ARTICLE

On Mergers, Acquisitions and Leveraged Buyouts Taxation in the United States

—A Debate on Integration of the Corporate and Individual Tax and on the Consumption Type or Cash Flow Personal Income Tax (1)—

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Overview

1 CORPORATE EXPANSION

Corporations expand in two ways—by internal growth and by acquiring existing businesses from third parties.

As for internal growth, corporations may use cash generated by operations, new capital, and borrowed money to expand existing businesses or start new businesses. For example, corporations may start new businesses by building new plants, buying new equipment, opening new stores, and expanding into new territories.

As for acquisitions, corporations may also acquire existing businesses from third parties for cash, for debt, or for stock. Such transactions may involve such acquisitions as mentioned below.

(a) the acquisition of a newly formed corporation's first business. This is frequently called a leveraged buyout-"LBO".

(b) an acquisition by an old corporation—which already has one or more existing business—of a new business for the purpose of

disversification, vertical integration, or horizontal integration. Diversification unrelated to the corporation's current businesses. Vertical intergration means acquisitions of suppliers or customers. Horizontal integration means acquisitions of competitors.

Where the acquired or target corporation ("T") is approximately the same size as the acquiring or purchasing coporation ("P"), the transactions is frequently called a business combination or, imprecisely, a merger, especially where the management terms of the two companies are being integrement team dominant. Where T is considerably smaller than P, the transaction is frequently called a buyout or acquisition, especially where P's management team will be dominant. These labels are routinely used regardless of whether the legal form of the transaction is a state law merger (for P's stock or for cash) or an acquisition of T's stock or assets (for P's stock or for cash).

Where P is newly formed for the purpose of purchasing T with a small amount of equity and large amount of borrowed money, the transaction is generally called a leveraged buyout (or "LBO"), especially where the acquisition debt is recourse only against T or newly formed P (generally a corporation without substantial assets) or both and no individual or substantial existing entity on the buyer's side guarantees the debt. Where some or all of T's top officers become substantial shareholders of newly formed P. The transaction is often called a management-led LBO. Frequently in an LBO, a substantial portion of newly formed P is owned by financing parties. Financing parties means venture capitalists ("VCs"), investment bankers, mezzanine lenders, banks, etc.

So-called "bust-up" acquisitions are LBOs in which T is dismembered. A substantial portion, or perhaps all, of T's assets are sold in

a series of separate transactions within a relatively short period in order to pay down the acquisition debt and generate a profit for the P equity investors. The principal equity investor in a bust-up acquisition is typically an LBO fund or venture capitalist organized to acquire other businesses in this manner. The investors typically identify T as an undervalued company[1] and therefore acquire T in the hope of generating a relatively short-term profit through the piecemeal disposition of T's assets.

This treatise deals with the second form of expansion; mergers, acquisitions, and leveraged buyouts. In general, the term "acquisition" is used herein to refer to all of these transactions.

2 IMPORTANCE OF LEGAL AND TAX STRUCTURE TO THE ECONOMIC BARGAIN

Mergers, acquisitions, and LBOs begin with a business idea and are driven by economic factors. While the impact of the tax law is surely one such factor, the central concern in aquisition transactions is the commercial bargain struck by the parties. That is, the central concern is the determination of the economic benefits and burdens to be generated by the transaction and their allocation among the parties to the transaction.

There are several alternative structures and contractual clauses with radically different tax and legal result, so that the economics of the transaction will vary materially depending upon the structure and contractual clauses selected.

The parties invite serious conflict and do a disservice to themselves

1. For example, the net fair market value of T's assets is thought to exceed T's stock trading price.

and their professional advisers if they settle the price and the medium of payment without giving concurrent attention to the tax and legal structuring of the transaction and such contractual issues as the scope of the seller's representations, warranties, and indemnifications. Principal non tax issues include:

(1) Will the transaction be structured so that P inherits all of T's liabilities, disclosed and undisclosed, or structured to maximize the likelihood that P assumes only specified T liabilities and the remainder are left with T or inherited by its shareholders?

(2) Will T's contractual representations, warranties and indemnifications allow P to recover back from T or its shareholders a portion of the purchase price if, after the transaction is completed, P discovers that T has undisclosed liabilities[2], that T lacks good title to a portion of its assets, that part of T's receivables are not collectible or part of its inventory is not salable, that T's past financial statements are inaccurate, etc?

(3) Will T's executives receive employment contracts, golden parchute agreements, severance agreements or, instead, will they receive no employment protection? Will P obtain from T's executives covenants not to compete?

Principal tax issues include:

(1) Will the transaction be structured so that P obtains a new basis[3] in T's assets[4] or will P take a carryover basis in T's assets[5]?

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2. environmental cleanup, unpaid taxes, employment discrimination, antitrust violations, product liability, patent or trademark infringement, etc.

3. either a stepped-up or stepped-down basis

4. generally the purchase price paid by P plus the T liabilities assumed by P (or to which T remains subject if T becomes a P subsidiary) plus P's expenses of acquiring T)

5. generally T's much lower historical asset basis.

(2) Will the transaction cause T to pay corporate-level tax on all the appreciation inherent in its assets, including good will and other intangibles? If so, will the economic burden of this tax fall on P or on T's shareholders?

(3) Will T's shareholders pay tax on the appreciation inherent in their stock? Can that gain be deferred by the installment method, a tax-free reorganization, or the use of Code Sec. 351?

(4) If T has a net operating loss (NOL) or other tax attribute carryforward, will P inherit T's NOL or other tax attribute and, if so, what if any restriction will be imposed on P's enjoyment of T's NOL or other attribute?

3 FOUR BASIC ACQUISITION STRUCTURES AND THEIR TAX RAMIFICATIONS

The following examples discuss the tax ramifications of four principal structures for corporate acquisitions.

It will be useful to keep these four basic aquisition structures in mind when considering the issues discussed throughout this paper.

Example (1): P's Taxable Purchase of T's stock P purchases all of T's stock for cash and/or P notes. T's shareholders recognize any gain or loss (usually capital) realized on the sale of their T stock[6].

T shareholders who receive P notes generally may report their gain on the installment method, as long as the P notes received are not payable on a demand or readily tradable and T stock sold was not traded on an established securities market, and subject to penalty

6. if T's stock is owned by Bigco and T file a consolidated return, Bigco may generally not claim a loss on the sale of its T stock under regulations adopted in march 1990.

provisions imposed by code Sec. 453A (as amended by the 1988 Act) on large post-12/31/88 installment sales.

P's basis in the T stock purchased is equal to the purchase price paid, unless P issued notes bearing inadequate interest (as determined by one of several statutory tests). T's basis in its assets remains the same as before the acquisition unless P makes (or is deemed to make) an election under Code Sec. 338 (a "Sec. 338 election") to treat, in effect, the purchase of T's stock as a purchase of T's assets. T's other tax attributes are generally not affected by the acquisition (absent a Sec. 338 election); however, T's ability thereafter to use its net operating loss, capital loss, and tax credit carryforwards may be limited by Code Secs. 269, 382, 383 and 384.

If P makes (or is deemed to make) a Code Sec. 338 election to treat, in effect, its purchase of T stock as a purchase of T's assets, T's basis in its assets is stepped up (or down) to equal, in the aggregate, the purchase price paid by P plus T's liabilities plus P's acquisition expenses. T is taxed as if it had sold its assets and therefore recognizes the full gain or loss in its assets. T's tax attributes, including T' s net operating loss and tax credit carryforwards, will generally be useable to offset gain on the deemed asset sale but will not be useable by T or P after the deemed sale[7].

Example (2): P's Taxable Purchase of T's assets P purchases T's assets for cash and/or notes. P takes a basis in T's assets equal to the purchase price paid plus any T liabilities transferred to P plus P's acquisition expenses.

7. If T is a member of the Bigco consolidated group prior to P's acquisition of T, and Bigco sells its T stock at loss which is disallowed by regulations adopted in March 1990, Bigco may elect to retain all or a potion pf T's NOLs, not in excess of the disallowed loss.

T will recognize full gain or loss on the sale of its assets. T's tax attributes will not be acquired by P ; they will generally be useable by T to offset gain on the sale.

If T receives P notes that are not payable on demand or readily tradable, T is eligible to use the installment method to report the gain recognized on its assets[8], so long as T does not liquidate, and subject to penalty provisions imposed by Code Sec. 453A (as amended by the 1988 Act) on large post-12/31/88 installment sales.

For installment reporting, T's shareholders will not realize taxable gain or loss unless T liquidates. If T liquidates, its shareholders will recognize gain or loss (usually capital) on the disposition of their stock in the liquidation. However, if T distributes P notes to its shareholders in a prompt liquidation and if the P notes are qualifying and the T stock is not traded on an established securities market, T's shareholders generally may use the installment method to report their gain on the liquidation.

However, if T is an 80% or greater subsidiary of Bigco, Bigco will recognize no gain on the liqudiation, which will be a tax-free Sec. 332 liquidation as to Bigco. This paper assume (except where otherwise stated) that T is not an 80% or greater subsidiary of Bigco.

Example (3): P's Acquisition of T's stock in a Tax-Free Exchange

P acquires all of T's stock in exchange for P stock (or P stock plus "boot", i. e., generally any property other than P stock) in a transaction qualitying as a tax-free reorganization under Code Sec. 368, generally a "B" reorganization or a reverse subsidiary "A" reorganization[9].

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8. the assetis other than recapture, gain on marketable securities or inventory, and gain on certain other assets not qualifying

9. In some reorganization formats-generally those not involving a merger or subsidiary merger-only P voting stock may be received tax free.

T's shareholders will not recognize any gain or loss realized on the exchange of their stock, except that (if the reorganization employs a form that permits the delivery of boot) any T shareholder will recognize gain to the extent of any boot received.

Each T shareholder will take a substituted basis in the P stock received equal to the basis he had in his T stock, increased by any gain recognized and reduced by the amount of any boot received.

T's basis in its assets is unchanged and P may not elect to step up the basis of T's assets under Code Sec. 338. T recognize no gain on the exchange and generally retains its tax attributes; however, T's ability to use its net operating loss, capital loss, and tax credit carryforwards may be limited by Code Secs. 269, 382, 383 and 384.

Depending upon the format of the reorganization, P may take a basis in the T stock acquired (1) equal to the aggregate basis T's shareholders had in the T stock exchanged, or (2) equal to T's basis in its assets less its liabilities.

Example (4): P's Acquisition of T's Assets in a Tax-Free Exchange

P acquires all of T's assets in exchange for P stock (or P stock plus boot) in a transaction qualifying as a tax-free reorganization under Code Sec. 368, generally an "A" or "C" reorganization or a forward subsidiary "A" reorganization[10].

T shareholders will exchange their T stock for P stock (or, in some cases where the transaction is a statutory merger, P stock and boot) either because T has liquidated or because the asset acquisition was accomplished by statutory merger. T's shareholders will not recognize any gain or loss realized on the exchange, except that (if the

10. In some reorganization formats-generally those not involving a merger or subsidiary merger-only P voting stock may be received tax free.

reorganization employs a form that permits the delivery of boot) gain realized by a T shareholder will be recognized to the extent of any boot received. Each T shareholder will take a substituted basis in the P stock received equal to the basis in the T stock surrendered, increased by an gain recognized and reduced by the amount of any boot received.

P will take a carryover basis in T's assets and will generally acquire T's tax attributes ; however, P's ability to use T's net operating loss, capital loss, and tax credit carryforwards may be limited by Code Secs. 269, 382, 383 and 384, T will generally recognize no gain or loss on the transaction.

Taxable Purchase of T's Stock and Taxable Reverse Subsidiary Merger

1 GU REPEAL AND CODE SEC. 338 ELECTIONS

In those cases where it remains desirable to step-up the basis of T's assets[11] after G U Repeal[12] and the move to corporate unified rates, P can elect to treat the purchase of T's stock as a purchase of T's assets. If P makes a Code Sec. 338 ellection by the fifteenth day of the ninth month after P purchased at least 80 percent control of T :

(1) T is generally "treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction" to a new corporation ("New T").

(2) After G U Repeal, Old T recognizes and is taxed on the full gain

11. when is such a step up desirable ? See the discussion at 11.

12. "G U Repeal" is the 1986 Act's repeal of the so-called General Utilities doctrine, under which a corporation generally did not recognize gain on an in-kind distribution of apprecated assets in complete liquidation (except to the extent of recapture) nor did it generally recognize gain on the sale of appreciated property in connection with complete liquidation (again except for recapture).

and loss on the deemed sale of its assets[13]. Thus, G U Repeal and the move to corporate unified rates mean that P finds it advantageous to make a Code Sec. 338 election for T only in certain limited circumstances.

(3) New T is treated as "purchasing [Old T's] assets…as of the beginning of the day after the acquisition date."

(4) New T generally takes a basis for Old T's assets equal to the price P paid for T's stock, plus T's liabilities, plus P's costs of making the acquisition.

(5) Old T's tax attributes disappear

I must explain implications of G U Repeal for acquisitions. Before G U Repeal, if T sold its assets to P at a price higher than T's internal asset basis and T liquidated pursuant to Code Sec. 337 :

(1) T's shareholders would pay tax on their liquidation proceeds as if they had sold their T stock.

(2) Code Sec. 337 exempted T from corporate-level taxation, except on specified types of gain, principally recapture, and

(3) P would take a stepped-up basis in the Tassets purchased.

If P bought T's stock (rather than its assets) at a price higher than T's internal asset basis and P made a Code Sec. 338 election with respect to T. T would be treated as having sold its assets to itself ("New T") and liquidated under Code Sec. 337, so that :

(1) T would be taxed at the corporate level only on specified types of gain, again principally recapture.

(2) the basis of T's assets would be stepped up in the hands of New T, and

13. if the transaction took place before 1989 and T was a Small Corporation, T can avoid full gain recognition.

(3) T's shareholders would, of course, be taxed on their proceeds from the sale of their T stock to P.

G U Repeal radically changed these results. Post-1986 if P buys T's assets and T liquidates, T pays a corporate-level tax on its full gain from the sale of its assets, not merely its recapture items. T's shareholders continue to be taxed as if they had sold their stock for the liquidation proceeds (less T's corporate tax liability) and P continues to take a stepped-up basis in T's assets.

Post-1986 if P purchases T's stock and P makes a Code Sec. 338 election, T payes corporate-level tax on its full gain (as if it had sold all its assets without the benefit of any nonrecognition provision), not merely on recapture items. T's shareholders continue to be taxed on their proceeds from the sale of their T stock to P, and New continues to take a stepped-up basis in T's assets.

G U Repeal thus made the full recognition of all corporate-level gain, not merely recapture, the price of a step-up in the basis of T's assets. In conjunction with unified rates[14], G U Repeal made it unlikely that it will be advantageous to structure acquisitions to achieve a step-up in the basis of T's assets. Except in limited circumstances (discussed below), it is generally advantageous to structure acquisitions as carryover basis transactions.

In general, post-1986 acquisitions have been structured to avoid a purchase of assets, and Code Sec. 338 election have not been made when stock is purchased. The normal structure has been a purchase of

14. "Unified rates" means the 1986 Act's taxation of long-term capital gain at the same rate as ordinary income. Effective January 1, 1991, the 1990 Act reintoduces a three-percentage point long-term capital gain preference for individuals, ending unified rates for individuals. However, unified rates continue in effect for corporations.

stock with no Code Sec. 338 election. It follows that, in general, P has a lower tax basis of T's assets, resulting in lower tax depreciation and amortization deductions and cost of goods sold and higher taxable income, and P has a lower after-tax return on the acquisition than would have been the case had the tax basis of T's assets been stepped-up. Thus, except to the extent that lower tax rates on ordinary income (34 percent once the 1986 Act was finally effective rather than 46 percent before the 1986 Act) compensate for reduced tax depreciation/amortization and cost of good sold, the result is lower acquisition prices then would have been the case without G U Repeal.

Even after G U Repeal there are at least five situations in which it may be desirable to structure an acquisition to obstain a stepped-up basis in T's assets:

(1) T has a sufficiently large NOL with which to offset the gain on either an asset sale or a Code Sec. 338 election. T's NOL can offset such gain, but P's NOL can not.

(2) T is a subsidiary in a consolidated group (the Bigco group) one or more of whose menbers have sufficiently large NOLs with which to offset T's gain, in which case consolidated group may either sell T's stock and make a Code Sec. 338(h)(10) election (to treat the sale of T's assets)[15] or cause T to sell its assets and liquidate under Code Sec. 332.

(3) T is a consolidated subsidiary (or a division) of Bigco which owns other assets not being sold to P, and Bigco's gain on the sale of T's assets would not be materially greater than its gain on the sale of

15. of the sale of T's stock is made with a Code Sec. 338(h)(10) election wholly or partly for future payments, in the absence of helpful regulations it is not clear that T's corporate-level gain can be reported on the installment method, as it could have been in an actual sale of T's assets.

T's stock, in which case Bigco may either sell T's stock and make a Code Sec. 338(h)(10) election or cause T to sell its assets and liquidate under Code Sec. 332. The 1987 Act's repeal of the Woods Investment doctorine[16] makes it more likely that Bigco's basis in T's stock will not materially exceed T's basis in its assets, and thus will likely increase the number of cases in which a T asset purchase or a T stock purchase followed by a Code Sec. 338(h)(10) election is desirable.

(4) T is a subchapter S corporation which is not subject to the penalty tex of Code Sec. 1374 or old Code Sec. 1374 (or can find a way to avoid such penalty tax).

(5) T is a partnership.

As for desirability of Structuring Acquisition to Obtain Stepped-up Basis, it follows as mentioned bellow.

Because a stepped-up basis (via a purchase of assets or a purchase of stock with a Code Sec. 338 election) almost always means a front-end corporate-level tax, it is important to determine whether the ultimate tax benefit of the step-up in basis is worth paying such front-end tax or whether, on the other hand, it is more desirable to structure the acquisition for carryover basis (via a purchase of stock without a Code Sec. 338 election). The desirability of obtaining a stepped-up

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16. The consolidated return investment adjustment rules (as modified by Code Sec. 1503(e)[d], the anti-Woods Investment provision) generally adjust Bigco's outside basis in T's stock in lockstep with T's changes in net inside asset basis. Prior to the adoption of Code Sec. 1503(e)[d], Bigco's basis in T's stock could materially exceed T's basis in its assets since Woods Investment Co. V. commissionner. 85 TC 274, Dec. 42315(1985), acq 1986-2 CB 1, allowed Bigco to compute its investment adjustment in T's stock basis using straight-line E & P depreciation even though T used accelerated depreciation for regular income tax purposes. Thus, under Woods, Bigco's outside basis in its T stock was likely to exceed T's inside net asset basis.

basis for T's assets (and paying front-end corporate-level tax on T's assets) depens upon a comparison of :

(1) the front-end tax on T's assets with

(2) the discounted present value of the tax savings from the additional deductions for cost of goods sold, depreciation, and amortization resulting from the step-up.

There are at least five situation in which it may be desirable to structure an acquisition to obtain a stepped-up basis in T's assets after G U Repeal :

(1) T is a Small Corporation and was acquired before 1989 so as to qualify for the Small Corporation exemption from G U Repeal.

(2) T has a sufficiently large NOL which may be used to offset the gain on either an asset sale or a Code Sec. 338 election. T's NOL can offset such gain, but P's NOL can not.

(3) T is a subsidiary of a consolidated group (the Bigco group) which has a sufficiently large NOL with which to offset T's gain, in which case the consolidated group may either sell T's stock and make a Code Sec. 338(h)(10) ellection or cause T to sell its assets and liqudate under Code Sec. 332.

(4) T is a Subchapter S corporation which is not subject to the penalty tax of Code Sec. 1374 or Old Code Sec. 1374 (or can find a way to avoid such penalty tax).

(5) T is a consolidated subsidiary (or a division) of Bigco which owns other assets not being sold to P, and Bigco's gain on the sale of T's assets would not be materially greater than its gain on the sale of T's stock, in which case Bigco may either sell T's stock and make a Code Sec. 338(h)(10) election or cause T to sell its assets and liquidate under Code Sec. 332.

The legislative history of Code Sec. 338 also makes it clear that Code Sec. 338 "replaces any nonstatutory treatment of a stock purchase followed by a liquidation as an asset purchase under the step transaction doctrine of the Kmbell-Diamond case"[17].

A code Sec. 338 election is effective without any requirement that T be liquidated. This is a welcome change from pre-1982 law if T has assets that are difficult to transfer (e. g., assets the transfer of which requires the consent of third parties or the payment of transfer taxes or the filing of substantial documentation[18].)

P can make a Code Sec. 338 election not later than the fifteenth day of the ninth month after acquiring at least 80 percent control of T in a "qualifired stock purchase" (a "QSP"). This period did not, however, expire for any transaction before July 15, 1986[19].

For example, if P buys 79% of T's stock on 3/1/89, an additional 10% of T's stock on 4/20/89, and the remaining 11% on 5/31/89, P has acquired control of T in a QSP on 4/20/89 and accordingly, P has until 1/15/90, the 15th day of the ninth month after April 1989, to fire a Code

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17. 1982 General Explanation at 133. It is not altogether clear that the Kmbell-Diamond doctrine (treating a stock purchase followed by a pre-planned liquidation as an asset purchase) has been repealed by the 1982 Act where the stock purchase was not a "qualified stock purchase" so that P could not have made a Code Sec. 338 election. "Qualified Stock Purchase" (QSP) is any transaction or series of transactions in which, during a 12-month period, P purchases sufficient T stock to be able to file a consolidated return with T under Code Sec. 1504.

Generally, this means that P must purchase T Stock possessing at least 80 percent of T's voting power and at least 80 percent of T's value, except that nonvoting debt-like preferred stock is ignorred if it does not vote, is limited and preferred as to dividends, does not significantly participate in corporate growth, does not best an unreasonalble redemption premium, and is not covertible.

18. For those states which do not currently conform their tax laws to the federal changes, there may still be viable Code Sec. 334(b)(2) or Code Sec. 346(a) planning possibilities.

19. Temp. Reg. §1.388-I T(c).

Sec. 338 election.

In determining whether there has been a QSP, the IRS has announced in IRS Notice 87-63 that certain regulations under Code Sec. 1504, when issued, "will not be effective in determining whether there has been a Code Sec. 338 QSP for purchases made during any 12-month acquisition period beginning on or before the date proposed regulations are published"[20].

The regulations in question are those autorized by Code Sec. 1504(a)(5)(A) and (B), which permits the IRS to issue regulations defining an affiliated group treating options to acquire or sell stock as having been excercised, treating warrants, obiligations covertible in to stock, and other similar interests as stock, and treating stock as not stock. The safe harbor created by IRS Notice 87-63 applies only with respect to the definition of QSP, not for other Code Sec. 338 purposes. (e. g., such regulations might apply retroactively for purposes of the consistency rules.)

P has purchased T's stock only if all of the following conditions are met :

(1) The T stock is acquired in a transaction that does not result in P taking a carryover basis (in whole or in part) from T's former shareholders.

(2) The T stock is not acquired in an exchange to which Code Sec. 351 or Code Secs. 354 through 356 applies or in any other transaction described in regulations in which the transferor does not recognize full gain or loss.

(3) The T stock is not acquired from a person the ownership of whose stock would be attributed to P under Code Sec. 318 (without

20. IRS Notice 87-63, 1987-2 CB 375

regard to Code Sec. 318(a)(4) option attribution).

P can also back into the 80 percent purchase reguirement by purchasing less than 80 percent of T's stock and then causing T to redeem enough additional shares so that P then satisfies the 80 percent control requirement[21].

2 CODE SEC. 338 INCOME AND EXAMPLES (1)~(10)

T's income from the Code Sec. 338 election[22] goes on T's return and can not be included in P's consolidated return, if it files a consolidated return with T and P's other subsidiaries, if any. Hence, if P has an NOL, it can not be used to shelter T's Code Sec. 338 income[23].

If filed a separate return prior to its acquisition by P, T's Code Sec. 338 income would be on its own return for the short year ending on the acquisition date. If T was the common parent of a consolidated group, the temporary regulations permit T's an its subsidiaries' Code Sec. 338 income to appear on the group's consolidated return for the short taxable year ending on the acquisition date[24].

If T field a consolidated return with its parent Bigco, which sold T's stock to P, T's Code Sec. 338 income falls on T and can not be

21. 1982 General Explanation at 134 ; Temp. Reg. §1.338-4 T(c)(4). See also Rev. Rul. 90-95, 1990-2 CB 67 (P's transitory subsidiary S, founded in part will cash from P and in part with money S borrowed, merged with and into T. The former T shareholders received cash in exchange for their T stock, and T became P's wholly owned subsidiary. Held citing Rev. Rul. 79-273, 1979-2 CB 125, a part purchase part redemption QSP. Held further, the upstream merger of T into P (immediately after T became a wholly owned P subsidiary) did not after the result.)

22. Full gain for a Large Corporation and for a Small Corporation after the December 31, 1988 expiration of the G U Repeal Small Corporation Transition Period. For a Small Corporation during 1987 and 1988, generally recapture and gain or loss on ordinary and short-term capital assets.

23. Code Sec. 338(h)(9)

24. Temp. Reg. §1.338-1 T(f)(2)(ii) ; see also Code Sec. 338(h)(15)

sheltered by Bigco's NOL, ie., T files a separate one-day return which includes "only the items resulting from the deemed sale and the carry-over items [e.g., T's NOL and ITC carryovers[25]]." However, T is probably not entitled to the lower tax rates on the first $75,000 of income because it is a member of Bigco's Code Sec. 1563 group[26]. T and any T affiliate purchased by P at the same time can file a "combined" one-day return and hence should be able to use their NOLs against each other's Code Sec. 338 income unless the NOLs were SRLY NOLs[27].

However, if a special Code Sec. 338(h)(10) election is made, T can be included as a member of the Bigco group with respect to T's deemed sale of its assets (so that Bigco's NOL will offset T's Code Sec. 338 income), in which case the Bigco group will recognize gain or loss as if T had really sold its assets, and Bigco will recognize no gain or loss on the sale of T's stock[28].

Calculating Old T's Gain is as follows. The amount of gain on the deemed sale of T's assets (or the amount of recapture prior to G U Repeal) is normally calculated as if T had sold each of its assets at FMV.

The temporary regulations under Code Sec. 338 allowed P to elect to determine the amount of recapture by means of a formula (the "elective ADSP formula") that takes into account the price P paid for T, including T's liabilities[29].

Prior to G U Repeal, this formula reduced the amount of T's recapture where P made a bargain purchase of T (i.e., where the

26. Temp. Reg. §1.338-IT(f)(3)(V)
27. Code Sec. 338(h)(15)
28. Code Sec. 338(h)(10), Temp. Reg. §1.338(h)(10)-IT(a)
29. Code Sec. 338(h)(11); Temp. Reg. §1.338-4T(h)

aggregate price paid by P, plus liabilities and taxes on recapture, was less than the aggregate FMV of T's assets.) It is expected that this formula will be revised in light of G U Repeal so that it may be used to calculae full gain on the deemed sale, where the aggregate price paid by P, plus Iiabilities and taxes on the full gain recognized in the deemed sale, is less than the FMV of T's assets.

The temporary regulations under Code Sec. 338(h)(10) provide a formula-but one that is not similarly self-referential-to calculate gain on a deemed sale occuring after a Code Sec. 338(h)(10) election[30].

Effect of Code Sec. 338 election where old T has subsidiaries is as follows.

In March 1991, the IRS issued Temp. Reg. §1.338-6T, granting limited relief from the duplicative taxation of the same economic gain or loss when a Code Sec. 338 election is made with respect to a target corporation ("T") that has subsidiaries. Although Temp. Reg, §1.338-6T is surely a step in the right direction, it is flawed in important respects. Explicitly, the temporary regulation sanctions double taxation of a single economic gain in one significant class of cases. Additionally, the temporary regulation leaves wholly unclear whether double taxation occurs in a second significant class of cases.

We begin by illustrating the duplication of gain or loss that can occur when a Code Sec. 338 election is made with respect to a target that has subsidiaries. Next, we analyze Temp. Reg. §1.338-6T, including the circumstances in which the temporary regulation either

30. Code Sec. 338(h)(10) provides that old T is treated as a member of the Bigco consolidated group when the deemed sale occures. In contrast, old T is not treated as a member of either Bigco's or P's consolidated group for purposes of reporting the gain on the deemed sale triggred by a regular code Sec. 338 election, Code Sec. 338(h)(9).

clearly fails or possibly fails to eliminate gain or loss duplication. Finally, we identify practical ways of avoiding these problems of exorbitant taxation that reside in Temp. Reg. §1.338-6T.

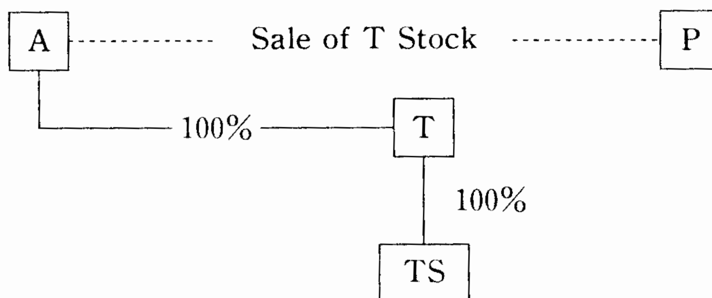
Where T holds at least 80 percent[31] of the stock of a subsidiary ("TS"), an express or deemed Code Sec. 338 election with respect to T automatically triggers a deemed Code Sec. 338 election with respect to TS[32].

For example,

(1): T owns and at all times has owned 100% of TS's outstanding stock. On 4/1/91, P buys 100% of T's stock for cash from individual A and makes a Code Sec. 338 election with respect to T.

P's Code Sec. 338 election with respect to T triggers a deemed Code Sec. 338 election with respect to TS. As a result, (a) Ts deemed to have sold all its assets, including its TS stock, to New T, and (b) TS is deemed to have sold all its assets to New TS[33].

《Figure 1》



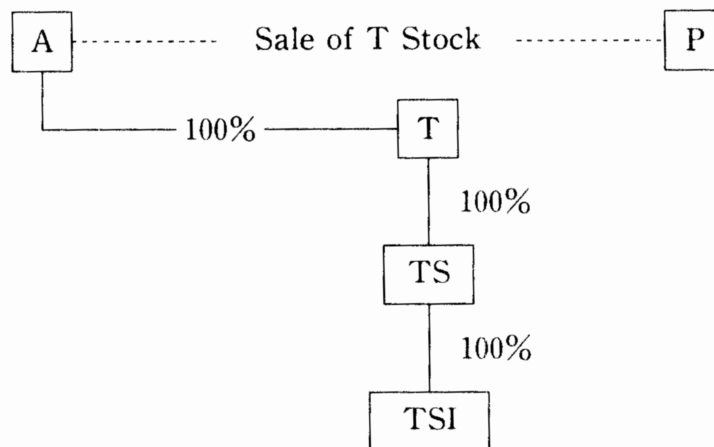
31. 80% in both voting power and value, excluding nonvoting straight preferred stock described in Code Sec. 1504(a)(2). See Code Secs. 338(d)(3) and 1504(a)(4).

32. Temp. Reg. §1.338-4T(e)(3). The deemed Code Sec. 338 election with respect to TS occurs as follows: As a result of P's actual Code Sec. 338 election with respect to T, T is deemed to have sold all its assets, including its TS stock, to New T. New T's deemed purchase of T's TS stock constitutes a QSP with respect to TS and, under the consistency rules of Code Sec. 338(f)(1) and (h)(8), triggers a deemed Code Sec. 338 election with respect to TS.

33. The result would be the same if P had purchased T's stock (a) from a number of holders (rather than from a single individual), or (b) from a single

Example (2): Same as Example (1), except that TS owns 100% of TSI's outstanding stock. P's Code Sec. 338 election with respect to triggers a deemed Code Sec. 338 election with respect to TS and TSI. As a result, (a) T is deemed to have sold all its assets, including its TS stock, to New T, (b) TS is deemed to have sold all its assets, including its TSI stock, to New TS, and (c) TSI is deemed to have sold all its assets to New TSI[34].

《Figure 2》



In Example (1) and (2), a literal application of the Code Sec. 338 deemed sale rule would trigger multiple levels of gain or loss recognition with respect to the same economic gain or loss. Specifically, in Example (1), (a) T would be taxed on the deemed sale of its TS stock and (b) TS would be taxed on the deemed sale of its adssets. In Example (2), (a) T would be taxed on the deemed sale of its TS stock, (b) TS would be taxed on the deemed sale of its assets, including its TSI stock, and (c) TSI would be taxed on the deemed sale of its assets[35].

corporation ("Bigco"). However, if immediately prior to the purchase, T is not the common parent of an affiliated group filing a consolidated return, T and its subsidiaries are treated less favorably under Temp. Reg. §1.338-6T than if T is the common parent of an affiliated group filing a consolidated return, as discussed and illustrated in the exemples below.

34. Id.

35. The concerns illustrated in Example (1) and (2) generally were not an issue

Recognizing that this duplicative taxation made no sense at all, the subchapter c tax bar, in a triuph of faith over experience, rather uniformly believed that, sooner or later and retroactive effect, either the IRS or congress would fix it. Faith, for a change, has ben rewarded, mostly. On March 14, 1991, the IRS issued Temp. Reg §1.338-6T granting relief from duplicative taxation in some but unfortunately not all circumstances, and leaving the outcome in one significant circumstance shrouded in mystery.

Here we need to make overview of Temp. Reg. §1.338-6T.

Temp. Reg. §1.338-6T contains two primary rules, discussed below.

Under the first primary rule ("-6T Rule #1"), where an actual or deemed Code Sec. 338 election is made with respect to a terget corporation, and T directly owns at least 80 percent[36] of the stock of a subsidiary, T will recognize no gain or loss on the deemed sale of its TS stock[37]. This is so regardless of whether T and TS join in filing a consolidated return and whether T is the common parcent of the affiliated group.

Similarly, although the definitionnal language of Temp. Reg. §1.338-6T is somewhat ambiguous, examples in and the Preamble to -6T

prior to the 1986 repeal of the General Utilities doctrine because, under old Code Sec. 337, which applied to Code Sec. 338 transactions under the pre-1986 Act version of Code Sec. 338, neither T nor TS recognized gain or loss on the deemed sale of its nonrecapture assets, including corporate stock (whether portfolio stock or stock of a subsidiary), See Temp. Reg. §1.338-4T(k)

36. 80% in both voting power and value, excluding nonvoting straight preferred stock described in Code Sec. 1504(a)(4). See Code Secs. 338(d)(3) and 1504(a)(4).

37. Temp. Reg. §1.338-6T(a), (b)(2) (first sentence), (c). The determination and allocation of the ADSP and the adjusted grossed-up basis is made by taking into account T's TS stock, not withstanding that T recognizes no gain or loss on its deemed sale of that stock under Temp. Reg. §1.388-6T. See Preamble to Temp. Reg. §1.338-6T(TD8339).

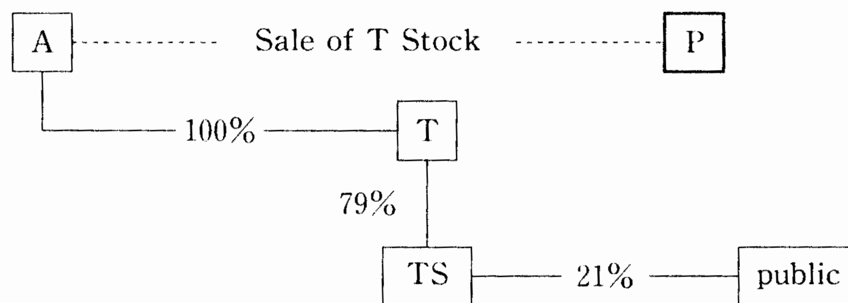
indicate that, by virtue of the deemed Code Sec. 338 election with reapect to TS that is triggered by the Code Sec. 338 election with respect to T, TS is treated as a "target" for purposes of applying "-6T Rule #1[38]."

Accordingly, in Example (2) TS will recognize no gain or loss on the deemed sale of its TSI stock, because TS directly owns at least 80 percent of TSI's out-standing stock.

Example (3): Same as Example (1). T and TS recognize gain or loss on the deemed sale of their assets, except that T recognizes no gain or loss on the deemed sale of its TS stock[39].

Example (4): Same as Example (2). T, TS, and TSI recognize gain or loss on the deemed sale of their assets, except that T recognizes no gain or loss on the deemed sale of its TS stock and TS recognizes no gain or loss on the deemed sale of its TSI sotck[40].

《Figure 3》



38. See Temp. Reg. §1.338-6R(c)(2) example (2), (d)(7) example; Preamble to Temp. Reg. §1.338-6T(TD8339). It appears from the excessively confusing statutory regulatory framework that, where P purchases T's stock, T is an "original target" and each subsidiary in which T directly or indirectly owns 80% of the stock(TS in Example (1) and (2)) is an "affected target," but that for purposes of applying -6T Rule #1, both the original target and each affected target is a "target". See Code Sec. 338(d)(2), (d)(3), and (h)(3)(13), Reg. §1.338-4T(b)(3) and (b)(4), Reg. § 1.338-1T(b)(7)

39. Temp. Reg. §1.338-6T(c)(2) example (1). This result follows whether T's stock is owned (a) 100% by individual A, (b) by a number of persons, or (c) 100% by Bigco.

40. Temp. Reg. §1.338-6T(c)(2) examples (1) and (2), (d)(7) example. This

Example (5): Same as Example (1), except that T owns on 79% of TS's outstanding stock, and the remaining 21% of TS's outstanding stock is held by the public.

In this case, T is taxed on the deemed sale of its 79% stock interest in TS[41]. However, P's Code Sec. 338 election with respect to T does not trigger a Code Sec. 338 election with respect to TS, because T does not hold the requisite 80% of TS's out-standing stock[42]. As a result, TS is not deemed to have sold its assets, and thus recognizes no gain or loss.

Under the second primary rule of Temp. Reg. §1.338-6T ("-6T Rule #2") if (a) T is the common parent of an affiliated group filing a consolidated return, (b) P makes an actual or deemed Code Sec. 338 election with respect to T, and (c) the final return for T and the members of its affiliated group is a consolidated return under Temp. Reg. §1.338-1T(f)(2)(ii), neither T nor any member of its consolidated group will recognize gain or loss on the deemd sale of any stock in any member of the group[43]. That is, if T is the common parent of an affiliated group that files its final return on a consolidated basis[44], the T group obtains the benefit of -6T non-recognition treatment with respect to stock that any T group member owns in any other T group member, even if no member of the T group owns an 80 percent or more direct stock

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result follows whether T's stock is owned (a) 100% by individual A, (b) by a number of persons, or (c) 100% by Bigco.

41. See Temp. Reg. §1.338-6T(b)(2); Preamble to Temp. Reg. §1.338-6T (TD 8339).

42. See Code Sec. 338(h)(6)(A)

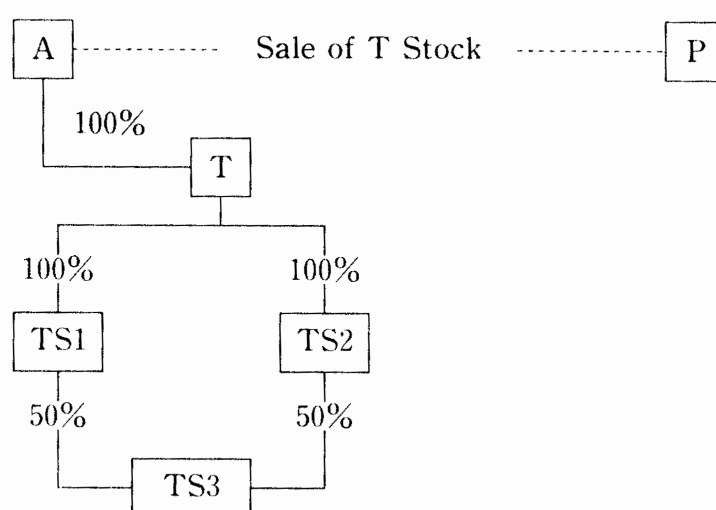
43. See Temp Reg. §1.338-6T(b)(2) (second sentence), (c)(2) example (2); Preamble to Temp. Reg. §1.338-6T(c)(2) (TD 8339)

44. The tax year of the T group will end on the date that P makes a QSP of T's stock. See Temp. Reg. §1.338-IT(b)(8), (5)

interest in such other member. Thus, -6T Rule #2 protects T or a T subsidiary from recognizing gain on the stock of a lower-tier subsidary even where no one T group member directly owns 80 percent or more of the lower-tier subsidiary's stock[45].

Example (6): Diamond Pattern. T(which is 100% owned by individual A) owns all the outstanding stock of TSI and TS2, and TSI and TS2 each own 50 percent of the outstanding stock of TS3[46]. T. TS1, TS2, and TS3 join in filing a consolidated return, with T as the com-

《Figure 4》



45. Although the definition of "Section 1.338-6T shareholder" in Temp. Reg. § 1.338-6T(a)(2) (second sentence) is less than completely clear in this regard, it appears that -6T Rule #2 also applies to stock that a lower-tier member owns in an upper-tier member. For instance, if T owns 90% of the stock of TS, TS owns 100% of the stock of TSI, and TSI owns the remaining 10% of the outstanding TS stock, -6T Rule #2 apparently accords TSI nonrecognition treatment on the deemed sale of its 10% stock interest in TS. The same result apparently obtains even with respect to stock in T, the common parent of the group. Thus, if T owns 100% of the out-standing stock of TS, and TS owns 5% of the outstanding stock of T, -6T Rule #2 apparently accords TS nonrecognition treatment on the deemed sale of its 5% stock interest in T.

46. The result in this Example (6) would be the same if P had purchased T's stock (a) from a number of holders or (b) from a foreign Bigco, but would not be the same if P had purchased T's stock from a domestic Bigco (whether or not T was filing a consolidated return with the domestic Bigco) or if the T group did not file a consolidated return.

mon parent of the group.

On 4/1/91, P buys 100% of T's stock from individual A for cash and makes a Code Sec. 338 election with respect to T. The T group's final return (for the short taxable year ending 4/1/91) is a consolidated return.

The Code Sec. 338 election with respect to T triggers a deemed Code Sec. 338 election with respect to TS1, TS2, and TS3. As a result, (a) T is deemed to have sold all its assets, including its TS1 and TS2 stock, to New T, (b) TS1 and TS2 are deemed to have sold all their assets, including their TS3 stock, to New TS1 and New TS2, and (c) TS3 is deemed to have sold all its assets to New TS3. As illustrated in Examples (3) and (4). T recognizes no gain or loss on the deemed sale of its TS1 and TS2 stock. This result follows under both-6T Rule #1 and -6T Rule #2.

However, -6T Rule #1 does not exempt TS1 and TS2 from gain or loss recognition on the deemed sale of their TS3 stock, because neither TS1 nor TS2 directly owns 80% of TS3.

Nevertheless, -6T Rule #2 applies to exempt TS1 and TS2 from recognizing gain or loss on the deemed sale of their TS3 stock, even though neither TS1 nor TS2 directly owns 80% of TS3. -6T Rule #2 applies only because TS1, TS2, and TS3 are members of a consolidates return group of which T(the corporation whose stock P purchased in a QSP) is the common parent[47].

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47. The definitional language of Temp. Re. §1.338-6T is somewhat ambiguous regarding whether -6T Rule #2 accords nonrecognition treatment to TS1 and TS2, and one must look to Temp. Reg. §1.338-6T(c)(2) example (2) and Preamble(TD8339) to discern the drafter's intent.

Specifically, Temp. Reg. §1.338-6T(b)(2) states that "[a] section 1338-6T shareholder is also a target that directly owns stock in an affected target if both the target and the affected target are members of a consolidated group filing a final

For reasons discussed in page 50 below, it is important to bear in mind that -6T Rule #1 accords nonrecognition treatment only to a T group member that directly holds at least 80 percent of the outstanding stock of another member. That is, if a single T group member directly owns at least 80 percent, but less than 100 percent, of the outstanding stock of a lower-tier member, and other T group members own the remaining shares of the lower-tier member, -6T Rule #1 applies only to the member that owns the 80-percent-or-more stock interest, and does not apply to the members that own the minority interests.

Example (7): Same as Example (6), except that TS1 owns 80% of TS3's stock, and TS2 owns the remaining 20% of TS3's stock. As illustration in Example (6), T recognize no gain or loss on the deemed sale of its TS1 and TS2 stock. This result follows under both -6T Rule #1 and -6T Rule #2. Similarly, TS1 recognizes no gain or loss on the deemed sale of its TS3 stock, under both -6T Rule #1 and -6T Rule # 2.

However, not withstanding that TS1 owns at least 80% of TS3's stock, -6T Rule #1 does not accord TS2 nonrecognition treatment on the deemed sale of its 20% TS3's stock (i. e., -6T Rule #1 applies only to 80% or more shareholders). Thus, as in Example (6), TS2 is accord-

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consolidated return described in section 1.338-IT(f)(2)(ii)" (emphasis added). It appears from the excessively confusing statutory/regulatory framework that, where P purchases T's stock, T is an "original target" and each T subsidiary in which T directly or indirectly owns 80% of the stock (here TS1, TS2 and TS3) is an "affected target", but that for purposes of applying the -6T nonrecognition rules both the original target and each of the affected targets are "targets". See Code Sec. 338(d)(2), (d)(3), and (h)(3)(B); Temp. Reg. § 1.338-4T(b)(3) and (b)(4); and Temp. Reg. §1338-IT(b)(7). Temp. Reg. §1.338-6T(c)(2) example (2) and the Preamble (TD8339) confirm that where T is the common parent of a consolidated group, -6T Rule #2 applies to stock held by affected targets, e. g., the TS3 stock held by TS1 and TS2.

ed nonrecognition treatment with respect to its TS3 stock only under -6T Rule #2, which applies only because TS2 and TS3 are members of a consolidated return group of which T (the corporation whose stock P acquired in a QSP) is the common parent.

The relation between Temp. Reg. §1.338-6T and a Code Sec. 338(h)(10) is as follows.

Temp. Reg. §1.338-6T by its terms does not apply where P purchases T's stock out of a cosolidated group and joins with T's ultimate parent in making a Code Sec. 338(h)(10) election with respect to T[48]. Temporary regulations under Code Sec. 338(h)(10) have long provided that, in all circumstances, T and the members of its consolidated group recognize no gain or loss on the deemed sale of stock in any other member of the group[49].

Accordingly, the flaw in Temp. Reg. §1.338-6T discussed in page 50 below is not relevant if a Code Sec. 338(h)(10) election is made with respect to T.

Example (8): Same as Example (6), except that P purchases 100% of T's stock from Bigco, the common parent of the Bigco consolidated group, and P and Bigco Join in making a Code Sec. 338(h)(10) election with respect to T.

Temp. Reg. §1.338-6T by its terms does not apply in this Example (8). However, the temporary regulaions under Code Sec. 338(h)(10) accord T nonrecognition treatment with respect to the deemed sale of its TS1 and TS2 stock, and accord TS1 and TS2 nonrecognition treatment with respect to the deemed sale of their TS3 stock.

Here we explain about flaw in Temp. Reg. §1.338-6T where T is

48. See Temp. Reg. §1.338-6T(a)
49. Temp. Reg. §1.338(h)(10)-IT(e)(2)

not the common parent of a cosolidated group.

In important respects, Temp. Reg. §1.338-6T is in our view flawed. That is, incertain situations (where no Code Sec. 338(h)(10) election is made) the temporary regulation in appropriately sanctions duplicative taxation of the same economic gain or loss. This flaw as discussed below, generally becomes relevant where T (the corporation whose stock P acquires in a QSP) is not the common parent of a consolidated group.

When does duplicative taxation clearly result? Duplicative taxation clearly results in one important situation: If the affiliated group of which T is a member (either as common parent or subsidiary) does not file a consolidated return. In this situation, -6T Rule #1 applies, but -6T Rule #2 does not, so that nonrecognition treatment with respect to a subsidiary's stock is accorded only where T or single T subsidiary directly owns at least 80 percent of the lower-tier subsidiary's stock[50].

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50. Temp. Reg. §1.338-6T(b)(2) (second sentence) (limiting -6T Rule #2 to members of a consolidated group that files a final consolidated return described in Temp. Reg. §1.338-1T(f)(2)(ii); Preamble to Temp. Reg. §1.338-6T(TD8339) ("New section 1.338-6T does not provide on exception from multiple gain taxation in the case of a deemed sale of stock of [a subsidiary] by a target that does not meet the definition of a section 1.338-6T shareholder. One case not covered by the new temporary regulation arises where [T or T subsidiary does not directly own at least 80% of a lower-tier subsidiary] and T is not the common parent of an affiliated group filing a consolidated return".) As noted in page 47 above -6T Rule #1 accords nonrecognition treatment only to the T group member that directly owns an 80%-or-more stock interest in a lower-tier subsidiary. For example, if T owns 80% of the outstanding stock of TS1, and another T subsidiary TS2, owns the remaiing 20% of TS1's stock, -6T Rule #1 accords nonrecognition treatment only to T, and not to TS2. See Example (7) above.

In the Preamble (TD 8339), the IRS implies that further regulations may provide that "in some cases" TS1 and TS2 will not recognize gain or loss with respect to a deemed sale of their TS3 stock. The Preamble states, however, that IRS expects any such further relief to "apply only to transactions occuring after the [relevant] regulations are issued".

That is, T or T subsidiary that holds some stock, but less than 80 percent of the stock, in a lower-tier subsidiary will recognize gain or loss with respect to that stock.

Example (9): Diamond Pattern (no consolidated return). Same as Example (6) (i. e., A owns all of T's stock, on 4/1/91. A sells the T stock to P, and P makes a Code Sec. 338 election with respect to T) except that the T affiliated group does not file a consolidated return for its final year ending 4/1/91.

The results with respect to T are the same as in Example (6). That is, because T directly owns at least 80 percent of the stock of TS1 and TS2, -6T Rule #1 accords T nonrecognition treatment on the deemed sale of its TS1 and TS2 stock. The results with respect to TS1 and TS2, on the other hand, are not the same as in Example (6). Specifically, because neither TS1 nor TS2 directly owns at least 80 percent of TS3's stock, -6T Rule #1 does not apply. Moreover, because T is not the common parent of an affiliated group filing a consolidated return, -6T Rule #2 does not apply. As a result, TS1 and TS2 will recognize gain or loss on the deemed sale of its assets. This results in duplicative gain recognition with respect to TS3's stock and assets[51]. When may duplicative taxation not result?

There is an important, related situation where, read literally, -6T Rule #2 does not apply, but, good sense argues, the drafters of Temp. Reg. §1.338-6T should have intended the application of -6T Rule #2. Here is the case: T is a membr, but not the common parent, of an

51. The result would be the same if T's stock were owned by a number of shareholders or were owned 100% by Bigco, so long as no consolidated return is filed by the sold group (if T is the common parent) or by the selling group (if Bigco is the common parent). The uncertain tax results that follow when the Bigco selling group is filing a cosolidated retutn are explored immediately below.

affiliated group filing a cosolidated return, and "Old" T, TS1, TS2, and TS3 report their Code Sec. 338 gain or loss by filing a "combined deemed sale return" (a "combined return") under Code Sec. 338(h)(15)[52].

Example (10): Diamond Pattern (Bigco group consolidated return). Same as Example (6), except that Bigco, rather than individual A, owns all of T's stock. Thus Bigco (not T) is the common parent of the Bigco-T-TS1-TS2-TS3 affiliated group. Moreover, the Bigco group files a consolidated return[53]. Bigco sells all of T's stock to P for cash and P makes a Code Sec. 338 election. No election is made under Code Sec. 338(h)(10)[54].

If in Example (10), "old" T, TS1, TS2, and TS3 do not report their Code Sec. 338 gain or loss by filing a combined return, the results clearly are duplicative taxation as set out in Example (9). That is, (a) -6T Rule #1 accords T nonrecognition treatment with respect to its

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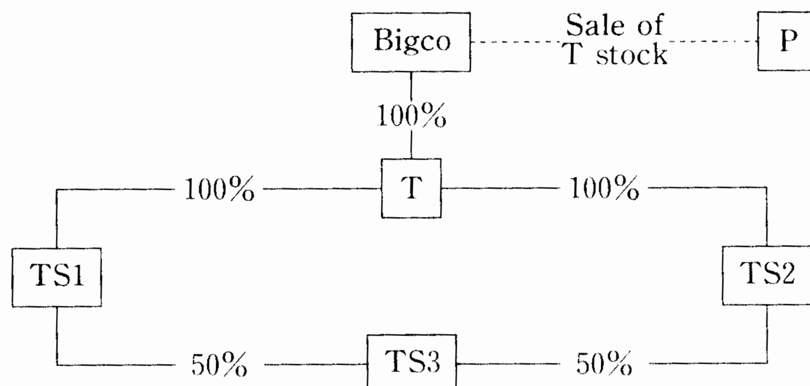
52. As discussed in more detail below, Temp. Reb. §1.338-4T(k)(6), which implements the combined return provision of Code Sec. 338(h)(15), in effect treats "old" T and its subsidiaries as a consolidated group for purposes of reporting their Code Sec. 338 gain or loss. A combined return can be filed for "old" T, TS1, TS2, and TS3 only if, on the date P makes a QSP of T's stock, T is a member of an affiliated group filing a consolidated return. See Code Sec. 338(h)(15); Temp. Reg. §1.338-4T(k)(6) Q & A1.

53. If the Bigco group does not file a consolidated return, the tax results clearly are the results illustrated in Example (8), i. e., duplicative taxation of TS3 asset gain and stock gain.

54. If Bigco and P join in a Code Sec. 338(h)(10) election, TS1 and TS2 would not recognize gain or loss on the deemed sale of their TS3 stock. Temp. Reg. §1. 338(h)(10)-1T(a)(2). See page 29 above.

Some state income tax laws do not recognize a Code Sec. 338(h)(10) election but rather treat it as a regular Code Sec. 338 election, in which case (depending on state tax law) a Code Sec. 338(h)(10) election as to T may result at the state tax level in the adverse tax results described in the text where T and its subsidiaries own one or more subsidiaries in a diamond pattern and T is not the common parent of a consolidated group. For a thorough discussion of the state income tax consequences of a Code Sec. 338(h)(10) election, see Needham, Consequences of a Section 338(h)(10) Election at the State Level, Tax Notes, September 24, 1990, at 1681.

《Figure 5》



TS1 and TS2 stock, but (b) neither -6T Rule #1 nor -6T Rule #2 protects TS1 and TS2 from gain or loss recognition with respect to their TS3 stock. Again, duplicative taxation of the same economic gain or loss results, because TS1 and TS2 recognize gain or loss with respect to their TS3 stock and TS3 recognizes gain or loss with respect to its assets.

If, on the other hand, "old" T, TS1, TS2, and TS3 do file a combined return, the tax results in Example (10) may be beneficially altered. Explicitly, if a combined return is filed, T and its subsidiaries in effect are treated, for purposes of reporting their Code Sec. 338 gain or loss, either as a single corporation or, more precisely perheps, as a cosolidated group. This follows not from the words of Temp. Reg. §1.338-6T, but rather from Temp. Reg. §1.338-4T(k)(6) which sates that:

> The combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all of the targets required to be included in the combined return. The combined return reflects the deemed sales of all of the targets required to be included in the combined return. Gains and losses recognized on the deemed sale of assets by targets included in the combined rerurn are treated as gains or losses of a single target.

> In addition, loss carryovers of a target that were not subject to the [SRLY limitations] while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return[55].

Where T, TS1, TS2, and TS3 are reporting all their "gains and losses recognized on the deemed sale of assets…as gains and losses of a single target", it is wholly inconsistent for this "single target" to recognize gain or loss on the deemed sale of the stock of any one of the entities (e. g., TS3) that is a constituent part of the "single target". Therefore, whatever the IRS's rationale is for limiting -6T Rule #2 only to instances where T is the common parent of a consolidated group (see discussion below), that rationale ought to apply as well where T and its subsidiaries file a combined return. Hence, in Example (10), -6T Rule #2 should accord TS2 and TS3 nonrecognition treatment with respect to their TS3 stock.

Why, however, does -6T Rule #2 refer only to a consolidated return and not to a combined trturn? The reason, we believe, is uncomplicated. The drafters of Temp. Reg. §1.338-6T simply did not see the combined return issue. Since (as discussed below) there is no valid reason to treat TS2 and TS3 differently in Example (6) (Where T is the common parent of a consolidated group) and in Example (10) (where T and its subsidiaries file a combined return), we hope and in face expect that sooner or later—and with retroactive effect— the IRS will annonce that the filing of a combined return avoid duplicative taxation of the same economic gain[56].

55. Temp. Reg. §1.338-4T(k)(6) Answers 2 and 3

56. This flaw in Temp. Reg. §1.338-6T might most easily by corrected by amending the second sentence of Temp. Reg. §1.338-6T(b)(2) to read as follows: "A section 1.338-6T shareholder is also a target that directly owns stock in an affected

What is possible rationale for the basic flaw in Temp. Reg. §1.338-6T ? It is barely possible to conjure up two arguments in support of the disparate treatment of TS3's stock in Example (8), (9), and (10), i. e., the sensible result of no gain recognition, on TS3's stock in Example (6) versus the unnecessarily harsh duplicative gain recognition on TS3's stock in Example (9) (and in Example (10) as well should the IRS mistakenly reject our combined return analysis.) Neither argument, however, suffices to justify the harsh treatment in Example (9) (and possibly in Example (10)).

The first argument runs as follows: in Example (6) T, TS1, TS2, and TS3 (filing a consolidated return with T as the common parent) are deemed to have made Code Sec. 338 asset sales while still members of their pre-Code Sec. 338 consolidated group; whereas in Example (9) T, TS1, TS2, and TS3 (not filing a consolidated return at all), by definition are not deemed to have made Code Sec. 338 asset while still members of a pre-Code Sec. 338 consolidated group[57].

This argument, however, if it says anything, argues that in Example (9) neither -6T Rule #1 nor -6T Rule #2 should apply. It does not explain why in Example (9) -6T Rule #1 does apply but -6T Rule #2 does not apply.

The second argument runs as follows: in Example (6) (where T is

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target if both the target and the affected target either (i) are members of a consolidated group filing a consolidated return decribed in section 1.338-1T(f)(2)(ii), or (ii) are acquired from a single selling consolidated group (as defined in section 338(h)(10)(B)) and file a combined deemed sale return under section 338(h)(15) and section 1.338-4T(K)(6)"

57. Technically, in Example (10), even if "old" T, TS1, TS2, and TS3 file a combined return, they are not deemed to have made their Code Sec. 338 asset sales which still members of a pre-Code Sec. 338 consolidated group (i. e. the Bigco group).

the common parent of a consolidated group), TS3 could have been liquidated into TS1 and TS2 prior to the sale of T's stock to P without triggering gain or loss to TS1 and TS2 with respect to their respective 50 percent stock interests in TS3[58], whereas in Example (9) (no consolidated return), liquidating TS3 prior to the sale of T's stock to P would have triggered gain or loss to TS1 and TS2 with respect to their respective 50 percent stock interests in TS3[59]. But while this is so, it can not in fact be the rationale for the differential treatment accorded in Example (6) and Example (9). A variation on Example (10) (where T is a member of the Bigco consolidated group) demonstrates: Assume P does not file a combined return for T and its subsidiaries. The case now falls squarely within Example (9), requiring that TS1 and TS2 recognize gain with respect to their TS3 stock, even though TS3's liqudation into TS1 and TS2 prior to Bigco's sale of T's stock to P would not have triggered gain or loss to TS1 and TS2 with respect to their TS3 stock[60].

In sum, it is difficult to see why any of this justifies the unpalatable duplicative tax result that obtains under the Temp. Reg. §1.338-6T in Example (9) and that will result in Example (10) as well if no combined return is filed or if IRS rejects the analysis, earlier proffered, Keyed to the -4T(k)(6) regulation. A manifestly superior regulatory solution, we think, would concentrate on the desirability of avoiding double corporate tax on what is economically the same gain —TS3's stock and

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58. See Code Sec. 332, Reg. §1.1502-34. Although Code Sec. 337(c) creates deferred intercompany asset gain at the TS3 level despite the consolidated return, Code Sec. 337(c) does not overside tax-free treatment to TS1 and TS2 on their TS3 stock under Code Sec. 332.

59. See Code Sec. 331.

60. See Code Sec. 332, Reg. §1.1502-34

TS3, s assets— and would declare that whenever the Code Sec. 338 deemed sale rule requires recognition of asset gain to a corporation, gain will not be recognized under Code Sec. 338 with respect to the stock of that corporation[61].

What is methods of avoiding the basis flaw in Temp. Reg. §1.338-6T ?

The harsh duplicative gain recognized by TS1 and TS2 in Example (9), and in Example (10) as well pending favorable IRS clarification of the combined return issue discussed earlier, can be avoided through adequate advance planning, explicitly by combining or reconfiguring corporations prior to P's purchase of T's stock. For instance, TS2 might merge into TS1 in a tax-free reorganization, thereby converting TS3 to TS1's wholly owned subsidiary[62]. Or, if corporate merger is undesirable, T could contribute TS1 all of S2's stock, following which TS1 could contribute its 50 percent of TS3's stock to TS2, thereby converting TS2 into TS1's wholly owned subsidiary and converting TS3

61. That, after all, is exactly the sensible notion that fuels the nonrecognition conclusion, with respect to target stock, when a Code Sec. 338(h)(10) election is made. See page 29 above.

62. Is there any realistic concern that the TS2-into-TS1 merger might fail the continuity of interest, business purpose, and/or continuity of business enterprise requirements necessary for the merger to qualify as a tax-free reorganization, i. e., because (i) T will be deemed to have sold all its TS1 stock (including the TS1 stock T actually or constructively receives in the TS2-into-TS1 merger) as a result of the subsequent Code Sec. 338 election, (ii) TS1 will be deemed to have sold all of the assets it received from TS2 in the TS2-into-TS1 merger as a result of the subsequent Code Sec. 338 election, and/or (iii) the TS2-into-TS1 merger is being undertaken to avoid stock gain ? We believe that the merger satisfies the requirement of a tax-free reorganization, without regard to the subsequent Code Sec. 338 election, but we have not located direct confirming authority. For a discussion of the continuity of shareholder interest, business purpose, and continuity of business enterprise requirements, see page 39 (Basis Principles of Tax-free Reorganization).

into TS2's wholly owned subsidiary[63]. Or, possibly, TS2 could sell its TS3 stock to TS1, thereby converting TS3 TS1's wholly-owned subsidiary and enabling TS1 to avoid gain recognition on the subequent Code Sec. 338 deemed sale of 100 persent of TS3's stock[64].

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63. Is there any realistic concern that T's contribution of its TS2 stock to TS1 and TS1's contribution of its TS3 stock to TS2 might fail the "control" "immediately after" requirement of Code Sec. 351 (or, alternatively, the contributions are characterized as "B" reorganization under Code Sec. 368(a)(1)(B), the continuity of shareholder interest, business purpose, and continuity of business enterprise requirements)? Again, we believe the answer is no. See page 39 (The Step Transaction Doctrine); Sheffield & Kimball, Organizing the Corporate Venture (CCH TAX TRANSACTIONS LIBRARY), at 503 and 504.

64. If the T(or Bigco) group does not file a consolidated return, TS2' sale of its TS3 stock to TS1 will be governed by Code Sec. 304. As a result of the enactment of Code Sec. 304(b)(4) in 1987, however, the precise tax results of the sale are unclear. See H. R. Rep. No. 495 (Conf. Rep.), 100th Cong., 1st Sess. 968-70(1987). Prior to Code Sec. 304(b)(4), the tax results of TS2's sale essentially would have been as follows: (i) TS2 would have been deemed to have received a distribution from TS1 in an amount equal to the sales proceeds, taxable as a dividend to TS2 to the extent of the combined earnings and profits of TS1 and TS3, and (ii) TS1 would hold the TS3 stock at the same basis as TS2 held the stock. See Rev. Rul. 70-496, 1970-2 CB 74.

If the T(or Bigco) group does file a consolidated return, the IRS now holds that Code Sec. 304 does not apply to the sale (even though Code Sec. 304 by its terms does apply), and instead that the sale constitutes a deferred intercompany transaction under Reg. §1.1502-13 and Temp. Reg. §1.1502-13T. See Prop. Reg. §1.1502-80 (proposed to be effective for stock sales occurring on or after July 21, 1991). Thus, TS2 will recognize gain on the sale of its appreciated TS3 stock to TS1 equal to the excess of the sales price over TS2's basis in the TS3 stock. That gain will be doferred intercompany gain, and will be triggered upon P's purchase of T's stock and Code Sec. 338 election.

If T is a member of the Bigco group, and the Bigco group files a consolidated return, TS2 should not sell its appreciated TS3 stock to TS1 if there is a reasonable likelihood that Bigco and the ultimate purchaser of T's stock (i. e., P) might make a Code Sec. 338(h)(10) election with respect to T. This is because if TS2 sells its TS3 stock to TS1 and a Code Sec. 338(h)(10) election is made, TS2 will recognize gain on the sale, which gain would not have been recognized had TS2 not sold its TS3 stock to TS1 (i. e., where a Code Sec. 338(h)(10) election is made, TS1 and TS2 recognize no gain or loss with respect to their TS3 stock, not with standing that neither owns at least 80% of TS3's stock ; see page 29 above.

Alternatively, in Example (10) (although not Example (9)), gain recognition by TS1 and TS2 with respect to the stock of TS3 unquestionably can be avoided if P and Bigco join in making a Code Sec. 338(h)(10) election with respect to T[65]. Similarly, in Example (10) (although not Example (9)), gain recognition by TS1 and TS2 with respect to their TS3 can be avoided by liquidating TS3 into TS1 and TS2 prior to P's QSP of T's stock[66].

Finally, in Example (9) (although not Example (10)), T and the members of T's affiliated group could elect to file a consolidated return for the group's final tax year (i. e., the tax year that ends on the date of P's QSP of T's stock) and thereby unquestionably avoid recognition of gain with respect to the TS3 stock. See Example (6) above.

Basic Principles of Tax-Free Reorganizations

1 TAX-FREE ACQUISITIONS IN GENERAL

For an acquisition exchange to qualify as wholly or partly nontaxable, it must qualify either as a "reorgaization" defined in Code Sec. 368 or as a transfer to a controlled corporation under Code Sec. 351.

If an acquisition exchange does not qualify under either Code Sec. 368 or Code Sec. 351, it will be taxed in accordance with wholly different recognition rules that have been described in page 1 through

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65. Temp. Reg. §1.338(h)(10)-1T(e)(2). See page 29 above.

66. See Code Sec. 332, Reg. §1.1502-34. Although Code Sec. 337(c) creates deferred intercompany asset gain at the TS3 level despite the Bigco consolidated return, Code Sec. 337(c) does not override tax-free treatment to TS1 and TS2 on their TS3 stock under Code Sec. 332. Moreover, TS1 and TS2 will hold TS3's assets at an FMV basis, and thus (although the defferred intercompany gain is triggered by Bigco's sale of T's stock) the gain inherent in TS3's assets at the time of the liquidation will not be taxed again as a result of P's Code Sec. 338 election with respect to T.

page 39.

The summary of basic reorganization principles in this paper assumes that P acquires, in exchange for P stock (or P stock plus "boot"), either T's assets from T or T's stock from T's shareholders, and that the exchange qualifies as a tax-free reorganization under Code Sec. 368.

2 THE STEP TRANSACTION DOCTRINE

A judicially created substance over for concept often referred to as the "step transaction doctrine" applies throughout the tax law, including the corporate reorganization area. The step transaction doctrine in effect permits a series of formally separate steps to be amalgamated and treated as a single transaction if the steps in substance are "intergrated, interdependent, and focused toward a particular result"[67].

Stated another way, if a taxpayer's ultimate objective is to go from point X to point Y and, rather than taking a direct route, the taxpayer interposes one or more largely meaningless transactions between point X and point Y solely or primarily to abtain more favorable tax consequence, the step transaction doctrine will ignore these intermediate transactions and cause the taxpayer to be taxed as though he took the direct route from point X to point Y.

Hence, where the step transaction doctrine applies, the tax consequences of series of imterrelated transactions are determined by ignoring the intermediate transactions and by forcusing solely on the ultimate result.

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67. R. A. Penrod, 88 TC 1415, 1428, Dec. 43, 941(1987); see Estate of E. Christian, 57 TCM 1231, Dec. 45, 926(M), TC Memo. 1989-413, Rev. Rul. 79-250, 779-2 CB 156.

In theory, either the IRS or the taxpayer can assert the step transaction doctrine. As a practical matter, however, a taxpayer may find it substantially more difficult than will the IRS to assert the step transaction doctorine and to disregard the form of the taxpayer's transactions[68].

This will be particularly true in "whipsaw" situation, i. e., where the taxpayer assets the step transaction doctrine to improve its tax pasture and the other party to the transaction improved its tax posture by reporting the transaction in accordance with its form.

3 BUSINESS PURPOSE

To qualify as a tax-free reorganization, P's acquisition of T must satisfy the Judicially established "business purpose" requirement[69]. That is, P's acquisition of T must have a business purpose.

The business purpose requirement entered the tax law more than a half-century ago, at a time when the distribution and reorganization provisions of the tax law were relatively uncomplicated[70]. Notwithstanding the doctrine's longevity, however, the exact contours of the

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68. See e. g., Pittsburg Realty Investment Trust V. Commissioner, 67 TC 260, 274-78, Dec. 34, 104(1976), Warsaw Photographic Associates V. Commissioner, 84 TC 21, 39, Dec. 41, 822(1985), C. Johnson, The Danielson Rule an Anodyne for the Pain of Reasoning (Student Note), 89 Columbia Law Review No. 6, 1320(Oct. 1989). For instances where a taxpayer successfully asserted the step transaction doctrine, see, e. g., King Enterprises, Inc. V. United States, Ctcls, 69-2 USTC 99720, 418F2d511, Mcdonald's Restaurants of Illinois, Inc., CA-7, 82-2 USTC 9581, 688 F2d520, cf. Rev. Rul 83-142, 1983-2CB68, Rev. Rul. 78-397, 1978-2 CB150.

69. Gregory V. Helvering, Set, 35-1 USTC 9043, 293 US 465(1934), G. R. Laure, CA-6, 81-2 USTC 9517, 653 F2d 253, Wortham Machinery Co. V. U. S., CA-10, 75-2 USTC 9665, 521 F2d 160, American Bronze Corp, 64 TC 1111, Dec. 33, 442(1975); Reg. § 1.368-1(b), (c), -2(g); IRS Technical Advice Memorandum 8941003, July 11, 1989.

70. see page 41 below

business purpose requirement, and even its proper formulation, remain unclear[71].

For instance, it is unclear whether the business purpose requirement focuses only on the corporate-level business porpose, or whether a valid shareholder-level business purpose will suffice. The authority in this regards is mixed. It also is unclear whether, in instances where a reorganization is undertaken for both a valid business purpose and a tax avoidance purpose, the valid business purpose must be the principal motivation for the reorganization.

Before considering unresolved issues in the business purpose area, three general points merit attention. First, as a practical matter, if P and T are dealing at arm's length and are not owned by substantially the same shareholders, the business purpose ruquirement ordinarily will not raise a concern. In arm's-length situations (and particularly if either P or T is a public company), rarely if ever will tax avoidance constitute the parties' primary motive in undertaking a reorganization. On the other hand, in instances where P and T are closely held and share ownership overlaps, business motivation is less assured. Indeed, in these instances the business purpose requirement may present a substantial issue if either P or T has tax attributes, such as NOL carryforward, that the other party is better positioned to utilize.

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71. This point is well illustrated by G. R. Laure, 70 TC 1087. Dec. 35, 441(1978), revd, CA-6, 653F2d 253, 81-2 USTC 9517, where the Tax Court held that a purported reorganization failed the business purpose requirement, while the Sixth Circuit, finding an adequate business purpose, reversed the Tax Court on this point. The point is also illustrated by comparing (RS Technical Advice Memorandum 8803001, September 29, 1987, where the IRS found an adequate business purpose, with IRS Technical Advice Memorandum 8941004, July 11, 1989, where the IRS revoked Technical Advice Memorandum 8803001 on the ground that the facts submitted in that ruling were insufficient to make a business purpose determination.

Second, to satisfy the business purpose requirement, the transaction must proceed from a commercial motive. It is not a requirement of the doctrine that, in conducting the commercial transaction, the taxpayer should obtain bad tax advice or no tax advice at all. In the acquisitive reorganization provisions Congress has determined that P may acquire T without triggering immediate gain to T or its shareholders. Thus, the mere fact that P and T structure P's business-motivated acquisition of T to qualify as a tax-free reorganizatitn, rather than as a taxable asset or stock purchase, does not constitute a tax avoidance motive proscribed by the business purpose requirement.

Third, although not completely clean, the business purpose requirement as applied to acquisitive reorganizations probably is substantially less stringent than the business purpose requirement as currently applied to Code Sec. 335 transactions.

4 CONTINUITY OF SHAREHOLDER INTEREST

A Judicially created continuity of interest requirement applies to all acquisitive reorganization[72]. The objective is to ensure that T's

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72. See Pinellas Ice & Cold Storage Co. V. Commissioner, Sct, 3 USTC 1023, 287 US 462 (1933), Helvering V. Minnesota Tea Co., Sct, 36-1 USTC 9015, 296 US 378, Nelson V. Helvering, Sct, 36-1 USTC 9019, 296 US 374, Paulsen V. Commissioner, Sct, 85-1 USTC 9116, 469 US 131(1985). Fine works discussing continuity of interest include Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 1411 (5thed. 1987) Wolfman, Continuity of Interest and the American Law Institute Study, 57 TAXES 840(1979), Mcgaffey & Hunt, Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations, 59 TAXES 659(1981).

The continuity of interest requirement, however, does not apply to Code Sec. 368(a)(1)(E) recapitalizations. See Rev. Rul. 77-479, 1977-2 CB 119, Rev. Rul. 77-415, 1977-2 CB 311.

On the other hand, the IRS apparently takes the position that virtually 100% continuity of interest is required for Code Sec. 368(a)(1)(F) reorganizations. See Rev. Rul. 78-441, 1978-2 CB 152, Rev. Rul, 75-561, 1975-2 CB 129, Rev. Rul. 79-250, 1979-2 CB 156, Rev. Rul, 79-289, 1979-2 CB 145, IRS Letter Ruling 8840027, July

shareholders maintain, if only indirectly, a substantial part of their equity participation in T's enterprise following P's or S's acquisiion of the outstanding T stock or T assets. If the historic T shareholders do not satisfy the continuity of interest requirement, the P-T acquisition will not qualify as a tax-free reorganization[73].

In general, to satisfy the continuity of interest requirement, the historic T shareholders, as a group

(1) must exchange a "substantial part" —generally 40-50 percent— of their T stock for R stock in the reorganization (here after, the minimum amount of T stock that must be exchanged for P stock is referred to as the "continuity amount"[74]).

(2) must have the unrestricted right to maintain ownership of the continuity amount of P stock for some period following the reorganization (ordinarily five years will, and two years should, suffice), and

(3) either must (a) in fact retain ownership of the continuity amount of P stock for some period following the reorganization (ordinarily,

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11, 1988, IRS Letter Ruling 8802061, October 20, 1987. But cf. Reef Corporation, CA-5, 66-2 USTC 9716, 368 F2d 125, cert. denied 386 US 1018(1967), Aetna Casualty and Sarety Co. V. United States, CA-2, 77-1 USTC 9120, 568 F2d 811, reh'g denied, 77-1 USTC 9261, 568 F2d 811, Casco Products Corp, 49 TC 32, Dec. 28641(1967), Rev. Rul. 79-250, 1979-2 CB 156.

For a discussion of the extent to which the continuity of interest requirement applies to Code Sec. 351 transaction, see page 50.

73. The failed reorganization, if it does not qualify for "tax-free" treatment under Code Sec. 351, will be taxed in accordance with the principles discussed in page 1 through page 39 above.

74. Helvering V. Minnesota Tea Co., Sct, 36-1 USTC 9015, 296 US 378. The IRS's ruling guidelines set the continuity amount at 50%, i. e., at least 50% by value of the outstanding T stock munt be exchanged for P stock in the reorganization. In our experience, however, a continuity amount of at least 40%, or perhaps a bit less, should suffice. This topic is discussed in greater detail in page 46 below.

in our experience, two years will sufficice) or (b) in the event of the continuity amount of P stock, demonstrate that the early disposition was not pursuant to a plan or arrangement in place at the time of the reorganization.

The continuity of interest requirement plays different roles depending on the type of reorganization in focus. Specifically, in the context of acquisitive reorganizations that do not specify a minimum percentage of P stock (or P voting stock) that must be issued as consideration —i. e., the two perty "A" merger and the Forward Subsidiary Merger— the continuity of interest requirement in effect serves two purposes. First, the requirement ensures that the historic T shareholders exchange at least 40-50 percent by value of the outstanding T stock for P stock in the reorganization. Second, the requirement ensures that the historic T shareholders receive and retain the "continuity amount" of P stock —i. e., that the historic T shareholders do not dispose of too much T stock in contemplation of the reorganization and do not dispose of too much P stock too soon after the reorganization.

In the context of an acquisitive reorganization that does specify the amount of T stock that must be exchanged for P stock —the "B" and "C" reorganizations and the Reverse Subsidiary Merger— the continuity of interest requirement in effect serves only the second purpose described above, i. e., it ensures that the historic T shareholders do not dispose of too much T stock in contemplation of the reorganization and do not dispose of too much P stock too soon after the reorganization.

5 CONTINUITY OF BUSINESS ENTERPRIZE

A transaction constitutes a tax-free reorganization only if there is "a continuity of the business enterprise under the modified corporate form"[75]. This means that P(or S) must "either (1) continue [T's] historic business or (2) use a significant portion of [T's] historic business assets in a business"[76]. If T has more than one line of business, clause (1) above will be satisfied if P continues "a significant line of business" of T[77]. In determining whether a line of business of a portion of T's histouic business assets is "significant", all relevant facts and circumstances are considered[78].

75. Reg. §1.368-1(6)

76. Reg. §1.368-1(d)(2). In connection with the significant portion test, see George R. Laure V. Commissioner, CA-6, 81-2 USTC 9517, aff'g, and rem'g TC, 653 F 2d 253

77. Reg. §1.368-1(d)(3).

78. Reg. §1.368-1(d)(3), (4) Reg. §1.368-1(d)(5) includes the following example:

(1) If has three historic business approximately equal in value, sells two, and then transfers its assets (cash proceeds from two business and the operating assets of the third business) to P for P stock, will the third business continuing uninterrupted, the continuity of business enterprise requirement will be met.

(2) If T transfers its historic business assets to P for P stock and P "immediately after the merger" sells T's assets and discontinues T's business, the continuity of business enterprise requirement will not be met.

(3) If T, "as part of a plan of reorganization", sells its sole historic business for cash, invests the proceeds in "a highly diversified portfolio of stocks and bonds" for three and one-half years, and then transfers its assets to P (a mutual fund) for P stock, the continuity of business enterprise requirement will not be met, because "T's investment activity is not its historic business, and the stocks and bonds are not T's historic business assets".

The continuity of business enterprise regulations, adopted in 1980, were intended to terminate the practice whereby T first sells its assets for cash in a taxable transaction (frequently where T's basis for its assets approximates the selling price, so that T's taxable gain on the sale is not substantial) and then transfers its "replacement" assets (the sale proceeds or marketable securities purchased with those proceeds) to a mutual fund, receiving in exchange (and redistributing to T's shareholders) voting stock of the mutual fund corporation in a purported tax-free "C" reorganization. By such a two-step transaction, T's shareholders (who typically had a very low basis in their T stock) sought to avoid tax on

In Rev. Rul. 79-434[79], T sold its sole historic business for cash "in anticipation of" transferring its assets —cash and Treasury notes purchased there with— to a mutual fund (P) in exchange for P stock, and the IRS ruled that the exchange "does not qualify as a reorganization…because in substance it represents a purchase by 〔T〕 of the shares of 〔P〕 prior to 〔T's〕 liquidation. In Rev. Rul. 81-92[80], the IRS ruled that P's acquisition of all of T's stock solely in exchange for P voting stock does not qualify as a "B" reorganization where T's assets consist solely of cash from the sale of its previous busisess. In Rev. Rul. 87-76[81], where T, an investment company that historically had invested in corporate stocks and bonds, sold its entire portfolio and reinvested the proceeds in municipal fonds pursuant to a reorganization plan, the IRS ruled that P's subsequent acquisition of T's assets solely in exchange for P voting stock did not qualify as a "C" reorganization, because "T' s historic business of investing in corporate stocks and bonds is not the same line of business as investing in municipal bonds"[82].

Rev. Rul. 87-76 and the example from Reg. §1.368-1(d)(5) discussed above imply that a company that sells its assets and then operates as an investment company for many years can develop a new historic business, i. e., investing, which will then support a later reorganization, but the example from the regulations discussed in (3), above, suggests that three and one-half years is not long enough, at least where there is a plan to do a second step reorganization.

Another possible path around the continuity of business enterprise

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the exchange (in the liquidation of T) of their T stock for stock of the mutual fund.

79. Rev. Rul. 79-434, 1979-2CB 155

80. Rev. Rul. 81-92, 1981-1CB 133

81. Rev. Rul. 87-76, 1987-2CB 84

82. Cf. Code Sec. 368(a)(2)(F) (prohibiting a tax-free reorganization of a nondiversified investment company into another investment company).

problem may be to reverse P and T. Perhaps T could sell its business and then acquire P's historic assets in return for T stock without violating the continuity of business enterprise test. As is the case of the continuity of shareholder interest requirement discussed at page 43 above, the continuity of business enterprise doctrine apparently applies only to the acquired company's business[83]. Therefore, it may be advantages in some cases to reverse the acquiring and acquired corporations.

In Rev. Rul. 81-247[84], the IRS described three situations in which P acquired T's historic assets in a merger and then transferred all or part of such assets to one or more wholly owned subsidiaries of P. There subsequent transfers were held not to violate the continuity of business enterprise requirement.

In Rev. Rul. 85-197[85], T, whose only asset was 100 percent of the stock of S, an operating company, merged downstream into S, with the T shareholders receiving S stock in exchange for their T stock. The IRS held that the merger satisfied the continuity of business enterprise requirement, noting that "for purpose of the continuity of business enterprise requirement, the historic business of 〔T〕 is the business of S, its operating subsidiamy"[86].

The IRS carried this indirect continuity notion one step further in

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83. See Rev. Rul. 81-25, 1981-1 CB 132

84. Rev. Rul. 81-247, 1981-2 CB 87

85. 1985-2 CB 120

86. See Reg. §1. 368-1(d)(2) ("The application of 〔the continuity of business enterprise requirement〕 to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances.") IRS Letter Ruling 8918068, February 7, 1989, IRS Letter Ruling 8844019, August 5, 1988 (T owned approximately 20% of S's stock, T transferred its assets downstream to S, held tax-free "C" reorganization), IRS Letter Ruling 8809050, December 7, 1987 (T owned 50% of S's stock, T merged downstream into S, held tax-free "A" reorganization), IRS Letter Ruling 8651060, September 23, 1986.

Rev. Rul. 85-198[87]. In that ruling, T, a holding company, owned 100 percent of the stock of S, an operating company, which in turn owned 100 percent of the stock of S1, also an operating company. The S1 stock constituted a substantial percentage of S's value. As part of a plan, (1) T merged into P, (2) P caused S to distribute all of the stock of S1 to P, (3) P then transferred the S1 stock to X, a wholly owned P subsidiary, and (4) P sold the S stock to an unrelated purchaser. Treating the business of S and the business of S1 an T's business, the IRS ruled that the merger of T into P satisfied the continuity of business enterprise requirement, because P retained one of T's two business after the merger[88]. Hence, under Rev. Rul. 85-198, for purposes of the continuity of business enterprise requirement T will be treated as owing the business not only of first tier but also of second tier (and presumably third and lower tier) T subsidiaries.

The continuity of business enterprise requirement generally should be satisfied where T conducts a business and owns 100 percent of the stock of S that also conducts a business, T sells its own business for cash (but retains S's stock), and immediately there after T is acquired by P in a tax-free reorganization.

The continuity of business enterprise test does not apply to a Code Sec. 368(a)(1)(E) recapitalization[89].

Acquisitions and Dispositions Using Code Sec. 351

1 GENERAL PRINCIPLES OF CODE SEC. 351

The tranditional way to make an acquisition tax free is to qualify

87. 1985-2 CB 120

88. See IRS Letter Ruling 8923021, March 10, 1989.

89. Rev. Rul. 82-34, 1982-1 CB 59, General Cousel's Memorandum 38705, May 1, 1981.

it under the reorganization provisions of Code Sec. 368, as discussed above. However, somewhat different tax-free treatment can be obtained for an acquisition which does not qualify as a Code Sec. 368 reorganization but does fit within Code Sec. 351 (dealing generally with the formation of a new corporation…"Newco"[90])[91].

A transfer of property (including T stock from T's shareholders to Newco) will generally qualify for Code Sec. 351 nonrecognition treatment if the transaction satisfies all of the following requirements:

(1) the property is transferred to a corporation (here Newco) by one or more persons (the "transferors");

(2) the transferors receive in exchange Newco stock, and if a transferor of property receives, in addition to Newco stock, cash or Newco debt instruments or any other form of "boot", it is important that the Newco stock constitute more than a nominal part, e. g., at least 10 percent by FMV, of the consideration received in exchange, and

(3) "immidiately after the exchange" the transferors "control" Newco, i. e., own Newco stock, possesing both of the following:

(a) at least 80 percent of the total combined voting power of all classes of Newco's stock entitled to vote, and

(b) at least 80 percent of the total number of shares of all other classes of Newco's stock, meaning in the IRS's view, each clas of novoting stock[92].

90. Alternatively, "Newco" may be an existing corporation in which substantial new investment is made, in exchange for a large issue of new stock.

91. If an acquisition does not qualify under either Code Sec. 368 or 351, it will be a taxable acquisition, in which case wholly different tax rules govern, as described above.

92. Code Secs. 351(a) and 368(c)

Prior to 1989, Code Sec. 351(a) generally permitted a transferor of property to Newco to receive tax free both Newco stock and Newco long-term debt securities. The 1989 amendment to Code Sec. 351 eliminated long-term debt "securities" from the catalog of permissible nonrecognition consideration.

Thus, under current tax law, both long-term and short-term debt instruments are denied Code Sec. 351 treatment, while only short-term debt instruments were denied Code Sec. 351 treatment prior to 1989. As a result, the tax treatment of an exchange qualifying as a Code Sec. 368 reorganizations and the tax treatment of an exchange that does not so qualify but does fit within Code Sec. 351, while no idential, are today for more alike than they once were. That change, as will be discussed below, is not to the advantage of taxpayers.

The 1989 amendment to Code Sec. 351 deleting long-term debt "securities" as permissible nonrecognition consideration was generally effective for transfers of property made after October 2, 1989[93]. Prior to this amendment, "Old" Code Sec. 351 contemplated receipt by a transferor, in exchange for property, of Newco "stock or [long-term debt] securities". (In the case of a transferor of property who received in exchange only Newco long-term debt "securities", and did not already own any Newco stock, it was the position of the QRS that "old" Code Sec. 351 did not cover, i. e., did not afford nonrecognition

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93. See Sec. 7203 of The Revenue Reconciliatlon Act of 1989. The October 2, 1989 effective date was subject to a "kinding written contract" exception, Sec. 7203(c)(2), and a special rule in Sec. 7203(c)(3) substituting July 11, 1989 for October 2, 1989 in the case of property transferred (directly or indirectly through a partnership or otherwise) by a C corporation, unless the transferor and transferee corporations were in a Code Sec. 1504(a)(2) relationship (consolidated return eligibility) and the transfer was not part of a plan to decontrol the transferee corporation thereafter.

treatment to, the exchange.) Thus, in contrast to the definition of shareholder-level "boot" for purposes of Code Sec. 368 tax-free reorganization (see page 23), prior to October 3, 1989 "boot" for purposes of Code Sec. 351 meant any property other than Newco's "stock or [long-term debt] securities", so that such long-term debt securities could be received by a transferor under Code Sec. 351 free of current tax, without regard to the principal amount of securities surrendered. In this respect Code Sec. 351 was more taxpayer-friendly than the reorganization provisions. However, if the interest rate on such securities was less than the AFR, there would have been OID under Sec. 1274[94].

2 USING TAX-FREE PREFERRED STOCK IN AN OTHERWISE CASH ACQUISITION—THE NATIONAL STARCH RULING

Under Code Sec. 351, an acquisition may be structured to give certain shareholders preferred stock tax-free in an otherwise cash acquisition. This technique was initially sanctioned by the IRS in a private letter ruling[95] involving the National Starch Corp and has

94. If a selling shareholder, as part or full payment for his T stock, receives a P obligation that pays less than market rate of interest, the Code's imputed interest rules may apply. These include the original issue discount ("OID") rules of Code Secs. 1271 through 1275 and the imputed interest rules of Code Sec. 483, both as drastically revised by the 1984 Act and the 1985 Imputed Interest Simplification Act (the "1985 Act").

When the imputed interest rules apply, a portion of the purported principal payments on P's obligation are recharacterized (and, under the OID rules, often accrual regime) as payments of lnterest. As a result, amounts that otherwise wonld be treated as purchase price (and thus would generally give rise to capital gain to the seller and basis to the buyer) will be treated as interest (thus give rise to ordinary income to the seller and current deductions to the buyer).

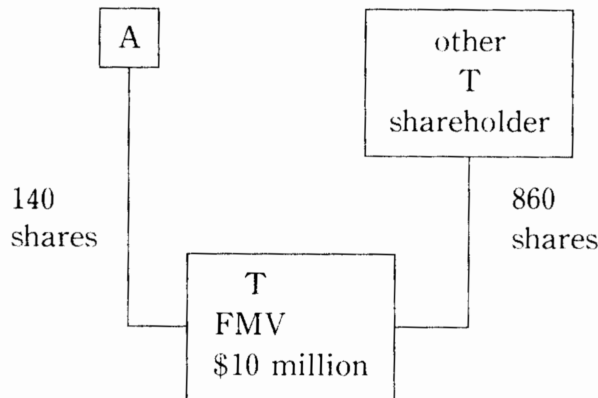
For a more extensive discussion of Code Sec. 351, see CCH TAX YRANSACTIONS and Kimball.

95. IRS Letter Ruling 7839060, June 23, 1978.

subsquently been approved in published revenue rulings discussed below.

T has 1,000 shares of common stock outstanding. A owns 140 shares (14 percent) and several other individuals (or the public) own 860 shares (86 percent). T is worth $10 million, so that A's shares are worth $1.4 million and the other shareholder's shares are worth $8.6 million. A is of advanced age, has a low basis in his stock, and does not wish to dispose of his 14 percent interest in T in a taxable transaction during his lifetime. T's other shareholders are younger and willing to dispose of their T stock in a taxable transaction, indeed they desire cash. P wishes to have the ability, but not the obligation, to obtain a stepped-up basis in T's assets.

《Figure 6》



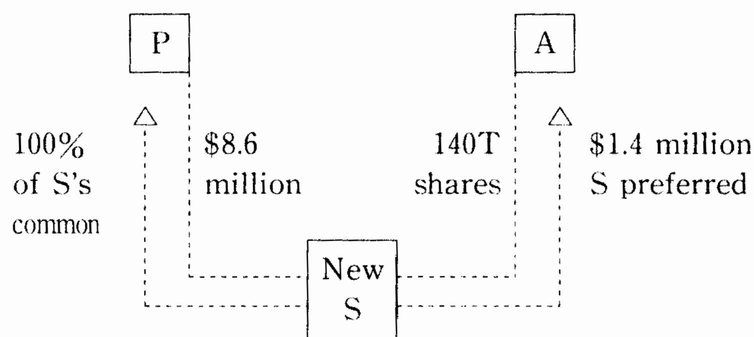
The solution to the National Starch problem as outlined in a 1978 private letter ruling[96] is as follows.

(1) Ptransfer cash to newly organized S in exchange for 1,000 shares of S voting common stock. This cash (together with borrowed cash) totals $8.6 million, i. e., the FMV of the 86 percent of T's stock not owned by A.

96. IRS Letter Ruling 7839060, June 23, 1978

(2) Simultaneously, A transfers to S his 140 T share (FMV $1.4 million) in exchange for S nonvoting cumulative preferred stock with a liquidation preference of $1.4 million and cumulative preferential dividends at a specified rate.

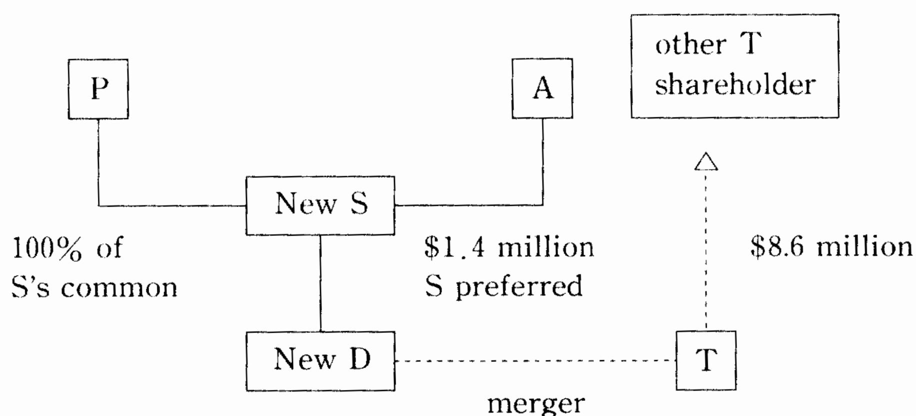
《Figure 7》



(3) S contributes the $8.6 million of cash to a newly formed dummy subsidiary("D").

(4) Immediately thereafter, D is merged into T, the T shareholders other than A exchange their T shares for the $8.6 million of cash, and S's D stock is coverted into T common stock, so that T ends up as a wholly owned S subsidiary. (S's 14 percent of T's stock, previously received from A, is cancelled in merger).

《Figure 8》



(5) P, S, and T file a consolidated federal income tax return.

(6) S has no right to call its preferred stock held by A but, after A'

s death, S is obligated to redeem the preferred shares from his estate (but no earlier thas five years from the date the S preferred shares were issued).

On the facts described above, the IRS held, inter alia, in the original 1978 private letter ruling[97] that:

(1) Under Code Sec. 351(a), A recognized no gain or loss on his exchange of T common shares for S nonvoting preferred shares.

(2) Under Rev. Rul. 73-427[98], the formation of D and the merger of D into T will be disregarded and the transaction viewed as a purchase by S for cash of the 86 percent of T's outstanding common stock held by the shareholders other than A.

(3) If the redemption price of S preferred had exceeded 110 percent of its issue price (generally the FMV of the T shares exchanged as of the exchange date), A might have recognized ordinary income over time under Code Sec. 305(c)[99].

Two years later in Rev. Ruls. 80-284[100] and 80-285[101], the IRS reversed direction and concluded that become A's exchange of T common stock for S preferred was an "integral part of a larger transac-

97. IRS Letter Ruling 7839060, June 28, 1978.

98. 1973-2 CB 301

99. If a debenture pays interest in stock (common or preferred) rather than in bunny debentures, such interest is treated as currently paid, so that the holder has current interest income, and the issure has a current interest deduction, equal to the FMV of the stock issued, and the OID rules do not apply at all. (See Prop. Reg. § 1.1275-1(b)(1) (last sentence), Prop. Reg. § 1.1273-1(b), Code Sec. 1273(a)(2), NYSBA Tax Section, "Report of Ad Hoc Committee on Proposed Original Issue Discount Regulations, "34 Tax Notes 363, 376-77 (1987).

If issuer has the option to pay interest in eash or bunny debntures, interest on the bunny debentures may be contingent interest under Prop. Reg. §1.1275-4(b) and as a result could be treated as separate debt instruments under Prop. Reg. §1.1275-4(c)(3) or (e)(3).

100. 1980-2 CB 117

101. 1980-2 CB 119

tion…which does not meet the continuity of interest test [for a Code Sec. 368 reorganization]", the transaction is "beyond the underlying assumptions and purpose [of Code Sec. 351]". Accordingly, the IRS held that the transaction described above was fully taxable to all of T' s shareholders, including A.

Then in 1984 the IRS again reversed direction, revoked the 1980 published rulings, and adopted a position consistent with the 1978 National Starch private ruling:

"Upon consideration the Service has concluded that the face that 'larger acquisition transactions' such as descrided in Rev. Rul. 80-284 and Rev. Rul. 80-285, fail to meet the requirements for tax-free treatment under the reorganization provisions of the Code does not preclude the applicability of section 351(a) to transfers that may be described as part of such larger transactions, but also, either alone or in conjunction with other transfers, meet the requirement of section 351(a)"[102]

Two corporations can use the National starch concept to combine their activities wholly or partially tax free in ways not permitted by the reorganization provisions. Such a transaction is known as the "hol-izontal double-dummy technique" and is illustrated below:

T1, an Illinois corporation, is worth $75 million. T2, a Delaware corporation, is worth $50 million. Both T1 and T2 are publicly held.

T1's and T2's managements have agreed to combine their enterprises, if the following conditions can be met:

(1) For good business reasons, the two corporations (or corporate successors) are to be kept separate. T2 may be a subsidiary of T1

102. Rev. Rul. 84-71, 1984-1 CB 106
Here we explain about the horizontal double-dummy technique.

or both corporations may be first-tier subsidiaries of a new holding company, but T1 and T2 are not to be combined into a single corporation.

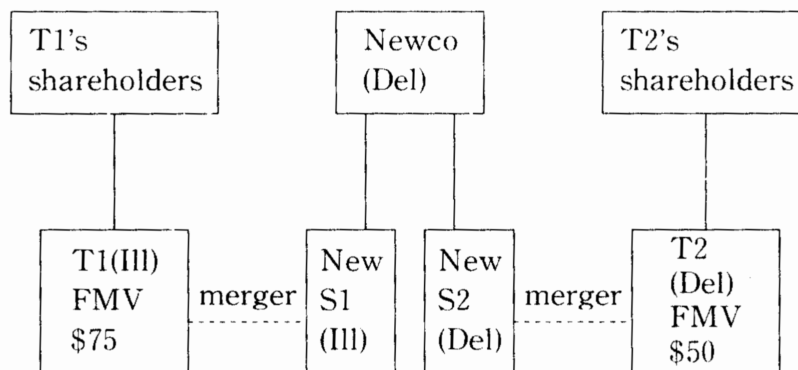
(2) T1's shareholders are to end up with solely common stock (worth $75 million) in the amalgamated enterprise, and T2's shareholders are to end up with 50 percent common stock (worth $25 million) and 50 percent convertible debentures (worth $25 million) in the amalgamated enterprise.

(3) Because of potential problems under leases and lorg-term agreements, neither T1 nor T2 is to transfer its assets by deed and, if possible, neither is to transfer its assets by operation of law.

(4) If possible, neither T1's not T2's shareholders (other than dissenters) are to recognize taxable gain on the transaction. If the transaction is structured as a conventional reorganization T2's shareholders would of course be taxed on the debentures received[103]. Prior to the 1989 amendment to Code Sec. 351 (described above in page 50), all of the objectives could be achieved by using Code Sec. 351(a) as the operative provision. The extent to which that is no longer true is analyzed below.

The mechanics are as follows:

《Figure 9》



103. Code Sec. 356

(1) A new corporation ("Newco") is organized in Delaware, along with two Newco subsidiaries: S1 under Illinois law and S2 under Delaware law. S1 and S2 are transitory corporations organized solely to participate in the amalgamation.

(2) Pursuant to an intergrated plan, S1(Illinois) is merged into T1(Illinois) and S2(Delaware) is merged into T2(Delaware).

(3) In the merger of S1 into T1, T1's previously outstanding shares are exchanged for 750,000 voting common shares of Newco (worth $75 million). Newco's previously outstanding S1 share are exchanged for new T1 shares, as that T1 ends up as a wholly owned Newco subsidiary.

(4) In the merger of S2 into T2, T2's previously outstanding shares are exchanged for 250,000 voting common shares of Newco (worth $25 million) and $25 million face amount of Newco covertible debentures (worth face). Newco's previously outstanding S2 shares are exchange for new T2 shares, so that T2 ends up as a wholly owned Newco subsidiary.

(5) Newco, T1 and T2 file a consolidated federal income tax return. As a result Newco's interest payments on the convertible debentures will be deductible in computing consolidated taxable income, and dividends received from T1 and T2 will not be taxable to Newco[104].

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104. For example, in some states a parent and subsidiary are not permitted to file a consolidated return or are prevented from so doing if consolidation would achieve a state tax saving. Hence, in such a state, if Newco has borrowed substantial amounts while T earns the group's operating income, Newco's substantial interest expenses may not be offset against T's income for state tax purpose.

One possible partial solution to this problem—if a two corporation structure is desirable although state consolidated returns are prohibited—is for T to pay Newco a reasonable management fee. Another possible solution, where Newco is supply-

Special Consideration in Tax-Free Acquisitions Involving an S Corporation

1 ACQUISITIONS INVOLVING AN S CORPORATION GENERALLY

Here we will discuss the special considerations that arise in a merger, acquisition, or leveraged buyout ("LBO") when at least one of the participating corporations is or becomes an S corporation ("SCO"). For purposes of this discussion, when P (the acquiring or purchasing corporation) is an SCo, it will be referred to as "P-SCo" and when T (the acquired or target corporation) is an SCo, it will be referred to as "T-SCo".

"S corporation", a defined term in the Code, means a qualified small business corporation for which an S corporation election is in effect[105]. "C corporation", also a defined term in the Code, means any corporation that is not an S corporation[106]. The income of an S corporation generally is not subject to corporate tax, but passes through to the shareholders and is taxed at individual rates (beginning in 1991, generally a maximum of 31 percent on ordinary income and 28 percent on lomg-term capital gain). Losses incurred by an S corporation flow through to its shareholders (subject to the at risk rules of Code Sec. 465 and the passive activity loss rules of Code Sec. 469) up to the amount of each shareholder's adjusted basis in his stock and debt, if any, of the S corporation[107].

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ing new capital to T, is for Newco to loan part or all of such new capital to T with T paying reasonable interest to Newco.

105. Code Sec. 1361(a)(1)
106. Code Sec. 1361(a)(2)
107. Code Secs. 1363 and 1366(d)

By contrast, income of a C corporation is taxed at corporate rates (up to 34 percent) and, following G U Repeal, C corporation income is almost always subject to double taxation. C corporation losses do not flow through to shareholders.

If and when a S corporation cases to be a qualified small business corporation, its S election terminates, and reelection of S status without the IRS's consent is prohibited for five years[108]. Moreover, once a new S election is made for a former C corporation, the penalty tax of new Code Sec. 1374 applies during the next 10 years. S corporation status is thus a valuable attribute, and preserving S corporation status is often a principal concern where one SCo acquires another SCo or where an individual or group of individuals acquires an SCo.

Where a C corporation (P) acquires an SCo (T) in a taxable transaction, it is frequently possible to structure the transaction so that P obtains a stepped-up basis (SUB) for the acquired assets while T-SCo and its shareholders are subjected to only one tax (despite G U Repeal). However, old Code Sec. 1374 or new Code Sec. 1374 may raise concerns, and there are substantial difference in treatment between a sale of stock and a sale of assets.

Not all states (and cities, where there is a city income tax) recognize an S election, and some states require a special state S election filing. Hence, local tax law in each jurisdiction must be reviewed when a federal S election is made.

2 P-SCO's TAX-FREE ACQUISITION OF T'S ASSETS

The tax consequences of P-Sco's tax-free acquisition of T's assets should generally be the same as described in page 9 through 10 above.

108. Code Secs. 1362(d)(2) and 1362(g)

In general, the sub-chapter C rules apply to an SCo and its shareholders unless inconsistent with subchapter[108-1] S.

Thus, the Code Sec. 368 reorganization rules apply to acquisitions by an SCo and issuance of the SCo's stock in such acquisitions, so that compliance with the reorganization rules will result in a tax-free acquisition.

3 P-SCO'S TAX-FREE ACQUISITION OF T'S STOCK

P-SCo nay acquire less than 80 percent of T's stock (as defined in Code Sec. 1504) (and other property) in excharge for an amount of P-SCo stock constituting control of P-SCo (as defined in Code Sec. 368(c), generally 80 percent), so long as all members of the group transferring the property (inciuding T shareholders) who receive P-SCo stock are qualified S corporation shareholders. This approach should be tax free to the contributing T shareholders, give rise to no taxable gain at the T corporate level, and permit P-SCo to continue as an S corporation.

In taxable years beginning after December 31, 1991. under "New' Code Sec. 1361(b)(2) as proposed to be amended by § 404(b) of the Tax Simplification Act of 1991, P-SCo in a Code Sec. 351 exchange may acquire any amount, including all, of T's stock without the loss of P-SCo's corporation status.

Tax Aspects of Financing and Structuring LBOs

1 STRUCTURING COSIDERATIONS IN A LEVERAGED BUYOUT

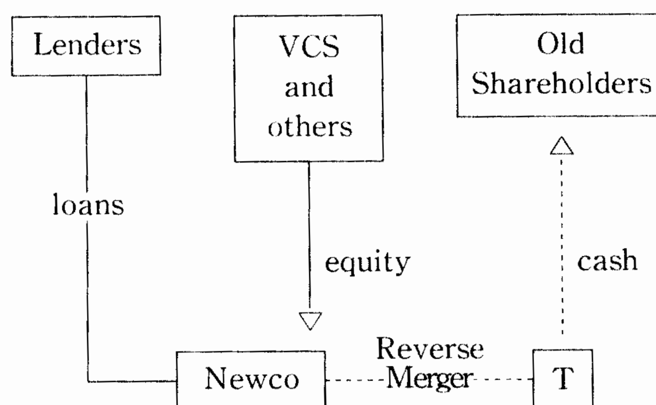
108-1. 1973-2 CB 313

There are several ways to structure a leveraged buyout, and many tax and nontax factors to be taken into account in selecting the proper structure.

Discussed below are four alternatives for structuring an LBO and the distinct federal income tax ramifications of each : (1) a one-corporation approach in which Newco mergers directly into T (i. e., a taxable reverse merger), so that T is the only corporation remaining after the merger ; (2) a parent-subsidiary approach with borrowing at the parent level, in which a Newco subsidiary merges into T (i. e., a taxable reverse Subsidiary merger), so that after the merger Newco is a holding company owing all of T's stock ; (3) a parent-subsidiary approach, as in (2), but with part of the borrowing at the subsidiary level ; and (4) an approach consisting of part purchase and part redemption, in which Newco purchases part of T's stock directly from T's shareholders and T redeems the rest using borrowed funds.

Under the simplest approach, Newco acquires T after the transaction there is only one corporate entity, T :

《Figure 10》



In this structure, Newco is formed and obtains debt and equity financing. Newco then merger into T, with T's old shareholders receiving cash (or cash and T notes) and Newco's shareholders and

lenders receiving T stock and T debt instruments. Thus, after the merger only one corporate entity (T) remains.

For tax purposes, Newco is disregarded as a transitory corporation, and in general the transaction is treated as if had obtained new debt and equity financing and then redeemed all of its old shareholders, who are thus taxed under Code Sec. 302[109].

However, to the extent that T's new shareholders (i. e., the VCs and others buying Newco stock, which is converted in the merger into T stock) have purchased their new stock for cash, T's old shareholders instead may be treated (under a step transaction analysis) as having sold their stock directly to T's new shareholders ; to the extent of such treatment, T's old shareholders wound be taxed under Code Sec. 1001 rather than under Code Sec. 302[110].

Under the parent-subsidiary approach to an LBO, Newco acquires T in a taxable reverse subsidiary merger ; so that after the transaction Newco is a holding company owning all of T's stock.

In this structure, Newco is formed and obtains debt and equity financing ; Newco forms a subsidiary ("New Sub") ; and New Sub then

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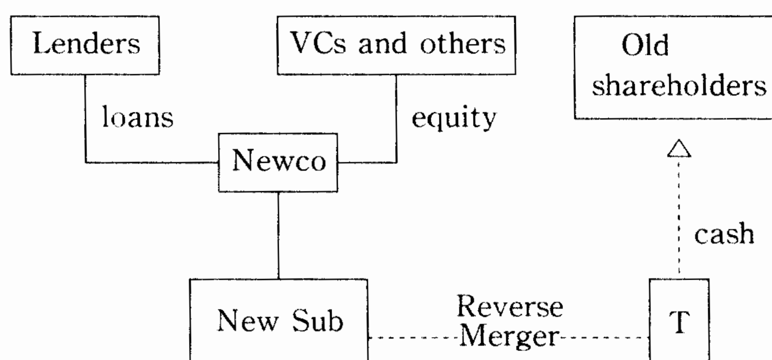
109. Rev. Rul. 78-250, 1978-1 CB 83

110. See Rev. Rul. 78-250, 1978-1 CB 83, Rev. Rul. 79-273, 1979-2 CB 125 ; Rev. Rul. 73-427, 1973-2 CB 301. Under such a Code Sec. 1001 analysis, the transaction essentially would be taxed as though (i) Newco had never existed, (ii) T had incurred directly the acquisition debt, and (iii) T's old shareholders had disposed of therir T stock partly by direct sale to VC and the other investors and partly by redemption. A principal reason for not actually structuring the transaction in this manner—which reaches basically the same economic result as the reverse merger structure—is that the reverse merger of Newco into T permits VC and the other investors to cash out old T minority shareholders who would not voluntarily sell their T stook. Moreover, a reverse merger of Newco into T is generally preferable to a forward merger of T into Newco because (i) it avoids the need to transfer T' s operating assets to a new legal entity and (ii) a forward merger will generally result in corporate-level tax on T as if had sold its assets to Newco.

《Figure 11》



mergers into T in a taxable reverse subsidiary merger, with T's old shareholders receiving cash (or cash and Newco notes) and New Sub's sole shareholder (Newco) receiving T stock. Thus, after the merger Newco owns 100 percent of T's stock[111].

For tax purposes, New Sub is disregarded as a transitory corporation and the transaction is treated as if Newco had obtained new debt and equity financing and then purchased all of T's stock from T's old shareholders[112]. Except as discussed below, T's old shareholders recognize capital gain or loss uneer Code Sec. 1001 on the deemed sale of their T stock to Newco, and Newco takes a cost basis in the acquired T stock.

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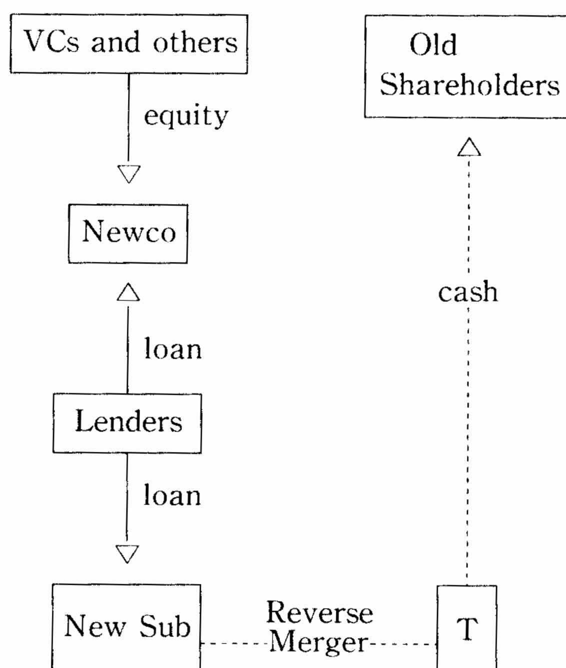
111. The same economic result (and the same tax result as is described in the text) is achived if Newco simply buys T's stock from its old shareholders without using New Sub at all. The principal advantage of a taxable reverse subsidiary merger over a direct stock purchase is that often it will enable Newco to cash out old T minority shareholders who would not voluntarily sell their T stock to Newco.

Another means of aoquiring 100% of T's stock is a 2-step variant of the acquisition structure described in the text : (1) Newco purchases T stock directly (e. g., by tender offer) from those shareholders willing to sell, and (2) T's remaingng shareholders are cashed out by a reverse merger of New Sub into T. The tax consequences are the same as those described in the text. This structure is frequently used when T's stock is publicly traded. If Newco acquires sufficient T shares in step (1), the merger of New Sub might be executed through a "short-form merger," which does not require the approval of T's old shareholders.

112. Rev. Rul. 73-427, 1973-2 CB 301 ; Rev. Rul. 79-273, 1979-2 CB 125

Here we will explain about parent-subsidiary approach with part of borrowing at subsidiary level. This approach, like the approach discussed above, is a taxable reverse subsidiary merger, except that New Sub directly borrows part of the money needed to acquire T:

《Figure 12》



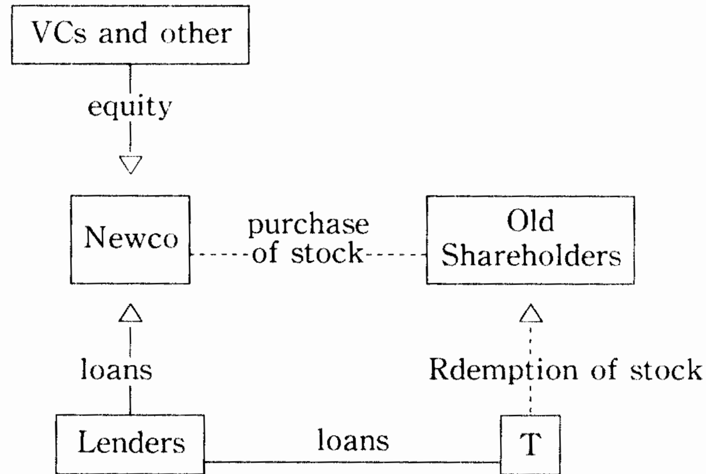
For tax purposes, (1) to the extent New Sub borrows money to pay off T's old shareholders (so that T is liable for the debt after the merger of New Sub into T), the transaction is treated as T's redemption of its stock, and (2) to the extent Newco borrows money (so that T is not liable for the debt after the merger) or Newco raises equity capital to pay off T's old shareholders, the transaction is treated as Newco's acquisition of T stock by purchase or (depending on the application of Code Secs. 304 and 351) by a contribution to Newco's capital[113].

Under part purchase-part redemption approach, Newco purchases

113. Rev. Rul. 79-273, 1979-2 CB 125, Rev. Rul. 78-250, 1978-1 CB 83, Rev. Rul. 73-427, 1973-2 CB 301.

part of T's stock and T redeems the remainder of its stock.

《Figure 13》



In this structure, Newco is formed and obtains debt and equity financing to purchase part of T's stock and T simultaneously borrows money to redeem the remainder of its stock, so that after the transaction Newco owns all of T's outstanding stock.

For tax purposes, the transaction is treated as if (1) Newco purchased from T's old shareholders the poriton of T's stock acquired with money borrowed by Newco and money obtained by Newco as equity and (2) T redeemed the T stock acquired with T's cash on hand and money borrowed by T[114].

The tax treatment is the same as in page 64 above.

2 FTC PREMERGER NOTIFICATION RULES——HART-SCOTT-RODINO ACT

The Federal Trade Commission ("FTC") Premerger Notification Rules (the "Rules") were promulgated pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"), which

114. See Zenz V. Quinlivan, CA-6, 54-2 USTC 9445, 213 F2d 914

added new section 7A to the Clayton Act[115]. The Rules potentially cover any type of transaction which results in one entity (including a natural person) acquiring the voting securities of assets of another entity, including through stock or asset purchase, merger, tender offer, exercise of warrant or option, conversion from nonvoting to voting securities, formation of a new corporation or any other direct or indírect means.

The Rules prohibit one entity ("P") from acquiring any voting securities or assets of another entity ("T"), unless P and T have complied with the reporting and waiting period requiremnts of the HSR Act, where:

(1) P and T both meet the dollar criteria of the size-of-person test (described below) and

(2) the transaction meets the dollar or percentage criteria of the size-of-transaction test (described below) and

(3) the transaction is not covered by a specific exemption (described below).

The size-of-person test is met if at least one of the following size criteria is met:

(1) T is engaged in manufacturing and has annual net sales or total assets of at least $ 10 million and P has annual net sales or total assets of at least $ 100 million.

(2) T is not engaged in manufacturing and has total assets of at least $ 10 million and P has annual net sales or total assets of least $ 100 million.

(3) T (regardless of its business) has annual net sales or total assets

115. 15 USC §18A

of at least $ 100 million and P has annual net sales or total assets of at least $ 10 million.

"Annual net sales" and "total assets" are measured at the level of P's or T's "ultimate parent entity (i. e., an entity which is not "controlled" by and other entity), to which is added the assets and sales

"Control" means as follows:

(a) beneficial ownership of securities with 50 percent or more of an entity's voting power or contractual power to designate 50 percent or more of the entity's directors (or individuals exercising similar functions in an unincorporated entity, e. g., trustees) or (b) in the case of an entity that the FTC believes has no outstanding voting seeurities (e. g., a partnership), the right to receive 50 percent or more of the profits of the entity (or of its assets on dissolution).

(continued to next Volumes)