

Part I

Section 368(a)(1)(A). - - Definitions relating to corporate reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.

Rev. Rul. 2001-46

ISSUE

Under the facts described below, what is the proper tax treatment if, pursuant to an integrated plan, a newly formed wholly owned subsidiary of an acquiring corporation merges into a target corporation, followed by the merger of the target corporation into the acquiring corporation?

FACTS

Situation (1). Corporation X owns all the stock of Corporation Y, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, X acquires all of the stock of Corporation T, an unrelated corporation, in a statutory merger of Y into T (the Acquisition Merger), with T surviving. In the Acquisition Merger, the T shareholders exchange their T stock for consideration, 70 percent of which is X voting stock and 30 percent of which is cash. Following the Acquisition Merger and as part of the plan, T merges into X in a statutory merger (the Upstream Merger). Assume that, absent some prohibition against the application of the step transaction doctrine, the step transaction doctrine would apply to treat the Acquisition Merger and the Upstream

Merger as a single integrated acquisition by X of all the assets of T. Also assume that the single integrated transaction would satisfy the nonstatutory requirements of a reorganization under 368(a) of the Internal Revenue Code.

Situation (2). The facts are the same as in Situation (1) except that in the Acquisition Merger the T shareholders receive solely X voting stock in exchange for their T stock, so that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A) by reason of 368(a)(2)(E).

LAW

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.

Rev. Rul. 90-95, 1990-2 C.B. 67 (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.

Section 1.338-3(d) of the Income Tax Regulations 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.

Section 368(a)(1)(A) defines the term reorganization as 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 (controlling corporation), which before the merger was 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 the properties of the merged corporation, and (ii) in the transaction, former shareholders of the surviving corporation exchange, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

In Rev. Rul. 67-274, 1967-2 C.B. 141, Corporation Y acquires all of the stock of Corporation X in exchange for some of the voting stock of Y and, thereafter, X completely liquidates into Y. The ruling holds that because the two steps are parts of a plan of reorganization, they cannot be considered independently of each other. Thus, the steps do not qualify as a reorganization under 368(a)(1)(B) followed by a liquidation under 332, but instead qualify as an acquisition of X's assets in a reorganization under 368(a)(1)(C).

ANALYSIS

Situation (1)

Because of the amount of cash consideration paid to the T shareholders, the Acquisition Merger could not qualify as a reorganization under 368(a)(1)(A) and

368(a)(2)(E). If the Acquisition Merger and the Upstream Merger in Situation (1) were treated as separate from each other, as were the steps in Situation (2) of Rev. Rul. 90-95, the Acquisition Merger would be treated as a stock acquisition that is a qualified stock purchase, because the stock is not acquired in a 354 or 356 exchange. The Upstream Merger would qualify as a liquidation under 332.

However, if the approach reflected in Rev. Rul. 67-274 were applied to Situation (1), the transaction would be treated as an integrated acquisition of T's assets by X in a single statutory merger (without a preliminary stock acquisition). Accordingly, unless the policies underlying 338 dictate otherwise, the integrated asset acquisition in Situation (1) is properly treated as a statutory merger of T into X that qualifies as a reorganization under 368(a)(1)(A). See King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) (in a case that predated 338, the court applied the step transaction doctrine to treat the acquisition of the stock of a target corporation followed by the merger of the target corporation into the acquiring corporation as a reorganization under 368(a)(1)(A)); J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995) (same). Therefore, it is necessary to determine whether the approach reflected in Rev. Rul. 90-95 applies where the step transaction doctrine would otherwise apply to treat the transaction as an asset acquisition that qualifies as a reorganization under 368(a).

Rev. Rul. 90-95 and 1.338-3(d) reject the 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. The rejection of step integration in Rev. Rul. 90-95 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. H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. (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.) 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.

The policy underlying 338 is not violated by treating Situation (1) as a single statutory merger of T into X because such treatment results in a transaction that qualifies as a reorganization under 368(a)(1)(A) in which X acquires the assets of T with a carryover basis under 362, and does not result in a cost basis for those assets under 1012. Thus, in Situation (1), the step transaction doctrine applies to treat the Acquisition Merger and the Upstream Merger not as a stock acquisition that is a qualified stock purchase followed by a 332 liquidation, but instead as an acquisition of T's assets through a single statutory merger of T into X that qualifies as a

reorganization under 368(a)(1)(A). Accordingly, a 338 election may not be made in such a situation.

Situation (2)

Situation (2) differs from Situation (1) only in that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A) by reason of 368(a)(2)(E). This difference does not change the result from that in Situation (1). The transaction is treated as a single statutory merger of T into X that qualifies as a reorganization under 368(a)(1)(A) without regard to 368(a)(2)(E).

HOLDING

Under the facts presented, if, pursuant to an integrated plan, a newly formed wholly owned subsidiary of an acquiring corporation merges into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the transaction is treated as a single statutory merger of the target corporation into the acquiring corporation that qualifies as a reorganization under 368(a)(1)(A).

APPLICATION

Pursuant to 7805(b)(8), the Service will not apply the principles of this revenue ruling to challenge a taxpayer's position with respect to the treatment of a multi-step transaction, one step of which, viewed independently, is a qualified stock purchase if:

(1) a timely (including extensions) and valid (without regard to whether there was a qualified stock purchase under the principles of this revenue ruling) election under

338(h)(10) or 338(g) (Election) is or was filed with respect to the acquisition of the stock of the target corporation; and

(2) either

(a) the acquisition date for the target corporation is on or before September 24, 2001; or

(b) the acquisition of stock of the target corporation meeting the requirements of 1504(a)(2) by the purchasing corporation is pursuant to a written agreement that (subject to customary conditions) is binding on September 24, 2001, and at all times thereafter until the acquisition date; and

(3) such taxpayer does not take a position for U.S. tax purposes that is inconsistent with the treatment of the acquisition as a qualified stock purchase with respect to which the Election was made.

Further, the Service and the Treasury are considering whether to issue regulations that would reflect the general principles of this revenue ruling, but would allow taxpayers to make a valid election under 338(h)(10) with respect to a step of a multi-step transaction that, viewed independently, is a qualified stock purchase if such step is pursuant to a written agreement that requires, or permits the purchasing corporation to cause, a 338(h)(10) election in respect of such step to be made. The Service and the Treasury request comments regarding the adoption of such an approach.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 67-274 is amplified and Rev. Rul. 90-95 is distinguished.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Reginald Mombrun and Joseph M. Calianno of the Office of the Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Mombrun on (202) 622-7750 (not a toll-free call) or Mr. Calianno on (202) 622-7930 (not a toll-free call).