CHAPTER 9

ACQUISITIVE REORGANIZATIONS

A. INTRODUCTION

1. HISTORICAL BACKGROUND

Some of the major litigation arising under the early federal income tax laws involved a variety of transactions loosely described as corporate reorganizations. Long before they became distracted by tax considerations, corporate lawyers and investment bankers were busy devising transactions ranging from complicated mergers, acquisitions and recapitalizations to routine changes in the state of incorporation. With the arrival of the income tax, the courts were required to determine whether and to what extent these fundamental changes in the structure of a corporate entity were taxable events.

Working with a pristine statute and an unsophisticated perspective, the Supreme Court became one of the first protectors of the comprehensive tax base. In a series of cases, the Court concluded that even minor changes in the form of a corporate business enterprise (e.g., changing the state of incorporation from New Jersey to Delaware) caused the shareholders to realize gain.[1] While these cases were pending, however, Congress quickly came to the rescue by enacting one of the earliest nonrecognition provisions. Preceding even the forerunner of Section 351, Section 202(b) of the Revenue Act of 1918 provided that no gain or loss would be recognized on the "reorganization, merger or consolidation of a corporation" where a person received "in place of stock or securities owned by him new stock or securities of no greater aggregate par face value."[2]

The rationale for the reorganization provisions reflects the broader policies of nonrecognition. Congress concluded that the tax collector should not impede these diverse transactions because they are mere readjustments of a continuing interest in property, albeit in modified corporate form,[3] and the new property received is "substantially a

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1 Marr v. United States, 268 U.S. 536, 45 S.Ct. 575 (1925). See also United States v. Phellis, 257 U.S. 156, 42 S.Ct. 63 (1921); Rockefeller v. United States, 257 U.S. 176, 42 S.Ct. 68 (1921).

2 Pub.L. No. 254, 40 Stat. 1057 (1919).

3 Reg. § 1.368–1(b). See also S.Rep. No. 275, 67th Cong., 1st Sess. (1921), reprinted in 1939–1 (Part 2) C.B. 181, 188–189, where the Senate Finance Committee justified the principal forerunners of the modern nonrecognition provisions on the ground that they would permit businesses to proceed with necessary adjustments and remove "a source of grave uncertainty" in the law.

continuation of the old investment still unliquidated."[4] But to the extent that a shareholder liquidates a corporate investment, recognition of gain or loss *is* appropriate. The 1921 predecessor of the present reorganization regime thus provided that shareholders must recognize their realized gain, if any, to the extent of the "boot" (money and other property) received.[5] Congress soon refined the statutory scheme by making clear what it had suggested in earlier versions: nonrecognition really means deferral rather than total forgiveness of gain or loss. The Revenue Act of 1928 introduced rules for carryover and substituted bases in order to preserve the unrecognized gain or loss for recognition at the time that the shareholder liquidated his investment.[6]

What began as a relatively simple concept has evolved into a vast and challenging body of law that governs some of the most financially significant transactions in the business world. It is important to recognize at the outset that the system you are about to study is not necessarily sensible. Functionally different transactions are lumped together and labelled "reorganizations." At the same time, economically equivalent acquisition methods are tested for reorganization status under sharply different criteria that often place a great premium on the form chosen by the parties. Moreover, determining the tax consequences of a corporate combination or readjustment requires an application of both precise statutory provisions and judicially created "common law" principles of uncertain scope. Analysis is further complicated by the possibility of an overlap between the reorganization provisions and other parts of Subchapter C.

In view of these defects in the reorganization scheme, it is not surprising that commentators long ago called for a complete overhaul of the current system.[7] Some modest reforms have come from the Service through regulations and rulings that ease the path to qualifying as a tax-free acquisition. Those pronouncements harmonize some of the requirements of Section 368 and in so doing increase flexibility in structuring tax-free acquisitions. But Congress has not yet fully embraced the simplification movement, and so we must turn to a more detailed examination of provisions that Professors Bittker and Eustice have described as "extraordinarily complex, even for the [Internal Revenue] Code."[8]

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4 Reg. § 1.1002–1(c).

5 Revenue Act of 1921, § 202, Pub.L. No. 98, 42 Stat. 227.

6 Revenue Act of 1928, § 113(a)(6)–(9), Pub.L. No. 562, 45 Stat. 791.

7 See generally Federal Income Tax Project, Subchapter C, American Law Institute (1982); Staff of the Senate Finance Committee, The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff, 99th Cong., 1st Sess. 50–58 (S.Prt. 99–47, 1985). See Section D of this chapter, infra.

8 Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.01[4].

2. OVERVIEW OF REORGANIZATIONS

Code: Skim §§ 336(c); 354–356; 358; 361; 362(b); 368(a)(1), (b), (c); 381(a); 1032.

Regulations: § 1.368–1(a)–(c).

The term "reorganization" generally is associated with the rehabilitation of a bankrupt company. Under the Internal Revenue Code, however, "reorganization" is a term of art[9] used to describe corporate combinations or readjustments that fall into the following three broad categories:

(1) *Acquisitive reorganizations,* which are considered in this chapter, are transactions in which one corporation (the "acquiring corporation") acquires the assets or stock of another corporation (the "acquired" or "target" corporation). Included in this category are statutory mergers or consolidations ("A" reorganizations); acquisitions of stock of the target for voting stock of the acquiring corporation ("B" reorganizations); acquisitions of assets of the target for voting stock of the acquiring corporation ("C" reorganizations, sometimes called "practical mergers" because of their similarity to statutory mergers); and several other more complex acquisition techniques involving the use of a subsidiary or multiple steps.

(2) *Divisive reorganizations,* which result in the division of a single corporation into two or more separate entities and which often are preceded by a "D" reorganization. Corporate divisions are considered in Chapter 10.

(3) *Nonacquisitive, nondivisive reorganizations,* which involve adjustments to the corporate structure of a single, continuing corporate enterprise. This residual category includes recapitalizations ("E" reorganizations); changes in identity, form or place of incorporation ("F" reorganizations); certain transfers of substantially all of the assets from one corporation to another, followed by a liquidation of the first corporation (nondivisive "D" reorganizations); and transfers of a corporation's assets to another corporation pursuant to a bankruptcy reorganization plan ("G" reorganizations). These transactions are considered in Chapter 11.

A common organizational thread weaves its way through these diverse categories. First, definitional provisions set forth requirements ranging from the general and very flexible test to qualify as a Type A reorganization to the complex criteria imposed by Section 355 for corporate divisions. To qualify as a reorganization, a transaction also

9 See I.R.C. § 368(a)(1); Reg. § 1.368–1(c).

must pass muster under "common law" doctrines developed by the courts to reinforce the rationale for nonrecognition. The principal judicial doctrines affecting acquisitive reorganizations are continuity of shareholder proprietary interest, continuity of business enterprise and business purpose. In general, the continuity of interest doctrine requires that a substantial part of the value of the proprietary (i.e., equity) interests in the target corporation must be preserved in the reorganization through an exchange of target stock or assets for stock in the acquiring corporation.[10] For some transactions, the continuity of interest doctrine has been incorporated into the statutory definition of "reorganization." For example, the only permissible consideration in a B reorganization is voting stock of the acquiring corporation.[11] The doctrine assumes far more importance if the statute is imprecise, as with Type A reorganizations, where the Code merely requires a "statutory merger or consolidation" without any elaboration on the permissible consideration.[12] We therefore examine continuity of interest questions primarily in connection with Type A reorganizations—the context in which that doctrine most frequently arises.

The continuity of business enterprise doctrine, as its name implies, focuses on the continuing business operations of the target. This requirement has been incorporated in the regulations[13] and also is considered with "A" reorganizations. Because the business purpose doctrine was first applied and has the greatest importance in the context of a corporate division, it is discussed in Chapter 10. In general, all these requirements must be satisfied in order for a transaction to qualify as an acquisitive reorganization.[14] To further complicate matters, the Service sometimes applies the step transaction doctrine to corporate reorganizations to convert what in form may be separate nontaxable steps into what in substance is a taxable transaction, or vice versa.[15]

If all these statutory and judicial requirements are met, they unlock the doors to the "operative provisions"—sections of the Code that provide for nonrecognition of gain or loss and that govern collateral matters such as the treatment of liabilities, basis, holding period and carryover of tax attributes.[16] For example, Sections 354 and 356 grant total or partial nonrecognition of gain to the shareholders of the target corporation in an acquisitive reorganization. Section 358, which we encountered earlier in connection with tax-free incorporations, provides a formula for determining the substituted basis of the stock or securities received by these shareholders in a reorganization. At the corporate level, Section

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[10] Reg. § 1.368–1(e)(1).

[11] I.R.C. § 368(a)(1)(B).

[12] I.R.C. § 368(a)(1)(A).

[13] Reg. § 1.368–1(d).

[14] Reg. §§ 1.368–1(b); 1.368–2(g).

[15] See, e.g., Rev. Rul. 79–250, 1979–2 C.B. 156.

[16] See Section C of this chapter, infra.

361(a) generally provides for nonrecognition when a corporation transfers its assets in a reorganization and distributes property in a liquidation pursuant to a reorganization plan,[17] and Section 357 generally ensures that the assumption of the target's liabilities is not treated as boot for this purpose. The acquiring corporation is accorded nonrecognition under Section 1032 with respect to stock used to make the acquisition and takes a transferred basis in the target's assets or stock under Section 362(b). In keeping with the continuity of investment principle, the tax attributes of the target corporation (e.g., earnings and profits and net operating losses) generally carry over to the acquiring corporation under Section 381, subject to various limitations to patrol abuse.[18]

If a transaction does not qualify as a reorganization, these operative provisions do not apply and the tax consequences of the transaction must be determined under other parts of Subchapter C. For example, an asset acquisition that fails as a Type A or C reorganization ordinarily would be a taxable transaction to the shareholders under the rules considered in Chapters 7 and 8. But it is the rare reorganization that fails. Because of the high stakes involved, taxpayers historically were reluctant to proceed with reorganization transactions without first obtaining the Internal Revenue Service's blessing in the form of an advance ruling or, when time was of the essence, a reliable opinion letter from private counsel. Over time, the Service has scaled back its practice of providing "comfort rulings" in advance of a transaction to assure favorable tax consequences. It now declines to issue a ruling on whether a transaction constitutes a reorganization,[19] but the Service will rule on one or more "significant" issues regarding a proposed reorganization, as distinguished from ruling on the transaction as a whole.[20] An issue is "significant" if it is "an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction."[21] As a result of the Service's limited willingness to issue rulings approving the tax-free status of reorganizations, its administrative guidelines on these issues often are tantamount to the law in the area, and taxpayers who disagree with the government's viewpoint must proceed with a transaction at their substantial risk.

Finally, as we move to an examination of the reorganization "alphabet," it will be helpful to use shorthand terminology to identify the cast of familiar characters first encountered in connection with taxable acquisitions. Once again, we will refer to the acquiring corporation as "P" and the target corporation as "T."

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17 See also I.R.C. § 336(c).

18 See Chapter 12, infra.

19 Rev. Proc. 2013–32, § 4.01(1), 2013–28 I.R.B. 55. See also Rev. Proc. 2019–3, § 3.01(55), 2019–1 I.R.B. 130, 134.

20 Rev. Proc. 2013–32, supra note 19, at § 4.01(1).

21 Id. at § 4.01(3).

B. TYPES OF ACQUISITIVE REORGANIZATIONS

1. TYPE A: STATUTORY MERGERS AND CONSOLIDATIONS

Code: § 368(a)(1)(A). Skim §§ 354(a); 356(a); 357; 358(a); 361; 362(b); 368(a)(2)(C), (b); 381(a)(2); 1032.

Regulations: §§ 1.368–1(d)(1)–(3) & (5) Examples 1–5; –1(e)(1); –1(e)(2)(i) & (v) Example 1; –1(e)(8) Example 1; –2(a), (b)(1)(i), (ii), (iii) Examples 1, 2 & 6, (g).

a. THE MERGER OR CONSOLIDATION REQUIREMENT

In General. The Type A reorganization is defined in the Code as a statutory merger or consolidation. For this purpose, "statutory" refers to a merger or consolidation pursuant to local (usually corporate) law.[22] Under a typical state merger statute, the assets and liabilities of the target corporation are transferred to the acquiring corporation without the need for deeds or bills of sale, and the target dissolves by operation of law.[23] The consideration received by the target's shareholders is specified in a formal agreement of merger between the two companies. The shareholders may receive stock or debt instruments of the acquiring corporation, cash or a combination of all three. A consolidation involves a similar transfer of the assets and liabilities of two corporations to a newly created entity followed by the dissolution of the transferor corporations, and the shareholders of the transferors become shareholders of the new entity by operation of law. Either transaction may require approval by a simple majority or two-thirds vote of the shareholders of both corporations,[24] and under state corporate law dissenting shareholders may be granted the right to sell their target stock at a price determined in an appraisal proceeding.[25]

"Divisive" Mergers. To qualify as a Type A reorganization, a merger must be an acquisitive rather than a divisive transaction. To be "acquisitive," the result of the transaction must be that one corporation acquires the assets of another (target) corporation by operation of law,

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[22] Russell v. Commissioner, 40 T.C. 810 (1963), aff'd, 345 F.2d 534 (5th Cir.1965). The regulations provide that a transaction may qualify as a "statutory" merger or consolidation without requiring it to be effected under a domestic statute, thus permitting foreign corporations to be parties to a Type A reorganization. Reg. § 1.368–2(b)(iii) Examples 13 & 14.

[23] See, e.g., Cal. Corp. Code § 1107.

[24] Id. As a general rule, most state corporate laws give voting rights to shareholders of the purchasing ("P") and target ("T") corporations. But where the amount of P stock used in the acquisition is less than 20 percent of its outstanding shares, P shareholders usually do not have the right to vote. In an acquisition initiated by a tender offer, there is no formal shareholder vote because T shareholders individually may decide whether or not to sell. Some states, such as Delaware, also do not give P shareholders the right to vote on asset acquisitions not structured as a merger, triangular mergers where a P subsidiary makes the acquisition, stock acquisitions, or certain acquisitions for cash or cash equivalents. See generally Oesterle & Haas, Mergers and Acquisitions in a Nutshell (3d ed. 2019); Bainbridge & Anabtawi, Mergers and Acquisitions: A Transactional Perspective (2017).

[25] Under Delaware law, for example, dissenting target shareholders have appraisal rights in statutory mergers but not in asset acquisitions. 8 Del. Code §§ 262, 271.

and the target must cease to exist. By contrast, a "divisive" transaction is one in which a corporation's assets are divided among two or more corporations. In Revenue Ruling 2000–5,[26] the Service relied on this distinction in ruling that a transaction in which T "merged" under state law into P, transferring only some of its assets and liabilities, and T remained in existence, was not a Type A reorganization.[27] Similarly, a transaction where T transferred some of its assets and liabilities to each of two acquiring corporations and then T dissolved, with each T shareholder receiving stock in both acquiring corporations, was not a Type A reorganization even though it was a merger under state corporate law.[28] Although both transactions were called "mergers" under state law, they were divisive rather than acquisitive because T's assets were divided between two corporations, and T's shareholders wound up with stock in two separate companies.[29]

Revenue Ruling 2000–5 was the Service's response to a new form of corporate merger statute enacted by the Texas legislature to permit divisive mergers.[30] The understandable concern was that permitting such mergers to qualify as Type A reorganizations would be inconsistent with the policy of Section 368 and undermine Section 355, which imposes strict and detailed requirements for corporate divisions to qualify for tax-free treatment.[31] The ruling serves as a reminder that simple compliance with a state corporate merger law does not ensure that a transaction will qualify as a Type A reorganization.

Mergers Involving Disregarded Entities. In a similar response to emerging acquisition techniques, the Service issued regulations addressing mergers between corporations and disregarded entities (such as a single-member limited liability company).[32] The regulations take a common sense approach to the two most typical transactional forms: (1) the merger of a single-member limited liability company ("LLC") with a corporate owner ("X") into an acquiring corporation ("P"), and (2) the merger of a target corporation ("T") into a single-member LLC in exchange for stock of LLC's corporate owner ("P"). In both situations, the LLC is a disregarded entity and thus is treated for tax purposes as a division of its corporate owner unless it elects to be taxed as a separate corporation. The first transaction does not qualify as a Type A reorganization because X's assets and liabilities are divided between X

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26 2000–1 C.B. 436 (Situation 1).

27 Id. See also Reg. § 1.368–2(b)(1)(iii) Example 1.

28 Rev. Rul. 2000–5, 2000–1 C.B. 436 (Situation 2).

29 Some divisive transactions also may be tax-free but they must satisfy the requirements of Section 355. See Chapter 10, infra.

30 For an analysis and critique of Revenue Ruling 2000–5, see Bank, "Taxing Divisive and Disregarded Mergers," 34 Geo. L. Rev. 1523 (2000).

31 See Chapter 10, infra.

32 See Reg. § 301.7701–2(a) and Chapter 1E2, supra, for a discussion of disregarded entities. Certain real estate investment trusts and S corporation subsidiaries also may be treated as disregarded entities for tax purposes.

and P as a result of the merger.[33] But a merger of T into a single-member LLC in exchange for stock of the LLC's corporate owner ("P") may qualify as a Type A reorganization if the other requirements (e.g., the continuity of interest doctrine, discussed below) are met and the separate legal existence of T terminates.[34] This favorable result is consistent with the treatment of a disregarded entity as a division of its owner. It is as if T merged directly into P. Permitting statutory mergers into disregarded entities to qualify as Type A reorganizations offers more flexibility by eliminating the need for these transactions to pass muster under the stricter requirements applicable to Type C stock-for-assets acquisitions.[35]

Shareholder and Business Enterprise Continuity Requirements. The Code is strangely silent as to the permissible consideration in a Type A reorganization and the degree to which the target's historic business must be conducted by the acquiring corporation. To fill these gaps and preserve the integrity of the nonrecognition scheme, the courts developed the continuity of proprietary interest and continuity of business enterprise requirements.[36] Both doctrines are examined in the materials that follow.

b. CONTINUITY OF PROPRIETARY INTEREST: QUANTITY AND QUALITY

Southwest Natural Gas Co. v. Commissioner

United States Court of Appeals, Fifth Circuit, 1951.
189 F.2d 332.

■ RUSSELL, CIRCUIT JUDGE.

The correctness of asserted deficiencies for corporate income tax for the year 1941 and of declared value excess profits tax and excess profits tax for 1942 due by Southwest Natural Gas Company depends upon whether a merger of Peoples Gas & Fuel Corporation with the taxpayer, effected in accordance with the laws of Delaware, was a sale, as asserted by the Commissioner, or a "reorganization" within the terms of Section 112(g) [the predecessor of Section 368] of the Internal Revenue Code, as contended by the taxpayer. The parties so stipulated the issue in the Tax Court. That Court upheld the Commissioner's determination. Southwest Natural Gas Company has petitioned this Court for review.

The facts found by the Tax Court (which, as facts, are not challenged) and the grounds for its judgment in law thereon are fully set forth in its published opinion. In substance that Court held that literal compliance

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33 Reg. § 1.368–2(b)(1)(iv) Example 6.

34 Reg. § 1.368–2(b)(1)(iii) Example 2.

35 For example, Type C reorganizations require the acquiring corporation to acquire substantially all of the target's properties and to use mostly voting stock and only a limited amount of boot in making the acquisition. See Section B3 of this chapter, infra.

36 The earliest continuity of interest cases involved Type C reorganizations but the doctrine now applies primarily to statutory mergers and consolidations.

with the provisions of a state law authorizing a merger would not in itself effect a "reorganization" within the terms applicable under Internal Revenue Statutes; that the test of continuity of interest was nevertheless applicable; and that the transaction in question did not meet this test. This ruling is assigned as error upon grounds which, while variously stated, require for their maintenance establishment of at least one of the propositions that: if the literal language of the statute is complied with, that is if there is a "statutory merger" duly effected in accordance with state law, the statute requires it be treated as a reorganization; or, at least where such merger has been effected the Tax Court must hold the transaction a reorganization in the absence of a finding that it was not in truth and in substance a merger; or, even if this be not correct, that the facts of this case disclose sufficient "continuity of interest." It is insisted in either view the Tax Court was required to hold under the facts found by it that the transaction in question was in truth a "statutory merger" and hence a "reorganization."

Consideration of the underlying purposes of the terms and provisions of Section 112 of the Internal Revenue Code in its entirety and of this Section (g)(1)(A) as involved here, in particular, as being enacted "to free from the imposition of an income tax purely 'paper profits or losses' wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form, the tax being postponed to a future date when a more tangible gain or loss is realized." Commissioner of Internal Revenue v. Gilmore's Estate, 3 Cir., 130 F.2d 791, 794, and thus applicable to transactions which effect only the "readjustment of continuing interest in property under modified corporate forms," clearly discloses, we think, that the accomplishment of a statutory merger does not *ipso facto* constitute a "reorganization" within the terms of the statute here involved. This has been expressly held by the Court of Appeals for the Third Circuit in a well considered opinion, supported by numerous authorities cited. Roebling v. Commissioner, 143 F.2d 810. There is no occasion for elaboration or reiteration of the reasoning and authorities set forth in that opinion. In Bazley v. Commissioner, 331 U.S. 737, 67 S.Ct. 1489, 1491, 91 L.Ed. 1782, the Supreme Court enforced a similar construction with reference to the "re-capitalization" provision of the section. The authorities are clearly to the effect that the terms expressed in the statute are not to be given merely a literal interpretation but are to be considered and applied in accordance with the purpose of Section 112. Thus the benefits of the reorganization provision have been withheld "in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § 112, in its purpose and particulars concerns itself. * * * "

It is thus clear that the test of "continuity of interest" announced and applied by these cited authorities, supra, must be met before a statutory merger may properly be held a reorganization within the terms of Section

112(g)(1)(A), supra. Each case must in its final analysis be controlled by its own peculiar facts. While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear that the requirement of continuity of interest consistent with the statutory intent is not fulfilled in the absence of a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, (2) that such retained interest represents a substantial part of the value of the property transferred.

Among other facts, the Tax Court found that under the merger all of Peoples' assets were acquired by the petitioner in exchange for specified amounts of stock, bonds, cash and the assumption of debts. There was a total of 18,875 shares common stock of Peoples' entitled to participate under the agreement of merger. The stockholders were offered Option A and Option B. The holders of 7,690 of such shares exercised Option B of that agreement and received $30.00 in cash for each share, or a total of $230,700.00. In respect to the stock now involved, the stockholders who exercised Option A, the holders of 59.2 percent of the common stock received in exchange 16.4 per cent of petitioner's outstanding common stock plus $340,350.00 principal amount of six per cent mortgage bonds (of the market value of 90 per cent of principal), which had been assumed by petitioner in a prior merger and $17,779.59 cash. The 16.4 per cent of the common stock referred to was represented by 111,850 shares having a market value of $5,592.50, or five cents per share, and represented the continuing proprietary interest of the participating stockholders in the enterprise. This was less than one per cent of the consideration paid by the taxpayers.

We think it clear that these and other facts found by the Tax Court find substantial support in the evidence, and the conclusion of the Tax Court that they failed to evidence sufficient continuity of interest to bring the transaction within the requirements of the applicable statute is correct.

The decision of the Tax Court is affirmed.

[The dissenting opinion of Chief Judge Hutcheson has been omitted. Ed.]

Revenue Ruling 66–224

1966–2 Cum. Bull. 114.

Corporation *X* was merged under state law into corporation *Y*. Corporation *X* had four stockholders (*A*, *B*, *C*, *D*), each of whom owned 25 percent of its stock. Corporation *Y* paid *A* and *B* each $50,000 in cash for their stock of corporation *X*, and *C* and *D* each received corporation *Y* stock with a value of $50,000 in exchange for their stock of corporation *X*. There are no other facts present that should be taken into account in determining whether the continuity of interest requirement of section 1.368–1(b) of the Income Tax Regulations has been satisfied, such as sales, redemptions or other dispositions of stock prior to or subsequent to the exchange which were part of the plan of reorganization.

Held, the continuity of interest requirement of section 1.368–1(b) of the regulations has been satisfied. It would also be satisfied if the facts were the same except corporation *Y* paid each stockholder $25,000 in cash and each stockholder received corporation *Y* stock with a value of $25,000.

NOTE

Measuring Continuity of Interest. The continuity of interest doctrine historically required the shareholders of the target corporation to receive a sufficient proprietary interest in the acquiring corporation to justify treating the transaction as a wholly or partially tax-free reorganization rather than a taxable sale.[37] The early cases focused on both the quality of the consideration received by the target's shareholders and the percentage of equity consideration (relative to total consideration) received by those shareholders as a group. For example, in one of the first cases to apply the doctrine, the Supreme Court held that a transaction literally satisfying the definition of a reorganization nonetheless was a taxable sale because the T shareholders received only short-term notes of the acquiring corporation.[38] In a later case, the Court held that there was sufficient continuity of interest where the T shareholders received 38 percent nonvoting preferred stock of the acquiring corporation and 62 percent cash.[39]

In evaluating continuity of interest, it is the overall continuity preserved in the transaction that controls, not the continuity of any individual shareholder.[40] All classes of stock, whether voting or nonvoting, provide the requisite continuity while any other consideration (cash, short-term notes, bonds, assumption of liabilities) will fail to meet the test.[41] The lines with respect to the percentage of stock that must be received are not so easily drawn if one refers to the case law.[42] The Service once provided a practical benchmark by declaring that it would rule favorably on a Type A reorganization if P uses at least 50 percent equity consideration in making the acquisition.[43] An example now in the regulations confirms the Service's more permissive newer view that 40 percent continuity is sufficient[44]—a position long advocated by experienced tax advisers and supported by case

[37] See generally Bittker & Eustice, supra note 8, ¶ 12.21.

[38] Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 53 S.Ct. 257 (1933). See also Helvering v. Minnesota Tea Co., 296 U.S. 378, 56 S.Ct. 269 (1935).

[39] John A. Nelson Co. v. Helvering, 296 U.S. 374, 56 S.Ct. 273 (1935).

[40] See Rev. Rul. 66–224 at p. 398, supra; Reg. § 1.368–1(e)(1)(i).

[41] See, e.g., John A. Nelson Co. v. Helvering, supra note 39.

[42] See, e.g., John A. Nelson Co. v. Helvering, supra note 39 (38% redeemable nonvoting preferred sufficient for continuity); Miller v. Commissioner, 84 F.2d 415 (6th Cir.1936) (25% stock sufficient).

[43] Rev. Proc. 77–37, 1977–2 C.B. 568. See also Rev. Proc. 86–42, 1986–2 C.B. 722.

[44] Reg. § 1.368–1(e)(2)(v) Example 1.

law.[45] Keep in mind that this "percentage" is the proportion of equity consideration relative to total consideration used by P to acquire T, not the percentage of P stock owned by former T shareholders after the P's acquisition of T. Moreover, overall qualification as a reorganization under this liberal standard does not mean that all T shareholders will be able to defer recognition of their gain. Those receiving nonequity consideration must recognize gain, if any, perhaps as ordinary income, to the extent they receive boot.[46] But if the entire transaction fails to qualify as a reorganization, all the parties (including T), not merely those receiving nonequity consideration, must recognize gain or loss.

These venerable principles are not altered by Section 356(e), which treats certain debt-like preferred stock, defined in Section 351(g) as "nonqualified preferred stock," as other property (i.e. boot) for purposes of recognition of gain or loss by the T shareholders in a reorganization. In treating nonqualified preferred stock as boot for gain recognition purposes, Congress was responding to concerns about acquisitive transactions in which T shareholders received a relatively secure instrument labelled as "stock" but bearing many of the characteristics of debt in exchange for a riskier equity investment. In those circumstances, Congress believed it was appropriate to view the new debt-like preferred stock as taxable consideration because the T shareholder was obtaining a more secure form of investment. Congress indicated, however, that nonqualified preferred stock would continue to be treated as equity under other provisions of the Code, such as Sections 351 and 368, at least until prospective regulations provide otherwise.[47]

Remote Continuity. The continuity of interest test was once interpreted as requiring the T stock or assets acquired in a reorganization to be held directly by the corporation that issues its stock to T shareholders.[48] This "remote continuity" doctrine focused on the requisite link between the former T shareholders and the T business assets after the reorganization. Subsequent amendments to the Code provided more flexibility—for example, by permitting "drop-down" transfers to subsidiaries of the acquiring corporation[49] or allowing a controlled subsidiary to use its parent's stock as consideration in a merger.[50] The regulations go further by permitting successive transfers of T stock or assets among various members of an affiliated group of corporations or, in some cases, to a controlled partnership.[51] In general, these regulations provide that continuity is not broken by a transfer or successive transfers of the acquired T stock or assets to lower-tier subsidiaries provided that the transferor continues to "control"

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[45] See generally Ginsburg, Levin & Rocap, Mergers, Acquisitions and Buyouts ¶ 610.2 (April 2018).

[46] See Section C1 of this chapter, infra.

[47] Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, 105th Cong., 1st Sess. 212–213 (1997). See Chapter 3B3, supra.

[48] See, e.g., Groman v. Commissioner, 302 U.S. 82, 58 S.Ct. 108 (1937); Helvering v. Bashford, 302 U.S. 454, 58 S.Ct. 307 (1938).

[49] I.R.C. § 368(a)(2)(C).

[50] I.R.C. § 368(a)(2)(D). See Section B4 of this chapter, infra.

[51] See, e.g., Reg. §§ 1.368–2(f), –2(k)(1), –2(k)(2) Examples 1–3.

(using the 80 percent tests in Section 368(c)) each transferee[52] and the continuity of business enterprise requirement is satisfied.[53]

When to Measure Continuity of Interest. In determining whether the requisite proprietary interest in the target corporation has been preserved for continuity of interest purposes in a potential reorganization where the merger agreement provides for "fixed" consideration," the regulations provide that the appropriate measuring date is the last business day before the first date that the contract is a "binding contract."[54] This is known as the "signing date rule." A "binding contract" is an instrument enforceable under applicable law against the parties to it.[55] The presence of conditions outside the parties' control (such as the need for regulatory approval) or the fact that insubstantial terms remain to be negotiated or customary conditions satisfied will not prevent a contract from being "binding."[56] Consideration is "fixed" if the contract recites the number of shares of P stock and the amount of nonstock consideration to be received by T's shareholders,[57] and the contract does not include contingent adjustments that prevent T's shareholders from being subject to the economic benefits and burdens of ownership of P as of the signing date (e.g., when T shareholders are entitled to receive additional consideration if the price of P stock declines by specified amounts during the interval between the signing and deal closing dates). Without this pro-taxpayer signing date rule, a decline in the value of the acquiring corporation's stock between the signing date and the date the acquisition is consummated could cause the transaction to fall below the continuity threshold. The policy for the signing date rule is that, if a contract provides for fixed consideration, the T shareholders are properly viewed as being subject to the "economic fortunes" of P as of the date the contract becomes binding.[58]

If the consideration received in a potential reorganization is not fixed, continuity of interest is measured based on the value of the P stock as of "the effective date" of the transaction.[59] This is known as the "closing date rule." Under this approach, a decline in the value of the P stock between the signing and closing dates could cause a transaction to fail the continuity of interest requirement.

In valuing stock for continuity of interest purposes in most real-world transactions, the parties usually prefer to hedge against market volatility by using an average price over a period of time rather than a closing price on a single date. If either the signing or closing date rule applies, the Service authorizes three safe harbor valuation methods using average trading prices

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52 Reg. § 1.368–2(k)(1).

53 Reg. § 1.368–1(d)(4), (5).

54 Reg. § 1.368–1(e)(2)(i). The regulations detail how continuity of interest is measured if the deal terms are modified before the closing date, how tender offers are handled, and how the rules are applied when an agreement provides for shareholder elections, contingent adjustments, and escrowed stock arrangements. Reg. § 1.368–1(e)(2)(ii)–(iv).

55 Reg. § 1.368–1(e)(2)(ii)(A).

56 Id.

57 Reg. § 1.368–1(e)(2)(iii)(A).

58 Reg. § 1.368–1(e)(2)(i).

59 Rev. Proc. 77–37, 1977–2 C.B. 568; Reg. § 1.368–1(e)(2)(v) Example 1.

over a range of measuring periods if the P stock is traded on a national securities exchange, all the parties treat the transaction consistently, and a binding agreement specifies the measuring period and other details.[60]

c. IDENTIFYING THE SHAREHOLDERS WHO MUST MAINTAIN CONTINUITY OF INTEREST

Because the shareholders of the target corporation must receive a sufficient amount of stock of the acquiring corporation to satisfy the continuity of interest doctrine, it sometimes is necessary to identify which target shareholders count for purposes of this requirement. At one time, the IRS's position was that a substantial part of the consideration paid by the acquiring corporation ("P") must consist of P stock paid to T's "historic" shareholders—i.e. shareholders who held their T stock before P commenced its efforts to acquire control of T in a reorganization. Identifying historic shareholders often was problematic, however, in acquisitions of publicly traded companies because of numerous open market transactions that occur after an acquisition is announced but before it is finally consummated.

For example, assume on January 1 that T is owned by 100 shareholders each of whom owns one percent of T stock. Two corporations, P-1 and P-2, each wish to acquire T and each suitor makes a tender offer to the T shareholders. By March 1, P-1 purchases the stock of 30 T shareholders for cash while P-2 purchases the stock of 45 T shareholders, also for cash. The ultimate winner is P-2, which on June 1 completes its acquisition by acquiring all the T stock it does not already own (55 percent, including P-1's 30 shares and the 25 shares not tendered to either suitor) for P-2 common stock, and then T merges into P-2.

Does the merger of T into P-2 qualify as a Type A reorganization? Recall that a key qualification issue is whether shareholders owning at least 40 percent of the T stock maintain sufficient continuity of interest by receiving P-2 common stock in exchange for their T stock. If continuity is measured with reference to T's January 1 shareholders (the "historic" shareholders of T), the acquisition fails the test because 75 percent of those shareholders sold their T stock for cash. But if the continuity of interest test is based on the T shareholders at the time of P-2's June 1 acquisition, then T shareholders holding 55 percent of T will have received P-2 stock, and the test will be met. In J. E. Seagram Corp. v. Commissioner,[61] the Tax Court considered similar facts and declined to measure continuity of interest solely by looking to the "historic" (i.e., January 1) shareholders of T. The court held that continuity of interest was satisfied on these facts, reasoning that P-1 "stepped into the shoes"

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[60] Rev. Proc. 2018–12, 2018–6 I.R.B. 349.

[61] 104 T.C. 75 (1995). Seagram was a "role reversal" case in which the unsuccessful bidder (P-1 in the example in the text) argued that the transaction did not qualify as a reorganization in order to deduct a loss on its exchange of T stock for P stock. The IRS argued that the transaction qualified as a Type A reorganization.

of the 30 percent T shareholder group who sold their stock to P-1 for cash. The court also reasoned that focusing on the "historic shareholders" of a publicly traded target corporation to measure continuity would require tracking all the transactions in T stock once an acquisition is announced and be "completely unrealistic."

The Tax Court's decision in *Seagram* represented an evolution in the understanding of the historic shareholder concept. The IRS ultimately adopted the court's reasoning, and the regulations now eliminate the relevance of historic T shareholders except in very limited situations. They provide that a "mere disposition" of T stock prior to a potential reorganization to buyers unrelated to T or P will be disregarded in applying the continuity of interest doctrine.[62]

The regulations offer tax practitioners some interesting planning opportunities. For example, assume T is owned 70 percent by shareholder A and 30 percent by shareholder B, and P wishes to acquire T in a tax-free merger. At one time, it was thought that P could not achieve its goal if A wished to cash out of T. Under the regulations, however, if A can find an independent third party purchaser who is willing to buy A's T stock for cash and who eventually becomes a P shareholder after the merger, each of the party's business and tax objectives may be satisfied with careful planning.[63] A's sale for cash, of course, is a taxable event to A, but B achieves nonrecognition of gain on the exchange of B's T stock for P stock in the merger, and T does not recognize gain or loss on the transfer of its assets to P.

The regulations guard against situations where a T shareholder may indirectly receive cash compensation from P. In one example, shareholder A owns 100 percent of T and, in a merger, A receives P stock which A sells to B, an unrelated buyer. If that was the whole story, it would be a happy ending because the continuity of interest requirement would be satisfied. The fatal flaw in the example is that shortly thereafter, and in connection with the merger, P redeems B's stock for cash. The regulations conclude that the continuity of interest requirement is not satisfied on those facts because, in substance, P acquired the T stock solely for cash.[64] But if T redeems the stock of one of its shareholders for cash prior to the acquisition, with no consideration coming from P, the preacquisition redemption does not affect continuity of interest, which in this fact pattern is determined solely with reference to the remaining T shareholders.[65]

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62 Reg. § 1.368–1(e)(1)(i).

63 See Reg. § 1.368–1(e)(8) Example 1(ii).

64 Reg. § 1.368–1(e)(8) Example 5.

65 Reg. § 1.368–2(e)(8) Example 9.

d. POST-ACQUISITION CONTINUITY

Another aspect of the continuity of interest doctrine relates to the length of time that the target shareholders must hold their stock in the acquiring corporation. For example, assume T merges into P in a tax-free reorganization in which the only consideration is P stock, but shareholders who hold 80 percent of the T stock are legally committed at the time of the merger to sell their P stock to a third party. Does the prearranged sale disqualify the merger as a Type A reorganization because the continuity of interest test is not met. The selling T shareholders will be taxed in either event, of course, although the timing of their gain may be affected if the merger and subsequent stock sale occur in different taxable years, but what about the 20 percent who retain their P stock? And what are the appropriate tax consequences to the target and acquiring corporations?

The Service has never required T's shareholders to maintain continuity of interest in P for any particular period of time after an acquisitive reorganization. But in determining if the continuity of interest requirement has been satisfied, the Service for many years considered sales and other dispositions of stock occurring subsequent to a merger which are part of the same overall "plan."[66] The courts disagreed over whether a pre-merger intent to sell (without any binding commitment) would defeat continuity of interest.[67]

The regulations resolve the issue by providing that subsequent dispositions of P stock received in a potential reorganization by former T shareholders generally will be disregarded in determining whether the continuity of shareholder interest requirement is met, even if the dispositions were pursuant to a preexisting binding contract.[68] This is consistent with the Service's current position that the continuity of interest requirement is satisfied if a substantial part of the value of the proprietary interest in T is preserved through an exchange for a proprietary interest (i.e., stock) of P. But if the facts demonstrate that T shareholders have sold their P stock for cash to P or a related party (e.g., a P subsidiary) before or after the acquisition, the continuity of interest requirement may not be satisfied.[69] For example, if P reacquired stock that it issued in the reorganization from T shareholders in exchange for cash, the reacquisition would be considered in determining if the continuity of interest requirement was satisfied. But sales of P stock by

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66 Rev. Proc. 77–37, supra note 43.

67 See, e.g., McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir.1982), rev'g 76 T.C. 972 (1981), where the Tax Court treated a post-merger sale of P stock by former T shareholders as a separate transaction because the shareholders were not contractually bound to sell, but the Seventh Circuit found that a pre-merger intent to sell was sufficient to invoke the step transaction doctrine and cause the merger to lack continuity of interest. See also Penrod v. Commissioner, 88 T.C. 1415 (1987) (no binding commitment or pre-merger intent to sell; continuity of interest test satisfied).

68 Reg. § 1.368–1(e)(1)(i), –1(e)(8) Example 1(i).

69 Reg. § 1.368–1(e)(1)(ii), –1(c)(2).

former T shareholders to outsiders would be ignored, even if the sales were pursuant to a binding commitment entered into prior to the reorganization.[70]

Revenue Ruling 99–58, which follows, is another illustration of the Service's tolerance toward post-acquisition continuity issues.

Revenue Ruling 99–58

1999–2 Cum. Bull. 701.

ISSUE

What is the effect on continuity of interest when a potential reorganization is followed by an open market reacquisition of P's stock?

FACTS

T merges into P, a corporation whose stock is widely held, and is publicly and actively traded. P has one class of common stock authorized and outstanding. In the merger, T shareholders receive 50 percent common stock of P and 50 percent cash. Viewed in isolation, the exchange would satisfy the continuity of interest requirement of § 1.368–1(e) of the Income Tax Regulations. However, in an effort to prevent dilution resulting from the issuance of P shares in the merger, P's preexisting stock repurchase program is modified to enable P to reacquire a number of its shares equal to the number issued in the acquisition of T. The number of shares repurchased will not exceed the total number of P shares issued and outstanding prior to the merger. The repurchases are made following the merger, on the open market, through a broker for the prevailing market price. P's intention to repurchase shares was announced prior to the T merger, but the repurchase program was not a matter negotiated with T or the T shareholders. There was not an understanding between the T shareholders and P that the T shareholders' ownership of P stock would be transitory. Because of the mechanics of an open market purchase, P does not know the identity of a seller of P stock, nor does a former T shareholder who receives P stock in the merger and subsequently sells it know whether P is the buyer. Without regard to the repurchase program, a market exists for the newly-issued P stock held by the former T shareholders. During the time P undertakes its repurchase program, there are sales of P stock on the open market, which may include sales of P shares by former T shareholders.

LAW AND ANALYSIS

Requisite to a reorganization under the Internal Revenue Code is a continuity of interest as described in § 1.368–1(e). Section 1.368–1(b). The general purpose of the continuity of interest requirement is "to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations."

70 See Reg. § 1.368–1(e)(8) Example (4)(i).

Section 1.368–1(e)(1)(i). To achieve this purpose, the regulation provides that a proprietary interest in the target corporation is not preserved to the extent that, "in connection with the potential reorganization, . . . stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed." Id. However, for purposes of the continuity requirement, "a mere disposition of stock of the issuing corporation received in the potential reorganization to persons not related . . . to the issuing corporation is disregarded." Id. The regulation provides that all facts and circumstances will be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.

Under the facts set forth above, continuity of interest is satisfied. There was not an understanding between the T shareholders and P that the T shareholders' ownership of the P shares would be transitory. Further, because of the mechanics of an open market repurchase, the repurchase program does not favor participation by the former T shareholders. Therefore, even if it could be established that P has repurchased P shares from former T shareholders in the repurchase program, any such purchase would be coincidental. The merger and the stock repurchase together in substance would not resemble a sale of T stock to P by the former T shareholders and, thus, the repurchase would not be treated as "in connection with" the merger. Under the facts presented, a sale of P stock on the open market by a former T shareholder during the repurchase program will have the same effect on continuity of interest as a mere disposition to persons not related to P.

HOLDING

Under the facts presented, the open market repurchase of shares through a broker has no effect on continuity of interest in the potential reorganization.

e. RELATIONSHIP OF CONTINUITY OF INTEREST DOCTRINE TO TAXABLE STOCK ACQUISITIONS

The tax-free reorganization rules often overlap with other provisions in Subchapter C. One potential jurisdictional conflict is between the treatment of a "qualified stock purchase" (e.g., P's purchase of 80 percent or more of T stock) as defined in Section 338 and an acquisitive reorganization. The Service has issued regulations addressing the tax consequences of the transfer of T's assets to P or a P affiliate following P's qualified stock purchase where P does not make a Section 338 election.[71] They provide that the T stock acquired by P in the qualified stock purchase will count for continuity of interest purposes if T later transfers its assets to a P subsidiary ("S"), enabling the second step of the transaction to qualify as a tax-free acquisitive reorganization.[72] As a

[71] Reg. § 1.338–3(d)(1). See Chapter 8C2, supra.

[72] Reg. § 1.338–3(d)(2). Similarly, P is treated as a T shareholder for purposes of determining whether, immediately after the transfer of T assets, a T shareholder is in "control"

result, T does not recognize gain on the transfer of its assets, which will take a transferred basis in S's hands.[73]

These regulations reverse the holding in Yoc Heating v. Commissioner,[74] a much discussed old Tax Court case where P bought 85 percent of T's stock for cash and notes and, as part of the same transaction, T subsequently transferred its assets to S, a newly formed P subsidiary and then dissolved. P received additional S stock in exchange for its T stock, and the T minority shareholders received cash in exchange for their T stock. The Tax Court viewed P's purchase of T stock and the subsequent T asset transfer to S as an integrated transaction in which P acquired all of T's assets for cash and notes. Consequently, it held that there was insufficient continuity of interest to qualify the asset transfer as a Section 368 reorganization because the historic shareholders of T did not receive any P stock. The upshot was that S received a cost basis in the T assets rather than the transferred basis it would have taken if the acquisition had qualified as a reorganization. Because the *General Utilities* doctrine was still alive at the time of this transaction, T did not recognize any corporate-level gain or loss as a result of the court's decision.

The regulations take the position that the result in *Yoc Heating* is inconsistent with the policy of Section 338 to preempt the subjective *Kimbell-Diamond* doctrine, which treated P's purchase of T stock for cash followed by a liquidation of T as a taxable purchase of T's assets.[75] The regulations also provide that the operative reorganization provisions applicable to shareholders of the target corporation in an acquisitive reorganization do not apply to minority shareholders of T unless the transfer of T assets is pursuant to a reorganization under generally applicable tax rules without regard to the regulations.[76] To illustrate, assume P buys 85 percent of the stock of T for cash from shareholder A and does not make a Section 338 election. The remaining 15 percent of T is owned by Mrs. K. Shortly thereafter, as part of the same plan, T merges into S, a 100 percent subsidiary of P, and Mrs. K receives P (or S) stock in exchange for her T stock. Under the regulations, the continuity of interest requirement is not met in determining the tax consequences to Mrs. K, who thus recognizes gain or loss with respect to the exchange of her T stock.[77] Why? How can a transaction qualify as a reorganization for some purposes (T's transfer of its assets) but not for others (Mrs. K's exchange of her T stock)?

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of the corporation to which the assets are transferred for purposes of Section 368(a)(1)(D). Reg. § 1.338–3(d)(3). See Chapter 11B, infra.

73 Reg. § 1.338–3(d)(5) Example (iii).

74 61 T.C. 168 (1973).

75 See Chapter 8C1, supra.

76 Reg. § 1.338–3(d)(5) Example (v). See also Kass v. Commissioner, 60 T.C. 218 (1973).

77 Id. See also Reg. § 1.368–1(e)(8) Example 4(ii).

f. CONTINUITY OF BUSINESS ENTERPRISE

Bentsen v. Phinney

United States District Court, Southern District of Texas, 1961.
199 F.Supp. 363.

■ GARZA, DISTRICT JUDGE.

[Rio Development Company was a Texas corporation engaged in the land development business along with two other corporations. All three corporations were controlled by the Bentsen family. The three corporations transferred all their assets, subject to liabilities, to a newly formed life insurance company. The transferor corporations then liquidated, and their shareholders became shareholders of the new insurance company. The parties stipulated that there was a business purpose for the transaction.

After failing to obtain an advance ruling from the Service that their exchange of stock in the land development companies for stock in the insurance company was a tax-free transaction, the taxpayers reported a taxable gain and then took the necessary procedural steps to file a refund suit in federal district court. The taxpayers contended that the transaction qualified as a reorganization, while the Service argued that it failed to meet the requirements of Section 368 because of a lack of continuity of business enterprise. Ed.]

The question for the Court to decide is: Was such corporate transaction a corporate "reorganization", as the term "reorganization" is defined in Section 368(a)(1), Internal Revenue Code of 1954, 26 U.S.C.A. § 368(a)(1), even though Rio Development Company engaged in the land development business and thereafter the new Insurance Company engaged in the insurance business?

The plaintiff taxpayers contend there was a corporate reorganization. The Government, Defendant in this cause, maintains that there was not a corporate reorganization under Section 368(a)(1) of the Internal Revenue Code of 1954, because there was not a continuity of business enterprise before and after the reorganization; and that this is a prerequisite as set out in the Treasury Regulations.

This case is governed by the Internal Revenue Code of 1954, 26 U.S.C., the applicable sections of which provide [the quoted excerpts from Sections 368 and 354 have been omitted. Ed.].

* * *

It is conceded that the 1939 Internal Revenue Code was the same in this respect as the 1954 Code, and that the corresponding Treasury Regulations issued under the 1939 Code are similar to the corresponding Treasury Regulations issued under the 1954 Code.

The Treasury Regulation states: "Requisite to a reorganization under the Code, are a continuity of business enterprise under the modified corporate form."

The Government contends that since there was a lack of "continuity of the business enterprise", there was not a reorganization as contemplated under the statutes.

The question for this Court to decide is the meaning of "continuity of business enterprise", and whether or not it exists in this case.

The Government takes the position that "continuity of business enterprise" means that the new corporation must engage in the same identical or similar business. Stated in another manner, the Government maintains it is necessary that there must be an identity of type of business before and after the reorganization.

The plaintiff taxpayers have cited to the Court the case of Becher v. Commissioner, 221 F.2d 252 (2d Cir.1955) affirming 22 T.C. 932 (1954), which the Government has tried to distinguish. In this case the taxpayer owned all the stock in a corporation engaged in the sponge rubber and canvass-product manufacturing business. The new corporation engaged in the business of manufacturing upholstered furniture. In that case, the Government took the position that there had been a reorganization and that a cash distribution to the shareholders of the old corporation was taxable as "boot" and was ordinary income to the shareholders. The Government prevailed in that case, and the Court, at 221 F.2d 252, 253, said:

> " * * * but the Tax Court here correctly held that a business purpose does not require an identity of business before and after the reorganization. * * * "

Other cases cited are Pebble Springs Distilling Co. v. Commissioner, 231 F.2d 288 (7th Cir.1956), cert. denied 352 U.S. 836, 77 S.Ct. 56, 1 L.Ed.2d 55 affirming 23 T.C. 196 (1954). There the old corporation had the power to carry on both a whiskey distilling business and a real estate business, but it engaged solely in the real estate business.

Another case cited to the Court is Morley Cypress Trust v. Commissioner, 3 T.C. 84 (1944). In that case the old corporation owned land held for timber and the land was conveyed to a new corporation engaged in the oil business.

The Government tries to distinguish these last two cases by saying that in the Pebble Springs Distilling Co. case the new corporation could engage in the whiskey distilling business if it had wanted to, and that in the Morley Cypress Trust case, after the problem of continuity of business enterprise had been presented, the required continuity could have been found because both the old and the new corporations were actively engaged in exploiting the natural resources of the same land.

The Government also contends that under Texas law an insurance company cannot engage in any business other than that of insurance.

The Morley Cypress Trust case cited above, this Court believes, is the case most like the case before the Court. In the Morley Cypress Trust case the land was held for timber. In this case it was held for development. In the Morley case land was conveyed to a new oil corporation for use in the oil business. In this case, land (plus proceeds from the sale of land) was conveyed to a new corporation to furnish the means to capitalize a new insurance business.

The Government contends that the corresponding Treasury Regulation issued under the 1939 Code was in existence when the 1954 Code was enacted and Congress did not see fit to make any changes; that Treasury Regulations have the force of law when the Code section which they interpret is reenacted after they have once been promulgated, and cites Roberts v. Commissioner, 9 Cir., 176 F.2d 221, 10 A.L.R.2d 186.

The Government has been unable to present the Court with any decision in which the meaning of "continuity of business enterprise" as used in the Treasury Regulations, has been interpreted. Since no Court had upheld the contention made by the Government as to the interpretation to be given said words in the Regulations, it is unfair to say that Congress had an opportunity to make a change in passing the 1954 Code. Congress was not apprised of the meaning that the Government wishes to give to said language in the Regulations, and therefore the rule expressed in Roberts v. Commissioner, supra, is not controlling here.

This Court finds that no court has passed on the question of whether "continuity of business enterprise", as used in the Regulations, means that the new corporation must engage in the identical type of business or a similar business; and it is, therefore, held that this Court is not bound by any Treasury Regulation since it is the province of the Court to decide whether the Treasury Regulation means what the Government contends it means; and whether or not if it means what the Government contends, said Regulation is one that could be promulgated under the appropriate sections of the Internal Revenue Code.

This Court finds that "continuity of business enterprise", as used in the Regulations, does not mean that the new corporation must engage in either the same type of business as the old or a similar business, for if this be the requirement, then said Regulation is without authority.

To qualify as a "reorganization" under the applicable statutes, the new corporation does not have to engage in an identical or similar type of business. All that is required is that there must be continuity of the business activity.

This Court therefore finds that there was a reorganization under the applicable sections of the Internal Revenue Code.

Under the facts stipulated in this case, it is found that there was a continuity of the business activity and all requisites having been complied with, the plaintiff taxpayers have a right to a refund of the income taxes paid on the exchange of stock. The amounts to be refunded by the Government are to be those as stated in the Stipulation.

The Clerk will notify Counsel for the plaintiffs to submit an appropriate order and judgment.

Revenue Ruling 81–25

1981–1 Cum. Bull. 132.

ISSUE

For a transaction to qualify as a reorganization under section 368(a)(1) of the Internal Revenue Code of 1954, does the continuity of business enterprise requirement apply to the business or business assets of the acquiring (transferee) corporation prior to the reorganization?

LAW AND ANALYSIS

Section 1.368–1(b) of the Income Tax Regulations states that in order for a reorganization to qualify under section 368(a)(1) of the Code there must be continuity of the business enterprise under the modified corporate form.

Rev. Rul. 63–29, 1963–1 C.B. 77, holds that the continuity of business enterprise requirement of section 1.368–1(b) of the regulations was satisfied where a transferee corporation sold its assets and discontinued its business, then acquired the assets of another corporation in exchange for its voting stock, and used the sales proceeds realized from the sale of its assets to expand the business formerly conducted by the acquired corporation. The holding of Rev. Rul. 63–29 is now reflected in the recent amendment to section 1.368–1 (1.368–1(d)) of the regulations, which looks only to the transferor's historic business or historic business assets for determining if the continuity of business enterprise requirement is satisfied.

HOLDING

In a section 368(a)(1) reorganization the continuity of business enterprise requirement does not apply to the business or business assets of the transferee corporation prior to the reorganization.

* * *

NOTE

The continuity of business enterprise doctrine requires P either to continue T's historic business or to use a significant portion of T's historic business assets in a business.[78] This determination is based on all the facts

[78] Reg. § 1.368–1(d)(1).

and circumstances, applying the permissive regulations. For example, the continuity of business enterprise doctrine is satisfied in the acquisitive reorganization setting even if P transfers the acquired T assets or stock to controlled P subsidiaries, or in certain cases even to a partnership that is controlled by the P corporate group.[79] Numerous examples in the regulations illustrate how the doctrine is applied to various transactional structures.[80]

2. TYPE B: ACQUISITIONS OF STOCK SOLELY FOR VOTING STOCK

Code: § 368(a)(1)(B), (c). Skim §§ 354(a); 358; 362(b); 368(a)(2)(C), (b); 1032(a).

Regulations: § 1.368–2(c).

In its simplest form, a Type B reorganization is P's acquisition of T stock solely in exchange for P voting stock (or the voting stock of P's parent) provided that P emerges from the transaction with "control" of T.[81] For this purpose, "control" is defined as ownership of 80 percent or more of T's voting power and 80 percent or more of the total number of shares of each class of T's nonvoting stock.[82] When the smoke clears, T remains as a controlled subsidiary of P. A transaction that otherwise qualifies as a B reorganization is not disqualified if P transfers all or part of the T stock it acquires to a controlled subsidiary of P.[83]

Solely for Voting Stock Requirement. P "voting stock" is the only permissible consideration in a Type B reorganization. With a few minor exceptions discussed below, the use of even an insignificant amount of nonvoting stock, debt, or cash will disqualify the transaction. As the courts have consistently held, albeit with considerably more verbiage,[84] that there can be "no boot in a B." But the nagging policy question remains: why should the requirements for a stock-for-stock acquisition be so strict when the acquiring corporation in some other types of acquisitive reorganization has the leeway to use from 20 to 60 percent nonequity consideration?

The rigid requirements for a B reorganization have placed considerable pressure on the definition of "voting stock." Although the term is not specifically defined in the Code, "voting stock" has been

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79 Reg. § 1.368–1(d)(4) & (5).

80 Reg. § 1.368–1(d)(5). For a rare case in which a transaction was found to fail the continuity of business enterprise requirement, see Honbarrier v. Commissioner, 115 T.C. 300 (2000), where the acquiring corporation did not continue the target's historic business or use a significant portion of its historic business assets in a business.

81 I.R.C. § 368(a)(1)(B).

82 I.R.C. § 368(c).

83 I.R.C. § 368(a)(2)(C).

84 See, e.g., Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980) and Heverly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980), each rev'g Reeves v. Commissioner, 71 T.C. 727 (1979). In *Reeves*, a decision that proved to be an aberration, the Tax Court had held that there could be some boot in a B reorganization as long as P acquired at least 80 percent of T stock for P voting stock in one transaction.

interpreted to require an unconditional right to vote on regular corporate decisions (election of directors, shareholder proposals, etc.) and not merely extraordinary events such as mergers or liquidations.[85] The class of stock transferred is immaterial provided that it has voting rights. Although the Supreme Court has long held that hybrid equity securities, such as warrants to purchase additional voting stock, do not constitute voting stock, contractual rights to receive additional voting stock may qualify.[86]

The Service has allowed the parties to a B reorganization some flexibility despite the stringency of the voting stock requirement. For example, the "solely" requirement is not violated if the acquiring corporation issues cash in lieu of fractional shares.[87] The acquiring corporation also may pay the target corporation's expenses (e.g., registration fees, legal and accounting fees and other administrative costs) related to the reorganization, but payment of legal, accounting or other expenses of the target's shareholders will constitute forbidden boot.[88] Certain preferred stock with debt-like characteristics, labelled by Section 351(g) as "nonqualified preferred stock,"[89] is treated as boot for gain recognition purposes but remains "stock" for all other purposes until the regulations are modified and provide to the contrary. Thus, the receipt by target shareholders of nonqualified preferred stock with voting rights (an unlikely occurrence) should not disqualify a transaction as a Type B reorganization, but T shareholders would recognize realized gain to the extent of the value of any nonqualified preferred stock received in exchange for their T stock.[90]

Buying out Dissenting Shareholders. A particular challenge in planning a B reorganization involves shareholders of the target who insist on receiving cash. If the acquiring corporation pays cash directly to these dissenters, the transaction will violate the solely for voting stock requirement and all the target's shareholders must recognize gain. But the Service permits the target to redeem the shares of dissenters prior to a valid B reorganization provided that the cash does not emanate from the acquiring corporation and continuity of interest requirements are satisfied.[91] Another possible approach might be for the transaction to proceed as a stock-for-stock exchange, followed by a later redemption of the acquiring corporation stock held by the dissenters.[92] If they were truly dissenters, however, one would assume they would have sought

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85 Cf. Reg. § 1.302–3(a).

86 Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 62 S.Ct. 546 (1942); Rev. Rul. 66–112, 1966–1 C.B. 68.

87 Mills v. Commissioner, 39 T.C. 393 (1962), affirmed on other grounds, 331 F.2d 321 (5th Cir.1964); Rev. Rul. 66–365, 1966–2 C.B. 116.

88 Rev. Rul. 73–54, 1973–1 C.B. 187.

89 See Chapter 2B3, supra.

90 I.R.C. § 356(e).

91 Rev. Rul. 55–440, 1955–2 C.B. 226. See also Rev. Rul. 68–285, 1968–1 C.B. 147.

92 See Rev. Rul. 56–345, 1956–2 C.B. 206; Rev. Rul. 57–114, 1957–1 C.B. 122.

some assurance, albeit informal, that the later redemption would occur. In that event, the redemption likely would be part of the original reorganization plan and, if so, the entire transaction would fail.

Creeping Acquisitions. The acquiring corporation is not required to *acquire* "control" of T in a Type B reorganization. It simply must emerge from the reorganization with control, as measured by the 80 percent benchmarks in Section 368(c). It thus is possible for a Type B reorganization to be the culmination of a series of acquisitions of T stock provided, of course, that only voting stock is used as consideration and any earlier acquisitions of T stock for cash, notes or other consideration were "old and cold"—i.e., unrelated to the final stock-for-stock exchange. Whether or not an earlier cash acquisition is unrelated is essentially a factual "step transaction" question. The regulations assume that acquisitions are related if they occur over a short time span (e.g., 12 months) but not if they are separated by very long interval (e.g., 16 years).[93] This leaves a vast middle ground of uncertainty.

Contingent Payments and Escrowed Stock Arrangements. During the negotiations over an acquisitive reorganization, the parties may disagree over the price to be paid for the target corporation. The acquiring corporation may contend that the target's earnings are unpredictable or that the value of the business is clouded by contingent liabilities. The target may counter by producing optimistic earnings projections. A common method of breaking this type of stalemate is through a contingent consideration agreement. The acquiring corporation may issue a specified amount of stock or securities and agree to issue additional shares under specified contingencies. For example, additional shares may be issued to the former target shareholders if the earnings of the target attain certain levels during a specified time period after the acquisition.

There are a variety of methods to handle the payment of contingent consideration. The parties simply may agree that additional shares will be issued on the happening of specified events. The acquiring corporation may issue negotiable certificates of contingent interest. Or the parties may take the formal step of transferring the additional shares to an escrow agent with instructions to issue the shares if certain future events occur.

At one time, the Service contended that contingent rights to acquire additional stock violated the "solely for voting stock" requirement for a Type B (and Type C) reorganization. This position was not sustained by the courts, however, and the Service now concedes that contingent consideration will not disqualify an acquisitive reorganization if certain conditions are met.[94] The Service has issued guidelines for approval of

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[93] Reg. § 1.368–2(c).

[94] See, e.g., Hamrick v. Commissioner, 43 T.C. 21 (1964), acq.; Carlberg v. United States, 281 F.2d 507 (8th Cir.1960). The Service now agrees that contingent consideration is not boot

contingent and escrowed stock arrangements. The more important requirements for contingent consideration agreements are:[95] (1) to ensure compliance with the continuity of interest doctrine, only additional stock can be received; (2) the acquiring corporation must issue the stock within five years after the reorganization; (3) the arrangement must be based on a valid business reason, such as a valuation dispute; (4) there is a maximum number of contingent shares that can be issued; (5) at least 50 percent of the maximum number of shares of each class of stock must be issued in the initial distribution; (6) the contingent rights may be neither assignable nor readily marketable; and (7) the events triggering the issuance of additional stock are not within the control of the shareholders. Similar requirements are imposed where the acquiring corporation goes beyond merely promising to issue more stock and actually places the shares in escrow with an independent agent. In addition, escrowed stock must be shown as issued and outstanding on the acquiring corporation's financial statements, and the target shareholders must be entitled to any dividends paid on the stock and voting rights if, as is required in a Type B reorganization, the escrowed stock has voting rights.[96]

3. TYPE C: ACQUISITIONS OF ASSETS FOR VOTING STOCK

Code: § 368(a)(1)(C), (a)(2)(B), (a)(2)(G). Skim §§ 336(c); 354(a); 356(a); 357; 358(a); 361; 362(b); 368(a)(2)(C), (b); 381(a)(2); 1032(a).

Regulations: § 1.368–2(d).

General Requirements. Type C reorganizations are known as "practical mergers" because their end result is generally the same as a merger. The only difference may be the form of the transaction under local corporate law. In a statutory merger, all the assets and liabilities of the target are absorbed by the acquiring corporation automatically, while an asset acquisition technically requires a "transfer" of assets and liabilities under a negotiated agreement and does not necessarily require the target to sell all of its assets or to liquidate.[97]

Despite their similarities in form, it is far more difficult to qualify as a Type C stock-for-assets exchange than as a Type A statutory merger because of the more stringent consideration requirements. Section 368(a)(1)(C) requires the target to transfer "substantially all" of its properties *solely* in exchange for voting stock of the acquiring corporation. Although "voting stock" has the same meaning for both B and C reorganizations, the term "solely" in Section 368(a)(1)(C) is subject to two

but only if the contingent rights to additional shares are not negotiable. See Rev. Rul. 66–112, 1966–1 C.B. 68.

[95] See Rev. Proc. 77–37, supra note 43, amplified by Rev. Proc. 84–42, 1984–1 C.B. 521.

[96] Rev. Proc. 84–42, supra note 95.

[97] See, e.g., Cal. Corp. Code § 1100; 8 Del. Code § 251. A liquidation of the target is required in a Type C reorganization, however, unless the Commissioner waives the requirement. I.R.C. § 368(a)(2)(G)(ii).

important exceptions. First, the assumption of liabilities by the acquiring corporation (or the taking of property subject to liabilities) is not treated as disqualifying boot.[98] Second, a "boot relaxation rule" permits the acquiring corporation to use up to 20 percent boot, but for this purpose the transferred liabilities are considered as cash consideration.[99] A transaction thus can qualify as a Type C reorganization when the consideration consists of a substantial amount of debt relief as long as no other boot is used and sufficient voting stock is transferred to maintain continuity of interest. But a combination of debt relief and other boot likely will spell doom for the transaction.

To illustrate the operation of these rules, assume that Target ("T") has gross assets of $120,000 and liabilities of $30,000. Acquiring Corporation ("A") proposes to acquire all of T's assets in exchange for the assumption of $30,000 of liabilities and $90,000 of A voting stock. The transaction qualifies as a C reorganization because the liabilities are not treated as boot. But if A assumes the $30,000 of liabilities and transfers $80,000 of voting stock and $10,000 of cash, the transaction does not qualify. The liabilities are treated as "money paid" for purposes of the boot relaxation rule, and thus A has acquired only 66⅔ percent of the $120,000 gross assets of T for voting stock. On these facts, A must use at least $96,000 of voting stock (80 percent of $120,000) in order for the transaction to qualify as a Type C reorganization under the boot relaxation rule. This example illustrates that in the normal situation where T's liabilities exceed 20 percent of the value of its gross assets, no boot may be used.

Substantially All of the Properties. The target also must transfer "substantially all" of its properties. The Service's longstanding administrative benchmark requires a transfer of "assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the target corporation immediately preceding the transfer."[100] These guidelines further provide that "all payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the corporation immediately preceding the transfer and which are part of the plan of reorganization will be considered as assets held by the corporation immediately prior to the transfer."[101] Other authorities are not as stringent in defining "substantially all," and it is possible that a complete transfer of *operating* assets may qualify even if the Service's percentage tests are not met.[102] Moreover, the Service has ruled that the "substantially all" test is met when the target corporation sells 50 percent

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98 I.R.C. § 368(a)(1)(C).

99 I.R.C. § 368(a)(2)(B).

100 Rev. Proc. 77–37, supra note 43, § 3.01.

101 Id.

102 See, e.g., Rev. Rul. 57–518, 1957–2 C.B. 253; Commissioner v. First National Bank of Altoona, 104 F.2d 865 (3d Cir.1939) (86% of net worth is "substantially all").

of its historic assets to unrelated parties for cash and then transfers all of its assets, including the sales proceeds, to the acquiring corporation.[103] The key to this favorable ruling is that the overall transaction is not "divisive" because the cash proceeds from the asset sale were not retained by the target or its shareholders.

Liquidation Requirement. At one time, the target corporation in a C reorganization was not required to distribute its assets (which ordinarily will consist primarily of voting stock of the acquiring corporation) in complete liquidation. Some targets chose to stay alive as a holding company with a fresh set of tax attributes.[104] Others opted to distribute the voting stock acquired in the reorganization while retaining other assets that might trigger adverse tax consequences (e.g., a dividend) if distributed to the shareholders.[105] To prevent these and other perceived abuses, Congress added a new rule requiring the target to distribute all of its assets pursuant to the plan of reorganization unless the Service, pursuant to regulations that it has yet to issue, agrees to waive the distribution requirement.[106] In the event of a waiver, however, the legislative history states that the retained assets must be treated as if they had been distributed to the T shareholders and recontributed to the capital of a new corporation.[107]

Creeping Acquisitions. A final issue is the treatment of a transaction where the acquiring corporation has previously purchased some stock of the target and now seeks to assume complete control by acquiring all of T's assets through a liquidation of T. We have seen that a creeping acquisition will not necessarily poison the final stock-for-stock exchange in a B reorganization, at least if the stock previously acquired for cash is "old and cold"—i.e., acquired in an unrelated transaction. For many years, creeping C reorganizations were impeded by the Service's wooden interpretation of the "solely for voting stock" requirement.[108] This longstanding position has been reversed by regulations providing that P's prior ownership of a portion of T stock will not by itself prevent the "solely for voting stock" requirement from being met.[109] The Service finally came to its senses and concluded that a transaction in which P converts an

[103] Rev. Rul. 88–48, 1988–1 C.B. 117.

[104] The tax attributes (e.g., earnings and profits) of the target automatically pass to the acquiring corporation on a Type C reorganization. I.R.C. § 381(a)(2).

[105] See Rev. Rul. 73–552, 1973–2 C.B. 116.

[106] I.R.C. § 368(a)(2)(G). See Rev. Proc. 89–50, 1989–2 C.B. 631, for representations which ordinarily must be included in a request for the Service to waive the liquidation requirement.

[107] H.R.Rep. No. 98–861, 98th Cong., 2d Sess. 846 (1984).

[108] Rev. Rul. 54–396, 1954–2 C.B. 147 (P, which owned 79 percent of S as result of prior unrelated cash purchase, acquired T's assets in exchange for P voting stock, after which T liquidated and distributed P stock to minority shareholders. The transaction was ruled not to qualify as a Type C reorganization because P acquired only 21 percent of T's assets for voting stock and the remaining 79 percent as a liquidating distribution in exchange for previously held T stock). The Service's position was sustained in Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.1959).

[109] Reg. § 1.368–2(d)(4)(i).

indirect interest in T's assets to a direct interest in those assets does not necessarily resemble a taxable sale by T of those properties.

To enforce the statutory continuity of interest rules, the regulations provide that where the Section 368(a)(2)(B) boot relaxation rule applies to the final step of a creeping Type C reorganization, the sum of: (1) the money or other boot distributed to T shareholders other than P and to T's creditors, and (2) the liabilities of T assumed by P, may not exceed 20 percent of the value of all of T's properties.[110] But if P acquires T stock from a shareholder of T or T itself for cash or boot as part of the acquisition, such consideration is counted as boot in applying the boot relaxation rule.[111] To illustrate, assume that in an unrelated transaction P acquired 60 percent of the stock of T for cash. T's assets have a value of $110, and it has $10 of liabilities. Assume T transfers all its assets to P and, in exchange, P assumes the liabilities and transfers to T $30 of P voting stock and $10 of cash, and then T distributes the P voting stock and cash to its shareholders (other than P) and liquidates. This transaction will qualify as a Type C reorganization because the sum of cash paid and liabilities assumed ($20) does not exceed 20 percent of the value of T's assets.[112] If, however, P's cash acquisition of 60 percent of T was not "old and cold"—i.e., was related to the subsequent asset acquisition—the transaction would not qualify as tax-free because only 30 percent of the consideration used by P was voting stock.[113]

Step Transaction Issues. Assume T Corporation is acquired by P Corporation in a stock-for-stock exchange that qualifies as a Type B reorganization but, as part of an overall acquisition plan, T promptly liquidates, distributing its assets to P. Should the overall transaction be treated as a Type C reorganization and tested accordingly or should the two steps be considered independently in determining the tax consequences? When would it make any difference? The IRS's view on the application of the step transaction to this fact pattern is revealed in Revenue Ruling 67–274, below.

Revenue Ruling 67–274

1967–2 Cum. Bull. 141.

Advice has been requested whether the transaction described below qualifies as a reorganization within the meaning of section 368(a)(1)(B) of the Internal Revenue Code of 1954.

Pursuant to a plan of reorganization, corporation Y acquired all of the outstanding stock of corporation X from the X shareholders in exchange solely for voting stock of Y. Thereafter X was completely liquidated as part of the same plan and all of its assets were transferred

110 Id.

111 Id.

112 Reg. § 1.368–2(d)(4)(ii) Example 1.

113 Reg. § 1.368–2(d)(4)(ii) Example 2.

to Y which assumed all of the liabilities of X. Y continued to conduct the business previously conducted by X. The former shareholders of X continued to hold 16 percent of the fair market value of all the outstanding stock of Y.

Section 368(a)(1)(B) of the Code provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control (as defined in section 368(c) of the Code) of such other corporation. Section 368(a)(1)(C) of the Code provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, is disregarded.

Under the circumstances of this case the acquisition of X stock by Y and the liquidation of X by Y are part of the overall plan of reorganization and the two steps may not be considered independently of each other for Federal income tax purposes. See Revenue Ruling 54–96, 1954–1 C.B. 111, as modified by Revenue Ruling 56–100, 1956–1C.B. 624. The substance of the transaction is an acquisition of assets to which section 368(a)(1)(B) of the Code does not apply.

Accordingly, the acquisition by Y of the outstanding stock of X will not constitute a reorganization within the meaning of section 368(a)(1)(B) of the Code but will be considered an acquisition of the assets of X which in this case is a reorganization described in section 368(a)(1)(C) of the Code. * * * .

4. TRIANGULAR REORGANIZATIONS

Code: § 368(a)(1)(B) (first parenthetical) and (C) (first parenthetical), (a)(2)(C), (D) & (E), (b).

Regulations: § 1.368–2(b)(2), (f), (j)(1), (3)–(6).

Background. The three basic types of reorganizations offer limited flexibility if the acquiring corporation desires to operate the target as a wholly owned subsidiary. Assume, for example, that P, Inc. wishes to acquire T, Inc. and keep T's business in a separate corporation for nontax reasons. Although this objective could be met by a Type B reorganization, the stringent "solely for voting stock" requirement might be an insurmountable obstacle if P desired to use nonvoting stock as consideration or if a large number of T shareholders were unwilling to accept any class of P stock. Even the flexible A reorganization may not be feasible from a nontax standpoint. P may not wish to incur the risk of T's unknown or contingent liabilities which would remain P's responsibility even if T's assets were dropped down to a subsidiary. P also may be reluctant to bear the expense and delay of seeking formal approval of its shareholders or unwilling to provide T shareholders with the appraisal rights to which they would be entitled under state law on a direct merger.

To maneuver around these problems, corporate lawyers developed other acquisition methods involving the use of a subsidiary. One approach is for P to acquire T's assets in a qualifying Type A or C reorganization and immediately drop down the acquired assets to a newly created subsidiary. This technique does not solve the hidden liability problem, however, and it may not obviate the need for shareholder approval and appraisal rights.[114] An alternative is for P to transfer its stock to a new subsidiary ("S"), and then cause T to merge directly into S, with the T shareholders receiving P stock and, perhaps, other consideration in exchange for their T stock. Or P could form S and have S acquire substantially all of the assets of T in exchange for P voting stock.

The tax consequences of these and other triangular acquisition techniques have been a major subplot within the reorganization drama. In two early cases, the Supreme Court constructed several large roadblocks by holding that transactions similar to those described above failed to satisfy the continuity of interest doctrine if: (1) T merges into S but T shareholders receive P stock in a triangular reorganization, or (2) P makes the acquisition using P stock but drops T or its assets down to a subsidiary.[115]

Over the years, Congress gradually came to recognize that there was no reason to deny tax-free status to "drop downs" or triangular reorganizations that were economically equivalent to the simpler acquisition methods authorized by Section 368. In the 1954 Code, it added Section 368(a)(2)(C), which provides that an otherwise qualifying Type A or C reorganization will not lose its tax-free status merely because the acquiring corporation drops down the acquired assets to a subsidiary and it later added a similar rule for Type B reorganizations. Congress also permitted the acquiring corporation in a B or C reorganization to use voting stock of its parent to make the acquisition. For both drop downs and triangular reorganizations, Section 368(b) now makes it clear that the controlling parent will be a "party" to the reorganization. But the Service persisted in ruling that a merger of the target into a controlled subsidiary of the acquiring corporation was not tax-free when the target shareholders received stock of the parent because the parent was not a "party" to the reorganization and the T shareholder lacked continuity of

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[114] "Drop downs" also are inconvenient because they usually require an inordinate amount of paperwork (e.g., deeds and other documents of transfer, with accompanying recording fees and transfer taxes) as the assets pass from the parent to the subsidiary.

[115] Groman v. Commissioner, 302 U.S. 82, 58 S.Ct. 108 (1937); Helvering v. Bashford, 302 U.S. 454, 58 S.Ct. 307 (1938). These cases also suggested that in no event could the T shareholders receive stock in both S and P because the receipt of stock in two separate corporations violated continuity of interest requirements.

interest.[116] Once again, Congress responded by adding two new categories of tax-free reorganizations: the Section 368(a)(2)(D) forward triangular merger and the Section 368(a)(2)(E) reverse triangular merger.

Forward Triangular Mergers: Section 368(a)(2)(D). From the time it was authorized as a tax-free reorganization in 1969, the forward triangular merger has become one of the most widely used acquisition techniques. Section 368(a)(2)(D) permits S to acquire T in a statutory merger, using P stock as consideration, provided that: (1) S acquires "substantially all" of the properties of T; (2) no stock of S is used in the transaction; and (3) the transaction would have qualified as a Type A reorganization if T had merged directly into P. In typically perverse fashion, Congress—without expressly articulating its rationale—reached into its bag of requirements and borrowed one from the Type C model ("substantially all of the properties") and another from the Type A model (the tests for permissible consideration). Although the legislative history is obscure, it is now clear that the "could have merged with parent" test merely requires the transaction to pass muster under the continuity of interest doctrine.[117] As a result, T shareholders only must receive at least 50 percent P stock (voting or nonvoting) under the Service's continuity guidelines, allowing the parties the freedom to use up to 50 percent cash and other nonequity consideration. Of course, the T shareholders who receive boot must recognize their realized gain to that extent, but those who receive solely stock will enjoy nonrecognition if the overall transaction qualifies under these liberal standards.

Reverse Triangular Mergers: Section 368(a)(2)(E). Before examining the tax consequences of a reverse triangular merger, the transaction itself must be explained. Suppose P desires to acquire the stock of T in a tax-free reorganization and keep T alive as a subsidiary, but P is unable (or unwilling) to structure the deal as a Type B reorganization because of the "solely for voting stock" requirement. Neither a merger nor an asset acquisition is feasible because T, as a corporate entity, has a number of intangible assets (e.g., grandfather rights under state law; franchises or leases; favorable loan agreements) that would be jeopardized if T were dissolved or it would simply take longer or involve cumbersome regulatory hoops to structure the deal as a merger. One ingenious solution to this dilemma is for P to create S, contributing to it P voting stock, and then for S to merge into T under an agreement providing that T shareholders will receive P stock (and, possibly, other consideration) in exchange for their T stock. A variation on the theme, albeit a rare one, would be to use an existing subsidiary with ongoing business activities. In that event, the reverse merger would result in T's business being augmented by S's, all conducted under the same corporate roof. In either

116 Rev. Rul. 67–448, 1967–2 C.B. 144.

117 Reg. § 1.368–2(b)(2).

case, when the smoke clears P will own all the stock of T and S will disappear as a result of the merger.

Section 368(a)(2)(E) provides that this type of reverse merger will qualify as a tax-free reorganization if: (1) the surviving corporation (T) holds substantially all of the properties formerly held by both corporations (T and S), and (2) the former T shareholders exchange stock constituting "control" (measured by the 80 percent tests in Section 368(c)(1)) for P voting stock.[118] Once again, Congress borrowed from its bag of requirements and combined tests from Type A (merger), Type B (control) and Type C (substantially all of the properties) reorganizations. The reverse merger is thus less flexible for tax purposes than the forward triangular merger, perhaps reflecting its Type B origins. But there *can* be boot in an "(a)(2)(E)" reorganization; only 80 percent of the T stock must be acquired for P voting stock, and the rest may be obtained for cash or other property—or simply not acquired at all if P is willing to put up with minority shareholders.

Although Congress deserves applause for abandoning the formalisms of the old case law, its piecemeal approach to triangular reorganizations is yet another example of the major flaw in the reorganization scheme. In enacting Sections 368(a)(2)(D) and (E), each with its own distinct requirements, Congress added further embroidery to what already had become a crazy quilt. As the Senate Finance Committee staff lamented in its preliminary report on the reform and simplification of Subchapter C, many of the arcane distinctions in Section 368 "defy rationalization" and "[n]o discernible public policy would so sharply distinguish among the forms of an acquisition that are economically so similar."[119] Congress would be well advised to move toward a system that would impose consistent requirements on economically equivalent acquisition techniques.[120]

5. MULTI-STEP ACQUISITIONS

Regulations: § 1.338(h)(10)–1(c)(2).

We have seen that choosing the optimal structure for a corporate acquisition involves a wide range of legal and strategical considerations. From the buyer's perspective, important factors include determining the price to be paid for the target corporation and the mix of consideration to be used. Apart from taxes, other factors driving deal structure are the accounting treatment, regulatory hurdles, stock exchange rules, treatment of employer stock options, and timing, to name just a few.

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[118] I.R.C. § 368(a)(2)(E)(ii). See Reg. § 1.368–2(j)(3)(ii).

[119] See Staff of the Senate Finance Committee, Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations, 98th Cong., 1st Sess., 26–27, 55–66 (Comm.Print S. 98–95, 1983).

[120] See Staff of the Senate Finance Committee: The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff, 99th Cong., 1st Sess. (S.Prt. 99–47, 1985); Posin, "Taxing Corporate Reorganizations: Purging Penelope's Web," 133 U. Penn. L. Rev. 1335 (1985).

For all these reasons, it is often desirable for the parties to an acquisition to employ a multi-step structure. For example, acquisitions of public companies may proceed at a quicker pace if the first step does not require regulatory clearance, consents from lenders or others with a contractual relationship to P or T, or actions that could impede the momentum of the deal. A good example of a two-step acquisition is when P makes a tender offer for T's stock at an attractive price and acquires sufficient stock to achieve control (but not 100 percent ownership) of T, enabling P to orchestrate a merger of T into P (or more likely into a P subsidiary), squeezing out the minority shareholders. The non-tax aspects of this and other deal structures are complex and beyond the scope of this text. Our concern here is to what extent the federal tax laws have accommodated the multi-step acquisition phenomenon.

The rulings below are a reflection of the Service's willingness to apply the step transaction doctrine to facilitate multi-step acquisitions.[121] This often results in qualifying the integrated transaction as a tax-free reorganization where the separate steps, if viewed in isolation, would not qualify.

Revenue Ruling 2001–26

2001–1 Cum. Bull. 1297.

ISSUE

On the facts described below, is the control-for-voting-stock requirement of § 368(a)(2)(E) of the Internal Revenue Code satisfied, so that a series of integrated steps constitutes a tax-free reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) and § 354 or § 356 applies to each exchanging shareholder?

FACTS

Situation 1. Corporation P and Corporation T are widely held, manufacturing corporations organized under the laws of state A. T has only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of the outstanding stock of T. For valid business reasons, the acquisition will be effected by a tender offer for at least 51 percent of the stock of T, to be acquired solely for P voting stock, followed by a merger of a subsidiary of P into T. P initiates a tender offer for T stock conditioned on the tender of at least 51 percent of the T shares. Pursuant to the tender offer, P acquires 51 percent of the T stock from T's shareholders for P voting stock. P forms S and S merges into T under the merger laws of state A. In the statutory merger, P's S stock is

reverse triangular merge

T sh receive: 66.6% P v
33.3% cas

[121] See also Rev. Rul. 2001–24, 2001–1 C.B. 1290 (following a forward triangular merger of T into S, a P subsidiary, P may drop down the S stock to another of its controlled subsidiaries); Rev. Rul. 2001–25, 2001–1 C.B. 1291 (following a reverse triangular merger of S, a transitory subsidiary of P, into T, T may sell 50 percent of its operating assets to an unrelated buyer without violating the "substantially all of its properties" requirement of Section 368(a)(2)(E) if it retains the sales proceeds).

converted into T stock and each of the T shareholders holding the remaining 49 percent of the outstanding T stock exchanges its shares of T stock for a combination of consideration, two-thirds of which is P voting stock and one-third of which is cash. Assume that under general principles of tax law, including the step transaction doctrine, the tender offer and the statutory merger are treated as an integrated acquisition by P of all of the T stock. Also assume that all nonstatutory requirements for a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E) and all statutory requirements of § 368(a)(2)(E), other than the requirement under § 368(a)(2)(E)(ii) that P acquire control of T in exchange for its voting stock in the transaction, are satisfied.

Situation 2. The facts are the same as in Situation 1, except that S initiates the tender offer for T stock and, in the tender offer, acquires 51 percent of the T stock for P stock provided by P.

LAW AND ANALYSIS

Section 368(a)(1)(A) states that the term "reorganization" means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) will not be disqualified by reason of the fact that stock of a corporation (the "controlling corporation") that before the merger was in control of the merged corporation is used in the transaction, if (1) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (2) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation that constitutes control of such corporation (the "control-for-voting-stock requirement"). For this purpose, control is defined in § 368(c).

In King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct.Cl.1969), as part of an integrated plan, a corporation acquired all of the stock of a target corporation from the target corporation's shareholders for consideration, in excess of 50 percent of which was acquiring corporation stock, and subsequently merged the target corporation into the acquiring corporation. The court held that, because the merger was the intended result of the stock acquisition, the acquiring corporation's acquisition of the target corporation qualified as a reorganization under § 368(a)(1)(A).

* * *

Section 1.368–1(c) of the Income Tax Regulations provides that a plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in § 368(a) and the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Section 1.368–2(g) provides that the term plan of reorganization is not to be construed as broadening the definition of reorganization as set forth in § 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in § 368(a).

As assumed in the facts, under general principles of tax law, including the step transaction doctrine, the tender offer and the statutory merger in both Situations 1 and 2 are treated as an integrated acquisition by P of all of the T stock. The principles of King Enterprises support the conclusion that, because the tender offer is integrated with the statutory merger in both Situations 1 and 2, the tender offer exchange is treated as part of the statutory merger (hereinafter the "Transaction") for purposes of the reorganization provisions. Cf. J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995) (treating a tender offer that was an integrated step in a plan that included a forward triangular merger as part of the merger transaction). Consequently, the integrated steps, which result in P acquiring all of the stock of T, must be examined together to determine whether the requirements of § 368(a)(2)(E) are satisfied. Cf. § 1.368–2(j)(3)(i); § 1.368–2(j)(6), Ex. 3 (suggesting that, absent a special exception, steps that are prior to the merger, but are part of the transaction intended to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E), should be considered for purposes of determining whether the control-for-voting-stock requirement is satisfied).

In both situations, in the Transaction, the shareholders of T exchange, for P voting stock, an amount of T stock constituting in excess of 80 percent of the voting stock of T. Therefore, the control-for-voting-stock requirement is satisfied. Accordingly, in both Situations 1 and 2, the Transaction qualifies as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E).

Under §§ 1.368–1(c) and 1.368–2(g), all of the T shareholders that exchange their T stock for P stock in the Transaction will be treated as exchanging their T stock for P stock in pursuance of a plan of reorganization. Therefore, T shareholders that exchange their T stock only for P stock in the Transaction will recognize no gain or loss under § 354. T shareholders that exchange their T stock for P stock and cash in the Transaction will recognize gain to the extent provided in § 356. In both Situations 1 and 2, none of P, S, or T will recognize any gain or loss in the Transaction, and P's basis in the T stock will be determined under § 1.358–6(c)(2) by treating P as acquiring all of the T stock in the Transaction and not acquiring any of the T stock before the Transaction.

HOLDING

On the facts set forth in Situations 1 and 2, the control-for-voting-stock requirement is satisfied in the Transaction, the Transaction constitutes a tax-free reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E), and § 354 or § 356 applies to each exchanging shareholder.

Revenue Ruling 2008–25

2008–1 Cum. Bull. 986.

ISSUE

What is the proper Federal income tax treatment of the transaction described below?

FACTS

P | X T

T is a corporation all of the stock of which is owned by individual A. T has 150x dollars worth of assets and 50x dollars of liabilities. P is a corporation that is unrelated to A and T. The value of P's assets, net of liabilities, is 410x dollars. P forms corporation X, a wholly owned subsidiary, for the sole purpose of acquiring all of the stock of T by causing X to merge into T in a statutory merger (the "Acquisition Merger"). In the Acquisition Merger, P acquires all of the stock of T, and A exchanges the T stock for 10x dollars in cash and P voting stock worth 90x dollars. Following the Acquisition Merger and as part of an integrated plan that included the Acquisition Merger, T completely liquidates into P (the "Liquidation"). In the Liquidation, T transfers all of its assets to P and P assumes all of T's liabilities. The Liquidation is not accomplished through a statutory merger. After the Liquidation, P continues to conduct the business previously conducted by T.

LAW

Section 368(a)(1)(A) of the Internal Revenue Code provides that the term "reorganization" means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) shall not be disqualified by reason of the fact that stock of a corporation in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of the surviving corporation. Further, § 1.368–2(j)(3)(iii) of the Income Tax Regulations provides that "[i]n applying the 'substantially all' test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account."

Section 368(a)(1)(C) provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other shall be disregarded. Section 368(a)(2)(B) provides that if one corporation acquires substantially all of the properties of another corporation, the acquisition would qualify under § 368(a)(1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and the acquiring corporation acquires, solely for voting stock described in § 368(a)(1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to § 368(a)(2)(A)) be treated as qualifying under § 368(a)(1)(C). Section 368(a)(2)(B) further provides that solely for purposes of determining whether its requirements are satisfied, the amount of any liabilities assumed by the acquiring corporation shall be treated as money paid for the property.

Section 1.368–1(a) generally provides that in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine.

Section 1.368–2(k) provides, in part, that a transaction otherwise qualifying as a reorganization under § 368(a) shall not be disqualified or recharacterized as a result of one or more distributions to shareholders (including distribution(s) that involve the assumption of liabilities) if the requirements of § 1.368–1(d) are satisfied, the property distributed consists of assets of the surviving corporation, and the aggregate of such distributions does not consist of an amount of assets of the surviving corporation (disregarding assets of the merged corporation) that would result in a liquidation of such corporation for Federal income tax purposes.

Rev. Rul. 67–274, 1967–2 C.B. 141, holds that an acquiring corporation's acquisition of all of the stock of a target corporation solely in exchange for voting stock of the acquiring corporation, followed by the liquidation of the target corporation as part of the same plan, will be treated as an acquisition by the acquiring corporation of substantially all of the target corporation's assets in a reorganization described in § 368(a)(1)(C). The ruling explains that, under these circumstances, the stock acquisition and the liquidation are part of the overall plan of reorganization and the two steps may not be considered independently of each other for Federal income tax purposes. See also, Rev. Rul. 72–405, 1972–2 C.B. 217.

Rev. Rul. 2001–46, 2001–2 C.B. 321, holds that, where a newly formed wholly owned subsidiary of an acquiring corporation merged into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the step transaction doctrine is applied to integrate the steps and treat the transaction as a single statutory merger of the target corporation into the acquiring corporation. Noting that the rejection of step integration in Rev. Rul. 90–95, 1990–2 C.B. 67, and § 1.338–3(d) is based on Congressional intent that § 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine, the Service found that the policy underlying § 338 is not violated by treating the steps as a single statutory merger of the target into the acquiring corporation because such treatment results in a transaction that qualifies as a reorganization in which the acquiring corporation acquires the assets of the target corporation with a carryover basis under § 362, rather than receiving a cost basis in those assets under § 1012. (In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation's assets with the purchaser receiving a cost basis in the assets.)

Section 338(a) provides that if a corporation makes a qualified stock purchase and makes an election under that section, then the target corporation (i) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value and (ii) shall be treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. Section 338(d)(3) defines a qualified stock purchase as any transaction or series of transactions in which stock (meeting the requirements of § 1504(a)(2)) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period. Section 338(h)(3) defines a purchase generally as any acquisition of stock, but excludes acquisitions of stock in exchanges to which § 351, § 354, § 355, or § 356 applies.

Section 338 was enacted in 1982 and was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine." H.R. Conf. Rep. No. 760, 97th Cong, 2d Sess. 536 (1982), 1982–2 C.B. 600, 632. Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a § 338 election. If the election is made or deemed made, asset purchase treatment results and the basis of the target assets is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, the stock purchase treatment generally results. In such a case, the basis of the target assets is not adjusted to reflect the stock purchase price and other relevant items.

Rev. Rul. 90–95 (Situation 2), holds that the merger of a newly formed wholly owned domestic subsidiary into a target corporation with the target corporation shareholders receiving solely cash in exchange for their stock, immediately followed by the merger of the target corporation into the domestic parent of the merged subsidiary, will be treated as a qualified stock purchase of the target corporation followed by a § 332 liquidation of the target corporation. As a result, the parent's basis in the target corporation's assets will be the same as the basis of the assets in the target corporation's hands. The ruling explains that even though "the step-transaction doctrine is properly applied to disregard the existence of the [merged subsidiary]," so that the first step is treated as a stock purchase, the acquisition of the target corporation's stock is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase regardless of whether a § 338 election is made. Thus, in that case, the step transaction doctrine was not applied to treat the transaction as a direct acquisition by the domestic parent of the assets of the target corporation because such an application would have resulted in treating a stock purchase as an asset purchase, which would be inconsistent with the repeal of the Kimbell-Diamond doctrine and § 338.

Section 1.338–3(d) incorporates the approach of Rev. Rul. 90–95 into the regulations by requiring the purchasing corporation (or a member of its affiliated group) to treat certain asset transfers following a qualified stock purchase (where no § 338 election is made) independently of the qualified stock purchase. In the example in § 1.338–3(d)(5), the purchase for cash of 85 percent of the stock of a target corporation, followed by the merger of the target corporation into a wholly owned subsidiary of the purchasing corporation, is treated (other than by certain minority shareholders) as a qualified stock purchase of the stock of the target corporation followed by a § 368 reorganization of the target corporation into the subsidiary. As a result, the subsidiary's basis in the target corporation's assets is the same as the basis of the assets in the target corporation's hands.

ANALYSIS

If the Acquisition Merger and the Liquidation were treated as separate from each other, the Acquisition Merger would be treated as a stock acquisition that qualifies as a reorganization under § 368(a)(1)(A) by reason of § 368(a)(2)(E), and the Liquidation would qualify under § 332. However, as provided in § 1.368–1(a), in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. In this case, because T was completely liquidated, the § 1.368–2(k) safe harbor exception from the application of the step transaction doctrine does not apply. Accordingly, the Acquisition Merger and the Liquidation may not be considered independently of each other for purposes of determining whether the transaction satisfies the statutory requirements of a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E). As such, this transaction does not qualify as a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E) because, after the transaction, T does not hold substantially all of its properties and the properties of the merged corporation.

In determining whether the transaction is a reorganization, the approach reflected in Rev. Rul. 67–274 and Rev. Rul. 2001–46 is applied to ignore P's acquisition of the T stock in the Acquisition Merger and to treat the transaction as a direct acquisition by P of T's assets in exchange for 10x dollars in cash, 90x dollars worth of P voting stock, and the assumption of T's liabilities.

However, unlike the transactions considered in Revenue Rulings 67–274, 72–405 and 2001–46, a direct acquisition by P of T's assets in this case does not qualify as a reorganization under § 368(a). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(C) because the consideration exchanged is not solely P voting stock and the requirements of § 368(a)(2)(B) are not satisfied. Section 368(a)(2)(B) would treat P as acquiring 40 percent of T's assets for consideration other than P voting stock (liabilities assumed of 50x dollars, plus 10x dollars cash). See Rev. Rul. 73–102, 1973–1 C.B. 186 (analyzing the application of § 368(a)(2)(B)). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(D) because neither T nor A (nor a combination thereof) was in control of P (within the meaning of § 368(a)(2)(H)(i)) immediately after the transfer. Additionally, the transaction is not a reorganization under § 368(a)(1)(A) because T did not merge into P. Accordingly, the overall transaction is not a reorganization under § 368(a).

Additionally, P's acquisition of the T stock in the Acquisition Merger is not a transaction to which § 351 applies because A does not control P (within the meaning of § 368(c)) immediately after the exchange.

Rev. Rul. 90–95 and § 1.338–3(d) reject the step integration approach reflected in Rev. Rul. 67–274 where the application of that approach would treat the purchase of a target corporation's stock without a § 338 election followed by the liquidation or merger of the target corporation as the purchase of the target corporation's assets resulting in a cost basis in the assets under § 1012. Rev. Rul. 90–95 and § 1.338–3(d) treat the acquisition of the stock of the target corporation as a qualified stock purchase followed by a separate carryover basis transaction in order to preclude any nonstatutory treatment of the steps as an integrated asset purchase.

In this case, further application of the approach reflected in Rev. Rul. 67–274, integrating the acquisition of T stock with the liquidation of T, would result in treating the acquisition of T stock as a taxable purchase of T's assets. Such treatment would violate the policy underlying § 338 that a cost basis in acquired assets should not be obtained through the purchase of stock where no § 338 election is made. Accordingly, consistent with the analysis set forth in Rev. Rul. 90–95, the acquisition of the stock of T is treated as a qualified stock purchase by P followed by the liquidation of T into P under § 332.

HOLDING

The transaction is not a reorganization under § 368(a). The Acquisition Merger is a qualified stock purchase by P of the stock of T under § 338(d)(3). The Liquidation is a complete liquidation of a controlled subsidiary under § 332.

NOTE

Experienced tax professionals have come to understand that "the step-transaction doctrine generally applies . . . except when it doesn't."[122] What factors in the rulings above supported application of the doctrine? Was it because the first step was conditioned on the second occurring? Does Revenue Ruling 2001–26 offer any guiding principle for application of the doctrine, or does it simply assume for purposes of analysis that the tender offer and merger should be integrated?

A critical point made in the most recent multi-step acquisition rulings is that application of the step transaction doctrine is permissible when it does not violate the policy of Section 338. What policy? Does that suggest that the step transaction doctrine should not be applied to the prototype *Kimbell-Diamond* transaction where P purchases 80 percent or more of T's stock and promptly liquidates T, winding up with direct ownership of its assets? If the step transaction doctrine did apply to that fact pattern, P would take a cost basis in T's assets even though no Section 338 election was made—a result clearly at variance with the policy of Section 338.

What if the first step is a qualified stock purchase under Section 338, and P and S (T's corporate parent) jointly make a Section 338(h)(10) election? In that situation, should the first step be viewed in isolation for tax purposes or should step transaction principles be applied, resulting in reorganization treatment and nullification of the Section 338 election? What if T is not a subsidiary and P unilaterally makes a Section 338 election?

The Service has issued regulations answering some of these questions. They provide that the step transaction doctrine will not apply to a multi-step acquisition if the first step is a qualified stock purchase under Section 338 and the parties to the transaction make a joint Section 338(h)(10) election with respect to that step, whether or not the overall transaction would have qualified as a reorganization.[123] To illustrate, assume that P, Inc. owns all the stock of Y, Inc., a newly formed subsidiary, and S, Inc. owns all the stock of T, Inc. As the first step in P's acquisition of T's assets, Y, Inc. merges into T, with T surviving, and S (T's only shareholder) receives 50 percent P voting stock and 50 percent cash. This step, viewed independently, does not qualify as a reorganization and does constitute a qualified stock purchase. T then merges into P. If P and S do not make a Section 338(h)(10) election, the step transaction doctrine would be applied, and the overall acquisition would be treated as a Section 368 reorganization. But if P and S jointly make a Section 338(h)(10) election, the regulations "turn off" the step transaction doctrine and treat P's acquisition of the T stock in the reverse merger as a qualified stock purchase, causing "old T" to recognize gain or loss on the deemed sale of its assets and "new T"—and then P, after the merger into P—to take a cost basis in its assets.[124] If, however, the first step does not constitute a qualified stock purchase under Section 338(d)(3)—such as where the first step, viewed

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[122] See Stratton, "Step-Transaction Doctrine Tested Under Corporate Rulings," 93 Tax Notes 332 (Oct. 15, 2001), quoting an I.R.S. official who was quoting an unnamed law professor.

[123] Reg. § 1.338(h)(10)–1(c)(2).

[124] Reg. § 1.338(h)(10)–1(e) Examples 11 and 12.

independently, was a Section 368 reorganization—then no Section 338(h)(10) election can be made and the overall acquisition will be treated as a reorganization.[125] The regulations do not address a situation where a unilateral Section 338 election is made by the acquiring corporation with respect to the first step.

Revenue Ruling 2008–25 is unique insofar as it "turns on" the step transaction doctrine for purposes of concluding that P's acquisition of T's assets and assumption of its liabilities fail to qualify as a Type C reorganization but then "turns off" the doctrine in determining the ultimate tax consequences of the failed reorganization. The reason for this seeming inconsistency is the Service's obsession with protecting the policy of Section 338. The upshot is that because P's acquisition of T stock (Step 1) did not qualify as a reorganization, it is treated as a Section 338 qualified stock purchase followed by a tax-free liquidation of T under Section 332. The bad news is that T's sole shareholder, A, who could reasonably have expected to limit his gain to the $10x cash received in the initial reverse merger, must recognize his entire gain just as if he sold his stock for all cash. Since P did not make a Section 338 election, T does not recognize gain on its assets, and P takes those assets with a carryover rather than cost basis.

Would the result have been the same if the second step in Revenue Ruling 2008–25 had been an upstream merger of T into P rather than a liquidation?

PROBLEMS

P
...m share.
...V 10/sh.

1. Publishing Company, Inc. ("P") is a publicly traded C corporation engaged in the publication of professional textbooks. P has 5 million shares of voting common stock outstanding. The stock is currently trading at $10 per share.

P wishes to acquire control of Target Press, Inc. ("T"), a closely held corporation that is the leading publisher of student study aids for law students. T has 4,000 shares of common stock (its only class) outstanding, held by 10 shareholders each of whom owns 400 shares. T's assets and liabilities are as follows:

T
4K sh. 10 shareholder 各 400sh.

Asset	Adj. Basis	Fair Mkt. Value
Cash	$ 600,000	$ 600,000
Inventory	200,000	1,000,000
Equipment	800,000	1,400,000
Goodwill	0	2,000,000
	$1,600,000	$5,000,000

...ternatives ?
...pe A + drop down to P sub → exposure to T liability.
...ype → x ∵ x dilute existing sh.
...pe C → limited ability to pay boot if assume liability.
...ward triangular merger → T isolated from P. can use 60% boot. P x need use any voting stock.
...verse triangular merger → with less boot
redeem dividend free, with cash, stock for stock dead after 2 yrs. (Type B reorg)

[125] Reg. § 1.338(h)(10)–1(e) Example 14.

Liabilities	
Bank Loan	1,000,000
	$1,000,000

4sh -> low basis so want to avoid gain

1sh -> want cash high

5sh -> want diversification (cash / liquid stock).

Both P and T have substantial accumulated earnings and profits.

T's board of directors has agreed to sell the business for $4 million. Four of T's shareholders have a very low adjusted basis in their stock and wish to minimize their taxable gain on a sale. One shareholder, Dee Minimis, recently inherited her stock and would not have any significant realized gain. The other shareholders are interested in diversifying their investments and less concerned about the tax liability on a sale.

P does not wish to dilute the interests of its current shareholders by issuing too much voting common stock to acquire T, but P is willing to use a mix of consideration (including newly issued preferred stock) and to assume T's $1,000,000 bank loan. For business reasons, P ultimately wishes to operate T's business through a wholly-owned subsidiary and would prefer to avoid exposure to any unknown T liabilities. Assume that any preferred stock used by P to make the acquisition is not "nonqualified preferred stock" within the meaning of Section 351(g).

Various plans are under consideration to complete the acquisition. Consider generally the tax consequences of each of the alternative plans described below, focusing on whether the acquisition will qualify as a tax-free reorganization. Then propose one or more desirable alternatives that are compatible with the objectives of the parties. Unless otherwise indicated, assume in all cases that the consideration to be exchanged for stock or assets of T is valued as of the date that the contract was legally binding.

(a) T merges directly into P, and each T shareholder receives $300,000 of P nonvoting preferred stock and $100,000 of P five-year notes. ✓ Type A reorg

any type of P stock. nonvoting is OK. sufficient "continuity of interest" -> 3/4 consideration is P stock

(b) Same as (a), above, except four T shareholders (holding 40% of the T stock) each receives $400,000 of P voting common stock and the other six T shareholders each receives $400,000 cash. ✓ Type A reorg > look at overall sh as a group when assess continuity of interest

(c) Same as (b), above, except that the value of the P stock declined between the time the merger agreement was signed and four months later, when the merger was finalized and, as a result, the four T shareholders holding 40% of the T stock receive only $250,000 of P voting stock. 1m stock & 2.4m cash -> stock < 40% of P stock. ∴ still fine Type A ✓.

measure value of stock on the day merger agreement s[igned]

(d) T merges directly into P, and each T shareholder receives $400,000 of P voting common stock. Pursuant to a binding commitment entered into prior to the merger, six of the former T shareholders (who held 60% of the T stock) sell their new P stock for cash to a third party three weeks after the merger. Type A reorg still OK ✓. subsequent sale to unrelated [party] is OK

(e) Same as (a), above, except shortly after the merger and as part of its original plan, P sells T's assets to an unrelated party at a nice profit and uses the sales proceeds to expand its professional textbook business.

use / continue T's historic business -> if ✓ then OK; if × -> × Type A

T's historic business cease.

Stock for stock deal, 但 × reorg ∵ 有 boot, ∴ × qualified as Type B

(f) In exchange for their respective 400 shares of T stock, P transfers to each T shareholder $360,000 of P voting preferred stock and $40,000 cash.

Step 2 potential type B, 但 ∵ step 1 3 month ago, × old & cold. ∴ × Type B ∵ likely integrated.

(g) P purchases 400 shares of T stock from Dee Minimis for $400,000 cash. Three months later, P transfers $400,000 of P voting preferred stock to each of the nine remaining T shareholders in exchange for their respective 400 shares of T stock.

Potential Type C reorg √ substantially all asset. note is boot, ∴ liability also viewed as boot. ∴ 1m + 400k note. 1.4m / 5m = 38% > 20% ∴ × Type C!

(h) P acquires all the T assets, and assumes the $1,000,000 liability, in exchange for $3.6 million of P voting common stock (360,000 shares) and $400,000 in P five-year notes. Immediately thereafter, T completely liquidates, distributing the P shares and notes pro rata to its shareholders. P drops down the assets it acquires to S, a newly created subsidiary. → OK.

Type C √. only boot is liability ∴ ignore liability. Net: ~~3.6/4~~ 3.6/4 = 90% > 90% Gross: 4.6/5 = 92%, > 70% ∴ substantially all of the property

(i) Same as (h), above, except that T retains $400,000 of its cash, P acquires the balance of T's assets, and assumes the liability, for $3.6 million of P voting common stock, and T distributes the P shares and cash pro rata to its shareholders in complete liquidation.

2. Assume the same basic facts as Problem 1, above, except P wishes to acquire T in one of the following multi-step transactions:

× Type A reverse triangular merger. → ∵ fail control test (Only 60% of T share exchanged for P sh.) less than 80%

(a) P acquires all the T stock in a reverse triangular merger in which Y-1, a transitory subsidiary of P, merges into T. In the merger, four T shareholders (holding 40% of the T stock) each receive $400,000 cash and the other six T shareholders each receive $400,000 of P nonvoting preferred stock. T then merges upstream into P. → 若 2 step integrated, T merged into P 整体 √ Type A merger.

look like forward triangular. P; subs: Y-1 → T → Y-2

(b) Same as (a), above, except the second step in the transaction is a merger of T into Y-2, a subsidiary of P. 若 integrated, √ satisfy (a)(2)(D)

(c) Same as (a), above, except the second step is the complete liquidation of T into P in a transaction that is not a statutory merger under state law. 若 step together, could be type C, but fail 80% but relaxes

why structure this way? if it fails as integrated, will be treated as a busted reverse triangular merger → P purchase T stock by P. cheaper than failed forward triangular merger → P purchase T asset followed by liquidation of P

(d) Same as (a) above, except T is a wholly owned subsidiary of S, Inc. Y-1 merges into T and, in the merger, S, Inc. receives $500,000 cash and $500,000 of P nonvoting stock. P and S jointly make an election under § 338(h)(10). → treat a stock sale as asset sale, allow acquirer get FMV basis for its

P S 若分开, × reverse triangular merger ∵ fail 80% control; P ↓ → T

若 integrated → potential type A reorg; × step together 若 §338(h)(10) election!

3. Assume the same basic facts as in Problem 1, above, except that P purchased 10% of T's stock five years ago for cash, and purchased an additional 50% of T's stock one year ago for cash. P now wishes to acquire the remaining 40% of T's stock for P voting stock or, if possible, P nonvoting preferred stock. The T minority shareholders are willing to engage in the transaction if they can avoid recognition of taxable gain. Advise the parties on the best method for structuring the acquisition as a tax-free reorganization. ∵ 50% ...

1st purchase → old & cold. type A → P can use nonvoting preferred. 40% tes...
type B → only if previous 2 are old & cold.
type C → .
reverse triangular merger → × transfer control (80%) when T sh only have ...
forward triangular merger → √ possible

4. Are the results reached in Problems 1–3, above, rational as a matter of tax policy? Would it be preferable to have uniform tax rules governing all corporate acquisitions?

C. TREATMENT OF THE PARTIES TO AN ACQUISITIVE REORGANIZATION

Up to this point, we have been concentrating on the definition of a reorganization in Section 368. Compliance with those statutory requirements and the judicial doctrines unlocks the gate to the operative provisions, which govern the tax treatment of the target shareholders and corporations that are "a party to a reorganization" and provide for transferred and exchanged bases, tacked holding periods and the carryover of corporate tax attributes such as earnings and profits and net operating losses. Section 368(b) broadly defines "a party to a reorganization" to include any corporation resulting from a qualifying reorganization (e.g., the surviving corporation in a consolidation), the acquiring and target corporations in a straight acquisitive reorganization and the parent corporation in a "drop down" or triangular reorganization.

This section summarizes the operative provisions, beginning with the tax consequences to the target's shareholders and security holders and then turning to the treatment of the target and acquiring corporations.

1. CONSEQUENCES TO SHAREHOLDERS AND SECURITY HOLDERS

Code: §§ 354(a); 356(a), (c)–(e); 358(a), (b), (d), (f); 368(b). Skim §§ 351(g).

Regulations: §§ 1.354–1(a), (b); 1.356–1, –3, –4; 1.358–1(a), –2(a)(1), (a)(2)(i), (a)(2)(vii), (b), (c) Example 1.

Recognition of Gain or Loss. One of the principal benefits of reorganization status is the nonrecognition granted to the shareholders and security holders of the target corporation under Section 354(a). Shareholders are entitled to complete nonrecognition only when they receive solely stock or securities of the acquiring corporation.[126] This invariably occurs in a Type B reorganization, but the target shareholders in a Type A, C or any form of triangular reorganization may receive some boot. In that event, the shareholder must recognize any realized gain to the extent of the money plus the fair market value of any other boot received.[127] For this purpose, boot includes any property other than stock or securities of a party to the reorganization. To prevent avoidance of this rule through the use of debt "securities,"[128] Section 356(d) provides that if the principal amount of securities received exceeds the principal

[126] I.R.C. § 354(a)(1).

[127] I.R.C. § 356(a)(1).

[128] "Securities" are generally defined to encompass relatively long-term corporate debt instruments but not short-term notes, stock rights or warrants.

amount of securities surrendered or if securities are received but none are surrendered, the fair market value of the excess is treated as boot.[129] Consequently, a shareholder holding no securities who receives bonds in connection with a reorganization is treated as having "cashed out" his investment to the extent of the bonds—an appropriate result under the continuity of interest principle. But security holders who change their investment to an equity interest or exchange securities for the same or lesser principal amount have not significantly changed the form of their investment and therefore are entitled to nonrecognition treatment. As might be expected, however, a shareholder or security holder who receives boot may not recognize any realized loss.[130]

Characterization of Gain. Section 356(a)(2) provides that any recognized gain is treated as a dividend to a target shareholder if the exchange "has the effect of the distribution of a dividend." In that event, each T shareholder must treat as a dividend the amount of his recognized gain that is not in excess of that shareholder's ratable share of the corporation's accumulated earnings and profits.[131] Any remaining gain is treated as gain from the sale or exchange of the target stock or securities transferred.

The "boot dividend" issue historically was one of the most difficult questions arising under the operative provisions. The Service once contended that dividend treatment was automatic if boot were received,[132] but it later conceded that dividend equivalence should be determined by using the tests applicable to stock redemptions in Section 302(b),[133] treating the boot as if it were received as a distribution in redemption of the *target* corporation's stock immediately prior to the reorganization exchange.[134] Taxpayers argued, however, that dividend equivalence should be determined by examining the effect of the reorganization exchange as a whole, an approach that ultimately was adopted by the Supreme Court in Clark v. Commissioner.[135] Under the *Clark* test, each T shareholder is treated as initially receiving only P stock instead of the combination of P stock and boot actually received, and then P is treated as having distributed the boot in a hypothetical redemption of the portion of P stock not actually received by the T shareholder. If this redemption meets one of the tests for exchange

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129 See I.R.C. § 354(a)(2)(A).

130 I.R.C. § 356(c).

131 Note that the gain is not automatically characterized as ordinary income but, if it has the effect of a dividend, it is treated as a Section 301 distribution subject to the Section 243 dividends received deduction. In addition, the earnings and profits of the target corporation are reduced under Section 312(a).

132 See Commissioner v. Bedford's Estate, 325 U.S. 283, 65 S.Ct. 1157 (1945).

133 In applying Section 302(b) principles, the Section 318 attribution rules are applicable. I.R.C. § 356(a)(2). Rev. Rul. 74–515, 1974–2 C.B. 118. See also Wright v. United States, 482 F.2d 600 (8th Cir.1973).

134 See, e.g., Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115, 99 S.Ct. 1019 (1979).

135 489 U.S. 726, 109 S.Ct. 1455 (1989). See also Rev. Rul. 93–61, 1993–2 C.B. 118.

treatment in Section 302(b), the receipt of boot does not have the effect of a dividend, and the shareholder recognizes capital gain or loss. Otherwise, as previewed above, the recognized gain is a dividend (likely a qualified dividend taxable at long-term capital gains rates) to the extent of the shareholder's ratable share of "the corporation's"[136] accumulated earnings and profits, and any remaining gain is capital gain.

Whenever there is a meaningful rate preference for long-term capital gains and, unlike current law, dividends are taxed as ordinary income at the highest marginal rates, individual taxpayers will benefit from the Supreme Court's holding in *Clark*.[137] Corporate shareholders, however, ordinarily will prefer dividend classification in order to qualify for the dividends received deduction under Section 243.[138] Dividend treatment also may be preferable to the acquiring corporation because it reduces the earnings and profits that are inherited under Section 381 as a result of the reorganization. Finally, dividend classification may be undesirable where shareholders receiving notes from the acquiring corporation wish to report their gain on the installment method. Unless the target stock exchanged by the shareholder is publicly traded,[139] installment sale treatment generally is available if the transaction is treated as a sale but not if the receipt of installment boot is treated as a dividend under Section 356(a)(2).[140]

The boot dividend issue rarely is important to individual shareholders, however, as long as dividends and long-term capital gains are taxed at the same preferential rate. Since any amount characterized as a dividend under Section 356(a)(2) may not exceed the shareholder's recognized gain, the shareholder is always entitled to recovery of basis. If the dividend is "qualified," the rate is the same unless the capital gain is short-term (or the stock is not a capital asset), in which case dividend treatment is preferable. For transactions involving U.S. corporations, corporate shareholders will continue to prefer dividend classification because of the dividends received deduction, and dividend treatment is preferable to the acquiring corporation because it reduces earnings and profits inherited from the target corporation on the reorganization.

Allocation of Consideration. The regulations provide guidance for T shareholders who receive a mix of consideration or surrender different blocks or classes of stock or securities in a tax-free reorganization. Consider, for example, the tax consequences to a T shareholder who

136 The statute is unclear, but the majority view appears to be that the dividend determination should be based on the target corporation's earnings and profits.

137 The Service, as it must, has announced that it will apply the *Clark* approach to an acquisitive reorganization. See Rev. Rul. 93–61, 1993–2 C.B. 118.

138 But see I.R.C. § 1059(e)(1)(B), which treats any amount treated as a dividend on a non pro rata redemption of a corporate shareholder's stock as an "extraordinary dividend." See Chapter 4F3, supra.

139 See I.R.C. § 453(k)(2).

140 See I.R.C. § 453(f)(6); Prop. Reg. § 1.453–1(f)(2).

receives both P stock and boot in exchange for two blocks of the same class of T stock, acquired at different times and with different bases. The regulations adopt a default rule that under which the boot is allocated to each share of stock on a pro rata basis, according to the fair market value of the surrendered shares. But in a rare taxpayer-friendly gesture, the regulations give the parties flexibility to specify how the consideration received should be allocated as long as the specification is "economically reasonable."[141] Under this permissive approach, a shareholder with multiple blocks or different classes of stock with different bases can minimize her recognized gain by allocating boot to the blocks or classes with the highest per-share basis.

T sh T sh
30 90
FMV 100 100
zed G. 70 10
50 10 → if pro rata
stock 10 FMV 100
$100 cash

To illustrate, assume shareholder A owns two 10-share lots of T stock each of which has a fair market value of $100. A's basis for Block 1 is $30 ($3 per share) and her basis for Block 2 is $90 ($9 per share). P acquires T in a statutory merger that qualifies as a Type A reorganization. A surrenders her T stock and receives in exchange 10 shares of P stock worth $100 and $100 cash, and the receipt of cash does not have the effect of a distribution of a dividend. A's *realized* gain is thus $70 on Block 1 and $10 on Block 2, for a total of $80 realized gain on the transaction. If the terms of the merger do not specify that the P shares and cash are received in exchange for particular shares or classes of T stock, the default rule requires that a pro rata portion of the cash is treated as received in exchange for each share of T stock based on the fair market value of the surrendered shares. Under this approach, A would recognize $50 of her $70 realized gain on Block 1 and all $10 of her realized gain on Block 2.[142] But if the terms of the merger specify that A receives 10 shares of P stock in exchange for A's Block 1 shares and $100 cash in exchange for his Block 2 shares and those terms are economically reasonable,[143] A is not required to recognize any of her $70 realized gain on Block 1 (because none of the boot was allocated to that block) and recognizes $10 of gain on Block 2.[144]

Dividend Within Gain Approach: Policy Aspects. Section 356(a)(2) limits the amount of any boot dividend to the shareholder's recognized gain. Over 40 years ago, this approach was criticized as a "curious mixing of dividend and sale or exchange concepts" which "permits shareholders with a high basis in their stock * * * to withdraw corporate earnings in a reorganization without dividend consequences."[145] Allowing taxpayers to recover their basis even when a transaction is equivalent to a dividend is inconsistent with the rules applicable to stock redemptions in Section 302 and is difficult to justify. In what was once an annual ritual, the Treasury

141 Reg. § 1.356–1(b).

142 Reg. § 1.356–1(d) Example 3.

143 "Economically reasonable" means that the consideration received for a block of stock is of equivalent value to the surrendered shares.

144 Reg. § 1.356–1(d) Example 4.

145 Staff of the Senate Committee on Finance, The Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff, 99th Cong., 1st Sess. 45 (S.Prt. 99–47, 1985).

Department has at times proposed to repeal the "dividend within gain" rule, arguing that "[t]here is not a significant policy reason to vary the tax treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in a reorganization * * * with the treatment afforded ordinary distributions under section 301."[146]

Basis and Holding Period. Target shareholders determine the basis of nonrecognition property (i.e., the stock or nonboot securities received in the exchange) under Section 358 by reference to their basis in the stock that they relinquished, increased by any gain recognized and reduced by any boot received and liabilities assumed. Any boot (other than cash) received takes a fair market value basis under Section 358(a)(2). This is the same formula used many chapters ago in determining the basis of stock received in a Section 351 exchange. If different types of nonrecognition property are received (e.g., two classes of stock or stock and bonds), the aggregate exchanged basis is allocated among those properties in proportion to their relative fair market values under rules provided in the regulations.[147] The nonrecognition property generally takes a tacked holding period under Section 1223(1) and the holding period of the boot commences on the date of its acquisition.

The general basis rule in Section 358 is simple enough to apply when a target shareholder acquired all of her T stock at the same time. But it is not uncommon for a shareholder to have acquired T stock at different times, for different prices. When these multiple "tax lots" of T stock are exchanged in a tax-free reorganization for stock of the acquiring corporation, can T shareholders use the average basis in their T shares to determine the basis for all their new P stock or must they use an approach under which the basis of the P stock received is traced to the basis of the different blocks of T stock surrendered? And does it matter how the shares are held—e.g., in certificates that can be physically identified, or a brokerage account where separate lots may be more difficult or impossible to track?[148]

From the standpoint of simplicity and administrative convenience, the average basis method has much to offer even when separate lots are easily identifiable. But to prevent potential tax avoidance and also allow taxpayers some flexibility, the Service has concluded that tracing is the preferable approach.[149] Under the regulations, the basis of the stock received in a reorganization transaction, to the greatest extent possible,

[146] General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals 116 (Dept. of the Treasury, Feb. 2016).

[147] I.R.C. § 358(b)(1); Reg. § 1.358–2(a)(2)(i).

[148] Even without a reorganization, similar issues are raised when shares are sold by a taxpayer who acquired lots of that stock on different dates or at different prices. See, e.g., Reg. § 1.1012–1(c), providing that if the shares sold cannot be adequately identified, the earliest of the lots acquired is deemed to be sold first. In the reorganization setting, the cases are inconsistent. Compare, e.g., Arrott v. Commissioner, 136 F.2d 449 (3d Cir. 1943) (average basis) and Bloch v. Commissioner, 148 F.2d 452 (9th Cir. 1945) (tracing permissible).

[149] See generally Reg. § 1.358–2.

must be an allocable portion of the basis of each block of stock surrendered.[150] For example, if a T shareholder exchanges more than one block of a single class of T stock acquired on different dates with different bases, the regulations require the basis of the shares surrendered to be allocated to the shares received in a manner that reflects, to the greatest extent possible, that a share of stock received is in respect of (i.e., traceable to) shares of stock acquired on the same date and at the same price.[151] T shareholders who are unable to identify and trace the shares surrendered and received may designate which shares of P stock are received in exchange for each block of T stock provided the designation is consistent with the terms of the transaction.[152]

The regulations illustrate the tracing approach with this example of a Type A statutory merger where Corporation X is the target and Corporation Y is the acquiring corporation:[153]

> J, an individual, acquired 20 shares of Corporation X stock on Date 1 for $3 each and 10 shares of Corporation X stock on Date 2 for $6 each. On Date 3, Corporation Y acquires the assets of Corporation X in a reorganization under Section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, J receives 2 shares of Corporation Y stock for each share of Corporation X stock. Therefore, J receives 60 shares of Corporation Y stock. Pursuant to Section 354, J recognizes no gain or loss on the exchange. J is not able to identify which shares of Corporation Y stock are received for each share of Corporation X stock.
>
> J has 40 shares of Corporation Y each of which has a basis of $1.50 and is treated as having been acquired on Date 1 and 20 shares of Corporation Y each of which has a basis of $3 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of Corporation Y stock received becomes relevant, J may designate which of the shares of Corporation Y stock have a basis of $1.50 and which have a basis of $3.

In reorganizations where T shareholders receive shares of stock or securities of more than one class, or boot is received in addition to stock

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150 Reg. § 1.358–2(a)(2)(i). For simplicity, the discussion in the text is limited to exchanges of stock in acquisitive reorganizations. The regulations use a similar approach for reorganization exchanges of debt securities. If more than one class of stock or security of the target corporation is exchanged for multiple classes of the acquiring corporation, an additional layer of allocation is required. See, e.g., Reg. § 1.358–2(c) Example 3.

151 Reg. § 1.358–2(a)(2)(i). These regulations also address the more complex situation where stock and securities (e.g., bonds) are received.

152 Reg. § 1.358–2(a)(2)(vii). The designation must be made on or before the date when it is first relevant (e.g., at the time of a sale of the P stock received by the selling shareholder). If no designation is made at the time of a sale or transfer, the taxpayer is treated as selling or transferring the P shares received in respect of the earliest T shares purchased or acquired. Id.

153 Reg. § 1.358–2(c) Example 1. More complex fact patterns are analyzed in thirteen other increasingly mind-numbing examples but, not to worry—somewhere, a reputable company has designed portfolio management software to handle all these basis computations.

or securities, and the terms of the exchange specify which shares of P stock or securities are received in exchange for a particular share (or class) of T stock or securities, the specification controls for basis purposes if the terms are "economically reasonable."[154] If there is no specification, a pro rata portion of the P stock and securities is treated as received in exchange for each share of T stock and securities surrendered, based on the fair market value of surrendered stock and securities.[155] This approach is consistent with the allocation of consideration rules discussed above.[156]

2. CONSEQUENCES TO THE TARGET CORPORATION

Code: §§ 336(c); 357(a), (b), (c)(1); 358(a), (b)(1), (f); 361.

Regulations: § 1.357–1(a).

Treatment of the Reorganization Exchange. Without a nonrecognition provision, the target corporation in an acquisitive reorganization would recognize gain or loss on the transfer of its assets and the assumption of its liabilities by the acquiring corporation. If the acquisition qualifies as a reorganization, however, Section 361(a) comes to the rescue by providing that the target recognizes no gain or loss if it exchanges property, pursuant to the reorganization plan, solely for stock or securities in a corporation which also is a party to the reorganization. Section 357(a) offers similar protection by providing that the assumption of the target's liabilities in a reorganization exchange will not be treated as boot nor prevent the exchange from being tax-free under Section 361(a).[157] These rules apply primarily to Type A and C reorganizations and forward triangular mergers. In a Type B stock-for-stock exchange or a reverse triangular merger, no assets are transferred because the target corporation remains intact as a controlled subsidiary of the acquiring corporation.

The target in a Type C reorganization may receive a limited amount of boot without disqualifying the transaction under Section 368.[158] In that event, the target must recognize any realized gain (but may not recognize loss) on the reorganization exchange to the extent of the cash and the fair market value of the boot that the target does not distribute pursuant to the plan of reorganization.[159] Any transfer by the target of

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154 Reg. § 1.358–2(a)(2)(ii).

155 Id.

156 See p. 437, infra.

157 As in the Section 351 incorporation area, the general nonrecognition rule in Section 357(a) is subject to an exception in Section 357(b) if the liability assumption is motivated by tax avoidance or lacks a bona fide business purpose. The Section 357(c) exception for liabilities assumed in excess of the basis of the transferred assets only applies to a Type D reorganization. See Chapter 11B, infra.

158 I.R.C. § 368(a)(2)(B). Boot in a Type C reorganization would include any property other than voting stock of the acquiring corporation (or its parent). See Section B3 of this Chapter, infra.

159 I.R.C. § 361(b)(1), (2).

cash or other boot received in the exchange to creditors in connection with the reorganization is treated as a "distribution" pursuant to the reorganization plan.[160] Since the target in a Type C reorganization is generally required to distribute all of its properties pursuant to the plan,[161] gain or loss rarely will be recognized on the exchange.[162]

Section 361(a) only applies to the *receipt* of boot by the target pursuant to a reorganization plan. An acquiring corporation that transfers appreciated boot property to the target as partial consideration for the target's assets must recognize gain under Section 1001 because, to that extent, the transaction is considered to be a taxable exchange.[163] In that event, the target takes the boot property with a fair market value basis.[164]

Treatment of Distributions. Section 361(c) generally provides that a corporation does not recognize gain or loss on the distribution of "qualified property" to its shareholders pursuant to a reorganization plan. "Qualified property" is: (1) stock (or rights to acquire stock) in, or obligations (e.g., bonds and notes) of the distributing corporation, or (2) stock (or rights to acquire stock) in, or obligations of, another party to the reorganization which were received by the distributing corporation in the exchange. Thus, any stock, securities or even short-term notes of the acquiring corporation received by the target in the exchange and then distributed to its shareholders would constitute "qualified property." Section 361(c)(3) makes it clear that a transfer of "qualified property" by a target to its creditors in satisfaction of corporate liabilities is treated as a "distribution" pursuant to the reorganization plan.

If the target distributes an asset other than qualified property, it must recognize gain (but may not recognize loss) in the same manner as if the property had been sold to the distributee at its fair market value.[165] For example, the target would recognize gain on the distribution of an appreciated retained asset (i.e., an asset not acquired in the reorganization) or boot (other than notes of the acquiring corporation) which appreciated between the time it was received and the distribution to shareholders.[166]

Sales Prior to Liquidation. Before liquidating, the target corporation in a Type C reorganization may sell some of the stock or securities

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160 I.R.C. § 361(b)(3). The Service may prescribe regulations as necessary to prevent tax avoidance through abuse of this rule. Id.

161 I.R.C. § 368(a)(2)(G).

162 A rare situation where gain might be recognized is where liabilities of the target are assumed in a transaction to which Section 357(b) or (c) applies.

163 Section 361(a) does not apply in this situation because it only provides nonrecognition to the *recipient* of distributed boot.

164 I.R.C. § 358(a)(2). See also I.R.C. § 358(f).

165 I.R.C. § 361(c)(1), (2).

166 Since the target takes a fair market value basis in the boot under Section 358(a)(2) at the time of the exchange, it would recognize only post-acquisition appreciation on a later distribution of the boot.

received from the acquiring corporation in order to raise money to pay off creditors. Prior to the Tax Reform Act of 1986, the courts were divided over whether these sales were entitled to nonrecognition treatment.[167] The current version of Section 361 settles the debate by providing that only transfers of "qualified property" (i.e., stock or obligations of the acquiring corporation) or boot directly to creditors will qualify for nonrecognition because they are treated as "distributions" to the shareholders pursuant to the reorganization plan.[168] Sales of property to third parties are thus fully taxable events even if they were necessary to raise money to pay off creditors.

Basis and Holding Period. If the target corporation retains property received from the acquiring corporation, which only could occur in a Type C reorganization where the Commissioner waives the Section 368(a)(2)(G) distribution requirement, it is deemed to have distributed that property to its shareholders, who then are treated as having recontributed the property to a "new" corporation as a contribution to capital.[169] The basis and the holding period of the property in the hands of the "new" corporation depend upon the consequences to the shareholders. If the property is boot to the shareholders, it receives a fair market value basis and no tacked holding period in the hands of either the shareholders or the "new" corporation to which it is constructively recontributed.[170] If the property is nonrecognition property (e.g., stock or securities of the acquiring corporation) to the shareholders, then their exchanged bases and tacked holding periods transfer to the "new" corporation.[171] These rules are irrelevant in the typical Type C reorganization where the target liquidates and distributes the stock, securities and boot received in the transaction, along with any retained assets, to its shareholders. In that event, basis and holding period are determined under the operative provisions governing shareholders and security holders.

3. CONSEQUENCES TO THE ACQUIRING CORPORATION

Code: §§ 362(b); 368(b); 1032.

Regulations: § 1.1032–1.

Recognition of Gain or Loss. The acquiring corporation does not recognize gain or loss on the issuance of its stock or the stock of its parent in an acquisitive reorganization or, for that matter, in any other

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167 Compare General Housewares Corp. v. United States, 615 F.2d 1056 (5th Cir.1980) (allowing nonrecognition under former Section 337) with FEC Liquidating Corp. v. United States, 548 F.2d 924 (Ct.Cl.1977) (taxing such gains on the ground that former Section 337 and the reorganization provisions were conceptually incompatible).

168 I.R.C. § 361(b)(3), (c)(3).

169 H.R. Rep. No. 98–861, 98th Cong., 2d Sess. 845–846 (1984).

170 I.R.C. §§ 358(a)(2); 362(a).

171 I.R.C. §§ 358(a)(1); 362(a); 1223(1) and (2).

transaction.[172] To the extent that it may issue securities as consideration for the acquired property, the acquiring corporation recognizes no gain because the acquisition is a "purchase." If the acquiring corporation transfers other "boot" property to make the acquisition, however, it recognizes any realized gain or loss under general tax principles.[173]

Basis and Holding Period: In General. Under Section 362(b), the target assets acquired in a Type A, Type C or forward triangular reorganization take a transferred basis, increased by any gain recognized by the target on the transfer. Since Section 361(a) generally provides that the target does not recognize gain or loss on any exchange of property pursuant to the plan of reorganization, an upward basis adjustment for gain recognized by the target will occur only in the rare Type C reorganization where the target receives boot and does not distribute it to its shareholders or creditors. In the case of a Type B or reverse triangular reorganization, however, the property acquired is corporate stock whose transferred basis is determined by its basis in the hands of the target shareholders. In either case, the property acquired is allowed a tacked holding period under Section 1223(2).

The acquiring corporation in a Type B stock-for-stock exchange or reverse triangular merger often faces some logistical challenges in determining its exchanged basis in the T stock, especially when T is a publicly traded company. Assume, for example, that P acquires all the stock of publicly traded T in a Type B reorganization. P's basis in its newly acquired T stock is the same as the aggregate basis of the former T shareholders, but how is P supposed to acquire this information? For many years, the IRS's position was that P should use its best efforts to "survey" the surrendering T shareholders and, where that was impractical, P could use statistical sampling and estimates.[174] The IRS came to recognize that its procedures had not kept pace with changes in the securities markets (e.g., most stocks are held by brokers and custodians in street name). Revenue Procedure 2011–35[175] is the culmination of several years of study on this arcane but practically important issue. In 35 mind-numbing pages, the IRS sets forth four methodologies that basically provide more modern survey, statistical sampling and estimating techniques for corporations that acquire stock in transferred basis transactions. The most reliable approach is to survey all T shareholders but, when that is impractical, the revenue procedure explains how to use statistical sampling and other fallback techniques

[172] I.R.C. § 1032(a). It was once feared that Section 1032 would not apply where a controlled subsidiary acquired property in exchange for its *parent's* stock. The Service has ruled, however, that the subsidiary does not recognize gain or loss in this situation, presumably because such an acquisition is economically indistinguishable from a direct acquisition by the parent followed by a drop down of the assets to the subsidiary. See Rev. Rul. 57–278, 1957–1 C.B. 124. Reg. § 1.1032–2(b).

[173] See Rev. Rul. 72–327, 1972–2 C.B. 197.

[174] Rev. Proc. 81–70, 1981–2 C.B. 729.

[175] 2011–25 I.R.B. 890.

and permits the use of one or more of the prescribed methodologies in any combination.

Limit on Importation of Built-in Losses. The effect of the Section 362(b) transferred basis rule is to preserve not only built-in gains but also built-in losses when P acquires T's assets in a tax-free reorganization. This rule made it possible for U.S. corporations to engage in what became known as "basis shift" transactions with U.S. tax-indifferent parties, such as foreign corporations. The primary goal was to shift unrealized economic losses from foreign to U.S. taxpayers, who could then realize the losses and shelter their taxable income.

Section 362(e)(1) attempts to block basis-shift shelters by providing that if a net built-in loss is "imported" in a tax-free reorganization, the basis of such loss property in the hands of the transferee corporation is limited to its fair market value immediately after the transaction.[176] A net built-in loss is imported into the United States if the aggregate adjusted basis of the properties received by a domestic transferee corporation from a person not subject to U.S. tax exceeds the fair market value of the transferred properties.[177]

Basis of Target Stock Received in Triangular Reorganizations. Determining the acquiring parent corporation's basis in the stock of a subsidiary acquired in a reverse triangular reorganization raises a tantalizing technical question. Under Section 368(a)(2)(E), the acquiring corporation either may form a "phantom" subsidiary or use a preexisting operating subsidiary to merge into the target corporation. It ordinarily will transfer voting stock and possibly some boot to the subsidiary which then transfers that property to the target shareholders as the consideration for the acquisition.

In a straight Type B reorganization, the parent determines its basis in the target stock under Section 362(b) by reference to the stock bases of the former target shareholders. In the case of a reverse subsidiary merger, however, Section 358 would appear to require the acquiring corporation to take an exchanged basis—i.e., its basis in the target stock acquired would be the same as its basis in the stock of the disappearing subsidiary. That basis likely would be zero if a phantom subsidiary were used to effect the merger. A similar issue arises in the case of forward triangular merger, where the target merges into a subsidiary formed by the acquiring corporation immediately prior to the reorganization. Since the parent normally forms the subsidiary by transferring its own stock, in which it presumably has a zero basis, it would appear that the parent would retain a zero basis in the stock of the subsidiary even after it absorbs the target.

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176 I.R.C. § 362(e)(2)(A). For a similar rule limiting the transfer of built-in losses in Section 351 transactions, see I.R.C. § 362(e)(2), discussed in Chapter 3A, supra.

177 I.R.C. § 362(e)(1)(B), (C). Regulations help identify property and transactions subject to the anti-importation rule in Section 362(e)(1) and elaborate on the operation of the rule. See Reg. § 1.362–3.

The Treasury has issued regulations that address the zero basis problem. Those regulations seek to conform the tax consequences of a triangular reorganization with those of a "drop down" transaction in which P acquires T's assets or stock directly and then drops them down to a subsidiary ("S") in a tax-free transaction. To illustrate the operation of the regulations in a forward triangular merger in which T merges into S, a newly formed P subsidiary, the regulations permit P to increase its basis in its S stock by the net basis (assets less liabilities) of T's assets.[178] In a simple transaction where P had no prior basis in its S stock, the net effect is that P's basis in its S stock and S's basis in the acquired T assets will be the same.

In a simple reverse triangular merger where newly formed S merges into T, which survives as a P subsidiary, P's basis in its T stock is adjusted by assuming that T had merged into S in a forward triangular merger, applying the rules discussed above.[179] Thus, in a wholly tax-free reverse merger where 100 percent of the T stock is acquired, P's basis in its T stock would equal T's net basis in its assets plus any preexisting basis that P had in its S stock.

PROBLEMS

1. Acquiring Corporation ("P") has 500,000 shares of voting common stock outstanding (value—$10 per share) and $500,000 of accumulated earnings and profits. Target Corporation ("T") has assets with an aggregate adjusted basis of $300,000 and an aggregate fair market value of $500,000, and $100,000 of accumulated earnings and profits. Except as otherwise indicated below, assume that T has no liabilities. T's ten equal shareholders each owns 100 shares of T voting common stock with an adjusted basis of $20,000 and a fair market value of $50,000. Discuss the tax consequences to P, T and T's shareholders of each of the following alternative transactions:

...orp. ...gain recognized. allocate basis based on FMV ∴ 16k to voting & 4k to nonvoting. ...orp basis in T's asset ...transferred basis.

× Boot! .. × recognition

(a) T merges into P in a qualified Type A reorganization. Each T shareholder receives 4,000 shares of P voting common stock (value—$40,000) and P nonvoting preferred stock (not "nonqualified preferred stock") worth $10,000. What if the P nonvoting preferred were nonqualified preferred stock?

→ basis in P sh... → compare basis ∴ 20k. → × considered stock / se... ∴ boot!

→ under gain characterization, P distribute ~~stk~~ 500k & T treat as redeemed 100k as boot → likely meaningful redemption ∴ possible sale/exch treatment.

(b) Same as (a), above, but instead of the preferred stock each T shareholder receives 20-year market rate interest bearing P notes with a principal amount and fair market value of $10,000.

√ securities ∴ 문제 T sh receive securities > T surrendered securities (0) ∴ all securities will be boot!

T corp / P corp → same as (a)

(c) Same as (b), above, except that two of the shareholders receive all the notes (with a principal amount and fair market value of $100,000), and the remaining eight shareholders each receives P voting common stock worth $50,000.

∴ solely stock.

...eat as §302 redemption ∴ exchange treatment. (∵ complete redemption)

...356 × apply ∵ × sh + boot,

[178] Reg. § 1.358–6(c)(1).

[179] Reg. § 1.358–6(c)(2). Additional rules are provided for more specialized situations, such as where S was a preexisting subsidiary, the consideration is mixed, or less than all of T's stock is acquired in a reverse merger. See Reg. § 1.358–6(c)(2)(i)(C), –6(c)(4).

(d) Same as (b), above, except that T had $50,000 of accumulated earnings and profits.

(e) Assume for the remainder of the problem that T has assets with an aggregate fair market value of $600,000, an aggregate adjusted basis of $300,000, and a $100,000 liability. P acquires all T's assets in a qualified Type C reorganization in exchange for P voting stock worth $500,000 and P's assumption of T's $100,000 liability. T immediately distributes the P stock to its shareholders in complete liquidation.

(f) Same as (e), above, except P transfers $500,000 of P voting stock and $100,000 cash to T, which uses the cash to pay off its liability and then distributes the stock to its shareholders in complete liquidation.

(g) Same as (e), above, except P transfers to T $500,000 of P voting stock and investment securities with a basis of $40,000 and a fair market value of $100,000. T sells the securities for $100,000, using the proceeds to pay off its liability, and then liquidates and distributes the P stock to its shareholders.

(h) Same as (e), above, except P transfers $600,000 of its voting stock to T in exchange for all of T's assets and does not assume T's liability. T then sells $100,000 of P voting stock and uses the proceeds to pay off the liability. T then distributes the remaining P stock to its shareholders in complete liquidation.

(i) Same as (h), above, except T transfers $100,000 of P voting stock directly to its creditor in payment of the liability and then distributes the remaining P stock to its shareholders in complete liquidation.

2. Parent Corporation ("P") creates Subsidiary Corporation ("S") by transferring P stock as a preliminary step to acquiring the assets of Target Corporation ("T") in a separate subsidiary. T's shareholders own stock worth $200,000 with a basis of $50,000. T has assets worth $200,000 with a basis of $100,000.

(a) Assuming a valid § 368(a)(2)(D) forward triangular merger, what are the tax consequences to P, S, T and T's shareholders?

(b) Assuming a valid § 368(a)(2)(E) reverse triangular merger, what are the tax consequences to P, S, T and T's shareholders?

(c) What results in (a), above, if the transaction fails to qualify as a reorganization?

(d) What results in (b), above, if the transaction fails to qualify as a reorganization?

D. TAX POLICY ISSUES

Congress has been tinkering with Subchapter C since the enactment of the 1954 Code. Except for adding Section 338 in 1982, most revisions have been aimed at narrow technical problems. In the early 1980s, the

Senate Finance Committee began a comprehensive study of Subchapter C. The staff reviewed recommendations of prominent bar and accounting groups and relied heavily on the Subchapter C project of the American Law Institute. In September, 1983, it issued its preliminary report—a controversial document that proposed changes both large and small.

The Finance Committee staff followed up with its "final report"—the Subchapter C Revision Act of 1985. Some of its recommendations were incorporated in the Tax Reform Act of 1986. But even the 1986 Act left for another day the centerpiece of both the ALI and the Senate Finance Committee projects—the adoption of an entirely new scheme governing corporate acquisitions, including the replacement of the tax-free reorganization provisions with an essentially elective system that would permit nonrecognition under consistent standards for any corporate acquisition at the price of a carryover basis in the assets of the target corporation. It has now been over 40 years since the ALI proposal was put forth. If Congress ever entertains the idea of reforming the tax treatment of corporate acquisitions (a dim prospect), this idea could be resurrected. So while there is little expectation that the current regime will be changed in the near future, it is worth a moment to consider whether there is a better, more rational alternative. The following excerpt provides a summary of these acquisition proposals.

Joint Committee on Taxation, Present Law and Background Relating to Selected Business Tax Issues

(JCX–41–06), September 19, 2006.

C. Issues Relating to Mergers and Acquisitions

In general

The different rules permitting particular corporate transactions to receive tax-free treatment are varied and frequently inconsistent. In some cases, more than one rule could apply to the form of a particular corporate transaction. The statute and the administrative pronouncements of the IRS over the years have attempted to resolve overlap situations and to provide guidance regarding other interpretive issues.

The structure of present law is in part a result of the historical development and aggregation of provisions. The structure also reflects reactions to judicial decisions interpreting particular provisions, and reflects legislative developments establishing new rules and accompanying concern that existing provisions, if not limited, might conflict with or undermine the new rules.

The different, and often overlapping, variations within the merger and acquisition rules can be viewed as a significant source of complexity. On the other hand, these rules, as they have been interpreted and clarified over the years through administrative pronouncements, provide a large amount of taxpayer selectivity and certainty. Taxpayers are relatively assured of obtaining a specific tax result so long as the transaction satisfies the formalistic requirements of the chosen merger and acquisition provision. Moreover, comprehensive reform of these rules and the imposition of consistency could not generally be accomplished without recommending fundamental changes in the tax policy reflected by one or another of the provisions.

Discussion of certain proposals

Elective carryover basis for "qualified acquisitions"

An approach that has been suggested by a number of commentators in the past would generally permit a corporation to dispose of a business for any type of consideration, including cash, and elect to pay no corporate level tax, provided the consideration received is distributed to shareholders and that they pay tax (if they are taxable shareholders) on any cash or other consideration that is not a qualified continuing stock interest. The acquiring corporation would not obtain a stepped-up fair market value basis in the acquired corporate assets if the election were made not to pay corporate level tax. Only certain transactions that involved the acquisition of a significant amount of the stock of another corporation or the assets of a corporate business would qualify for this election.

Such a proposal was included in a 1985 report prepared by the Staff of the Senate Committee on Finance.[77] That proposal also included other conforming changes in its attempt to substitute a single approach for the present law varied rules affecting tax-free acquisitions. For example, the proposal would have conformed the various definitions of "control" under present law to the definition for filing a consolidated return.

Another version of such a proposal was presented at, and appears in the report of, an invitational conference addressing subchapter C issues sponsored by the American Bar Association and New York State Bar Association Tax Sections in 1987.[78] An earlier proposal of this type was made by the American Law Institute.[79]

This type of proposal involves a specific policy choice to abandon the existing statutory requirements for continuity of shareholder interest. The proposal would exempt a corporation from tax on a sale of its assets, even if the corporation receives cash consideration for the transfer of a

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77 The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff, Committee on Finance, United States Senate, S. Prt. 99–47 (May, 1985).

78 Ginsburg, Levin, Canellos, and Eustice, "Reexamining Subchapter C: An Overview and some Modest Proposals to Stimulate Debate" (copyright 1987 by Martin D. Ginsburg); reprinted in Corporate Tax Reform, A Report of the Invitational Conference on Subchapter C; American Bar Association Section of Taxation, New York State Bar Association Tax Section (1988) pp. 39–80; see, e.g., Proposals VII–VIIC and IX–XI.

79 "Proposals on Corporate Acquisitions and Dispositions" adopted by the American Law Institute June 13, 1980, published in American Law Institute, Federal Income Tax Project Subchapter C (1982).

business, so long as the cash is distributed to shareholders and the assets transferred retain a carryover basis.

Several policy arguments can be made in favor of such a change. First, as long as assets do not obtain a stepped up basis, there is corporate level tax in the future as the recipient corporation earns income and retains the low basis assets. Second, as long as shareholders pay tax on any cash that is received, this single tax is sufficient as a current tax. Third, the corporate reorganization provisions are complex and can be manipulated; and an explicit election would simplify corporate tax planning.

Several policy arguments can also be made against such a change. When assets are transferred from one corporation to another for cash, the transferring corporation is generally taxed on gain at the time of the transaction or when the cash is received. Payment of tax in the future, if the recipient corporation pays more because of a carryover basis, is not the economic equivalent of payment of tax at the time of the transaction, but is significantly less due to the time value of money. Questions may arise where to draw the line that would allow certain transfers of corporate assets, such as a transfer of a "business," to be exempt from corporate level tax while other transfers, such as sales in the ordinary course of business, would not be so exempt. Interpretations of the line so drawn would be required. In addition, proposals for such restructuring have often involved new sets of rules such as rules regarding the definition of control or other issues. New rules could also involve further interpretation and could lead to new uncertainty and complexity.

Provide one set of consideration and continuity rules for acquisitive reorganizations

There have been a number of proposals to conform the consideration rules for acquisitive reorganizations to require a specified percentage of stock consideration (*e.g.*, 50 percent) and to conform the rules as to whether the stock must be voting stock.[80]

One policy issue related to such recommendations is the determination what type of stock is counted in determining continuity and for purposes of determining whether shareholders are taxed. For example, one version of such a proposal suggested that all stock would count (thus eliminating a voting stock requirement) but made an exception for certain preferred stock that is redeemable within five years.[81]

The recommendations are typically made only for the reorganization rules contained in section 368. Frequently, no change is recommended to the non-reorganization rules relating to transfers to controlled

[80] See, e.g., American Bar Association recommendation 1981–5, 107 ABA Repts. 559, 34 Tax. L. Rev. 1386 (1981).

[81] American Bar Association recommendation 1981–5, supra.

corporations under section 351.[82] Under this type of proposal, if the rules for non-reorganization transfers to controlled corporations under section 351 are not modified, then many of the same planning choices that exist under present law would continue to be available. Unless the rules of section 351 are tightened to conform to the new 368 rules in cases that resemble acquisitive reorganizations, it is arguable that little general consistency would be accomplished.[83] On the other hand, such a modification that limited the application of section 351 could be viewed as a policy decision to tighten the rules relating to acquisitive transactions.

[82] The American Law Institute Proposals that included a provision for elective carryover basis, described above, did include a provision overriding section 351 for certain qualified acquisitions. However, since the basic proposal for qualified acquisitions abandoned a shareholder continuity of interest requirement for qualified acquisitions, the impact of overriding section 351 in those cases was confined to a much narrower range of issues.

[83] Partnership rules also could continue to offer different planning approaches to combining businesses and assets in some circumstances.