PENN STATE
LAW REVIEW

Basic Tax Issues in Acquisition Transactions

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I. INTRODUCTION

This article discusses basic U.S. tax issues that arise in an acquisition transaction. It is intended primarily for readers who are corporate lawyers rather than tax lawyers. The discussion is written in general terms and does not include every exception to the general rules (and exception to exception, and so on).

Most importantly, it is vital for the corporate lawyer to consult a tax lawyer at every stage of an acquisition transaction. The tax rules are detailed, often counterintuitive, and always changing. Details that are minor from a corporate point of view, such as which corporation survives a merger, can have vast consequences from a tax point of view. The particular structure of a transaction can mean that one party might achieve a significant tax benefit at the expense of the other party (e.g., your client), or even worse, both parties could end up significantly worse off than if a different corporate structure had been used. In addition, it is not enough merely to rely on the Internal Revenue Code and regulations, because there is a large body of Internal Revenue Service ("IRS") rulings, judicial decisions, and nonstatutory doctrines.

It is also essential that the tax lawyer begin to participate in a transaction at the very beginning. This is usually when the basic structural elements of the transaction are determined. It is much easier to propose a particular structure at the time an initial term sheet is being negotiated than it is to propose a change in structure after both sides (with or without their respective tax lawyers) have agreed to it.

Likewise, detailed ongoing participation by the tax lawyer is necessary to be sure that changes in documentation do not change the tax results that are important to the client.

Part II of this article discusses the considerations involved in deciding whether a transaction should be a taxable transaction or a so-called "tax-free reorganization." Part III discusses taxable transactions, including the different tax effects of stock and asset acquisitions and the different structures for achieving either of these tax results. Part IV discusses the requirements for a tax-free reorganization and the structures that can be used in a reorganization. Part V discusses other issues that arise in both taxable and tax-free transactions. Part VI provides conclusions.

This article assumes throughout that one corporation ("Acquiring") intends to acquire the business of another corporation ("Target"). The shareholders of Target are referred to as the "Shareholders." Unless otherwise indicated:

- Target and Acquiring are both taxable "C" corporations, i.e., they are taxable on their own income.[2] This is in contrast to an "S" corporation, which is a closely held corporation that meets various conditions,[3] that does not pay income tax itself,[4] and whose income is taxed directly to its shareholders.[5]

- Acquiring and Target are unrelated before the transaction. They have primarily different shareholders, and Acquiring does not own any preexisting stock in Target.

- The Shareholders hold their stock for investment, and are not dealers or in other special tax situations.

- Acquiring will acquire all the business of Target, i.e., there are no retained assets that will go to the Shareholders.

- References to tax are to federal income tax.

2. *See* I.R.C. § 11. All references to I.R.C. are to the I.R.C. as in effect on January 1, 2012.
3. *Id.* § 1361.
4. *See id.* § 1363.
5. *See id*. § 1366.

II. TAXABLE OR TAX-FREE TRANSACTION?

If the price being paid by Acquiring is all cash, the transaction can only be a taxable transaction. If a portion of the price being paid by Acquiring is stock of Acquiring, then it may be possible to structure the transaction as a tax-free reorganization in which Shareholders are not taxed on the receipt of Acquiring stock.

A. Is a Tax-Free Reorganization Possible?

In order for a tax-free reorganization to be possible, two basic conditions must be satisfied. First, at least 40% of the value of the total consideration paid to Shareholders must be in the form of stock of Acquiring (or in some cases stock of a parent of Acquiring).[6] In other words, the nonstock consideration, referred to as "boot", cannot exceed 60% of the total consideration. If the boot will exceed 60%, there cannot be a tax-free reorganization, although a more complex structure discussed below[7] that would achieve similar results may be possible.

Second, a reorganization requires that Target be a corporation for tax purposes.[8] If Target is a partnership, a tax free reorganization involving the acquisition of the partnership is not possible, although Acquiring could acquire one or more corporate partners of the partnership in tax-free reorganizations if the usual conditions for a reorganization with a corporate Target are satisfied. It is also not possible for any party to transfer assets to a new or existing corporate Target, and then, as part of the same plan, for those assets to be part of a tax-free reorganization in which Acquiring acquires Target. The so-called "step transaction" doctrine would treat those contributed assets as being transferred directly from the transferor to Acquiring in a taxable transaction, and not as part of the reorganization involving Target.[9]

Third, a reorganization might not be practicable if Target will retain a substantial amount of assets that will be transferred to the Shareholders rather than to Acquiring. While some types of reorganizations would permit Target to transfer some of its assets to the Shareholders before Target is acquired, such a transfer would generally be taxable to both Target[10] and the Shareholders.[11]

6. Treas. Reg. §§ 1.368-1(e)(1), (2)(v) ex.1. All regulations are cited as in effect on January 1, 2012.

7. *See infra* Part IV.D.

8. I.R.C. § 368(a)(1), (b); Treas. Reg. §§ 1.368-1(b), -2(b)(1)(i)(B), -2(b)(1)(ii).

9. Rev. Rul. 70-140, 1970-1 C.B. 73.

10. I.R.C. §§ 311(d), 361(c)(2) (taxable gain to Target on use of appreciated property to pay dividend, redeem stock, or make a distribution in connection with a reorganization).

On the other hand, a tax-free reorganization is possible if Target is a limited liability company (LLC) that has previously, and not as part of the same plan, elected (through a so-called "check the box" election) to be treated as a corporation for federal income tax purposes.[12] Likewise, Target may be a "Subchapter S" or "S" corporation,[13] which is a closely held corporation that meets certain conditions and is treated similarly to a partnership for tax purposes.[14] In fact, a major benefit of a business choosing to be an S corporation as opposed to a partnership or LLC is the ability of the owners to "sell out" on a tax-free basis through a reorganization as well as to obtain pass-through treatment of income on an ongoing basis.

Additional requirements of a reorganization are discussed in Part IV below. Moreover, if the conditions for a reorganization are satisfied, the transaction is automatically tax-free even if a taxable transaction is desired. Thus, if stock of Acquiring is being issued and a taxable transaction is desired, it is necessary to be sure that the transaction does not inadvertently satisfy all the requirements of a tax-free reorganization.

B. Is a Tax-Free Reorganization Desirable?

Even if a tax-free reorganization is possible, the question remains whether it is desirable in any particular case.

The main benefit of a reorganization is that Shareholders who exchange their Target stock for Acquiring stock are not taxed currently on the exchange.[15] In addition, Target is not subject to tax, even if the particular kind of reorganization is treated (as discussed in Part IV.C below) as a transfer of assets by Target to Acquiring followed by the liquidation of Target.[16]

The nontaxability of Shareholders on the receipt of Acquiring stock is primarily a timing benefit. Each Shareholder receives the same tax basis in the Acquiring stock that it had in the Target stock.[17] Thus, the

11. *Id.* §§ 301, 302, 356 (tax to Shareholder on receipt of assets from Target as dividend, payment for stock redemption, or as additional consideration in a tax-free reorganization).

12. Treas. Reg. § 301.7701-3(a).

13. I.R.C. § 1371(a) (an S corporation is a corporation for purposes of Subchapter C, which includes the reorganization rules).

14. *Id.* §§ 1361-1368.

15. *Id.* § 354(a)(1).

16. *Id.* §§ 361(a) (no tax to Target on exchange of assets for Acquiring stock), 361(b) (no tax to Target on receipt of boot from Acquiring that is distributed to Target shareholders), 361(c) (no tax to Target on its distribution of Acquiring stock to Target shareholders).

17. *Id.* § 358.

gain that is not taxed on the exchange will be taxed later when the Acquiring stock is sold.

In some cases, the benefit is more than a timing benefit. The holding period of Acquiring stock received by a Shareholder includes the Shareholder's holding period of the Target stock surrendered.[18] Thus, if the Shareholder has a holding period of less than a year in the Target stock at the time of the closing of the transaction, a taxable sale of the stock will result in short term capital gain,[19] which is taxable at ordinary income tax rates. A tax-free exchange will allow the holding period of the Target stock to carry over into the holding period of the Acquiring stock.[20] Then, a sale of the Acquiring stock after the total holding period exceeds one year will result in long term capital gain, currently taxable to an individual at a maximum 15% rate.[21]

Even more significantly, if a former individual Shareholder of Target dies while holding stock of Acquiring, the stock will receive a stepped up tax basis equal to its fair market value on the date of death.[22] Any gain existing in the stock at that time is permanently exempted from tax. This makes a tax-free transaction particularly beneficial to an elderly Shareholder that holds stock of Target with a low tax basis. In that situation, if the Shareholder has a choice, a taxable sale may be simply unacceptable because it results in tax that would be eliminated in the relatively near future.

On the other hand, the advantages of a tax-free transaction should not be overstated. Depending on the facts, but particularly in the public company context, Shareholders may not have much taxable gain in their stock. Even if they do, many of the Shareholders may be charities, pension funds or foreigners, all of whom are not subject to tax, even on a taxable sale. Moreover, in the public context, hedge funds or arbitrageurs may buy up a lot of the Target stock with the intent to exchange it into Acquiring stock and immediately sell the Acquiring stock (or even sell the Acquiring stock short before the transaction closes). They will obtain no benefit from a tax-free transaction. Shareholders with a loss in their stock will also obtain no benefit from a tax-free transaction. If they cannot easily sell their Target or Acquiring stock for cash outside the transaction, they might prefer to obtain their loss in a taxable acquisition.

18. *Id.* § 1223(1).
19. *Id.* § 1222(1).
20. *Id.* § 1223(1).
21. *Id.* §§ 1222(3), 1222(11), 1(h).
22. *Id.* § 1014.

In addition, the maximum tax rate on long term capital gains of individuals is currently 15%,[23] but is scheduled to increase significantly beginning in 2013.[24] In the current uncertain tax environment, it is impossible to predict whether all or part of this increase will come to pass and, in any event, whether future rates might be substantially higher than the current rate. A Shareholder may prefer to pay tax at the known rate of 15% today rather than at an unknown and possibly much higher rate in the future.

The advantages of a tax-free transaction will also be reduced if the transaction will involve a significant amount of boot. A Shareholder will be taxed on the *lesser* of the total gain on the Target stock (total value of stock and boot received over tax basis in the Target stock), and the amount of boot received.[25] Thus, if the Shareholder has a tax basis of $10 in each of its shares of Target stock and receives, for each such share, Acquiring stock worth $8 and cash of $6, the taxable gain will be $4 per share (lesser of total gain of $4 and cash of $6). This is exactly the same as in a taxable transaction. It may be possible to reduce the total taxable gain by allocating all the Acquiring stock received by a particular Shareholder to some of the Target shares held by the Shareholder, and all the cash received by the Shareholder to other Target shares held by the Shareholder.[26] However, these rules are uncertain in many respects and are in a state of flux.[27] They do not change the basic principle that a Shareholder receives less benefit from a tax-free transaction if the Shareholder also receives cash.

Moreover, in a tax-free reorganization, Acquiring receives the Target assets with a tax basis equal to Target's old tax basis.[28] There is no increase in tax basis for any boot paid by Acquiring in the transaction, as there is in an asset purchase.[29] This is consistent with the fact that Target does not recognize any gain on boot paid by Acquiring that is

23. *Id.* § 1(h)(1)(C).

24. The maximum rate will increase to 20% on January 1, 2013, upon expiration of the "Bush tax cuts." At the same time, recent health care legislation will impose a new tax of 3.8% on all investment income, including capital gains, of individuals with incomes over $200,000 for a single taxpayer or $250,000 for taxpayers filing a joint return. *Id.* § 1411(a)(1).

25. *Id.* § 356(a)(1).

26. Treas. Reg. § 1.358-2. In the example, the result would be that there is no taxable gain on the 8/14 of the Target shares exchanged entirely for Acquiring stock, and gain of $4 per share on the 6/14 of the Target shares exchanged entirely for cash. Because the same gain per share is recognized on fewer shares, the total recognized gain is reduced.

27. *See* Prop. Treas. Reg. §§ 1.354-1(d)(1), 1.356-1(b), 1.356-1(d) ex.4, 1.358-2, 74 Fed. Reg. 3509 (Jan. 21, 2009).

28. I.R.C § 362(b).

29. *See infra* Part III.C.

distributed to the Shareholders.[30] Nevertheless, this is a counterintuitive result, particularly if the reorganization is in the form of an asset acquisition as discussed in Part IV.C below.

A tax-free reorganization is also more complicated from a tax point of view than a taxable stock or asset purchase. The obligation of each party to close a tax-free transaction is almost always conditioned upon that party receiving an opinion from its tax counsel stating that the requirements for a tax-free reorganization are satisfied. Such tax opinions are based on elaborate representation letters by Acquiring and Target indicating that the required conditions are satisfied. If any difficult issues are raised, it may also be necessary to obtain a ruling from the IRS. The IRS has an expedited procedure under which rulings on reorganizations will often be issued within 10 weeks after the request is received.[31] However, this deadline is not always met, and a ruling can take 4-6 months or more to receive from the time the decision is made to request it.

Finally, the representations that Acquiring is required to give for either a tax opinion or IRS ruling will include representations that it does not plan to engage in certain future transactions that, if treated as part of the same plan as the reorganization, would cause the reorganization rules to be violated.[32] Even if the representation is true at the time it is given, as a practical matter Acquiring will not want to engage in any of the specified transactions for one or two years after the acquisition, unless clearly due to a change in circumstances. A transaction that is done sooner may call into question the correctness of the earlier representation about intent and therefore call into question the qualification of the acquisition as a tax-free reorganization. This loss of flexibility to Acquiring is an additional disadvantage to a tax-free transaction.

III. TAXABLE TRANSACTIONS

This Part discusses the issues that arise if the parties have decided to do a taxable transaction. The basic question at this point is whether the transaction should be one that is treated as a stock acquisition or an asset acquisition for tax purposes. These alternatives have vastly different tax consequences to Acquiring, Target, and the Shareholders. Once that decision is made, there are various legal forms of transactions, discussed in Parts III.D and III.E below, that can achieve the desired tax result.

30. I.R.C. § 361(b).

31. Rev. Proc. 2012-1, 2012-1 I.R.B. 1, § 7.02(4)(a).

32. *See* Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722, which are outdated but are the most recent published list of representations required by the IRS for a ruling on a reorganization.

A. *Transaction Treated as Stock Acquisition for Tax Purposes*

In a transaction treated as a sale of Target stock for tax purposes, the Shareholders will have capital gain or loss on the sale, and the gain or loss will be long term if the stock has been held for more than a year.[33] Target will not be subject to tax as a result of the sale. Acquiring will obtain a cost basis in the stock,[34] although that tax basis will not provide any tax benefit until Acquiring sells the stock. Most significantly for Acquiring, the tax basis of the Target assets will remain unchanged, rather than reflecting Acquiring's purchase price for the stock. Assuming the assets have a value in excess of their tax basis, this is an unfavorable result to Acquiring.

B. *Transaction Treated as Asset Acquisition for Tax Purposes*

In a taxable asset purchase, Acquiring's tax basis in the purchased assets will be equal to the purchase price including assumed liabilities.[35] This is generally the fair market value of the assets. Assuming the purchase price is greater than Target's tax basis in the assets, the tax basis of the assets is "stepped up" to the purchase price. This step-up in tax basis is particularly important to Acquiring if it intends to sell a portion of the acquired assets in the near future, because absent the step-up there could be significant tax on the sale even if the value of the assets is unchanged from the time of the acquisition by Acquiring.

If Acquiring retains the Target assets, the step-up allows Acquiring to obtain greater depreciation and amortization deductions over a period of years in the future. The amortization period for any asset is based on the assumed life of the particular asset.[36] In practice, much of the step up is usually allocable to intangible assets of Target that have a very low tax basis to Target and for which Acquiring is permitted to amortize the new basis over 15 years.[37] If the step-up is amortized over 15 years and Acquiring has a combined 40% federal and state marginal tax rate, then $100 of step-up will result in $40 of tax savings spread over 15 years. At a 10% discount rate, the present value of the tax saving from the step-up is about $20, or 20% of the amount of the step-up.

The relative benefit to Acquiring of an asset purchase as compared to a stock purchase may be offset in part by a different factor. A stock purchase would result in Target continuing to amortize its existing tax

33. I.R.C. § 1222(3)-(4).
34. *Id.* § 1012(a).
35. *Id*.
36. *Id.* §§ 167-68, 197.
37. *Id.* § 197. *See infra* Part III.F.

basis over the remainder of the statutory lives of its assets. However, an asset purchase would result in all of Acquiring's tax basis being amortized over a new statutory life beginning on the acquisition date. Therefore, even though an asset purchase gives Acquiring "new" asset basis to amortize, the result of the asset purchase may be to slow down the amortization of the "existing" asset basis. Normally, this factor is much less significant to Acquiring than the benefit of the step-up.

As to Target, unless it is an S corporation, it recognizes gain or loss on the sale of its assets.[38] Because corporations do not receive a reduced tax rate on capital gains, all the gain to Target is taxable at the 35% corporate tax rate.[39] This could be a very significant amount of tax unless Target has little or no gain on its assets, or net operating losses to shelter that gain. Assuming the Target liquidates after the asset sale and distributes the after-tax sale proceeds, the Shareholders (except for an 80% corporate Shareholder) recognize gain on the liquidation measured by the excess of the cash and property received over their tax basis in the Target stock.[40] The result is a double tax on a corporate sale of assets and liquidation. This result has existed since the repeal in 1986 of the so-called General Utilities doctrine,[41] which had exempted a C corporation from most corporate-level taxation on the sale of its assets followed by a complete liquidation.

C. Comparison of Taxable Stock and Asset Acquisition

1. Target a Stand-Alone C Corporation

If the Target is a C corporation that is not an 80% subsidiary of another corporation, the double tax on an asset sale makes a stock sale significantly more advantageous to the Shareholders than an asset sale. On the other hand, Acquiring is generally better off from a tax point of view from an asset sale as opposed to a stock sale because of the step-up in tax basis of the assets that only arises on an asset sale.

Because of the tax benefits of an asset purchase, Acquiring will be willing to pay more for an asset purchase than a stock purchase. (Or, as Acquiring would say, its bid price was already based on an asset purchase and will be reduced if a stock purchase is required by Target.) By contrast, the Shareholders will usually retain a significantly smaller amount of cash on an after-tax basis for any given sale price where the transaction is treated as an asset purchase rather than a stock purchase.

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38. *Id.* § 1001.
39. *Id.* § 11.
40. *Id.* §§ 331 (general rule), 332 (exception for 80% shareholder).
41. *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

The question, then, is which transaction results in less aggregate tax to all parties on a present value basis. Once the aggregate tax liability is minimized, the parties can then negotiate how to divide up the resulting tax benefits and detriments.

In practice, the total tax will almost always be minimized by a transaction treated as a stock sale rather than an asset sale. The reason is that the tax detriment to Target and the Shareholders from an asset sale as compared to a stock sale will usually be significantly more than the tax advantage to Acquiring from an asset purchase as compared to a stock purchase. This is because on an asset sale, Target pays immediate tax on its gain on the assets. The amount of gain is the same as the amount of Acquiring's step-up in tax basis and the increased dollar amount of tax deductions in the future. However, the additional tax deductions are generally spread over a period of up to 15 years.[42] As a result, assuming Target and Acquiring are subject to the same tax rates, the present value of the upfront tax to Target is much greater than the present value of the future tax savings to Acquiring.

Looking at the same point in a different way, assume Acquiring was willing to pay Target, for the opportunity to buy assets rather than stock, an extra amount equal to the full present value of the tax benefit of the step-up in asset basis. Even then, if Target is in the same tax bracket as Acquiring, the extra amount would be less than the cost to the Target and Shareholders of an asset sale as compared to a stock sale. As a result, almost all transactions involving a Target that is a "C" corporation without an 80% shareholder are done in a manner that is treated as a stock sale rather than an asset sale for tax purposes, unless Target has net operating losses to shelter the corporate level gain.

2. Target an S Corporation

The considerations are different if Target is an "S" corporation. An S corporation is generally not itself taxable,[43] so there is no "double tax" from an asset sale. Rather, the issue is whether the Shareholders will be subject to more tax if Target is treated as selling assets and liquidating than if the Shareholders are treated as selling their stock. Generally, the amount and character of the gain or loss at the Target level will pass through to the Shareholders,[44] will be taken into account on their individual tax returns,[45] and will increase or decrease their tax basis in

42. *See supra* Part III.B.
43. I.R.C. § 1363(a).
44. *Id.* § 1366.
45. *Id.*

the stock.[46] In principle, therefore, the Shareholders will have the same total net gain or loss if the Target sells its assets and liquidates, or if the Shareholders sell their Target stock for the same amount. As a result, because there is no harm to the Shareholders and there is a benefit to Acquiring from an asset sale, most sales of S corporations are structured as asset sales for tax purposes.

However, this is not always true. The Shareholders will generally have long term capital gain on a stock sale. On an asset sale, the character of the gain that is passed through to the Shareholders from the Target is determined by the nature of the Target's assets.[47] It is possible that some of the Target-level gain would be ordinary income[48] or short term capital gain, which when passed through to the Shareholders would put them in a worse position than if they had sold their stock. In an extreme case, the Shareholders might have ordinary income passed through from the Target in excess of their total economic gain on the stock, in which case such excess would be offset by a capital loss on the stock when Target liquidates.[49]

As a result, there could still be disadvantages to the Shareholders from an asset sale as compared to a stock sale. In that case, negotiations between the parties are necessary to determine if Acquiring is willing to pay a higher price for an asset purchase to offset the tax disadvantages to the Shareholders from an asset sale.

Finally, Target may owe additional tax if it was formerly a C corporation and if it sells assets within 10 years (or certain shorter statutory periods) after the effective date of the conversion to S status. If Target held any assets on the conversion date with "built-in gain," then Target must pay tax on that gain to the extent the gain is realized upon the asset sale.[50] This rule could also make an asset sale more expensive for the selling Shareholders than a stock sale.

3. Target an 80% Subsidiary

If Target is a C corporation and 80% or more of the Target stock is owned by another corporation, no double tax arises from an asset sale. Target recognizes gain on the sale of its assets, but the liquidation of Target is tax free to the 80% Shareholder (although not to a minority shareholder).[51] In this situation, the issue from the Target point of view

46. *Id.* § 1368.
47. *Id.* § 1366(a), (b).
48. *See, e.g.*, *id.* §§ 1245 (depreciation recapture is ordinary income), 1221(a)(1) (inventory is not a capital asset, resulting in gain being ordinary income).
49. *Id.* § 331(a).
50. *Id.* § 1374.
51. *Id.* § 332.

is the amount of the single tax that arises on either a stock or asset sale. If the Target is considered to sell assets, the taxable gain is based on the Target's tax basis for its assets. If the Shareholder is considered to sell the stock of the Target, the taxable gain is based on the tax basis in that stock. From Acquiring's point of view, an asset purchase is again more favorable because of the stepped-up tax basis it will receive in the assets.

If the Shareholder has the same tax basis in the stock of the Target as the Target has in its assets, the total tax to the selling group should be the same for a stock sale or asset sale. This will usually be the case if Target is a member of a consolidated federal income tax group and was originally formed within the group.[52] In that case, Acquiring will generally insist on buying assets, and the Target will have no reason to refuse. On the other hand, if the Shareholder has a higher tax basis in the stock of the Target than the Target has in its assets, an asset sale will result in more tax to the Target group than a stock sale. This will usually be the case if Target is in a consolidated group and the group had acquired the stock by purchase from a third party. In this case, depending on the difference in tax basis of stock and assets, the parties may or may not be able to agree on an increased purchase price for an asset purchase that will compensate the Target group for its extra tax cost and give Acquiring the benefit of the step up in asset basis. If Acquiring's potential benefit is less than the extra tax cost to the Shareholder, a stock sale will obviously occur.

D. Forms of Taxable Stock Purchase for Tax Purposes

Once the parties have agreed that the transaction should be treated as a taxable stock or asset purchase for tax purposes, the form of the transaction can be determined. This issue is significant because the legal form of the transaction does not necessarily correspond to its treatment for tax purposes.

A transaction intended to be a stock purchase for tax purposes can be accomplished in the following ways:

1. Straight Purchase of All Stock

Acquiring can individually purchase the Target stock from each Shareholder. This of course requires the agreement of each Shareholder. This may not be practicable if there are a significant number of Shareholders.

52. Treas. Reg. § 1.1502-32(b)(2) (tax basis in stock of consolidated subsidiary is increased and decreased by income and losses of subsidiary).

2. Reverse Merger

Acquiring can set up a new wholly owned subsidiary in the form of a corporation or LLC ("Newco"). Newco merges into Target, with Target surviving. The Newco stock held by Acquiring is converted into all the Target stock, and the old Target stock is converted into cash. Acquiring ends up owning 100% of the Target stock.[53] This form of merger in which Target survives is often referred to as a "reverse merger." This merger will generally require a vote of the Shareholders, because Target is a party to the merger. A vote of Acquiring shareholders is probably not necessary under state corporate law, because Acquiring is not a party to the merger.

3. Stock Purchase Followed by Merger

The two techniques described above can be combined. Acquiring first sets up wholly owned Newco. Newco purchases as much of the Target stock as it can, either by individual agreements with the Shareholders or, if Target is a public company, through a tender offer. Then, if Newco has acquired enough stock in Target to satisfy the state law requirements for a "short form merger," Newco can merge downstream into Target without a shareholder vote. In that merger, Target survives the merger, Acquiring's stock in Newco is converted into all the stock in Target, and the remaining Shareholders receive cash. Because Target stays alive at all times, this is treated as a taxable stock purchase by Acquiring for tax purposes.[54] If Newco does not acquire enough Target stock in the first step to be eligible for the short form merger statute, it may be possible for Newco to then buy additional Target stock directly from Target in order to meet the threshold ownership requirement, and then do the downstream merger. This would not change the tax result.

Alternatively, if Newco acquires at least 80% of the Target stock in the first step, Target can then merge upstream into Newco, with the minority Shareholders receiving cash from Acquiring. For tax purposes, this is a taxable purchase of some of the Target shares, followed by a liquidation of Target that is tax-free to Target[55] and Newco.[56]

As yet another alternative, Newco can set up a new wholly owned subsidiary, Newco2, after Newco acquires as much Target stock as it

53. *See* Rev. Rul. 79-273, 1979-2 C.B. 125 (treating this structure as a taxable stock purchase by Acquiring).

54. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (step transaction principles); IRS Field Service Advice 117 (June 25, 1992) (involving facts similar to the facts in the text).

55. I.R.C. § 337.

56. *Id.* § 332.

can,. Newco2 then merges into Target, with Target surviving and the remaining Shareholders receiving cash. This step would be viewed as an additional purchase of Target stock by Newco.[57] Target could then be merged upstream into its sole shareholder Newco on a tax-free basis.

E. Forms of Taxable Asset Purchase for Tax Purposes

A transaction intended to be an asset purchase for tax purposes can likewise be accomplished in a number of different ways.

1. Straight Purchase of All Assets

Acquiring can directly purchase all the assets of Target. Target will have taxable gain on the sale, and can choose to liquidate (with tax to the nonexempt Shareholders except 80% corporate Shareholders) or to keep its cash and stay alive. However, this transaction could result in significant state transfer taxes on the physical transfer of assets. In addition, it may not be easy to physically transfer title to a large number of assets on a single date. As a result, alternative methods of reaching the same result are often utilized.

2. Forward Merger

Target can merge into Acquiring or into Newco (a newly formed subsidiary of Acquiring), with the Shareholders receiving cash in the merger in exchange for their Target stock. This form of merger in which Target goes out of existence is known as a "forward merger." For tax purposes, this is treated as if Target sold its assets to Acquiring or Newco for cash, and then liquidated and distributed the cash to the Shareholders.[58] As a result, the double tax automatically arises unless Target has an 80% corporate Shareholder or is an S corporation. Note that the merger would require the approval of the Shareholders. The Acquiring shareholders would also have to approve a merger of Target into Acquiring, but might not have to approve a merger into Newco. If, as a business matter, Acquiring desires to hold the assets directly, a merger into Newco could be followed by the liquidation of Newco into Acquiring with no tax consequences.[59]

57. Rev. Rul. 79-273, 1979-2 C.B. 125.
58. Rev. Rul. 69-6, 1969-1 C.B. 104.
59. I.R.C. § 332.

3. Dropdown of Assets to LLC and Sale of LLC Interests

Target can drop down all its assets into a newly formed, wholly owned, LLC. The LLC could also assume any liabilities intended to be transferred to Acquiring. On the closing date, Target would sell 100% of the LLC interests to Acquiring. This procedure gives Target time to transfer title to the assets before the closing. In fact, the transfer will often be done before the purchase agreement with Acquiring is signed, so it is clear to both parties exactly which assets are being sold. From a tax point of view, the LLC is treated as a "disregarded entity," and all its assets are treated as if they were directly owned by Target.[60] As a result, Target is treated as selling the underlying assets, and Acquiring is treated as purchasing the underlying assets. Target can then either liquidate or stay alive with its cash.

4. Conversion of Target Into LLC, Then Sale of LLC Interests

The tax consequences of a sale of assets by Target can even be achieved without any physical transfer of the assets. Target would first convert into an LLC under state law. For tax purposes, this is treated as a taxable liquidation of Target. Assuming Target does not have an 80% corporate shareholder and is not an S corporation, Target has taxable gain on its assets[61] and the Shareholders have taxable gain on their stock.[62] Target at that point is treated as a partnership for tax purposes.[63] Immediately thereafter, the Shareholders would sell all the equity of the LLC to Acquiring, using one of the methods for a stock acquisition in Part III.D. The Shareholders, who had recognized taxable gain on the liquidation of Target, would have no additional gain on this sale, and Acquiring would become the sole owner of the LLC. Acquiring would be treated as if it had bought the assets of Target.[64]

5. New Holding Company Followed by Sale of LLC Interests

Under this structure, the Shareholders first transfer all their Target stock to a newly formed corporation, Newco. This step could be accomplished either by a direct transfer of Target stock to Newco in exchange for Newco stock, or by Newco setting up a new subsidiary that

60. *See* Treas. Reg. § 301.7701-2(c)(2)(i) (entity "is disregarded as an entity separate from its owner" for federal tax purposes).

61. I.R.C. § 311(b).

62. *Id.* § 331.

63. Treas. Reg. § 301.7701-3(b)(1).

64. Rev. Rul. 99-6, 1999-1 C.B. 432. This transaction would not work if the stock of Target was publicly traded, because a publicly traded partnership is taxable as a corporation. I.R.C. § 7704.

merges into Target, with Target shareholders receiving Newco stock in the merger. Next, Target converts into an LLC wholly owned by Newco. Finally, Newco sells all the LLC interests to Acquiring.

For tax purposes, after the first two steps, Newco is considered to be a continuation of the same corporation as Target, and the assets owned by the LLC are treated as being owned by Newco.[65] Then, Newco's sale of the LLC interests to Acquiring is treated as a sale of the assets of the LLC to Acquiring.

This structure has a number of advantages over the other techniques. First, there is no physical transfer of assets to Acquiring. Second, unlike the other cases that avoid a physical transfer of assets, there is no deemed liquidation of Target. Newco could stay alive with the cash proceeds of the sale of LLC interests, and there would be no current tax to the Shareholders. Third, this structure allows Newco to retain assets that will not be sold to Acquiring without any tax on those assets. The reason is that during the period that Target is an LLC wholly owned by Newco, the LLC is treated as part of Newco[66] and therefore can distribute assets to Newco without tax consequences. Newco can then sell the LLC, and is treated as selling the assets held by the LLC.

6. Section 338(h)(10) Election

If Target is either an S corporation or has an 80% U.S. corporate Shareholder, the parties can agree that Acquiring will buy the stock of Target, but that the parties will jointly elect to have the transaction treated as an asset sale for tax purposes. This election is universally referred to as an "(h)(10) election."[67] If both parties make the election, the transaction is treated as if Target sold its assets to a new corporation ("New Target") for cash, and then liquidated, distributing the cash to the Shareholders.[68] New Target, of course, is the same legal entity as Target, but the corporation at that point is treated for tax purposes as a newly formed corporation. As noted above, if Target is an S corporation, the result will be a single tax at the Shareholder level, while if Target has an 80% U.S. corporate Shareholder, the result will be a single level of tax at the corporate level.

When Target has an 80% U.S. corporate shareholder, it will generally be a member of a selling consolidated group. In that case, Target's gain on the deemed asset sale will be reported on that group's

65. In technical terms, these two steps constitute an "F" reorganization. Rev. Rul. 87-27, 1987-1 C.B. 134.

66. Treas. Reg. § 301.7701-2(c)(2)(i).

67. The reason is that it is made pursuant to I.R.C. § 338(h)(10).

68. *Id*; Treas. Reg. § 1.338(h)(10)-1.

tax return, not in Acquiring's return.[69] However, in the unusual case where Target is not a member of a consolidated group, Target itself will report the gain on its own tax return and will owe the tax on the gain.[70] Thus Acquiring (as the new shareholder of Target) in effect will owe the tax. An (h)(10) election would probably not be made in this situation.

As a practical matter, therefore, any time a consolidated subsidiary or S corporation is being purchased, the form of the transaction is almost always a stock sale. The only tax negotiation is over whether or not the seller will agree to an (h)(10) election that is desired by Acquiring. In addition, if Acquiring is only buying some of the assets of Target, and Target is a consolidated subsidiary, the election allows Target to distribute the "unwanted" assets to its parent corporation on a tax-free basis.[71] As a result, if the parties agree to the tax results of a sale of assets of a consolidated subsidiary, a stock sale and (h)(10) election is feasible even when some of the Target assets will be left behind in the selling group.

F. Allocation of Purchase Price

In a transaction intended to be a sale of assets for tax purposes, the purchase price (including assumed liabilities) must be allocated among the purchased assets.[72] This allocation determines the amount of gain or loss that Target has on each asset, and the tax basis that Acquiring receives in each asset. The allocation must be made by placing each asset into one of seven categories (starting with cash equivalents and ending with goodwill and going concern value). The purchase price is allocated to the assets in each category in sequence, up to the value of the assets in each category, until the purchase price runs out.[73] The effect is that to the extent the purchase price exceeds the value of all assets other than goodwill and going concern value, the remaining price is allocated to goodwill and going concern value (the so-called "residual category") and is eligible for 15-year amortization.[74] This method of allocation is referred to as the "residual method." In a typical asset purchase, a significant portion of the purchase price is allocated to the residual category.

69. Treas. Reg.§ 1.338(h)(10)-1(d)(3)(i) (5th sentence).
70. *Id.* (6th sentence); Treas. Reg. § 1.338-2(c)(10).
71. Treas. Reg. § 1.338(h)(10)-1(e) ex.2.
72. I.R.C. § 1060(a); Treas. Reg. §§ 1.338(h)(10)-1(d)(2), (3).
73. Treas. Reg. § 1.338-6 (procedure for section 338(h)(10) election); Treas. Reg. § 1.1060-1(a)(1) (adopting the same procedure by cross-reference for other purchases of the assets of a business).
74. I.R.C. § 197.

The principal factual uncertainty as to the allocation of price among the assets is the value of the assets in each of the categories other than the residual category. There is no legal requirement that Target and Acquiring take consistent positions on their respective tax returns, and therefore each could in principle take a different position favorable to itself. However, if they do so, the IRS is likely to discover this fact[75] and protect itself by challenging the positions taken by both parties. This would be undesirable for both.

To avoid this result, acquisition agreements almost always provide that the parties will attempt to agree on an allocation of price among the assets within a relatively short time after the closing of the transaction. If they cannot agree, the agreement will often require the parties to submit to binding arbitration. The agreement will also generally provide that the allocation that is agreed to by the parties or determined by arbitration will be binding on the parties for purpose of filing their own tax returns.

In reality, the particular allocation often will not matter to Target. Corporations are taxed at the same rate on capital gain and ordinary income, so Target may not care whether a greater amount of purchase price is allocated to an asset giving rise to capital gain or to an asset giving rise to ordinary income. Target may care in some cases, however, such as where it has unrelated capital losses that can only be used to shelter capital gains.[76] In that case, Target will prefer to take the position that the capital assets it is selling have a high value, and the ordinary income assets it is selling have a low value, in order to maximize the resulting capital gain.

The allocation usually matters more to Acquiring, because the allocation determines the speed at which Acquiring can claim depreciation and amortization deductions. Acquiring will prefer to allocate as much purchase price as possible first to inventory where the tax basis can be recovered quickly, next to other assets such as equipment with the shortest depreciable lives, and last to nondepreciable assets such as land. Consequently, Acquiring will try to negotiate for as much flexibility as possible in determining an allocation of purchase price that will be binding on Target.

75. IRS Form 8594 (Feb. 2006) and IRS Form 8883 (Dec. 2008) must be filled out by both sides to an asset sale and (h)(10) transaction, respectively. Both forms ask for the name and identifying information for the other party, and IRS Form 8594 also asks whether the allocations listed on the form were agreed to by the parties.

76. I.R.C. § 1211(a).

G. *Contingent Purchase Price*

A stock or asset purchase may involve additional payments to the Shareholders if specified conditions are satisfied, such as the Target business doing well in the hands of Acquiring. For tax purposes, a portion of such a payment will be considered imputed interest, based on the period of time from the closing date to the date of the payment.[77] The remainder of each payment is considered additional purchase price. Acquiring will increase its tax basis in the acquired stock or assets by this amount when each payment is made. In the case of an asset purchase, additional amortization deductions relating to that increase in basis will begin at that time.

The tax treatment of Shareholders in a transaction treated as a stock sale, or of Target in the case of a transaction treated as an asset sale, is more complex. Depending on the circumstances, the Shareholders or Target, as applicable, may be permitted or required to (1) disregard the payments until they are made, and then treat them as additional taxable purchase price,[78] (2) include the expected present value of the payments as additional taxable purchase price at the time the transaction closes,[79] or (3) elect the "installment method" for the sale.[80] Under the first two methods, the seller's tax basis can be used in full to reduce the upfront gain. Under the installment method, each payment is taxable when received, but the seller's tax basis must be allocated to each payment rather than being used in full to offset the initial taxable gain.[81]

H. *State and Local Tax Considerations*

State and local income and franchise taxes are generally based on federal taxable income. As a result, a transaction will generally be treated in the same manner for state and local purposes as it is for federal purposes. In particular, states will generally respect an (h)(10) election and treat the transaction in accordance with the federal characterization.

However, many state and local jurisdictions impose sales, documentary, or similar transfer taxes on the sale of certain categories of assets. For example, a sales tax might apply to the sale of tangible personal property other than inventory held for resale. In addition, many states impose real property transfer taxes. In general, these state transfer

77. *Id.* § 1274.
78. Treas. Reg. § 1.1001-3(g)(2)(ii) (allowing this method in the "rare and extraordinary circumstances" where the value of the contingent payment is not readily ascertainable).
79. *Id.*
80. I.R.C. § 453.
81. Treas. Reg. § 15A.453-1(c).

taxes are based entirely on the form of the transaction, and they do not apply to the sale of stock where the legal title to the property does not change. For example, they would not generally apply to an (h)(10) transaction. They might also not apply to a transfer of assets by operation of law pursuant to a merger of Target into Acquiring or a subsidiary of Acquiring.

Nevertheless, some states such as New York now impose a real property transfer tax, based on the value of real property located in the state, in the event of a transfer of a controlling stock interest in the corporation that owns the property.[82] These taxes would apply to a sale of the Target stock, whether or not an (h)(10) election was made.

IV. TAX-FREE REORGANIZATIONS

This Part discusses the requirements and acquisition structures for tax-free reorganizations. There are several different types of reorganization. Part IV.A describes the requirements that apply to all reorganizations. Parts IV.B and IV.C describe the different types of reorganizations and the additional requirements, if any, that apply to each type. Part IV.D describes a non-reorganization technique that reaches similar results.

It should be emphasized that many of the requirements for a reorganization are quite arbitrary and form-driven. It is impossible to rationalize the different requirements for different types of reorganizations. Nevertheless, the rules are quite specific, and a minor breach of any of the requirements will disqualify a transaction as a reorganization.

A. *General Requirements for Reorganizations*

1. Continuity of Interest

As noted above,[83] at least 40% of the value of the total consideration issued in a reorganization must consist of stock of Acquiring. If the acquisition agreement provides for fixed consideration for the Target stock, the Acquiring stock must be valued on the day before the acquisition agreement is signed.[84] Consequently, if the 40% test is satisfied on that day, a decline in value of the Acquiring stock thereafter and before the closing will not cause the 40% test to be violated. However, if the acquisition agreement provides for a contingent adjustment to the consideration based on a change in value of

82. *See, e.g.*, NEW YORK TAX LAW § 1401(b), (e) (McKinney 2012).
83. *See supra* Part II.A.
84. Treas. Reg. § 1.368-1(e)(2)(i).

Acquiring stock occurring between the signing and closing, in some situations the 40% test will be based on the value of the Acquiring stock at the time of closing.[85]

For stock to count favorably towards the 40% test, Acquiring (or its affiliates) cannot have a plan to buy back that stock after the transaction.[86] If Acquiring is publicly traded, it is allowed to buy back its stock on the open market pursuant to a general stock repurchase program, as long as the program was not negotiated in advance with Target, and as long as Acquiring cannot tell whether it is buying back stock from a former Shareholder of Target.[87] There is no restriction on the ability of a Shareholder to have a plan, or even a binding contract, before the acquisition to sell the stock of Acquiring after the acquisition, as long as the sale will not be to Acquiring or an affiliate of Acquiring.[88]

Preferred stock of Acquiring counts towards the 40% continuity test, just like any other stock. However, if the preferred stock is nonparticipating and has either a maturity of 20 years or less, certain put/call features within 20 years, or a floating dividend rate, it will be treated as boot to the Shareholders and taxable to them just like cash.[89] As a result, such preferred stock is rarely used.

2. Continuity of Business Enterprise

Acquiring must intend to continue a significant historic business of Target, or to use a significant amount (e.g., one-third) of Target assets in the same or a different business.[90]

3. Business Purpose

A reorganization requires a corporate level business purpose, as opposed to a purpose primarily to benefit the shareholders of Target or Acquiring.[91] As a practical matter, this test is easily satisfied except in very extreme cases where, for example, the only reason for the transaction is estate planning for a major shareholder of Target.

85. Treas. Reg. §§ 1.368-1(e)(2)(iii), (v) ex.10. An adjustment based on changes in value of the Target stock does not generally change the valuation date for the Acquiring stock. *Id.* ex.11-12.
86. *See* Treas. Reg. §§ 1.368-1(e)(1), (3).
87. *See* Rev. Rul. 99-58, 1999-2 C.B. 701.
88. Treas. Reg. § 1.368-1(e)(8) ex.1(i).
89. I.R.C. §§ 351(g), 354(a)(2)(C)(i).
90. Treas. Reg. § 1.368-1(d).
91. Treas. Reg. § 1.368-1(b) (transaction must be "required by business exigencies").

4. Subsequent Transfers of Assets

In general, Acquiring is permitted to move the Target stock or assets around within its corporate group. These rules have been liberalized in recent years, although it is still generally impermissible to move assets to a less-than-80% owned corporate subsidiary or, in some cases, to a partnership.[92]

Specific kinds of reorganizations have additional requirements. Reorganizations can be divided into two categories, those where Target stays alive and those where Target is merged or liquidated out of existence. These categories are discussed separately below.

B. Reorganizations Where Target Stays Alive

1. "(a)(2)(E)" Reorganization

An "(a)(2)(E)" reorganization[93] requires that a first tier corporate subsidiary of Acquiring, usually a newly formed subsidiary, merge into Target, with Target surviving. The Shareholders receive the merger consideration, and Acquiring ends up owning all the stock of Target. At least 80% of the consideration must consist of voting stock of Acquiring.[94] There is no requirement that each new share have the same voting power as other outstanding stock of Acquiring, so "high vote/low vote" structures are permissible.

In addition, Target must retain "substantially all" its assets as part of the transaction.[95] This means in effect that it cannot pay substantial dividends or make substantial stock redemptions before the reorganization that are part of the same plan. IRS ruling guidelines define "substantially all" to mean 90% of the net assets and 70% of the gross assets of Target.[96] If Target sells assets before the transaction, this will not count against the "substantially all" requirement as long as the proceeds of the sale are retained by Target.[97] Likewise, a sale of assets after the transaction does not violate the test as long as Target retains the cash proceeds.[98] Subject to the "substantially all" limit, Target may

92. Although Treas. Reg. § 1.368-2(k) allows a dropdown of assets to a less-than-80% owned corporate subsidiary, such assets would no longer count towards satisfaction of the continuity of business enterprise requirement in Treas. Reg. § 1.368-1(d). Therefore, the dropdown would not be permissible unless that requirement could be satisfied without taking those assets into account.

93. I.R.C. §§ 368(a)(1)(A), (2)(E).

94. *Id.* §§ 368(a)(2)(E)(ii), (c).

95. *Id.* § 368(a)(2)(E)(i).

96. Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.01.

97. Rev. Rul. 88-48, 1988-1 C.B. 117.

98. *See* Rev. Rul. 2001-25, 2001-1 C.B. 1291.

redeem stock with its own funds prior to the merger, and that stock will be disregarded in determining whether the foregoing 80% test for an "(a)(2)(E)" is satisfied.[99]

2. "B" Reorganization

A "B" reorganization[100] requires that Acquiring acquire the Target stock "solely" for voting stock of Acquiring. It can be accomplished by a direct acquisition of the Target stock by Acquiring, or by a first tier corporate or LLC subsidiary of Acquiring, in exchange for Acquiring stock. Alternatively, Acquiring (or a first tier subsidiary) can set up a new subsidiary that merges into Target, with the Shareholders receiving stock of Acquiring.[101]

A "B" reorganization is stricter than an "(a)(2)(E)" reorganization in that even $1 of boot will disqualify the "B" reorganization. On the other hand, the requirements for a "B" reorganization are more liberal than for an "(a)(2)(E)" reorganization because the stock can be acquired without a merger. In addition, there is no "substantially all" requirement for a "B" reorganization. This allows Target to redeem stock for cash as part of the reorganization without being limited by the "substantially all" test. As long as the cash does not come directly or indirectly from Acquiring, the "solely for voting stock" requirement for a "B" is not violated.[102] As in an "(a)(2)(E)" reorganization, high vote/low vote structures are allowed.

3. Structuring Issues

These rules demonstrate that, in order for Target to stay alive in a tax-free reorganization, at least 80% of the consideration must be in the form of voting stock of Acquiring. If this condition is not met, the only possibilities for a tax-free reorganization are those discussed below where Target liquidates or is merged out of existence.

If all the consideration paid to Shareholders will be voting stock of Acquiring, the transaction can be done as either a "B" or an "(a)(2)(E)" reorganization. The Shareholders are indifferent between a "B" and an "(a)(2)(E)." However, Acquiring would often prefer that the transaction be a "B" reorganization. This is because in a "B", its tax basis in Target stock will be the same as the tax basis of the former Shareholders in Target stock,[103] but in an "(a)(2)(E)," its basis in Target stock will be

99. Treas. Reg. § 1.368-2(j)(6) ex.3.
100. I.R.C. 368(a)(1)(B).
101. *See* Rev. Rul. 67-448, 1967-2 C.B. 144.
102. *See* Treas. Reg. § 1.368-2(j)(6) ex.5.
103. I.R.C. §§ 362(b), 358(e).

Target's net basis in its assets.[104] At least in the public company context, the former is usually higher than the latter.

In this situation, the form of the transaction will almost always be the merger of a subsidiary of Acquiring into Target. That merger might qualify as both a "B" and an "(a)(2)(E)" reorganization.[105] However, if for some reason a small amount of boot is deemed to exist, and so the transaction will not qualify as a "B" reorganization, it can still qualify as an "(a)(2)(E)," because there will likely not be more boot than is permitted in an "(a)(2)(E)" reorganization. This provides a fallback position to protect the Shareholders from taxability even if the transaction fails as a "B" reorganization. This fallback protection would not exist in an attempted "B" reorganization that did not involve a merger, because an "(a)(2)(E)" reorganization requires a merger.

Another important feature of both a "B" and "(a)(2)(E)" reorganization is that if for any reason the transaction fails to qualify as a reorganization, the Shareholders are taxable but there is no corporate level tax. Target stays alive with its own assets, and so there is no transfer of assets that would be taxable in a failed reorganization.

C. Reorganizations Where Target Goes out of Existence

1. "A" Reorganizations

An "A" reorganization[106] is a direct statutory merger of Target into Acquiring, or a consolidation of Acquiring and Target into a new corporation.[107] Alternatively, Target may merge into an LLC directly and wholly owned by Acquiring, because the LLC is disregarded for tax purposes and is treated as part of Acquiring.[108]

An "A" reorganization has no requirements in addition to the basic requirements for a reorganization. In particular, it is enough for 40% of the consideration to be stock, the stock does not have to be voting stock, and there is no "substantially all" requirement.[109]

2. "(a)(2)(D)" Reorganizations

An "(a)(2)(D)" reorganization[110] is similar to an "A" reorganization, except that Target merges into a wholly owned first tier corporate

104. Treas. Reg. § 1.358-6(c)(2)(i)(A).
105. In that case, P can choose whichever tax basis it wishes to have in the Target stock. Treas. Reg. § 1.358-6(c)(2)(ii).
106. I.R.C. § 368(a)(1)(A).
107. Treas. Reg. § 1.368-2(b)(1)(ii).
108. *See* Treas. Reg. § 1.368-2(b)(1)(iii) ex.2.
109. I.R.C. § 368(a)(1)(A).
110. *Id.* §§ 368(a)(1)(A), (2)(D).

subsidiary of Acquiring, or into an LLC wholly owned by a first tier corporate subsidiary.[111] In this case, the usual minimum of 40% stock consideration applies. However, the "substantially all" requirement applies in this case.[112]

3. "C" Reorganizations

A "C" reorganization[113] is a transfer by Target of substantially all its assets to Acquiring, or a subsidiary of Acquiring, in exchange for voting stock of Acquiring, followed by the liquidation of Target and distribution of the Acquiring stock to the Shareholders. Boot of up to 20% may be permissible, depending on the amount of Target liabilities assumed by Acquiring in the transaction.[114]

4. Structuring Issues

A "C" reorganization is rarely used today. The requirements are much more restrictive than those for an "A" reorganization, and the end result is the same. In practice, a "C" reorganization is primarily useful when the transaction requires a transfer of assets from Target to Acquiring without the existence of a statutory merger or consolidation. In that situation, the only kind of reorganization that is available is a "C" reorganization.

Putting aside "C" reorganizations, an "A" or an "(a)(2)(D)" reorganization, as opposed to a "B" or "(a)(2)(E)" reorganization, is necessary when less than 80% of the consideration will be in the form of voting stock of Acquiring. However, they can be used even if 80% or more of the consideration is in this form.

As to the form of an "A" or "(a)(2)(D)" reorganization, an "A" merger into an LLC owned by Acquiring, or an "(a)(2)(D)" merger into a corporate subsidiary of Acquiring, will often be preferable to an "A" merger directly into Acquiring. Either of the first two alternatives might avoid the need for a vote of the Acquiring shareholders under state corporate law, although a vote might be required anyway under federal securities laws or stock exchange rules on account of the issuance of Acquiring stock in the merger. A merger into a subsidiary of Acquiring also means that Acquiring does not become liable for any liabilities of Target.

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111. *See* Treas. Reg. § 1.368-2(b)(1)(iii) ex.4.
112. I.R.C. § 368(a)(2)(D).
113. *Id.* § 368(a)(1)(C).
114. If the liabilities of Target assumed by Acquiring equal or exceed 20% of the value of the Target assets, no boot is allowed. If such liabilities are less than 20% of the value of the Target assets, boot equal to the difference is allowed. *Id.* § 368(a)(2)(B).

As to the choice between merging into an LLC subsidiary of Acquiring or into a corporate subsidiary of Acquiring, the "A" merger into the LLC avoids the need to satisfy the "substantially all" test that is required for an "(a)(2)(D)" merger into a corporate subsidiary. If it is desired that the Target business be conducted through a corporate subsidiary, an "A" merger into an LLC is still practical, because it can be followed by the immediate conversion of the LLC into a corporation, or by the immediate transfer by Acquiring of the LLC to a corporate subsidiary of Acquiring.

It is particularly important to be sure that the reorganization rules are satisfied in an "A" or "(a)(2)(D)" (or "C") reorganization. Such a reorganization is treated for tax purposes as the transfer by Target of its assets to Acquiring, or to an Acquiring subsidiary, in exchange for stock of Acquiring and possibly cash, followed by the liquidation of Target. If the reorganization rules are satisfied, Target is not subject to tax on account of any of these transactions.[115]

However, if one of these transactions fails for any reason to qualify as a reorganization, the potential tax liability is much greater than in a failed "B" or "(a)(2)(E)" reorganization. Absent the protection of the reorganization rules, Target is deemed to sell all of its assets to Acquiring or an Acquiring subsidiary in a fully taxable transaction, and then to liquidate in a taxable liquidation.[116] Thus, not only would the Shareholders be taxable on the deemed taxable liquidation of Target, as in a failed "B" or "(a)(2)(E)," but Target itself could be subject to substantial corporate level tax.

This risk of corporate level tax in a failed "A" or "(a)(2)(D)" reorganization can be avoided by a small change in the structure. First, Acquiring sets up a new corporate or LLC subsidiary that merges into Target, with Target surviving. The Shareholders receive the same consideration in this merger that they would have received in the more typical structure. Second, and immediately afterwards, Target merges into Acquiring (its new parent) or an LLC or corporate subsidiary of Acquiring. The end result is exactly the same as in the "one-step" "A" or "(a)(2)(D)" reorganization. If the usual conditions for those reorganizations are satisfied, the transaction qualifies as such under step-transaction principles.[117]

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115. *See supra* Part II.B.

116. *See* Rev. Rul. 69-6, 1969-1 C.B. 104.

117. *See* Rev. Rul. 2001-46, 2001-2 C.B. 321. The ruling involves a second step merger into Acquiring that, combined with the first step, would qualify as an "A" reorganization. The same principles should apply if the second step merger is into an LLC subsidiary of Acquiring (which should likewise be an "A") or into a corporate subsidiary of Acquiring (which should likewise be an "(a)(2)(D)").

However, if for any reason the conditions for an "A" or "(a)(2)(D)" reorganization are not satisfied, the initial merger of the Acquiring subsidiary into Target is treated separately as a taxable purchase by Acquiring of the Target stock, and the second step is treated as a tax-free liquidation or merger of Target within the Acquiring group.[118] As a result, the Shareholders are still taxable if the transaction does not qualify as a reorganization, but Target is not taxable. Thus, there is no risk of corporate level tax for a failed reorganization, just as there is no risk in a "B" or "(a)(2)(E)" reorganization.

This structure is slightly more complicated to accomplish and much more complicated to explain. Some tax counsel believe this structure is a cheap insurance policy against corporate level tax and use it routinely for "A" or "(a)(2)(D)" reorganizations. Others use it only when there is an identified risk, however small, about the qualification of the transaction as a reorganization.

D. The "Double Dummy" Structure

One additional structure is sometimes used to combine Acquiring with Target. This structure is sometimes used for a "merger of equals," where neither party wants to be viewed as being acquired by the other. Alternatively, because this structure does not require compliance with the rules for tax-free reorganizations, it can be used when a tax-free transaction is desired but the requirements for a tax-free reorganization are not available. For example, it can be used when it is necessary or desirable to keep the Target corporation alive, but less than 80% of the consideration for the Target stock will be voting stock of Acquiring.

While variations on this structure are possible, in the simplest situation, a new parent corporation is created ("New Parent") with a temporary owner. New Parent sets up two new directly and wholly owned corporate or LLC subsidiaries (the "Double Dummies"). One of the Dummies merges into Target, and the other Dummy merges into Acquiring. Target and Acquiring are the surviving corporations, and both are then wholly owned by New Parent. The shareholders of Target and Acquiring receive stock of New Parent and possibly cash in exchange for their stock in Target and Acquiring, respectively.

Often the shareholders of Acquiring will receive solely voting stock of New Parent, and this aspect of the transaction would qualify as a "B" or "(a)(2)(E)" reorganization in which New Parent acquires Acquiring. Depending on the facts, New Parent's acquisition of Target might qualify under the same sections. However, this structure is very flexible in that

118. *Id.*

it works even if the acquisition by New Parent of Target (or even of Acquiring) would not qualify as a reorganization, for example because more than 20% of the consideration payable to the Shareholders is cash.

Under this structure, there is no risk of corporate level tax because Acquiring and Target remain alive. Moreover, even if the acquisition of Acquiring or Target does not qualify as a reorganization, it is nevertheless tax free to the Acquiring shareholders and to the Shareholders on account of section 351.[119] Under that section, transferors who transfer property to a corporation are not taxed on the receipt of stock of the transferee corporation, as long as the transferors own 80% of the transferee corporation after the transfers. Here, the Target and Acquiring shareholders transfer their shares in Target and Acquiring to New Parent, and collectively some or all of those shareholders end up owning 100% of the stock of New Parent, no matter how much cash they also receive. As a result, section 351 applies, and the transferring shareholders are taxed only on the cash they receive, up to their gain on the transferred stock.[120]

As noted, this transaction is somewhat complicated, and not every Acquiring will be willing to have a new holding company placed above it, particularly if it is a public corporation. Variations on this structure may also be possible, such as where Acquiring merges into New Parent (or an LLC owned by New Parent) rather than becoming a subsidiary of New Parent.[121] This structure and its variations are useful when the usual rules for a reorganization cannot be satisfied.

E. Foreign Transactions

This article is primarily about a domestic Acquiring corporation acquiring a domestic Target corporation. In general, the same rules apply if both Acquiring and Target are foreign. In that regard, a merger or amalgamation under foreign law is a good merger for purposes of an "A" or "(a)(2)(D)" reorganization.[122] Consequently, a Shareholder that is a U.S. person will not be subject to tax on the receipt of Acquiring stock in a transaction that qualifies under the U.S. reorganization rules.[123] However, a U.S. Shareholder that ends up owning five percent or more of a non-U.S. Acquiring corporation will receive tax-free treatment only if it files a so-called "gain recognition agreement," requiring the

119. *See* Rev. Rul. 84-71, 1984-1 C.B. 106.
120. I.R.C. § 351(b).
121. *See* Rev. Rul. 76-123, 1976-1 C.B. 94.
122. *See* Treas. Reg. § 1.368-2(b)(1)(iii) ex.13-14.
123. Treas. Reg. § 1.367(a)-3(b)(1)(i).

Shareholder to pay tax on the initial exchange if Acquiring disposes of the Target business within five years.[124]

Additional rules apply if Acquiring is foreign and Target is domestic. In that case, even if the general requirements for a tax-free reorganization are satisfied, the transaction cannot be a tax-free reorganization unless a number of additional conditions are satisfied.[125] One significant requirement is that Acquiring must have a fair market value at least equal to Target's fair market value on the acquisition date.[126] Market capitalization is usually used in applying this test when Acquiring and Target are public companies. This requirement was designed to prevent tax-free expatriations of U.S. corporations abroad, although it has not always been successful.[127] The rules for gain recognition agreements also apply in this situation.[128]

V. OTHER ISSUES ARISING IN ALL TRANSACTIONS

A number of other issues can come up in a taxable or tax-free transaction. Among them are the following.

A. Net Operating Losses

If Target has net operating losses (*i.e.*, losses that cannot be used as current deductions), those losses are subject to a limitation on usage in future tax years if there is a greater-than-50% change in ownership of Target within a three-year period.[129] The annual usage of those losses after such a change in ownership is limited to the value of the Target stock on the change date, multiplied by a tax-exempt, risk-free rate of return, subject to various adjustments.[130] A detailed study is required to determine the annual limit. The annual limit is cumulative, so that if there is not enough income in a future year to allow utilization of losses up to the limit for that year, the unused portion of the limit carries forward to future years.[131]

124. Treas. Reg. § 1.367(a)-3(b)(1)(ii).
125. Treas. Reg. § 1.367(a)-3(c).
126. Treas. Reg. § 1.367(a)-3(c)(3)(iii).
127. To further prevent expatriation, recent legislation provides that if 80% of the stock of Acquiring is issued to former Shareholders of Target, Acquiring will be treated as a U.S. corporation unless specified conditions are satisfied. *See* I.R.C. § 7874(b).
128. Treas. Reg. § 1.367(a)-3(c)(1)(iii).
129. I.R.C. §§ 382(a), (g)(1), (i)(1).
130. *Id.* § 382(b)(1); *see also* IRS Notice 2003-65, 2003-2 C.B. 747 (providing rules that usually result in an increase in the limit).
131. I.R.C. § 382(b)(2).

These rules do not apply if the transaction is treated as an acquisition of Target assets for tax purposes.[132] Then, there is no change of ownership of Target or shifting of losses to Acquiring. Rather, losses of Target can then be used in full to shelter Target's gain on the asset sale. In the case of a transaction treated as a taxable purchase of Target stock for cash, a 50% change in ownership would occur on the purchase date[133] and so the limitations would apply. In the case of a tax-free reorganization, the reorganization would result in a change in ownership of Target to the extent of the reduction in the percentage of direct and indirect ownership held by the Shareholders in Target, taking into account their indirect ownership in Target as a result of their ownership in Acquiring.[134] The reorganization itself would therefore result in a 50% change in ownership of Target if the Shareholders received less than 50% of the total then-outstanding stock of Acquiring.

B. Prior Spin-offs

When a parent corporation ("Distributing") distributes the stock of its subsidiary ("Spinco") to the Distributing shareholders, the distribution will be tax-free to both Distributing and Spinco if the requirements of a tax-free spin-off are satisfied.[135] However, (1) the spin-off requirements will likely not be satisfied if, at the time of the spin-off, the Distributing shareholders have a plan to dispose of their Distributing or Spinco stock in a taxable or partially taxable transaction after the spin-off,[136] and (2) even if the spin-off requirements are satisfied, the distribution will be taxable to Distributing, although not the Distributing shareholders, if, as part of the same plan as the spin-off, there is a 50% or greater change in ownership of either Distributing or Spinco.[137]

Normally there is a tax sharing agreement between Spinco and Distributing under which Spinco will indemnify Distributing for the Distributing tax liability that would arise under clause (2) if there is a 50% change in ownership of Spinco. Moreover, the agreement may give Distributing unlimited or limited veto rights over corporate transactions of Spinco for a one- or two-year period after the spin-off to avoid any tax risk to Distributing.

132. *Id.* § 382(g)(1) (defining an ownership change as a change in stock ownership or an equity structure shift).
133. *Id.* § 382(j)(1).
134. Temp. Treas. Reg. § 1.382-2T.
135. I.R.C. § 355(a)(1) (shareholders); *id.* § 355(c) (Distributing).
136. Treas. Reg. § 1.355-2(d)(2)(iii) (subsequent sale a negative factor in applying the "device" test).
137. I.R.C. § 355(e).

It is beyond the scope of this article to discuss the requirements for a tax-free spin-off. However, it is important for Acquiring to know whether Target was either the "Distributing" or the "Spinco" in a spin-off that occurred as part of the same plan as the proposed acquisition. For example, if Spinco had recently been spun off, tax liability would arise on the spin-off if, as part of the same plan, (1) Acquiring paid any material amount of cash for the Distributing or Spinco stock, or (2) Acquiring acquired Distributing or Spinco even solely for Acquiring stock if the Distributing or Spinco shareholders would end up owning 50% or less of Acquiring (and therefore indirectly 50% or less of Distributing or Spinco). Any event in clause (2) would result in a 50% change of ownership of Distributing or Spinco.[138]

This means, in practice, that if Distributing has announced a plan to spin off Spinco, and Acquiring would like to acquire either Distributing or Spinco after the spin-off, then with one exception discussed below, it is critical for Acquiring not to approach Distributing or Spinco before the spin-off, but rather to wait until after the spin-off is completed to begin discussions. This is necessary, and generally sufficient, to assure that Acquiring's acquisition of Distributing or Spinco is not considered part of the same plan as the spin-off, and therefore preserves the tax-free nature of the spin-off.[139] If Acquiring has had discussions with Distributing or Spinco before the spin-off, it is generally necessary for Acquiring to wait six months or one year after the spin-off in order to begin discussions anew without concern that the subsequent transaction might be considered part of the same plan as the spin-off.[140] By contrast, any competing acquiror that did not begin discussions with Distributing or Spinco until the day after the spin-off would not be subject to this limitation.

On the other hand, the spin-off rules are not violated if Distributing or Spinco is acquired by Acquiring after the spin-off as part of the same

138. Likewise, if Acquiring was the distributing or spun-off corporation in a prior spin-off, and its acquisition of Target was part of the same plan as the spin-off, it is important that the issuance of stock by Acquiring not result in a 50% change of ownership of Acquiring.

139. Treas. Reg. § 1.355-7(b)(2) (no "plan" for subsequent acquisition exists at time of spin-off if no agreement, arrangement or substantial negotiations for a similar acquisition occurred in the two years prior to the spin-off). The "device" test referred to in *supra* note 136 is also generally considered inapplicable if this condition is met.

140. Treas. Reg. § 1.355-7(d)(3) (safe harbor if no understanding at time of spin-off and subsequent negotiations do not begin until a year after the spin-off); *id.* § 1.355-7(d)(1) (safe harbor if good business purpose for spin-off and no substantial negotiations in period between one year before and six months after the spin-off). If no safe harbor in Treas. Reg. § 1.355-7(d) is available, it is generally advisable to wait for two years after the spin-off to begin discussions in order to avoid the presumption of a plan contained in I.R.C. § 355(e)(2)(B).

plan as the spin-off, where the consideration for the Distributing or Spinco stock is entirely Acquiring stock that represents more than half the then-outstanding stock in Acquiring. In that case, the old Distributing shareholders retain a greater than 50% direct or indirect interest in both Distributing and Spinco, and so there is not a 50% change in ownership of Distributing or Spinco as a result of the acquisition. Therefore, assuming no other "bad" changes in ownership of Distributing or Spinco as part of the same plan as the spin-off, the parties can agree to this transaction before the spin-off is completed.

If Acquiring acquires Distributing in this manner, the transaction is known as a "Morris Trust" transaction (after the name of the case that authorized it).[141] If Acquiring acquires Spinco in this manner, the transaction is known as a "reverse Morris Trust" transaction (for obvious reasons).

VI. CONCLUSIONS

This article only scratches the surface in describing the tax rules applicable to taxable and tax-free acquisitions. These rules are the subject of many lengthy treatises, as well as innumerable articles contained in a large number of daily, weekly, monthly, and quarterly tax publications. In addition, new tax regulations and rulings are issued by the Treasury Department and IRS on an almost daily basis.

A corporate lawyer in most cases would not have the slightest interest in learning all the detailed tax rules and keeping up with the changes in the rules. However, having a general familiarity with the basic underlying tax principles makes it easier to understand the reasons for the structures that the tax lawyer is proposing. It also facilitates discussions with a tax lawyer to develop structures that work from both a corporate and tax point of view. But to close this article where it began, a little knowledge is a dangerous thing, and the corporate lawyer needs to understand most of all the importance of consulting with a tax lawyer at all stages of a transaction.

141. Comm'r v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).