June 21, 2001

New Rulings Regarding Corporate Reorganizations

By: Elliot Pisem and David E. Kahen

Last month the IRS published rulings that address in a favorable manner what had been three troublesome issues under the rules governing tax-free corporate reorganizations. Each ruling appears to reach a sensible result that should ease the process of planning transactions intended to qualify as reorganizations under Internal Revenue Code section 368.

Triangular Reorganizations—Drop-Down of Acquisition Subsidiary

Revenue Ruling 2001-24 describes a typical forward triangular reorganization in which, pursuant to a plan of reorganization, corporation X merges into corporation S, a newly organized subsidiary of corporation P, in a transaction intended to qualify under Code sections 368(a)(1)(A) and 368(a)(2)(D). For such a transaction to qualify as an (a)(2)(D) reorganization, the shareholders of X must receive P stock in the transaction. After the merger, S continues the historic business of X.

As part of the plan of reorganization, P transfers the stock of S to S1, a pre-existing subsidiary of P—such that the acquired business is continued by what is now a second-tier subsidiary of P. The issue presented is whether this transfer prevents the merger from qualifying as a reorganization.

Section 368(a)(2)(D) provides that a statutory merger otherwise qualifying as a reorganization under section 368(a)(1)(A) may qualify as a reorganization if stock of the corporation controlling the acquiring corporation (that is, in the circumstances above, stock of P) is used to make the acquisition, so long as no stock of the acquiring corporation (that is, S) is used.

It is clear that "direct" control by P of S is required. For example, if the assets of X were acquired by a newly formed subsidiary of S, rather than by S, through a merger of X into the new subsidiary, the transaction would not qualify under section 368(a)(2)(D) because P would not own directly any stock in the subsidiary acquiring the assets. The question, thus, was whether the merger of X into S, followed by the transfer by P to S1 of the stock of S, would (under the step transaction doctrine or otherwise) be recast as a direct merger into a lower-tier subsidiary.

The IRS ruled that P did have the requisite control of S, and that the transaction could therefore qualify as a reorganization under section 368(a)(2)(D).

The IRS noted that similar drop-downs of assets or stock acquired in a transaction intended to constitute a reorganization are expressly authorized by Code section 368(a)(2)(C), with respect to reorganizations qualifying under sections 368(a)(1)(A), (1)(B) and (1)(C). Similar drop-downs are also permitted, under Treas. Reg. section 1.368-2(k)(2), following a reverse triangular reorganization under section 368(a)(2)(E) (in which, typically, a newly formed subsidiary of the controlling corporation is merged into the acquired corporation, which survives the merger); and the ruling notes that the legislative history for section 368(a)(2)(E) suggests that forward and reverse triangular mergers should generally be treated similarly.

Reverse Triangular Merger—Sale of Assets

In the circumstances described in Revenue Ruling 2001-25, P and T are both manufacturing corporations. S, a newly formed subsidiary of P, merges into T pursuant to a statutory merger in which the shareholders of T holding 90% of its stock exchange their T stock for voting stock of P, and the remaining shareholders of T receive cash in exchange for their T stock.

Immediately after the merger and pursuant to a plan that includes the merger, T sells 50% of its operating assets to an unrelated corporation for cash, and retains the sale proceeds. The question presented is whether that sale prevents the merger from qualifying as a reverse triangular reorganization under section 368(a)(2)(E).

Section 368(a)(2)(E) provides that a transaction otherwise qualifying under section 368(a)(1)(A) as a statutory merger will not fail to qualify by reason of the use in the transaction of stock of the corporation that controlled the merged corporation, so long as (i) the shareholders of the target receive voting stock of the controlling corporation in

exchange for an amount of stock in the target constituting control (generally, 80% of the voting stock) of the target corporation, and (ii) after the transaction, the surviving corporation "holds substantially all of its properties and of the properties of the merged corporation."

The question addressed in this ruling was whether the second requirement listed above could be met. In particular, the post-merger sale prevented T from holding substantially all of its historic business assets immediately after the merger. T did, however, retain the proceeds of sale.

Reverse triangular reorganizations under section 368(a)(2)(E), and certain other forms of corporate reorganizations, are subject to a "substantially all" requirement at least partly to restrict the use of the reorganization provisions to facilitate a disposition of one business on a non-taxable basis while another business is retained, in a so-called "divisive" transaction.

Revenue Ruling 2001-25 refers to Rev. Rul. 88-48 (1988-1 C.B. 117), concerning an intended "C" reorganization (that is, a transfer of the assets of one corporation to another in exchange for stock). In a C reorganization, the transferor corporation must also transfer "substantially all" of its assets. In Rev. Rul. 88-48, the IRS held that a sale of 50% of the historic business assets by the target to unrelated parties for cash, immediately before the transfer of assets intended to qualify as a reorganization, was not "divisive," and therefore would not prevent the later transfer of assets from qualifying as a C reorganization so long as the cash proceeds as well as the other assets of the target were transferred to the acquiring corporation for stock.

Taking the 1988 ruling into account, the IRS concluded in Rev. Rul. 2001-25 that a merger could qualify as a reverse triangular reorganization notwithstanding the post-merger sale of 50% of the assets, if the cash proceeds from the post-merger sale of assets are retained by T.

Two-Step Acquisition—Taxability of Pre-Merger Tender Offer

Revenue Ruling 2001-26 addresses whether the requirement that a controlling interest in the target corporation must be acquired in exchange for voting stock of the acquiror in order for a reverse triangular merger to be tax-free would be met in the context of two multi-step acquisition structures described in the ruling and summarized below.

In the first situation, each of P and T is a widely held manufacturing corporation, with T having only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of the stock of T and, for valid business reasons, completes the transaction in two steps.

First, P acquires 51% of the stock of T pursuant to a tender offer, in exchange for P stock.

Secondly, P forms S and S then merges into T. In the merger, each of the T shareholders holding the T stock not acquired in the first step exchanges T stock for a combination of consideration, two-thirds of which is P voting stock and the balance of which is cash. It is assumed that, under general principles of tax law including the step transaction doctrine, the tender offer and merger are to be treated as an integrated acquisition by P of T.

The second situation described in the ruling is the same as the first except that the tender offer is initiated by S. Thus, S, rather than P, acquires 51% of T stock (in exchange for P stock provided by P) before the merger of S into T that completes the acquisition.

If the merger were viewed in isolation, it clearly would not meet the requirement that, to qualify as a reverse triangular merger under section 368(a)(2)(E), target stock sufficient to constitute control of the target must be acquired for voting stock of the acquiror.

The Service noted, however, that, in *King Enterprises, Inc. v. United States* (418 F.2d 511 (1969)), the Court of Claims concluded that a two-step acquisition consisting of (i) the acquisition of all of the stock of one corporation by another in exchange for consideration of which more than 50% was the acquiror's stock, followed by (ii) an upstream merger of the acquired corporation into the acquiror, was an integrated transaction constituting a single statutory merger, such that a shareholder of the target was not required to recognize gain to the extent of the consideration it received in the form of stock.

Relying on the principles of *King Enterprises,* and with a reference to a more recent decision of the Tax Court (*J.E. Seagram Corp. v. Commissioner,* 104 T.C. 75 (1995)) also involving multiple steps ultimately held to constitute part of a single (forward triangular) reorganization, the IRS concluded that the tender offer and merger described in Rev. Rul. 2001-26 should be viewed together to determine if the requirements of section 368(a)(2)(E) are met. On that basis, the IRS concluded, the transactions described in both situations qualified as reorganizations under section 368(a)(2)(E).

Observations

All three rulings are favorable developments to be welcomed in their own right. The rulings are also consistent in tenor with other efforts by the IRS to project a "kinder, gentler" image and to resolve unnecessary and technical impediments to bona fide business restructurings.

The reorganization provisions of the Code (and other Code provisions) continue, however, to contain numerous technical requirements that are not subject to—or, at any rate, have not been made the subject of—amelioration by the IRS, and that remain traps for the unwary. The rulings should not be taken as an indication that these requirements will not be enforced as they have in the past, sometimes to taxpayers' dismay.

Reprinted with permission from the June 21, 2001 edition of the *New York Law Journal* © 2017 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. ALMReprints.com 877-257-3382 – reprints@alm.com.