**Type “B” Reorganizations & the Solely for Voting Stock Requirement**

Code: IRC §§ 368(a)(1)(B), 358(b)(1), 362(b)

Regs: Treas. Reg. §§ 1.368-2(c); 1.358-6(a), (b), (c)(3) & (4) *Example* 3; 1.1032-2.

Bittker & Eustice: ¶¶ 12.43[3]; 12.23

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Rev. Rul. 66-365, 1966-2 CB 116

Advice has been requested whether the payment of cash by an acquiring corporation to the shareholders of the acquired corporation in lieu of issuing fractional shares to the shareholders who are entitled to receive fractional share interests violates the “solely for voting stock” requirement of section 368(a)(1) (B) and (C) of the Internal Revenue Code of 1954. Advice has also been requested concerning the tax treatment of cash received by shareholders in lieu of fractional shares in certain reorganizations defined in section 368(a)(1) of the Code.

In Mills, et al. v. Commissioner, 331 F. 2d 321 (1964), reversing 39 T.C. 393 (1962), the United States Court of Appeals for the Fifth Circuit held that the “solely for voting stock” requirement of section 368(a)(1)(B) of the Code was satisfied where the acquiring corporation received all of the stock of several corporations and distributed in return for such stock, shares of its voting common stock and a small amount of cash in lieu of fractional shares. After finding that the cash given in lieu of fractional shares was simply a mathematical rounding- off for the purpose of simplifying the corporate and accounting problems which would have been caused by the actual issuance of <Page 117> fractional shares, the Court concluded that the receipt of the stock of the acquired corporations was for all practical purposes “solely in exchange for voting stock”.

The Internal Revenue Service will follow the decision of the Court of Appeals in Mills, et al. v. Commissioner in similar factual situations. Accordingly, the “solely for voting stock” requirement of section 368(a)(1) (B) and (C) of the Code will not be violated where the cash paid by the acquiring corporation is in lieu of fractional share interests to which the shareholders are entitled, representing merely a mechanical rounding-off of the fractions in the exchange, and is not a separately bargained-for consideration. Where, however, the cash paid by the acquiring corporation is not in lieu of fractional share interests to which the shareholders are entitled or is a separately bargained-for consideration, the “solely for voting stock” requirement of section 368(a)(1) (B) and (C) of the Code will not be satisfied.

In a transaction qualifying as a reorganization under section 368(a)(1) (A) or (D) or (C) by reason of section 368(a)(2)(B) of the Code where the cash paid by the acquiring corporation represents a separately bargained-for consideration it will be treated as the receipt of “boot” under sections 361(b) and 356(a) of the Code. See Tenney Ross v. United States, 173 F. Supp. 793 (1959), in which the cash distributed to the shareholders of the acquired corporation pursuant to a reorganization under section 368(a)(1)(A) of the Code was held to be dividend boot under section 356(a)(2) of the Code where the cash paid did not result in a mere mechanical rounding-off of fractions but was a separately bargained-for consideration. See also Revenue Ruling 56-220, C.B. 1956-1, 191, which holds, in effect, that all of the cash paid to the shareholders of the acquired corporation was separately bargained-for consideration in the exchange. The Revenue Ruling states that the acquiring corporation did not desire to give the stockholders of the acquired corporation a large common stock ownership in itself.

In all reorganizations described in the preceding paragraphs where the cash payment made by the acquiring corporation is not bargained for, but is in lieu of fractional share interests to which the shareholders are entitled, such cash payment will be treated under section 302 of the Code as in redemption of the fractional share interests. Therefore, each shareholder's redemption will be treated as a distribution in full payment in exchange for his fractional share interest under section 302(a) of the Code provided the redemption is not essentially equivalent to a dividend. The Mills case is an example of the type of case in which capital gain or loss treatment will be accorded a redemption where cash is paid in lieu of fractional share interests. If the redemption is essentially equivalent to a dividend, it will be treated as a distribution under section 301 of the Code as provided in section 302(d) of the Code. All the facts and circumstances of each case will be considered in determining whether the cash distribution in lieu of the fractional shares is essentially equivalent to a dividend.

The foregoing principles are illustrated by the following example. If, in a reorganization described in section 368(a)(1)(A) of the Code, a shareholder receives stock worth $100 and cash boot of $20, the gain, if any, realized on the exchange, will be recognized under section 356 <Page 118> (a) of the Code but not in excess of $20. If the shareholder also receives $4 and it is not bargained for but is in lieu of a fractional share interest, the $4 will be considered as the proceeds from a redemption of the fractional share interest under section 302 of the Code.

If the cash payment made by the acquiring corporation is in lieu of fractional share interests of stock which in section 306 stock, such cash payment will be treated as a distribution in redemption to which section 301 applies unless it is established to the satisfaction of the Commissioner that the distribution of cash was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. See section 306(b)(4) of the Code.

Revenue Ruling 56-220, C.B. 1956-1, 191, is clarified to remove any implication that the cash paid by the acquiring corporation to the shareholders of the acquired corporation was in lieu of fractional shares, rather than bargained-for additional consideration.

Rev. Rul. 73-54, 1973-1 CB 187

Advice has been requested whether the payment or assumption by the acquiring corporation of valid reorganization expenses of the acquired corporation or its shareholders violates the “solely for voting stock” requirement of section 368(a)(1)(C) of the Internal Revenue Code of 1954.

Pursuant to a plan of reorganization, X corporation proposes to transfer substantially all of its properties to Y corporation in exchange for shares of voting stock of Y followed by the distribution of the Y stock to the shareholders of X in the dissolution of X. As part of the plan of reorganization Y agrees to pay or assume certain expenses. These expenses are legal and accounting expenses; appraisal fees; administrative costs of the acquired corporation directly related to the reorganization such as those incurred for printing, clerical work, telephone and telegraph; security underwriting and registration fees and expenses; transfer taxes, and transfer agents' fees and expenses. These expenses are solely and directly related to the reorganization.

In order to satisfy the definition of a reorganization under section 368(a)(1)(C) of the Code, the consideration to be transferred by the acquiring corporation must consist solely of all or a <Page 188> part of its voting stock (or voting stock of a corporation which is in control of it). Thus, an acquisition of property for all or a part of the acquiring corporation's voting stock and other property cannot qualify under section 368(a)(1)(C) unless section 368(a)(2)(B) applies. As the Supreme Court of the United States stated in Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942), Ct. D. 1544, 1942-1 C.B. 218 at 220:

" 'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement.”

In Southwest Consolidated Corp., the Court held that the “solely for voting stock” requirement is violated where the acquiring corporation directly or indirectly transfers to the acquired corporation or its shareholders property other than voting stock in exchange for the equity interest being acquired.

However, in several court decisions, payments by the acquiring corporation of expenses arising in a reorganization have been held not to represent additional consideration (see Claridge Apartments Co. v. Commissioner, 1 T.C. 163 (1942), acquiescence, 1943 C.B. 4, reversed on other issues 138 F.2d 962 (1943), reversed on other issues, 323 U.S. 141 (1944); Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872 (1943), acquiescence, 1943 C.B. 1; New Jersey Mortgage & Title Co. v. Commissioner, 3 T.C. 1277 (1944), acquiescence 1945 C.B. 5; Roosevelt Hotel Co. v. Commissioner, 13 T.C. 399 (1949), acquiescence 1950-1 C.B. 4).

Although the acquired corporation and its shareholders are relieved of the reorganization expenses otherwise attributable to them, nevertheless, they will be receiving solely voting stock of the acquiring corporation. They will receive no other consideration from the transferee in exchange for the transferor's property.

Accordingly, it is held that the payment or assumption by the acquiring corporation of the valid reorganization expenses in the instant case will not prevent the plan from satisfying the definition of a reorganization under the above provision of the Code. Pursuant to the provisions of section 361(a) and section 354(a)(1) of the Code no gain or loss will be recognized to the acquired corporation or its shareholders, respectively. The principles of this Revenue Ruling are equally applicable to such valid reorganization expenses that are paid or assumed by an acquiring corporation in a reorganization described in section 368(a)(1)(B) of the Code. Valid reorganization expenses which may be paid or assumed by an acquiring corporation without violating the solely for voting stock requirement of section 368(a)(1)(B) or (C) of the Code are not necessarily limited to those involved in the instant case.

Expenses that are not solely and directly related to the reorganization, the transfer of the property of the acquired corporation for stock of the acquiring corporation, or the exchange of the equity interests of the shareholders of the acquired corporation for stock of the acquiring corporation, are other property if paid or assumed by the acquiring corporation and will prevent the transaction from satisfying the solely for voting stock requirement of section 368(a)(1)(B) or (C) of the Code. Examples of such expenses are fees incurred for investment or estate planning advice and those incurred by an individual shareholder, or group of shareholders, for legal, accounting or investment advice or counsel pertaining to participation in, or action with respect to, the reorganization. In addition, where the obligation to pay an applicable state transfer tax is solely that of a shareholder, payment or assumption of such tax by the acquiring corporation will violate the solely for voting stock requirement of section 368(a)(1)(B) or (C) of the Code.

Further, this ruling is not applicable and the transaction will not qualify under section 368(a)(1)(B) or (C) of the Code to situations in which there is a transfer by the acquiring corporation of cash or property other than voting stock to the acquired corporation or its shareholders with the intention that the acquired corporation or its shareholders will pay expenses of the acquired corporation or its shareholders even though they are solely and directly related to the reorganization.

Rev. Rul. 75-123, 1975-1 CB 115

Advice has been requested whether there can be a reorganization under section 368(a)(1)(B) of the Internal Revenue Code 1954 under the following circumstances.

Corporation X desired to acquire all the stock of corporation Y. Pursuant to a plan, X acquired 80 percent of the only outstanding class of Y stock solely in exchange for X voting stock and purchased the remaining 20 percent for cash from the Y shareholders who did not exchange Y stock for X stock.

Section 368(a)(1)(B) of the Code defines as a reorganization the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation that is in control of the acquiring corporation), of stock or another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not the acquiring corporation had control immediately before the acquisition).

To qualify under section 368(a)(1)(B) of the Code as a reorganization, the consideration for whatever stock is acquired by the acquiring corporation must be solely its voting stock and nothing else. See Helvering v. Southwest Consolidated Corporation, 315 U.S. 194 (1942), 1942-1 C.B. 218; Rev. Rul. 66-365, 1966-2 C.B. 116, and Rev. Rul. 68- 285, 1968-1 C.B. 147, 149.

In the instant case, the cash purchases of stock, pursuant to the same plan in which Y stock was exchanged for X stock, constitute additional consideration for the Y stock. Therefore, the “solely for voting stock” requirement of section 368(a)(1)(B) of the Code is not satisfied even though an amount of stock constituting control of Y, as defined in section 368(c), was acquired solely in exchange for X voting stock. Accordingly, there is no reorganization for purposes of sections 368(a)(1)(B) and 354, and gain or loss is recognized by the shareholders of Y on the exchange of their Y stock for X stock, as well as on the sale of their Y stock for cash, under sections 1001 and 1002.

Rev. Rul. 85-139, 1985-2 CB 123

ISSUE

Whether the transaction described below qualifies as a reorganization under section 368(a)(1)(B) of the Internal Revenue Code.

FACTS

P corporation owned all the stock of S corporation. P desired to obtain control of X corporation by acquiring all the shares of the one outstanding class of stock of X solely in exchange for P voting stock. Certain shareholders of X, owning ten percent of its stock, insisted, however, on receiving cash for their stock. Since P wanted to eliminate any possible adverse minority interest in X, and pursuant to one overall plan to acquire the stock of X, P acquired ninety percent of the stock of X solely in exchange for P voting stock, and P caused S to purchase for cash the remaining ten percent of the X stock. The cash paid by S for X's stock was not obtained directly or indirectly from P. S retained ownership of the X stock it had purchased.

LAW AND ANALYSIS

Section 368(a)(1)(B) of the Code provides that the term “reorganization” means the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation, if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition).

Section 1.368-2(c) of the Income Tax Regulations illustrates the application of the “solely for voting stock” requirement under section 368(a)(1)(B) as follows:

If, for example, corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of corporation Y, the transaction is not a reorganization under section 368(a)(1)(B).

The “solely for voting stock” requirement applies to the entire transaction in which stock of a corporation is acquired, not just to the acquisition of a block of stock constituting control. Therefore, the acquisition by a corporation of eighty percent of the stock of a corporation in exchange for its voting stock and the remaining twenty percent in exchange for cash violates “solely for voting stock.” Rev. Rul. 75- 123, 1975-1 C.B. 115; Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), cert. dism. 451 U.S. 1012 (1981); Heverly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980,cert. dism. 451 U.S. 1012 (1981); Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960), aff'd on other issues, 368 U.S. 337 (1961).

Accordingly, if P had acquired all the stock of X in exchange for its voting stock and cash, the acquisition would not have qualified as a reorganization under section 368(a)(1)(B). P's structuring of the transaction to have its wholly owned subsidiary acquire some of the X stock for cash does not produce a different result. Compare Rev. Rul. 69-48, 1969- 1 C.B. 106, which holds that the purchase for cash by P of stock of corporation X as part of a plan for P's wholly-owned subsidiary, S, to acquire substantially all the assets of X for P voting stock, violates the “solely for voting stock” requirement of section 368(a)(1)(C).

HOLDING

The purchase by S of ten percent of X's stock for cash violates the “solely for voting stock” requirement of section 368(a)(1)(B) of the Code. Compare Rev. Rul. 85-138, wherein it was held that a similar transaction does not qualify as a reorganization under section 368(a)(1)(C).