requirements are met.[59]

(1) All of the shares to be issued must be issued within 5 years of the date of the initial distribution;
(2) A valid business reason must exist for not issuing all of the stock immediately;
(3) The maximum number of shares which may be issued must be stated;
(4) At least 50 percent of the maximum number of shares of each class of stock which could be issued must be issued initially;
(5) The contingent right to additional stock must not be assignable except by operation of law; or if assignable, the right must not be marketable or evidenced by a negotiable certificate of any kind; and,
(6) The right to additional stock must be only with respect to stock of the acquiring corporation or a corporation in control thereof.

The Service has also warned that every delayed stock issuance case will be examined carefully to insure that the delay is caused by bona fide business reasons (such as the inability to value the stock of either the acquiring or acquired corporation) and that the contingent shares are issued solely for the stock or assets of the acquired corporation and not in lieu of some other consideration such as compensation or royalties. Since the subsequent issuance of the contingent shares can be viewed as a deferred payment, the imputed interest rules may apply and require that a portion of such shares be treated as interest income to the recipient.[60] This result should in no way vitiate the otherwise nontaxable status of the transaction, and, in addition, the corporation issuing the contingent shares will be entitled to an imputed interest expense deduction.

Some of the disadvantages inherent in the use of contingent shares may be overcome if such shares are actually issued at the date of the transaction but placed in escrow subject to reverting back to the issuing corporation upon the occurrence or nonoccurrence of the same conditions which would have triggered the issuance of contingent shares. Provided the persons who would otherwise have been entitled to contingent shares are the beneficial owners of the shares while they are held in escrow, the shares will be treated as issued and outstanding as of the date of the trans-

[58] Rev. Rul. 112, 1966-1 CUM. BULL. 68-70. *See also* Rev. Rul. 90, 1967-1 CUM. BULL. 79-81.
[59] Rev. Proc. 34, *supra* note 8, as modified by Rev. Proc. 13, 1967-1 CUM. BULL. 590-91.
[60] Treas. Reg. § 1,483-(b)(6) (example 7) (1966).

action, and no imputed interest should attach to the shares when they are released from escrow.[61] In addition, this technique should overcome the sometimes difficult problem of complying with the guidelines for advance rulings applicable to the use of contingent shares.

Conclusion

Tax planning for corporate acquisitions involves a careful consideration of many alternatives and potential pitfalls. Both nontaxable and taxable transactions have certain advantages and disadvantages. In addition, the suitability of alternatives may be controlled by other objectives and business and financing considerations. Once the tax aspects of the transaction are understood, however, the parties are in an effective position to select the plan that would best achieve their desired goals.

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[61] *Id.* (example 8).