St. John's Law Review

Volume 44
Number 5 *Volume 44, Spring 1970, Special Edition*

Article 82

December 2012

Acquiring the Closely-Held Corporation

Robert S. Taft

Follow this and additional works at: https://scholarship.law.stjohns.edu/lawreview

Recommended Citation
Taft, Robert S. (1970) "Acquiring the Closely-Held Corporation," *St. John's Law Review*: Vol. 44 : No. 5 , Article 82.
Available at: https://scholarship.law.stjohns.edu/lawreview/vol44/iss5/82

This Symposium is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact selbyc@stjohns.edu.

ACQUIRING THE CLOSELY-HELD CORPORATION

ROBERT S. TAFT*

There are numerous small, closely-held corporate businesses in America today which are considered "ripe for a takeover" by larger corporations. In this era of the conglomerate, the business "finders" have never been so busy. So too, the legal profession has had its own task to perform — to develop the best method of acquiring these small enterprises.

The typical situation might contain the following elements. Public corporation *P* is seeking to acquire closely-held company *T*. *P*'s stock is traded on a national exchange at a high multiple of earnings; *T* is owned and operated by one person, *S*, who operates the business with the assistance of a few valued employees and his son. *S* has no desire to sell his business and be taxed immediately on the proceeds thereof. In addition, he wants to be assured of continued employment for himself and his key assistants after the sale — at least for a period of several years. *P* is seeking to acquire *T* and its management and is looking forward to pooling the two businesses.

The initial problem to overcome is, perhaps, the easiest. The parties want the acquisition to be "tax free." *P* does not want to acquire *T* for cash and *S* does not want to pay taxes when he sells the business. Section 368 of the Internal Revenue Code of 1954 sets forth six methods of reorganization, described below, whereunder the exchange of stock or securities by shareholders or security holders may qualify for full or partial nonrecognition of gain (or loss) under sections 354, 355 or 356 of the Code, and the exchange of property between the corporations may qualify for nonrecognition of gain (or loss) under section 361 of the Code.

"A" Type Reorganization: statutory mergers or consolidations effected in accordance with the corporation laws of a state, territory, District of Columbia, or the United States, under whose laws the corporation was organized.[1]

"B" Type Reorganization: acquisition by one corporation of stock in another corporation in exchange solely for all or part of its voting stock, or in exchange solely for all or part of the voting stock of a corporation which has control of the acquiring corporation. The acquiring corporation must have attained 80 percent "control" of the acquired corporation immediately after the reorganization.[2]

"C" Type Reorganization: acquisition by one corporation of substantially all of the properties of another corporation, in exchange solely for all

---

* Member of the New York Bar. B.A., Dartmouth College, 1956; J.D., Columbia University, 1959; LL.M., New York Law School, 1960.

1 I.R.C. § 368(a)(1)(A).

2 *Id.* § 368(a)(1)(B).

or part of its voting stock or the voting stock of a corporation which controls the acquiring corporation.[3] If at least 80 percent of the fair market value of all of the property of the other corporation is acquired solely for voting stock, then the fact that the other 20 percent thereof is acquired for other than voting stock will not disqualify the reorganization.[4]

"D" Type Reorganization: a divisive reorganization whereby one corporation transfers all or part of its assets to another corporation controlled by one or more of its shareholders immediately subsequent to the transfer, and stock or securities of the acquiring corporation are distributed in a transaction which qualifies under sections 354, 355 or 356 of the Code.[5]

"E" Type Reorganization: recapitalization whereby the stock and other securities of the corporation are readjusted as to amount, income, or priority, or there is an arrangement among all the stockholders and creditors to change and increase or decrease the capitalization and/or debts of the corporation. This includes exchanges of stock for stock and bonds for bonds.[6]

"F" Type Reorganization: a change in identity, form or place of organization, however effected.[7]

There are certain basic requirements running through the methods of reorganization, such as continuity of interest, continuity of business enterprise, business purpose, and plan of reorganization. To the extent *P* and *T* comply, they have the means to accomplish their tax-free, non-cash reorganization. *P* will exchange some of its voting stock (usually non-registered) for either the stock or the assets of *T*.

ADVANTAGES OF "B" TYPE REORGANIZATION

Since *P* intends to pool the two businesses, it may well favor a stock-for-stock or "B" reorganization. A pooling of interests is an accounting concept whereby the assets of the acquired corporation are taken over by the acquiring corporation on its books at the same basis as on the books of the acquired corporation. Likewise, the earned surplus accounts of the two corporations are combined.[8]

Since the "B" reorganization is solely stock-for-stock, there can be no "boot"; the provisions of section 356 of the Code are therefore inapplicable. Section 355 of the Code, which covers divisive reorganizations, is similarly inapplicable. Section 354, on the other hand, applies, and states that no gain or loss is recognized if stock or securities of a corporation which is a party to

---

[3] *Id.* § 368(a)(1)(C).
[4] *Id.* § 368(a)(2)(B).
[5] *Id.* § 368(a)(1)(D).
[6] *Id.* § 368(a)(1)(E).
[7] *Id.* § 368(a)(1)(F).
[8] In the case of an acquisition involving contingent stock, the SEC will allow full pooling treatment provided not more than 25 percent of the initial shares that are issued are sold in the first year. In the second year, the 25 percent test is based on the relationship between the number of shares sold in that year and the total number of shares that are ultimately issued.

a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in the same corporation or in another corporation a party to the reorganization.[9] Under section 1032, the stock issued by the acquiring corporation in exchange for stock or assets of the acquired corporation results in no recognized loss or gain. The basis in the property transferred is a "substituted basis" to the acquiring corporation under section 362 of the Code. In other words, the basis of the property acquired is the same as it would be in the hands of its transferor. Similarly, under section 358, the basis of the stock or securities received in exchange for the property transferred is the same as the basis of the transferred property.

There are certain adjustments to basis both under sections 362 and 358 which do not apply to our "B" reorganization. The holding period for the stock or securities received for the property exchanged includes the period during which the taxpayer held the said property, if such property, at the time of the exchange, was either a capital asset or depreciable property used in the trade or business. There are also many ancillary tax considerations such as carry-overs, assumption of liabilities, receipt of boot, etc., but it is not the intent of this paper to deal with these areas.

Rather, we will return to *P*, *T* and *S*. It is agreed that *P* will acquire *T* in a "B" reorganization. The "B" structure requires solely voting stock of *P* for the stock of *T*. This is a requirement strictly construed.[10] "Voting stock" includes voting preferred shares as well as voting common. The right to vote must also be absolute rather than conditioned upon the occurrence of one or more future events. Accordingly, subscription rights and warrants to purchase voting stock do not qualify as voting stock.[11] As to the requirement of "solely," where the acquiring corporation pays cash in lieu of issuing fractional shares to shareholders of the acquired corporation as a mechanical rounding-off of the fractions in the exchange, and not as separately bargained for, it has been held that said requirement is not violated.[12]

If *T* has debt and *P* exchanges its own debt securities therefor as part of the "B" reorganization, that exchange is not tax exempt. Even if the principal of the debts is identical, if the holder has a basis in his *T* debt less than the value of the *P* debt received in exchange, he must recognize taxable gain.[13] If the *T* debt is convertible into *T* stock at the option of the holder, *P* can purchase the debt for cash without disturbing the reorganization provided the option has not been exercised.[14]

The problem of "solely" for voting stock also relates to the possible

[9] It may be noted that section 361 of the Code extends this nonrecognition to the corporation which transfers property in exchange for stock or securities in a reorganization.

[10] Turnbow v. Commissioner, 368 U.S. 337 (1961).

[11] Treas. Reg. § 1.354-1(e) (1955).

[12] Mills v. Commissioner, 331 F.2d 321 (5th Cir. 1964), *rev'g* 39 T.C. 393 (1962); Rev. Rul. 365, 1966-2 CUM. BULL. 116.

[13] Rev. Rul. 142, 1969 INT. REV. BULL. No. 13, at 8.

[14] Rev. Rul. 91, 1969 INT. REV. BULL. No. 9, at 12.

future registration of *P*'s shares under the Securities Act of 1933. Only cost properly attributable to *P* may be borne by *P*. Thus, *S* would be obliged to bear the underwriting discount and any transfer taxes attributable to his *P* shares, and perhaps the SEC filing fees with respect to said *P* shares.[15]

USE OF DEFERRED STOCK

In the situation under consideration, *T* is a closely-held corporation, the success of which has depended primarily on *S*. *P* cannot be certain that *T* will continue to flourish unless *S* continues to operate the business. In addition, *S* has built up in *T* a "hidden inventory" which could create problems. A straight exchange of stock for stock would be a very unsatisfactory solution to the acquisition from *P*'s point of view. *P* requires a flexible exchange which will afford it protection against adverse contingencies and afford *S* the opportunity to fully realize his expectations from *T*. The result is the use of "contingent" or "deferred" stock by *P*. This will satisfy *P* in that *S* will have to earn his *P* stock during a period of years after the reorganization. *S* is also protected in that if the long-term value of *P*'s stock declines, *S* will have a guaranty to receive additional shares based on *P*'s stock to earnings ratio, etc. Thus, deferred stock helps in settling the problem of the relative valuation of *P* and *T*.

There is very little case law on the use of deferred stock. The first time the Tax Court was faced with the problem was in 1945. In *McAbee v. Commissioner*,[16] the acquired corporation escrowed more than one-half of the shares received from the acquiring corporation for four years, to insure that all liabilities of said corporation would be satisfied. The shareholders were entitled to receive dividends on the escrowed shares during the escrow period and their rights to said shares were evidenced by assignable "Certificates of Beneficial Ownership." The Tax Court held that the reorganization was consummated in the year the assets were transferred and the stock was placed in escrow. The release of the stock from escrow and its delivery to the former shareholders of the acquired corporation was held to be a non-taxable transaction.

The next case of importance was *Carlberg v. United States*,[17] in which deferred stock was held back in a statutory merger and the shareholders of the acquired corporation received "Certificates of Contingent Interest." The ultimate number of shares to be issued depended upon the resolution of certain contingent liabilities relating to pending litigation and income tax problems. The Service ruled that the "Certificates of Contingent Interest" were property other than stock and constituted boot taxable as a dividend to the shareholders of the acquired corporation.[18] The ruling relied heavily

---

[15] Rev. Rul. 62-149, 1962-2 CUM. BULL. 66.

[16] 5 T.C. 1130 (1945), *acquiesced in*, 1946-2 CUM. BULL. 4.

[17] 281 F.2d 507 (8th Cir. 1960), *rev'g* 59-2 U.S. Tax Cas. ¶ 9724 (W.D. Mo. 1959).

[18] Rev. Rul. 586, 1957-2 CUM. BULL. 249.

on the fact that when the contingencies were resolved, the holders of the "Certificates of Contingent Interest" were to receive both stock and cash representing dividends paid during the escrow period. The district court agreed, but the Eighth Circuit reversed, holding that the "Certificates of Contingent Interest" were to be treated as stock, not boot.

This case was followed by *Hamrick v. Commissioner*,[19] which adopted the *Carlberg* rationale in holding that a contingent right to receive shares in return for transferred patent rights qualified as "stock" for purposes of section 351(a) of the Code. In that case, two inventors transferred their patent to a ready-formed corporation for stock and a contractual right to receive additional stock if the net earnings of the corporation exceeded a specific formula amount. Under the Tax Court ruling, neither the receipt of the contractual right in the year of the transfer nor the receipt of additional shares in subsequent years was taxable to either of the transferor inventors.

After *Hamrick*, it became apparent that the Internal Revenue Service had to take a position tending towards a limited acceptance of the use of deferred or contingent stock. Thus was born Revenue Procedure 66-34,[20] which was later amplified by Revenue Procedure 67-13.[21] Setting forth the ground rules for attaining a favorable ruling on a proposed reorganization involving deferred or contingent stock, the rulings basically stated that favorable rulings will be issued for "A," "B," and "C" reorganizations if six conditions are satisfied:

1. All of the stock will be issued within five years from the date of the transfer of assets in the case of reorganization under section 368(a)(1)(A) and 368(a)(1)(C) of the Code, or within five years from the date of the initial distribution in the case of reorganizations under section 368(a)(1)(B) of the Code;

2. There is a valid business reason for the use of deferred or contingent stock in the reorganization;

3. The maximum number of shares which may ultimately be issued is stated;

4. At least 50 percent of the maximum number of shares of each class of stock which may be issued is issued in the initial distribution;

5. The right to receive stock must be expressly made non-assignable, must not be readily marketable, and must not be evidenced by negotiable certificate of any kind;

6. The right may only give rise to the receipt of additional stock of the acquiring corporation or a corporation "in control" thereof, as the case may be.

The theory underlying these conditions is that when some stock must

---

[19] 43 T.C. 21 (1964), *acquiesced in result only*, 1966-1 CUM. BULL. 2, *remanded for decision per agreement of parties*, 17 Am. Fed. Tax R.2d ¶ 356 (1965).

[20] Rev. Proc. 34, 1966-2 CUM. BULL. 1232.

[21] Rev. Proc. 13, 1967-1 CUM. BULL. 590.

be withheld as a result of a valid business reason, such as the difficulty in determining the value of one or both of the corporations involved in the reorganization,[22] a five year period is sufficient to resolve all issues. Stating the maximum number of shares available will enable a determination of basis of shares received to be made, while the "50 percent" rule was established to prevent the use of deferred or contingent stock as disguised compensation.

The non-marketability rule is strictly enforced except that assignment by operation of law is permitted (by will, etc.). As to the "only additional stock" rule, delayed receipt of dividends with the additional stock will not satisfy the rule.

There is an ancillary problem to resolve in connection with the use of deferred or contingent stock. Section 483 of the Code provides that a portion of deferred payments received from the sale or exchange of property shall be treated as interest income, rather than as part of the sales price, thus causing interest income to seller and interest expense to purchaser. The regulations under section 483 require interest to be imputed on deferred delivery of stock pursuant to a reorganization, and treat the ultimate issuance of contingent stock as an "indefinite payment" for this purpose.[23] Therefore, absent any stated interest payment, a portion of the deferred issue of stock will be taxable as ordinary income. This fact will not disqualify an otherwise eligible "B" or "C" reorganization.[24] Of course, one cannot circumvent this rule by paying a stated interest for he would then run afoul of the "solely for voting stock" requirement of the "B" and "C" reorganization. However, if the interest payment is made by issuing shares in addition to the deferred distribution as otherwise computed, with the fair market value of the shares upon delivery equalling at least four percent per annum (presumably of the value of the deferred shares at the time of their delivery), the Internal Revenue Service will rule favorably on the reorganization and the inapplicability of section 483.[25] The "interest shares" should be excluded in computing the maximum number and the 50 percent thereof, to be consistent. It should be noted that utilization of an escrow arrangement renders section 483 inapplicable, thus avoiding the problem completely.[26] The holding period for shares received as stated or imputed interest would presumably begin on date of receipt, rather than as a carry-over holding period, as is applied to the deferred or contingent stock.

As mentioned above, there is a problem of basis with respect to the deferred or contingent stock. What happens if some shares are disposed of prior to the final distribution of deferred or contingent shares? The Internal Revenue Service has informally taken the view that basis in that situation

---

22 Rev. Rul. 67-90, 1967-1 CUM. BULL. 79.
23 Treas. Reg. §§ 1.483-1(b)(6), (e)(3) (1966).
24 Treas. Reg. § 1.483-2(a)(2) (1966).
25 Treas. Reg. § 1.483-1(d)(2) (1966).
26 Treas. Reg. § 1.483-1(b)(6) (1966).

ought to be allocated on the presumption that all of the deferred or contingent shares will ultimately be distributed. The courts have taken a different view. For example, in *Inaja Land Co., Ltd.*[27] the Tax Court held that where the basis of all of the taxpayer's interest in real property could not be apportioned with reasonable accuracy between property sold and property retained, no gain was recognized until the total basis for all the property had been recovered. This holding could lead to much tax avoidance and manipulation with deferred or contingent stock. As a result, it would seem imperative for the Internal Revenue Service to issue a definitive ruling as to the basis problem.

ADVANTAGES OF ESCROWED STOCK ARRANGEMENT

It was also mentioned above that an escrow arrangement offered certain advantages. Escrowed stock is considered as currently issued and owned by the shareholders of the acquired corporation, even though they may ultimately be returned in whole or in part to the acquiring company. Thus, dividends, whether held in escrow or paid out on a current basis, would be taxed to the shareholders of the acquired corporation.[28] It would then appear appropriate to allow as an offset against ordinary income any amount equivalent to previously taxed dividends which is returned to the acquiring corporation.[29]

Of the six conditions necessary to receive a favorable ruling for a deferred or contingent stock reorganization, it would seem that only the requirement of stating the maximum number of shares is appropriate to the escrow situation.

Where escrowed shares are later returned to the acquiring company, this may give rise to a taxable transaction for the shareholders of the acquired corporation. If the acquiring company pays a liability in behalf of the acquired corporation of $100 and receives back from escrow one share of its stock having a then fair market value of $100, but having had a fair market value of only $50 when placed in escrow, it would seem that the acquired company's shareholders had sustained a gain of $50 on the transaction. The answer to this is not clear.

If the return is not due to a specific liability of the acquired corporation (*i.e.*, the acquired corporation did not achieve a fixed earnings level), then the transfer back involves no tax.[30] I would be prone to argue that even if the return were triggered by payment of a fixed liability, this is merely an adjustment of the earlier exchange, which would require a reallocation of basis in the remaining shares and not the attribution of tax.

The Internal Revenue Service requires, as a prerequisite to issuing a

---

[27] 9 T.C. 727 (1947), *acquiesced in*, 1948-1 CUM. BULL. 2.

[28] Treas. Reg. § 1.483-1(b)(6) (example 8) (1966).

[29] *See* Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

[30] *See* Estate of McGlothlin v. Commissioner, 370 F.2d 729 (5th Cir. 1967), *aff'g* 44 T.C. 611 (1965).

favorable ruling, that voting rights attributable to all of the escrowed shares be passed on to the shareholders of the acquired company immediately. Therefore, *P* has two alternatives in acquiring *T* in a "B" reorganization. It can utilize an escrow arrangement or it can use deferred or contingent shares. But what would happen if *P* were then acquired by another corporation *P1*? *S* could immediately exchange issued and escrowed shares of *P* for shares of *P1* under section 354 of the Code. As for deferred or contingent shares, it would appear that *S* could also exchange his contingent contractual right to receive additional shares of *P* for a contingent contractual right to receive additional shares of *P1*, but this is not clear. Therefore, if such a secondary step is anticipated, the escrow arrangement is the better method to use.

An alternative which has been untested is the use of a convertible preferred stock of the acquiring company. Here the conversion right would provide a formula to cover the contingencies.

In any event, if the six conditions set forth in Revenue Procedure 66-34, as amplified by Revenue Procedure 67-13, are not satisfied, this does not necessarily mean that the reorganization is a taxable transaction. It merely means that the Internal Revenue Service will not rule favorably on the transaction in advance thereof. The reorganization may still be tax free, but the taxpayer must be prepared to prove it (by litigation or otherwise).

Example of Best Method of Acquiring Small Enterprise

So, we return to *P*, *T*, and *S*. *P* will acquire *T* in a "B" reorganization using contingent shares. It will set up a formula whereby it will exchange its voting shares for the stock of *T* in a ratio of a fixed multiple of earnings for the fiscal year ending in the year of the exchange. Then, as an incentive to *S* to remain with *T* and keep producing earnings, and as a means of bringing out hidden inventory, it will pay *S* an additional number of shares at the end of the four years subsequent to the exchange based on a multiple of the average increase in *T*'s earnings during the said four year period. As to the first payment of shares, *P* will guarantee a value, so that, if, at the time *S* is permitted to sell the shares, the total value thereof is greater than or less than the guaranteed value, an upward or downward adjustment would be made.

S, his son, and their key personnel would be given employment contracts and perhaps, at the end of the said four year earning period, *S* would have a consulting agreement for an additional number of years.

This concept can be demonstrated as follows: *T* has 1969 pre-tax earnings of $175,000. In 1970-1974, its pre-tax earnings are respectively $190,000, $200,000, $220,000, $190,000. The average pre-tax earnings during this period is $200,000, or an average increase of $25,000. If the formula is a ten times earnings, *S* would receive $1,750,000 in voting stock of *P* immediately (in 1969). In 1974, he would receive an additional $250,000 in *P* voting stock.

On the other hand, if the value of the *P* stock given to *S* in 1969 had

fallen to $1,250,000, *P* would be required to provide *S* with an additional $500,000 of its voting stock in 1972.[31]

This is an overly simplified example of how contingent stock is used in a tax-free acquisition of a closely-held corporation by a publicly-held corporation, but it does serve to demonstrate the ideal approach which satisfies all parties in that it eliminates contingent problems and better reflects the values of both corporations.

---

[31] *P* would be required to register the additional $500,000 of its voting stock if it were required to register the original shares.