

## Making M&A More Public Perspectives on tax disclosure rules applicable in January 2012



### Summary

On January 17, 2012, transitional relief to the reporting requirements of Section 6045B<sup>1</sup> will end and corporations will be required to report stock basis consequences that result from certain mergers & acquisitions (M&A) and restructuring transactions both to the Internal Revenue Service (IRS) and shareholders (“Issuer Reporting”).<sup>2</sup> This reporting is likely to cause public disclosure of key economic and tax terms of M&A transactions, which may come as a surprise to some private companies. Strategic buyers and private equity investors alike should be prepared to report transactions occurring in 2011 that are subject to Section 6045B. In addition, buyers must be conscious of Issuer Reporting considerations when conducting due diligence and when formulating overall M&A strategy.

### Background

Issuer Reporting under Section 6045B is the companion provision to the new broker reporting rules of Sections 6045(a) and (g), which require brokers to report the gross proceeds from the sale of certain securities, as well as the holders’ resulting tax bases in such securities.<sup>3</sup> Issuer Reporting is designed to supply brokers with the information necessary for them to determine the adjusted basis in a security. The reporting obligation is satisfied by furnishing an information return to the IRS and a written statement to affected shareholders. Subject to certain exceptions, Issuer Reporting is required whenever an entity taxed as a corporation for U.S. federal tax purposes (whether foreign or domestic) takes “organizational action” that affects the basis of its stock.

### What type of “organizational action” affects stock basis?

Considerable uncertainty exists regarding the types of transactions that trigger Issuer Reporting. While there is no statutory or regulatory definition, the legislative history and Treasury commentary refer to stock splits, mergers, and acquisitions as examples of such organizational actions. Through examples, treasury regulations also include in-kind stock distributions, but not cash dividends (i.e., dividends for tax purposes). (See special dividend rule discussion on page 5.)

<sup>1</sup> All references to “Section” refer to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> See Treas. Reg. § 1.6045B-1. Notice 2011-18, 2011-1 C.B. 549. Because January 15, 2012, is the Sunday before Martin Luther King Day, a federal holiday, the filing due date is January 17, 2012.

<sup>3</sup> For these purposes, a “security” includes any share of stock in a corporation (or other interest treated as stock for U.S. federal income tax purposes, such as an American Depository). See Treas. Reg. § 1.6045-1(a)(14).

As a general matter, tax-free transactions are most likely to affect stock basis and trigger Issuer Reporting. However, certain taxable transactions may trigger reporting as well. To determine whether a transaction affects stock basis, it may be helpful to classify a transaction either as a distribution or an exchange and/or sale.

Distributions are generally transfers of property by a corporation with respect to its equity (including “dividends” and “return of capital distributions”), and are typically unilateral corporate actions with existing shareholders. These include property distributions, stock distributions, and certain stock repurchases treated as distributions for tax purposes. Generally, tax-free distributions have the necessary effect on stock basis because they cause either a spreading of stock basis between outstanding shares and newly distributed shares or a concentration of stock basis among shares remaining after the organizational action. In contrast, the basis consequences from taxable distributions vary from cash dividends out of earnings and profits, which do not affect stock basis, to distributions that are a return of basis, which clearly affect stock basis.<sup>4</sup> While basis consequences of distributions made differ, they are commonly a result of organizational action.

Certain exchanges and sales arise out of organizational action. For instance, a corporation may be party to a bilateral or reciprocal transfer of equity interests with existing shareholders (or sometimes new shareholders). This includes stock contributions, stock reorganizations, asset acquisitions, and mergers.<sup>5</sup> Tax-free exchanges generally result in the transfer of historic basis from the relinquished stock to the replacement stock, with adjustments for any non-stock consideration (or “boot”) received and any gain recognized.<sup>6</sup> Tax-free exchanges arguably “affect” stock basis because they result in a transfer of historic basis to the replacement stock. However, in a single-entity transaction (i.e., an organizational action whose effect on stock basis is zero, such as an “F” reorganization), a case can be made that Issuer Reporting should not be triggered. Where an exchange also causes an adjustment to the historic stock basis, however, there is no question that the requisite effect is present.

Other exchanges may occur between unrelated parties (i.e., sales) with no corporate involvement. These transactions are not covered by the statute. However, similar “sales” that involve the corporation are arguably within the scope of the statute even though such sales can be viewed as having an effect on basis (in an attenuated sense) through the creation of initial stock basis. For example, the sale by a corporation of its stock results in the creation of initial basis in shares rather than adjusting basis in existing shares. Similarly, a corporation’s repurchase of its stock has no effect on any remaining shares held by the seller (unless the redemption is treated as a dividend for tax purposes).<sup>7</sup>

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## Issuer reporting may be an important consideration in an M&A transaction.

M&A transactions routinely involve distributions and exchanges. Pre-acquisition dividends, integrated redemption-sale mechanisms, and rollovers (taxable and tax-free) by management and employees are a few examples. This means that parties to a transaction may need to be cognizant of Issuer Reporting consequences when developing the acquisition structure and when conducting due diligence of the target’s historic transactions.

<sup>4</sup> A cash distribution only affects basis when it exceeds a corporation’s earnings and profits for tax purposes.

<sup>5</sup> Debt recapitalizations are similar to the treatment of sales transactions discussed below.

<sup>6</sup> It appears that the target of a stock or asset acquisition may be the “issuer” whose organizational action results in the exchange of shares, and thus, would be subject to Issuer Reporting. However, the acquiring corporation will be the one actually issuing stock and the acquiring corporation will likely have joint and several liability as noted below. So, as a practical matter, the burden will fall on the acquiring corporation.

<sup>7</sup> A related transaction is the repurchase (redemption) of outstanding shares from a shareholder that is treated as a “sale” by the shareholder for tax purposes under Section 302(b).

## Technical sidebar

A complicated technical analysis may be required to determine whether a distribution or exchange/sale transaction as part of an M&A transaction or restructuring has the requisite effect on stock basis. The following table identifies some common transactions by reference to applicable Internal Revenue Code sections with a perspective on their potential basis consequences.

	Likely affects basis	May not affect basis/uncertain
<b>Distribution</b>	Spin-off (§ 355) Share distribution (tax-free) (§ 305(a)) Return of basis distribution (§ 301(c)(2)) Extraordinary dividend (§ 1059(e)) Taxable deemed dividend (§ 305(c)) <sup>8</sup> Buyback—"dividend" equivalent (§§ 301/302(d))	Cash "dividend" (§ 301(c)(1)) Paid-in-kind "dividend" (§ 305(b))
<b>Exchange/sale</b>	Split-off/Split-up (§ 355) Asset reorganization (§ 368(a)(1)(A), (C), (D), (G)) <sup>9</sup> Stock reorganization (§ 368(a)(1)(B)) <sup>10</sup> Single entity reorganization (§§ 368(a)(1)(E), (F) and 1036) Contribution (§ 351) Related party "dividend" (§ 304)	Liquidation (§§ 331/332) Deemed liquidation (§ 338) Related party "capital" (§ 304) Initial Public Offering (§ 1031) Secondary offering (§1031) Third party sale (§ 1001) Buyback/capital redemption (§ 302(a)) Option exercise (§ 83)

## Corporations that undertook organizational actions during 2011 should be prepared to satisfy their Issuer Reporting obligations by January 17, 2012.

### IRS and shareholder disclosures under Section 6045B

Whenever an entity taxed as a corporation for federal tax purposes takes "organizational action" that affects the basis of its stock, the corporation must file an information return with the IRS (on Form 8937) within 45 days of the organizational action (or, if earlier, January 15 of the year following the calendar year). In lieu of filing with the IRS, a corporation may post the information return on its primary public website within the timeframe above. In addition, the corporation must furnish a written statement to all affected shareholders by January 15th or post Form 8937 on its website by such date. Information posted to the website must remain accessible for ten years.

The IRS has issued transitional relief while it finalizes Form 8937, which is expected to be released in final form shortly. For organizational action that occurs in 2011, a corporation will have until January 17, 2012, to file Form 8937 with the IRS or post such form on the corporation's website.<sup>11</sup> By that date, a corporation that has not posted Form 8937 on its website must furnish written statements to its shareholders. This means that corporations that are prepared to file Form 8937 and furnish shareholder statements by January 17, 2012, can avoid public disclosure of organizational action undertaken in 2011. While public companies may view the disclosure under Issuer Reporting as a slight inconvenience, portfolio companies and other closely held companies may find public disclosure highly objectionable.

<sup>8</sup> Assumes that the deemed shares are contributed to capital without the issuance of stock.

<sup>9</sup> Under Section 354, the exchange occurs between the target and its shareholders for tax purposes. Thus, Issuer Reporting is required for the target (or its successor), but secondary liability will exist for the acquiring entity.

<sup>10</sup> See *id.*

<sup>11</sup> Notice 2011-18, 2011-1 C.B. 549.

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Starting in 2012, a corporation generally has 45 days following an organizational action to file a return with the IRS or post the return on its website.

As a practical matter, year-end transactions are likely to result in public disclosure (via website posting) unless a corporation completes its tax analysis, prepares the shareholder statements, and furnishes such statements by January 17, 2012.

The normal filing requirements will apply to organizational action that occurs in 2012. Thus, a corporation should be prepared to file Form 8937 with the IRS (or post Form 8937 on its website) within 45 days of the organizational action and also furnish or post shareholders statements by January 15, 2013.

### Limited exceptions to issuer reporting

Issuer Reporting is not required if a corporation determines that all of its shareholders are corporations (foreign or domestic — but not S corporations), foreign persons, or tax-exempt organizations. Generally, the corporation must have actual knowledge of the shareholders' status or must obtain an exemption certificate from the holder. Significant diligence might need to be done to determine whether an exception to Issuer Reporting is available.

The practical import of this exception is that a transaction involving the upper-tier parent or holding company is not likely to qualify for this exception. On the other hand, internal restructurings involving wholly owned subsidiaries are less likely to trigger Issuer Reporting. However, a minority interest (such as an interest held by management or employees), no matter how small, will render the exception inapplicable.

### Information required to be disclosed

Existing tax regulations require a corporation to disclose substantial information regarding the nature of the organizational action and its effects on stock basis. In particular, a corporation must describe the type or nature of the organizational action along with details surrounding the timing of such action.

Further, a corporation must disclose the quantitative effect on the basis of each share held by a U.S. taxpayer as an adjustment per share or as a percentage of old basis. This basis information must be supported with a description of the calculation, the specific code provisions on which the treatment is based, the data supporting the calculation (e.g., market values), and any other information necessary to implement the adjustments (e.g., the reportable tax year and whether a loss may be recognized).

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Absent preparations prior to closing, year-end transactions are likely to make Issuer Reporting challenging.

Preparation of the disclosure may be a daunting task for a corporation that intends to file information returns within 45 days of an organizational action. To do so, it may be prudent to prepare draft disclosures when a transaction is executed to be certain that there will be adequate time to finalize the disclosure shortly after closing. In practice, Issuer Reporting may become a typical M&A work stream similar to information statements prepared in connection with a shareholder vote for golden parachute payments.

### Successor liability and penalties

Treasury regulations impose joint and several liability on acquiring and successor entities of a corporation that fails to satisfy Issuer Reporting obligations. No guidance is provided as to the meaning of the acquiring or successor entity for this purpose but the provision is expected to be applied broadly.

Failure to file penalties apply to both the information returns and the shareholder statements. Generally, there is a \$100 penalty per return (with a maximum calendar-year penalty of \$1.5 million) and a separate \$100 penalty per shareholder statement (\$1.5 million maximum per year). An agent may be used to satisfy the reporting requirements, but the corporation remains liable for any failure to comply unless it is shown that the failure is due to reasonable cause and not willful neglect.

In the context of an acquisition, it may be advisable for a buyer to perform due diligence on a target's Issuer Reporting profile.

## Conclusion

M&A transactions routinely involve organizational actions, and thus, parties to a transaction must be conscious of Issuer Reporting consequences when conducting due diligence and formulating M&A strategy. Corporations should be prepared to satisfy their reporting obligation for transactions occurring in 2011 by January 17, 2012, which is likely to be challenging for year-end transactions. Going forward, corporations should be prepared to fulfill their reporting obligations within 45 days of a triggering event.

### Special dividend rule and possible trap

For tax purposes, the term "dividend" has special meaning and significance. Generally, a distribution of property (e.g., cash) is treated as a dividend only to the extent of the corporation's current or accumulated earnings and profits ("E&P"). The significance of a dividend is that it has no effect on a shareholder's tax basis. For instance, if a shareholder has 100 shares of common stock with an adjusted basis of \$5 per share, the receipt of a \$1 dividend per share out of the company's E&P will neither increase nor decrease the shareholder's tax basis of \$5 per share. E&P is calculated after the close of the tax year, so a corporation may not be able to determine whether a distribution during the year will be out of E&P and, thus, a dividend.

Treasury regulations contain a special rule to assist corporations in determining whether a distribution is a "dividend" for tax purposes. If a corporation is unsure whether it has sufficient E&P, it may reasonably assume it has sufficient E&P.<sup>12</sup> In effect, by treating a distribution as a dividend, the organizational action will not be one that affects stock basis. Accordingly, Issuer Reporting is not required.<sup>13</sup> However, following the close of the year, if the corporation determines that its assumption is incorrect, it must satisfy its Issuer Reporting obligation at that time.

While the special dividend rule is a favorable convention, it is very narrow in its application. Taxpayers may erroneously apply the special dividend rule to "constructive" dividends. In certain instances, the tax code treats a taxable distribution as a normal dividend (e.g., so-called dividend-equivalent redemptions or constructive stock distributions). If a corporation has (or assumes it has) sufficient E&P, it may conclude these "deemed" dividends have no effect on basis as is the case with actual dividends. However, there is a critical difference between actual dividends (cash or stock) and deemed dividends. A fictional dividend is accompanied by a basis-shifting transaction or deemed recapitalization (to account for the actual shares that remain outstanding despite the fictional dividend). For example, if a shareholder owns 100 shares with a per share basis of \$5 and 20 of such shares are deemed to be redeemed for tax purposes, the remaining 80 shares will each have an adjusted basis of \$6.25.<sup>14</sup> Thus, a deemed "dividend" transaction will ultimately affect basis even though the special dividend assumption applies to the transaction.<sup>15</sup>

<sup>12</sup> See Treas. Reg. § 1.6045B-1(a)(2)(ii).

<sup>13</sup> See Treas. Reg. § 1.6045B-1(g) Ex. 2(ii).

<sup>14</sup> See Treas. Reg. § 1.302-2(c). Under proposed regulations, a dividend-redemption would result in a hypothetical reverse stock split. The basis consequences would be the same in this example (i.e., 80 shares with basis of \$6.25 per share). Prop. Treas. Reg. § 1.302-5(a)(2).

<sup>15</sup> See also Treas. Reg. § 1.6045B-1(g) Ex. 1(ii) (concluding that an in-kind stock distribution was an organizational action having stock basis consequences).

**For more information, please contact:**

**Raffi Baroutjian**

Principal  
M&A Transaction Services  
Deloitte Tax LLP  
+1 212 436 5050  
[rbaroutjian@deloitte.com](mailto:rbaroutjian@deloitte.com)

**Jeff Callender**

Partner  
Business Tax Services  
Deloitte Tax LLP  
+1 212 436 3465  
[jcallender@deloitte.com](mailto:jcallender@deloitte.com)

**Jon Lamphier**

Manager  
M&A Transaction Services  
Deloitte Tax LLP  
+1 212 436 4437  
[jlamphier@deloitte.com](mailto:jlamphier@deloitte.com)

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