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Formation, Reorganization Liquidation of Insolvent Corporation

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We think we know them when we see them -- tax practitioners tend to assume that a transaction taking a particular form must be within the scope of the provision of the Internal Revenue Code ("IRC") that generally applies to such transactions. A liquidation of a subsidiary into another corporation that is the subsidiary's sole shareholder must be a nontaxable distribution under IRC section 332, for example; and a transfer of property to a corporation in exchange for stock, issued to transferors who own 80% or more of the stock of the corporation after the transfer, must be a nontaxable exchange under IRC section 351.

On further inquiry, however, circumstances may emerge that will cast doubt on whether a transaction will have the "normal" consequences. Such circumstances include situations where the target corporation is insolvent, or where the fair market value of the assets being transferred is exceeded by the amount of liabilities being assumed or taken subject to.

Certain liquidations, corporate formation transactions, and reorganizations are ordinarily nontaxable, in the sense that neither gain nor loss is recognized by a party disposing of stock or assets in such a transaction. The IRS has recently proposed regulations that address the consequences of a transfer of assets that, after taking into account obligations assumed or taken subject to, lack net value.

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Proposed Regulations

The proposed regulations also deal with the "mirror image" case, in which valuable assets are transferred to a corporation that lacks net value (i.e., is insolvent) immediately after the transfer.

In general, the regulations require that there be an exchange or distribution of net value in order for nonrecognition rules to apply. They also provide that, under certain circumstances, creditors of a corporation will be treated as proprietors for purposes of determining whether the continuity of interest requirement applicable to most types of nontaxable reorganizations is met. In addition, the regulations provide guidance as to whether a liquidation involving the distribution of property with respect to some classes of stock of a corporation, but with no distributions being made with respect to one or more other classes of the liquidating corporation's stock, may satisfy the requirements for a nontaxable liquidation under IRC section 332.

Liquidations. Under IRC section 332, no gain or loss will be recognized by a corporate shareholder upon the receipt of property distributed in complete liquidation of another corporation, if two basic requirements are met. One requirement is that the shareholder owns stock in the liquidating corporation meeting the requirements of Code section 1504(a)(2) – that is, in general, stock constituting at least 80% of the outstanding stock of the liquidating corporation by vote and by value, excluding certain nonvoting, nonconvertible, nonparticipating, "straight" preferred stock.

The second requirement is that distributions be made by the liquidating corporation "in complete cancellation or redemption of all of its stock," and be completed within specified periods. The quoted language has long been interpreted to require that, in order for section 332 to apply, *some* distribution of property be made with respect to stock. Thus, if a corporation is insolvent, such that all of its property is distributed to creditors and none remains for distribution with respect to its stock, section 332 will not apply. Under case law, it is also clear that section 332 will not apply if the only distribution made with respect to stock is made with respect to "straight" preferred stock that is not taken into account for purposes of the 80% stock ownership test.

It is not clear under current law, however, whether section 332 may apply where a corporation that has issued more than one class of stock taken into account for purposes of section 1504(a)(2), for example, a voting or participating preferred stock and common stock, makes liquidating distributions with respect to at least one, but not with respect to all, of such classes of stock. The proposed regulations provide that section 332 will apply only if the 80% shareholder receives some distribution with respect to each class of stock that the shareholder owns in the liquidating corporation (Proposed Reg. § 1.332-2(b)).

Thus, if the liquidating corporation does not make a distribution with respect to one or more of its classes of stock, the benefits of section 332 will not be available; but the holder or holders of the stock with respect to which no distribution was made -- or with respect to which a distribution less than the shareholder's basis is made -- may be able to claim a loss with respect to the shares of that class.

Corporate Formations. Section 351 provides, in general, that no gain or loss will be recognized where property is transferred to a corporation solely in exchange for stock and the transferors are in control (under an 80% stock ownership standard) of the corporation immediately after the exchange. The proposed regulations provide that stock will not be treated as issued in exchange for property, and therefore that section 351 will not apply, unless there is both a "surrender of net value" by the transferor and a "receipt of net value."

For there to be a "surrender of net value," the fair market value of the transferred property must exceed the sum of the liabilities assumed by the transferee in connection with the exchange and the amount of money and the value of any other property received by the transferor in connection with the transfer. There will be a "receipt of net value" under the proposed regulations if the fair market value of the assets of the transferee exceeds its liabilities immediately after the transfer.

An underlying premise of the "receipt of net value" requirement appears to be that, if the liabilities of the transferee are equal to or exceed the fair market value of its assets, the stock of the transferee is worthless and the transferee has not received any meaningful equity interest in the exchange. (A similar comment could be made with respect to the "surrender of net value" requirement.) In reality, however, the stock of a corporation with liabilities in excess of assets may have at least speculative value, because the assets of the company may increase in value and/or generate sufficient earnings from operations, or creditors may be induced to accept less than the full amount of their claims, to an extent sufficient to permit a surplus to be realized after the corporate obligations are satisfied.

Perhaps because of concerns regarding administrability, the proposed regulations do not appear to take into account the potential for such speculative value.

Reorganizations. The proposed regulations would make two principal changes in rules relating to nontaxable reorganizations under IRC section 368.

The first relates to the fundamental requirement of continuity of interest. Under longstanding case law as well as regulations, the continuity of interest requirement, as applicable to most forms of nontaxable reorganizations, requires that a substantial part of the value of the proprietary interest of the target corporation in the reorganization be preserved in the reorganization transaction, through, for example, the exchange of a "proprietary interest" in the target for a proprietary interest in the acquiring corporation. If the entire proprietary interest in the target is surrendered in exchange for cash, the transaction will not constitute a reorganization, even if "nonproprietary" interests in the target, such as senior creditors, receive stock in the acquiring corporation.

The existing regulations do not indicate whether, for these purposes, a proprietary interest in a corporation is limited to an interest as a stockholder or may sometimes include an interest as a creditor. Consistent with cases such as *Helvering v. Alabama Asphaltic Limestone Co.* (315 U.S. 179 (1942)), the proposed regulations state that a creditor's claim against a target may constitute a proprietary interest if the target is in bankruptcy proceedings under title 11 of the U.S. Code or if the target's liabilities exceed the fair market value of its assets immediately before the potential reorganization (Proposed Reg. §1.368-1(e)(6)).

In those circumstances, if a creditor receives a proprietary interest in the surviving corporation in exchange for its claim, that proprietary interest may be taken into account in determining whether the continuity of interest requirement is met. Thus, if, for example, the assets of target corporation T are acquired by another corporation ("P"), and the creditors of T receive, in exchange for their claims, shares of P stock (with or without cash or other property), the continuity of interest requirement for a reorganization may be satisfied even if nothing is received by the shareholders of T in exchange for their stock.

The regulations under IRC section 368 would also be amended to provide that, with respect to most, but not all, categories of nontaxable reorganizations, there must be an "exchange of net value." The stated purpose of the requirement of an exchange of net value is to prevent transactions that resemble sales, such as a transfer of assets in satisfaction of liabilities, from qualifying for the nonrecognition of gain or loss under the reorganization rules.

In general, there is an exchange of net value only if there is a surrender of net value and a receipt of net value along the lines previously described: that is, the fair market value of the property transferred by the target to the acquirer must exceed the sum of the liabilities assumed by the acquirer and the fair market value of any other property received by the target in connection with the exchange, and the fair market value of the assets of the issuing corporation must exceed its liabilities immediately after the exchange.

The exchange of net value requirement does not apply to a recapitalization within the scope of IRC section 368(a)(1)(E), or to a mere change in identity, form, or place of organization of one corporation under IRC section 368(a)(1)(F), because these kinds of nontaxable reorganizations are not akin to sales.

The regulations also provide that, consistent with cases such as *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964), the exchange of net value rule will not apply to certain reorganizations where the assets of a solvent target corporation are acquired by, for example, a corporation with a high degree of overlapping ownership in exchange for cash, with the transferor then distributing cash to its sole shareholder and dissolving. Such transactions have been held to be reorganizations, notwithstanding the failure to issue stock in the transferee corporation to the transferor, because the result is essentially the same as a transfer of property by the target to the acquirer in exchange for acquirer stock that is then distributed to the parent corporation in liquidation of the target, coupled with a distribution of cash by the acquiring corporation to the parent.

The proposed regulations do not define the term "liability" for purposes of these new rules, or provide significant guidance as to how to determine the amount of a liability. The preamble to the proposed regulations states that the Treasury is currently considering various approaches to the determination of the amount of a liability; discusses various alternative approaches; and requests comments regarding the treatment of nonrecourse liabilities in particular – e.g., as to whether nonrecourse debt should be disregarded for purposes of these insolvency rules to the extent the amount of the debt exceeds the value of the property secured by the debt.

The regulations are proposed to apply to transactions occurring after the date of publication as final regulations.

Observations. The proposed regulations appear to contain few (if any) surprises and to reflect a desire by the IRS to establish bright line tests consistent with the case law and prior rulings concerning liquidations and other transactions involving insolvent corporations. At a minimum, however, the regulations are a strong reminder of the impact that the absence of net value may have on the treatment of liquidations and other corporate transactions for tax purposes.