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Step Transactions and Mergers: Rev. Rul. 2001-46

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The "step transaction doctrine," under which "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction," forms a vital part of our tax law.

The scope of this extra-statutory "doctrine" in particular cases can be quite uncertain; nevertheless, the parameters of its application in some transactional forms have become well-accepted and, in those cases, some certainty has been attained by taxpayers and the Internal Revenue Service ("IRS") regarding which individual steps of a "larger" transaction would and would not be granted independent significance for tax purposes. In Revenue Ruling 2001-46 (October 15, 2001), however, the IRS arguably changed its approach to analyzing one common form of corporate asset acquisition, described below, under the step transaction doctrine.

An acquiring corporation ("X") wishing to effect an acquisition of the assets of a widely-held target corporation ("T") may form a wholly owned subsidiary ("Y"). Pursuant to an overall "plan," Y will merge into T, with the shareholders of T tendering their T stock in exchange for cash, stock, or securities of X (or some combination thereof), following which T will merge into X.

Under longstanding guidance from the IRS, the "transitory steps" of the formation of Y and its merger into T were ignored; these transactions in which X became, at least momentarily, the sole shareholder of T were treated as an acquisition of T stock by X directly from the shareholders of T. By contrast, in analyzing the consequences of that "direct acquisition" of stock, the subsequent "upstream" merger of T into X was treated as a separate transaction, rather than as part of an overall "plan."

The effect of this analysis was to permit, in those cases in which the portion of the consideration received by the shareholders of T which did *not* consist of stock in X was sufficiently preponderant, treatment of the acquisition as a "qualified stock purchase" and the making by X of an election under section 338 of the Internal Revenue Code ("Code") to "step-up" the basis of T's assets to X's acquisition cost.

In Rev. Rul. 2001-46, however, the IRS held that all the steps described above, including the merger of T into X, *would* be treated as a *single* transaction, which could then be treated a statutory merger of T into X, if, under the circumstances, an actual merger of T into X would have qualified as a nontaxable reorganization under Code section 368(a)(1)(A).

Facts in Rev. Rul. 2001-46

Rev. Rul. 2001-46 describes two similar situations. In the first situation, X acquires all of the stock of T through a statutory merger of Y into T (the "Acquisition Merger"). In the Acquisition Merger, the shareholders of T exchange their T stock for consideration consisting of voting stock of X (to the extent of 70% of the overall consideration) and cash. Pursuant to an integrated plan, T then merges into X (the "Upstream Merger").

The second situation is the same as the first except that, in the Acquisition Merger, the shareholders of T receive no consideration other than voting stock in X. Accordingly, even if the Acquisition Merger were viewed independently of the Upstream Merger, the Acquisition Merger would itself qualify as a nontaxable "reverse triangular merger" under Code sections 368(a)(1)(A) and 368(a)(2)(E).

Analysis

The new Ruling discusses at length an earlier ruling (Rev. Rul. 90-95, 1990-2 C.B. 67) and regulations under Code section 338 (the provision concerning the treatment of "qualified stock purchases" as asset acquisitions in which a basis step-up may be available) regarding the treatment for purposes of section 338 of an acquisitive merger followed by an upstream merger or liquidation.

In general, Code section 338 permits a corporation purchasing 80% or more of the stock of another corporation to elect to treat the transaction as if it were a purchase of assets (with a resulting basis step-up in the target's assets), so long as the purchase of stock is a "qualified stock purchase" ("QSP"), as defined in section 338, and the other requirements of that section are met. However, if an acquisitive merger and subsequent upstream merger were "stepped

together" and treated as a single integrated acquisition under the step transaction doctrine, the purchase of the stock of the target corporation through the acquisitive merger would not constitute a QSP and section 338 would not apply.

It is interesting to note that, prior to the enactment of section 338 in 1982, the entire series of transactions would likely be treated as a purchase of T's *assets* by X under the step transaction doctrine (in this case, travelling under the name "*Kimbell-Diamond* doctrine," after a leading Tax Court case applying a step transaction analysis to these facts).

However, in an effort to provide certainty regarding the exactly when an asset basis step-up would be available in the context of the acquisition of stock of a target corporation, Congress indicated that such extra-statutory doctrines should not be taken into account and that a QSP under section 338 should be the exclusive means for attaining such a step-up. The IRS accordingly ruled in 1990 that the step transaction doctrine would not be applied to treat an acquisitive merger and subsequent upstream merger as an asset purchase. An asset basis step-up could still be available, however, as the IRS concluded that the acquisitive merger should be analyzed separately from the subsequent upstream merger of T into X and could itself constitute a QSP.

The holding in Rev. Rul. 90-95, later reflected in regulations under section 338, reached a sensible result in the context of that section. Unfortunately, it has since caused concern as to whether the IRS would, based on considerations of consistency, conclude that an acquisitive merger followed by an upstream merger or liquidation should also not be viewed as a single transaction for purposes of determining whether the overall transaction would qualify as a tax-free reorganization under Code section 368.

This apparent inconsistency, between, on the one hand, the inapplicability of step transaction principles in the taxable acquisition context and, on the other, developments in the case law arguably expanding the application of step transaction principles with respect to reorganizations, was underscored by the issuance earlier this year of Rev. Rul. 2001-26 (discussed by the authors in their June 2001 column).

In the first situation described in Rev. Rul. 2001-26, Corporation P acquired 51% of the stock of T in exchange for P voting stock. A newly formed subsidiary of P was then merged into T, with the T shareholders (other than P) receiving, pursuant to the merger, a combination of cash and P stock.

After citing *King Enterprises, Inc. v. United States* (418 F.2d 511 (Ct. Cl. 1969)) and *J.E. Seagram Corp. v. Commissioner* (104 T.C. 75 (1995)), two cases that apply step transaction principles in the reorganization context, the IRS held that the two transactions should be treated as an integrated acquisition by P of the stock of T in a transaction that constitutes a reorganization under sections 368(a)(1)(A) and (a)(2)(E).

That ruling caused a number of tax practitioners to question whether, and how, the IRS could reconcile its decision to apply, and to allow taxpayers to apply, the step transaction doctrine in the section 368 nontaxable reorganization context—in particular with respect to integrating the final upstream merger with the other steps in the plan—with its decision *not* to apply the step transaction doctrine in the same way in the context of determining whether a taxable acquisition constituted a QSP or otherwise gave rise to an asset basis step-up.

Rev. Rul. 2001-46 attempts to reconcile the apparent inconsistency. It identifies the policy underlying section 338 as being "to 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" (as was once the rule under the *Kimbell-Diamond* doctrine).

This policy would not be frustrated by treating the two mergers in the first situation described above (an acquisition of T's stock for X stock and cash, followed by an upstream merger) as a transaction qualifying as a reorganization, since this treatment would result in a carryover basis transaction, rather than in an asset purchase in which the buyer has a tax basis in the assets equal to cost.

The ruling therefore concludes that the transaction described in the first situation, consisting of the Acquisition Merger for stock and cash, followed by the Upstream Merger, would be treated as a single statutory merger of T into X qualifying as a reorganization under section 368(a)(1)(A). As a consequence, no section 338 election could be made in this situation (*see* Code section 338(h)(3)).

The second situation in Rev. Rul. 2001-46 differed from the first in that the Acquisition Merger, pursuant to which T shareholders surrendered their stock solely in exchange for stock of X, could itself qualify as a reverse triangular merger under section 368(a)(2)(E), even if viewed independently of the Upstream Merger. The IRS concluded, however, that the second situation should be treated in the same manner as the first, as a single statutory merger qualifying under section 368(a)(1)(A) without regard to section 368(a)(2)(E).

In order to avoid frustrating the expectations of taxpayers who may have expected a greater degree of consistency from the IRS, the ruling does provide for the grandfathering in certain instances of stock acquisitions completed by September 24, 2001, or for which a binding contract was entered into by that date.

Rev. Rul. 2001-46 also indicates that the IRS and the Treasury are considering whether to issue regulations that would reflect the principles of this ruling and coordinate the application of those principles with certain elections under section 338.

Observations

The distinction drawn by Rev. Rul. 2001-46 in the application of the step transaction doctrine, between the reorganization context and the determination of the existence of a qualified stock purchase under Code section 338, appears to be result-oriented and may not be intellectually satisfying. The results reached, however, appear to be appropriate, and should be helpful to corporations and their counsel in planning transactions intended to qualify as reorganizations.

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