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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT RESPONDING TO REV. RUL. 2001-46, DEALING WITH MULTI-STEP ACQUISITIONS

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REPORT RESPONDING TO REV. RUL. 2001-46, DEALING WITH MULTI-STEP ACQUISITIONS

This report[1] has been prepared in response to Rev. Rul. 2001-46,[2] which requests comments on whether regulations should be issued (i) reflecting the principles of Rev. Rul. 2001-46, and (ii) allowing taxpayers to make a valid election under section 338(h)(10)[3] with respect to a step of a multi-step transaction that, viewed independently, is a qualified stock purchase if such step is pursuant to a written agreement that requires, or permits the purchasing corporation to cause, a section 338(h)(10) election to be made in respect of such step.[4]

We commend the IRS on its recent guidance with respect to the step transaction doctrine as applied to multi-step acquisitions. Rev. Rul. 2001-46 is the latest in a long history of rulings and cases dealing with the integration of two steps in a multi-step acquisition.[5] The question presented in these transactions is whether a first step stock acquisition and second step asset acquisition should be integrated (pursuant to the application of the step-transaction doctrine) in determining whether the transaction is taxable or tax-free. In some cases, the steps are amalgamated (pursuant to the application of the step transaction doctrine) in determining the

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1 This report was prepared by members of the Committee on Reorganizations of the New York State Bar Association. The principal drafter was Gary B. Mandel. Helpful comments were received from Samuel J. Dimon, Ralph A. Gerra, Jr., Kathleen L. Ferrell, Michael L. Schler and Diana L. Wollman.

2 2001-42 I.R.B. 321.

3 Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended to date.

4 The IRS and Treasury apparently are also interested in comments about situations where taxpayers want to make a section 338(g) election, or where taxpayers make no section 338 election at all. See Step Transaction Doctrine Tested Under Corporate Rulings, 2001 TNT 196-3 (statement made by Treasury's Audrey Nacamuli at a D.C. Bar Taxation Section Corporate Tax Committee on October 9, 2001). This report addresses these situations.

5 *See, e.g.*, Kimbell-Diamond v. Commissioner, 14 T.C. 74 (1950); Rev. Rul. 67-274, 1967-2 C.B. 141; King Enterprises v. Commissioner, 418 F. 2d 511 (Ct. Cl. 1969); Treas. Reg. sec. 1.338-3(d); Kass v. Commissioner, 60 T.C. 218 (1973); Yoc Heating v. Commissioner, 61 T.C. 218 (1973); Rev. Rul. 90-95, 1990-2 C.B 67; J.E. Seagram v. Commissioner, 104 T.C. (1995); Rev. Rul. 2001-26, 2001-23 I.R.B. 1297.

tax consequences, while in other cases each step will be respected in evaluating the tax consequences. In resolving these seemingly disparate approaches, Rev. Rul. 2001-46 and, in part, its companion Rev. Rul. 2001-26[6], have established the rule that the two steps are integrated if the result would be a tax-free asset reorganization.

While this rule is admirable for its simplicity, we think it is unnecessarily rigid in preventing taxpayers, with respect to "qualified stock purchases", from choosing taxable asset treatment by making an election under either section 338(h)(10) or section 338(g). We believe allowing a section 338 election to "turn off" the step transaction doctrine is consistent with Congressional intent in this area of the law and presents no significant risk of unexpected consequences to (or inconsistent reporting by) affected taxpayers. This is clearest in the case of an election under section 338(h)(10), which requires a joint election by the selling group and the purchaser. In the case of an election under section 338(g), the theoretical risk is that target shareholders might not anticipate or be aware of the election and might report the transaction as a tax-free asset reorganization. In our experience, taxpayers take great precautions in drafting tax provisions in agreements when their intent is for the transaction to be tax-free.[7] We are convinced that in practice there are sufficient safeguards for tax-free treatment, where that is intended, and that no special rules are needed to ensure consistent reporting. We also believe the rule, as modified by our recommendations, should be set forth in regulations so taxpayers need not resort to analyzing the many potentially relevant rulings and cases.

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[6] 2001-23 I.R.B. 1297.

[7] It is typical for transaction documents, in cases where tax-free treatment is intended, to (i) provide a statement that the parties intend for the transaction to be treated as a tax-free reorganization,(ii) covenants that prohibit the parties from entering into transactions that would adversely effect the qualification of the transaction as a tax-free reorganization and (iii) closing condition opinions of counsel that the transaction will qualify as a tax-free transaction. In addition, in public deals, the SEC requires opinions of counsel if the transaction is tax-free to the shareholders. SEC Reg. S-K, 17 CFR sec. 229.601. Conversely, the SEC does not require an opinion of counsel when the transaction is taxable; in other words, taxable transactions are the norm.

Recommendations

(1) We support issuing regulatory guidance that would allow taxpayers affirmatively to elect to treat the first and second step of a multi-step transaction as separate and independent transactions provided that the first step by itself is a qualified stock purchase and an election under section 338(g) or section 338(h)(10) is made with respect to such qualified stock purchase.[8] We do not believe that the election needs to be evidenced in a written agreement between buyer and seller for proper administration of this proposed rule.

(2) We believe the regulations should contain a set of examples reflecting the consequences of certain multi-step acquisitions. The examples should be based on the many revenue rulings and the case law in this area and should incorporate our recommendations with respect to section 338 elections.

(3) We considered whether a first step that qualifies by itself as a qualified stock purchase would be sufficient to prevent integration of the first and second steps of a two-step transaction where integration would produce a tax-free asset reorganization. We rejected such approach as it does not have the same safeguards against inconsistent positions as does an election under section 338, or the same legal support in the legislative history as does an election under section 338 .

(4) We considered whether a first step that by itself is a tax-free transaction would be sufficient to prevent application of the step transaction doctrine if the integrated transaction would be a taxable transaction. We rejected such approach as inconsistent with long-standing legal precedents.

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[8] As discussed below, no such election should be required to "turn off" step transaction treatment where integration of a first step stock acquisition with a second step would not produce a tax-free asset reorganization.

Background

As a general principle, the step transaction doctrine is necessary to ensure that a transaction will be taxed according to its substance.[9] However, it is often difficult for taxpayers to determine with any degree of certainty whether the step transaction doctrine should apply to a particular set of facts. Moreover, the unwary taxpayer may find itself facing a step transaction analysis due to lack of precaution in effectuating the steps to a particular multi-step transaction.

If appropriate rules can be created that allow taxpayers to elect to have the form of a transaction control, the application of the step transaction doctrine and its potentially unforeseen consequences should give way to the benefits of certainty and simplicity. While it is no doubt difficult to provide a clear and comprehensive set of rules as to when the step transaction doctrine should apply, we believe it is appropriate to "turn off" the doctrine in certain multi-step acquisitions, provided there is adequate assurance that all taxpayers to the transaction will treat the transaction on a consistent basis.

In the context of multi-step acquisitions, the application of the step transaction doctrine generally results in the first step stock acquisition combined with the second step merger/liquidation being treated as a single integrated asset acquisition. In this context, the step transaction doctrine has been applied to both taxable and tax-free multi-step acquisitions. At one end of the spectrum, a transaction that is structured as a first step tax-free stock acquisition may be treated as a failed tax-free reorganization. At the other end of the spectrum, a first step taxable stock acquisition may be treated as part of a tax-free reorganization. Over the years, a body of law has developed which should be the basis for the promulgation of regulations.

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[9] To qualify as reorganization, the section 368 requirements must be met in both form and substance. See Gregory v. Helvering, 293 U.S.465, 470 (1935); Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). "The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of the transaction." Superior Coach of Florida v. Commissioner, 80 T.C. 895, 905 (1983). Thus, the step-transaction doctrine applies in testing whether separate steps were integrated parts of a single transaction qualifying as a reorganization. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-185 (1942); King Enters. Inc. v. United States, 418 F. 2d 511, 519 (1969); Rev. Rul. 67-274, 1967-2 C.B. 141.

Tax-Free Reorganizations

In Rev. Rul. 67-274,[10] a first step stock acquisition that otherwise qualified as a tax-free reorganization under section 368(a)(1)(B) and a second step liquidation of the acquired company were integrated and treated as a tax-free asset reorganization under section 368(a)(1)(C). In addition, the IRS has, in private letter rulings, consistently applied a step-transaction analysis to two-step acquisitions wherein both steps would, standing alone, qualify as tax-free reorganizations.[11] Moreover, in King Enterprises v. Commissioner[12] and in J.E. Seagram v. Commissioner[13] each court applied the step transaction doctrine to treat a first step tax-free stock acquisition and an integrated second step merger as a tax-free asset acquisition under section 368(a)(1)(A).

Taxable Transactions

Historically, the step transaction doctrine was applied to multi-step taxable transactions, converting a first step taxable stock acquisition into a taxable asset acquisition. In Kimbell-Diamond v. Commissioner,[14] the court held that the purchaser of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should treat the purchase as a purchase of target's assets.[15] Accordingly, under the Kimbell-Diamond doctrine, a taxable stock acquisition followed by a liquidation of the target corporation could be converted into a taxable asset acquisition, through step transaction principles.[16] Prior to the repeal of the

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[10] 1967-2 C.B. 141.

[11] PLR 199915013; PLR 199910038; PLR 9840004; PLR 9831018; PLR 9804038; PLR 9746010; PLR 9539018; PLR 9109055.

[12] 418 F.2d 511 (Ct. Cl. 1969).

[13] 104 T.C. 75 (1995).

[14] 14 T.C. 74 (1950), affd per curiam 187 F.2d 718 (5th Cir. 1951).

[15] Section 334(b)(2) of the Internal Revenue Code of 1954 was added to codify the principles of Kimbell-Diamond v. Commissioner. See S.Rep. No. 1622, 83d Cong. 2d Sess. 257 (1954).

[16] For the target shareholders, the transaction was treated as a sale of stock. The Kimbell-Diamond doctrine has been applied by reference to parent corporation's unilateral act in liquidating target corporation. See Dallas Downtown Development Co. v. Commissioner., 12 T.C. 114 (1949); Bethlehem Steel Co. v. Commissioner., 9 T.C.M. 864 (1950); Vendig v. Commissioner, 229 F.2d 93 (2d Cir. 1956).

General Utilities[17] doctrine, a purchaser could obtain a cost basis in the acquired assets without a cost at the target corporation level. Accordingly, cost basis treatment for the target assets was generally elective dependent upon whether target was liquidated.

Congress recognized that a result based on whether target is liquidated or not is purely a formal distinction that should not obscure the substance of the transaction. As a result, Congress enacted section 338 as an elective regime allowing taxpayers, through a reporting process with the IRS, to treat the acquisition as either a taxable stock or asset acquisition.

Type F Reorganizations are Different

In Rev. Rul. 79-250,[18] the IRS applied the step transaction doctrine to conclude that a reincorporation in another state immediately after a forward triangular merger was treated as a tax-free transaction under section 368(a)(1)(F) (an "F reorganization") because the acquisition and the reincorporation each had significantly meaningful independent economic motivations and therefore were separate and independent steps. In Dunlap & Associates v. Commissioner,[19] the Tax Court held that a reincorporation in preparation for a public offering was an F reorganization because the reincorporation did not depend on the acquisition of the minority interests in the subsidiaries. At first, it seemed that Rev. Rul. 79-250 was establishing a bright-line test in the application of the step transaction doctrine to multi-step transactions. Each step would be respected as a separate transaction for tax purposes if it demonstrated independent economic significance, was not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes. However, in Rev. Rul. 96-29, the IRS limited Rev. Rul. 79-250's impact on the step transaction doctrine by focusing on the uniqueness of the F reorganization.

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17 296 U.S. 200 (1935), repealed by The Tax Reform Act of 1986, Pub. L. No. 99-514 secs. 631-633.

18 1979-2 C.B. 156.

19 47 T.C. 542 (1967).

In Rev. Rul. 96-29, the IRS "turned off" the step transaction doctrine, holding that the reincorporation qualified as an F reorganization without regard to whether the steps would be integrated under step transaction principles. Since an F reorganization involves only one corporation, the reorganization is treated for most purposes as if there were no change in the corporation. The ruling modified Rev. Rul. 79-250, emphasizing that central to the holding in Rev. Rul. 79-250 is the unique status of reorganizations under section 368(a)(1)(F) and that Rev. Rul. 79-250 is not intended to reflect the application of the step transaction doctrine in other contexts.[20]

Enactment of section 338 Changes the Landscape for Taxable Transactions

Following the enactment of section 338 came the first multi-step acquisitions wherein the IRS and Treasury rejected the application of the step transaction doctrine. Citing the Committee reports to the enactment of section 338 that "section 338 replaces any nonstatutory treatment of a stock purchase as a an asset purchase under the *Kimbell-Diamond* doctrine",[21] the IRS held in Rev. Rul. 90-95[22] that a first step taxable stock acquisition of target followed by a liquidation of target would be treated as two separate transactions, namely a stock acquisition followed by a section 332 liquidation. Treasury followed suit with the issuance of Treasury Regulation section 1.338-3(d), providing that a first step taxable stock acquisition of target, followed by a merger of target with and into another first-tier subsidiary of parent, will be treated as two separate transactions, a stock acquisition followed by a tax-free asset reorganization. Target shareholders will have a taxable stock sale and, unless a section 338 election is made, the assets will have a carryover basis in the hands of the acquiring company.

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[20] See also PLR 9623031 (Mar. 7, 1996) (merger and transfer of assets and stock of corporation occurring either before or after re-domestication of corporation will not affect the qualification of the re-domestication as a section 368(a)(1)(F) reorganization); PLR 200103034 (Oct. 18, 2000) (contribution of all assets of a not-for-profit to a for-profit holding company in exchange for all of holding company's common stock will not prevent merger from qualifying as a section 368(a)(1)(F) reorganization).

[21] H.R. Rep. No. 760, 97 Cong. 2d Sess. 536 (1982), 1982-2 C.B. 600, 632.

[22] 1990-2 C.B. 67.

By separating the qualified stock purchase from the subsequent merger, Treasury Regulation section 1.338-3(d) treats parent as the owner of target stock prior to the transfer of target's assets for purposes of testing continuity of interest. Accordingly, the merger will qualify as a tax-free reorganization because, analyzing the merger part of the transaction in isolation, no cash was distributed to the then existing shareholders of target. Effectively, the taxable consideration provided by parent to purchase target stock is ignored and the stock consideration received by parent pursuant to the merger of target will qualify for continuity of interest purposes. However, with respect to any minority shareholders of target, the regulations do not separate the integrated transaction and minority shareholders will have a taxable transaction even if the only consideration they receive is stock.[23]

In Yoc Heating v. Commissioner,[24] the court held that for purposes of determining whether the continuity of interest requirement was met, the integrated stock acquisition and merger must be considered as one transaction. Accordingly, the shareholders of target stock immediately prior to the stock acquisition by parent were the relevant shareholders for testing continuity of interest. Since a majority of those shareholders received cash consideration from parent, continuity of interest was not satisfied. Treasury Regulation section 1.338-3(d) effectively overrules Yoc Heating solely with respect to parent's exchange in the second step merger.

As a result of the foregoing developments, a dichotomy emerged in the application of the step transaction doctrine to multi-step acquisitions—if the first step stock purchase was a tax-free reorganization then the step transaction doctrine could apply to convert the stock transaction into an asset acquisition if integration of the second step resulted in a tax-free asset reorganization. In contrast, if the first step stock acquisition was a qualified stock purchase, then the step transaction doctrine would not apply to convert the stock transaction into

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23 See Kass v. Commissioner., 60 T.C. 218 (1973), affd. 491 F.2d 749 (3d Cir. 1974).

24 61 T.C. 168 (1973).

a taxable asset acquisition. The foregoing authorities also demonstrate that, if one of the steps of a multi-step transaction qualifies as an F reorganization, then such F reorganization transaction will be treated as separate and independent of the other steps in the transaction.

Gaps in Authority Prior to 2001

The tension created by the integration aspects of the step transaction doctrine and the policy of section 338, which provides that steps should not be integrated to produce a taxable asset acquisition, left gaps in the law. As a result, the following multi-step transactions (among others) did not fit squarely into the existing authority: (1) a first step stock acquisition that qualified neither as a tax-free stock reorganization nor as a qualified stock purchase, followed by a second step acquisition that if integrated with the first step would qualify as a tax-free reorganization, and (2) a first step qualified stock purchase that if integrated with the second step asset acquisition would qualify as a tax-free asset reorganization.

The 2001 Revenue Rulings Begin to Fill the Gaps

Rev. Rul. 2001-26[25] concludes that a first step tender offer of Acquiring stock for 51% of Target's stock, followed by a merger of a subsidiary of Acquiring into Target for consideration consisting of one-third cash and two-thirds stock should be integrated and treated as a section 368(a)(1)(A) and 368(a)(2)(E) reverse triangular merger meeting the "control-for-voting-stock" requirement of section 368(a)(2)(E)(ii) (*i.e.*, Acquiring voting stock was used to acquire 83.67% of Target voting stock, and cash was used to acquire 16.33% of Target voting stock). The ruling cites King Enterprises in support of the step transaction analysis. The question left unanswered in Rev. Rul. 2001-26, i.e., the applicability of the step transaction to a first step stock acquisition that is a qualified stock purchase and when combined with the second step would be a tax-free asset reorganization, was dealt with in Rev. Rul. 2001-46.

In Rev. Rul. 2001-46's first step, a corporation ("Parent") acquires all of the stock of Target in a reverse subsidiary merger (the "Acquisition Merger"). The Target shareholders

[25] 2001-23 I.R.B. 1297.

receive consideration, 70% of which is Parent voting stock and 30% of which is cash. In the second step, as part of the plan, Target merges into Parent in a statutory merger (the "Upstream Merger"). The ruling assumes as a factual matter that the step transaction doctrine would apply to treat the Acquisition Merger and the Upstream Merger as a single acquisition by Parent of all of the assets of Target. The first step stock acquisition was a qualified stock purchase and not a tax-free stock reorganization. If integrated with the second step merger, however the combined acquisition would qualify as a tax-free asset reorganization. The ruling holds that the acquisition should be treated as a tax-free asset reorganization.

The ruling considered whether to apply the step transaction doctrine utilized in Rev. Rul. 67-274, King Enterprises and J.E. Seagram or to reject the step transaction pursuant to the policy behind the enactment of section 338 and the principles of Rev. Rul. 90-95 and Treasury Regulation section 1.338-3(d). Neither in Rev. Rul. 90-95 nor in Treasury Regulation section 1.338-3(d) would the integrated transaction have qualified as a tax-free transaction. In Rev. Rul. 67-274, King Enterprises, and J.E. Seagram, none of the transactions involved first-step qualified stock purchases. Accordingly, Rev. Rul. 2001-46 was on unchartered waters.

If the approach reflected in Rev. Rul. 90-95 were adopted *i.e.,* the first step and second step were not integrated, the Acquisition Merger would be treated as a stock acquisition that met the requirements of a qualified stock purchase, because the stock was not acquired in a section 354 or section 356 exchange. The Upstream Merger would qualify as a liquidation under section 332. However, if the approach reflected in Rev. Rul. 67-274 were applied, the transaction would be treated as an acquisition of Target's assets by Parent in a statutory merger qualifying under section 368(a)(1)(A).

The ruling applies the step transaction doctrine and holds that the multi-step transaction would be treated as a tax-free asset reorganization. The ruling concludes that the rejection of the step transaction doctrine in accordance with section 338 and Rev. Rul. 90-95 was not necessary to adhere to the Congressional mandate of precluding any nonstatutory treatment of a multi-step acquisition as an integrated asset purchase, because applying the step transaction doctrine in this case results in a carryover basis in the assets under section 362 and not a cost basis under section 1012. Thus, Rev. Rul. 2001-46 addressed a gap in the law and in so doing amplified Rev. Rul. 67-274 and distinguished Rev. Rul. 90-95.

Cases Still Lacking Direct Guidance

Another set of cases still not squarely addressed by existing authorities involve two-step acquisitions that, if integrated, would not result in a tax-free asset acquisition, but the first step of which, viewed in isolation, could qualify as a tax-free stock acquisition. Assume for instance, that as part of an integrated plan Target distributes certain of its assets that would cause it to fail the "substantially all" test. Thereafter, Parent acquires Target stock for Parent voting stock and liquidates Target in a transaction that is not a state law merger. It would seem that the general approach of Rev. Rul. 67-274 and step transaction analysis would treat the integrated transaction as an asset acquisition, rather than allowing the first step to qualify independently as a tax-free stock acquisition. However, the principles of Rev. Rul. 90-95 and Treas. Reg. section 1. 338-3(d) would preclude treating the integrated transaction as a taxable asset acquisition, absent a section 338 election. This appears to be the prevailing view.[26] In other words, the first step would be treated as a taxable stock acquisition and the assets would have a carryover basis absent a section 338 election.[27]

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26 See Jasper Cummings, Rev. Rul. 2001-46 Revisited, 2002 TNT 25-37 (Feb. 4, 2002); Jerred Blanchard, Reflections on Rev. Rul. 2001-46 and the Continued Vitality of Kimbell-Diamond Doctrine, 2002 TNT 2-34 (Dec. 31, 2001); Gregory Fowler, Practical Transactional Aspects of Rev. Rul. 2001-46, 2001 TNT 219-69 (Nov. 12, 2001), example 7; Step Transaction Doctrine Tested Under Corporate Rulings, 2001 TNT 196-3 (Oct. 9, 2001) (Government officials at a meeting of the DC Bar Taxation Section citing Rev. Rul. 75-521); Ginsburg and Levin, Integrated Acquisitive Reorganizations, 2001 TNT 112-105 (June 8, 2001) example 9; Ginsburg and Levin, Mergers, Acquisitions, and Buyouts para. 702. Views to the contrary—Philip Wright, Step Transaction Doctrine in Corporate Reorganizations, Mergers and Acquisitions (Feb. 2002) p. 3, 11; Robert Willens, Recent IRS Rulings Give Kimbell-Diamond Doctrine Continuing Vitality, DTR (Oct. 22, 2001).

27 Of course in order for a section 338 election to be available, the first step would have to be a qualified stock purchase. This would not be true, for instance, if the first step did not involve the acquisition of a sufficient amount of stock (*e.g.,* where the first step had the form of a "creeping" B reorganization).

Comments

We believe that issuing regulations reflecting (and to some degree modifying) the principles of the step transaction doctrine as espoused in Rev. Rul. 2001-46 would be worthwhile to the extent it provides a greater degree of certainty for taxpayers in structuring routine corporate acquisitions and dispositions and eliminates inconsistencies in administering the tax law. We are concerned, however, that such a regulation project could get bogged down with the uncertain scope of the step transaction doctrine and ultimately prove unwieldy to manage. Trying to capture fully the scope of the doctrine in regulations may only lead to unnecessary complexity and traps for the unwary. If instead the regulations provide (i) taxpayers with the right to "turn off" the step transaction in certain cases, as discussed below, and (ii) a set of examples (see model examples at the end of this report) based on the existing rulings and case law, then such a project could prove helpful as a guide or reference for taxpayers in structuring multi-step acquisitions.

We support regulatory guidance that would allow taxpayers in carefully identified circumstances affirmatively to elect to treat as separate and independent transactions first and second steps that would otherwise be subject to integration. We believe that such an elective regime can be crafted that is consistent with principles of current law and that will provide simplification and certainty to an area of the law that can be complicated and unpredictable. Specifically, we believe that, in the case of a first step stock acquisition that qualifies independently as a qualified stock purchase, but that if integrated with the second step would produce a tax-free asset reorganization, taxpayers should be permitted to make an election under either sections 338(g) or section 338(h)(10) and "turn off" the step transaction doctrine. This approach requires modification of the holding of Rev. Rul. 2001-46.

Permitting such an elective regime furthers the goal of simplification and is consistent with the policy of section 338. So long as the first step would qualify independently as a qualified stock purchase, we see no policy reason to allow the step transaction doctrine, the application of which is often uncertain, to override the availability of a section 338 election, which produces clear and appropriate results.[28] On the other hand, a first step stock acquisition that does not qualify as a qualified stock purchase, and if integrated with the second step asset acquisition would not qualify as a tax-free asset reorganization, should not be integrated so as to be treated as a taxable asset acquisition, since such an application of the step transaction doctrine would violate the Congressional mandate that the section 338 election replaces any non-statutory treatment of a stock purchase as an asset purchase.

We do not believe the regulations need to require that the section 338 election be evidenced in a separate written agreement between buyer and seller. In the context of a section 338(h)(10) election, both the buyer and seller are filing binding elections with the IRS to treat the taxable stock acquisition as an asset acquisition. As a result both the party paying the tax on the sale of assets (i.e., the selling parent corporation) and the party receiving the step-up on the purchase of the assets (i.e., purchaser through its acquisition of target) have affirmatively agreed to be legally bound to report the transaction consistently. Similarly, in the context of a 338(g) election, we believe that the purchasing corporation's election should be sufficient since it is, effectively, both the party paying the tax and the party receiving the step-up in basis on the purchase of the assets.

In the latter case, there is a theoretical risk that target shareholders, expecting the transaction to be tax-free pursuant to step transaction principles, would report on that basis, while the acquirer would file a 338(g) election. We do not believe, however, that target shareholders could plausibly treat a transaction that on its face was a taxable transaction as tax-free, based on step transaction principles, unless the transaction documents provided appropriate assurances that the acquirer would in fact cause the second step to occur and would refrain from taking any step (such as filing a section 338 election) that would preclude treatment of the transaction as a tax-free asset acquisition. It is of course conceivable, but in our judgment extremely unlikely,

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[28] Giving priority to the step transaction doctrine could tend to produce unnecessary transactional complexity, since taxpayers who wanted to ensure that a section 338 election was respected might artificially delay combining the target with the acquirer, or a subsidiary of the acquirer, in order to ensure that the step transaction would not apply.

that an acquirer would breach its commitments to preserve tax-free treatment. This kind of risk is theoretically present in many if not all reorganization contexts, however.[29] In our view it is not a sound reason to deny availability of a section 338(g) election, nor is there reason to impose any special protective rule (e.g. requirements of special written agreements or subsequent notice) in such a situation.

We do not believe, in cases where integration would produce a tax-free asset reorganization, that it is appropriate to reject the step transaction doctrine merely because the first step is a qualified stock purchase if no section 338 election is made. We believe Rev. Rul. 2001-46 handles this situation appropriately and in so doing resolves any apparent disparity between Rev. Rul. 90-95 and Rev. Rul. 2001-26. We also believe that the regulations we suggest would have the collateral effect of adding greater certainty that target shareholders would report the transaction on a consistent basis, i.e., target shareholders who dispose of their shares in the first step of a multi-step transaction would be on notice that the stock transaction will be treated separately from the second step asset acquisition if and only if an election is filed under section 338. The regulation would preclude target shareholders from relying on their interpretation of caselaw or rulings to reach a different conclusion.

The regulations should also deal with the two-step acquisitions that, as discussed above, still are lacking any direct guidance (*i.e.,* a first step that, analyzed separately, would qualify as a tax-free stock reorganization, but that is not part of an integrated tax-free asset reorganization). We believe that application of the step transaction doctrine to these cases to prevent tax-free treatment for the first step is necessary to preserve the integrity of the reorganization rules. On the other hand, the legislative repeal of Kimbell-Diamond precludes treating the integrated transaction as a taxable asset acquisition in the absence of on election under section 338.

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[29] For instance, an acquirer who had indicated that a stock-for-stock acquisition would qualify as a reorganization under section 368(a)(1)(B) could defeat reorganization treatment by purchasing some target shares for cash.

Conclusion

We suggest that regulations be issued providing that multi-step transactions that are part of an integrated plan be governed by the following principles:

(1) the first step stock acquisition would be treated as independent from the second step asset acquisition if the first step, analyzed alone, is a qualified stock purchase and an election is made pursuant to section 338(g) or section 388(h)(10);

(2) absent an election under section 338(g) or section 338(h)(10), the first step stock acquisition would be integrated with the second step asset acquisition if the integrated transaction would qualify as a tax-free asset acquisition;

(3) integration would not be applied if the result would be a taxable asset acquisition, although in such a context step transaction principles would apply for the limited purpose of precluding tax-free treatment for the first step stock acquisition.

Examples

We would suggest that the principles of the regulations be illustrated by the following examples. Other examples may also be appropriate. In each example, it is assumed that the steps are pursuant to an integrated plan.

Example 1. Parent, a domestic corporation, acquires 100% of the stock of Target from Target shareholders in exchange for cash and Parent stock. The exchange is consummated within a 12-month acquisition period. One-half of the Target shareholders exchange their Target stock for Parent stock, while the remaining Target shareholders exchange their Target stock for cash. Immediately after the acquisition, Parent causes Target to merge into Parent pursuant to applicable state law. Parent does not make a section 338 election with respect to the first step stock acquisition.[30]

Analysis: The stock acquisition and the subsequent merger will be integrated so that the transaction will be treated as an asset acquisition qualifying for tax-free treatment under

[30] Fact pattern of Rev. Rul. 2001-46, *supra*.

section 368(a)(1)(A) because (i) a section 338 election is not made and (ii) the integrated transaction qualifies as a tax-free asset reorganization. Target's shareholders who receive Parent stock are entitled to nonrecognition treatment. Parent gets a carryover basis in the Target's assets under section 362.

Example 2. Same facts as example 1, except that Target is owned 100% by Bigco, a domestic corporation, Bigco and Target file consolidated tax returns, and Parent, Bigco and Target join in making a section 338(h)(10) election.

Analysis: The stock acquisition and the subsequent merger will not be integrated because the first step stock acquisition is a qualified stock purchase and a section 338(h)(10) election is made. Target treats the transaction as a taxable sale of its assets reported by Bigco on its consolidated tax return. Parent gets a stepped-up basis in Target's assets.

Example 3. Parent, a domestic corporation, acquires 100% of the stock of Target from Target shareholders in exchange for Parent voting stock. Immediately thereafter all of the assets of Target are transferred to Parent and Target liquidates in a transaction that is not a state law merger.[31]

Analysis. The stock acquisition and the subsequent liquidation will be integrated so that the transaction will be treated as an asset acquisition qualifying for tax-free treatment under section 368(a)(1)(C) because (i) the first step is not a qualified stock purchase, and (ii) the integrated transaction qualifies as a tax-free reorganization. Target's shareholders who receive Parent stock are entitled to nonrecognition treatment. Parent gets a carryover basis in Target's assets under section 362. Parent is precluded from making a section 338 election because the first step stock acquisition is not a qualified stock purchase.

Example 4. Same as example 3, except that immediately before the stock acquisition Target redeems a 40% Target shareholder that is unrelated to the Parent.

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[31] Fact pattern of Rev. Rul. 67-274, *supra*.

Analysis: The first step stock acquisition and second step liquidation will be integrated for purposes of determining whether the transaction is a tax-free reorganization. Because the integrated transaction fails the "substantially all" test, the first step will not qualify as a tax-free stock reorganization. Target shareholders have a taxable stock sale. The transaction will not be integrated for purposes of determining whether it is a taxable asset acquisition. Absent an election under section 338(g), Parent receives a carryover basis in the Target's assets. Because the first step is a qualified stock purchase, Parent may make an election under section 338(g), in which case Parent gets a stepped-up basis in Target's assets.

Example 5. Pursuant to an agreement with Target, Subsidiary, a domestic corporation and a wholly owned subsidiary of Parent, commences a tender offer for all of Target's stock. The agreement between Target and Subsidiary calls for Target to be merged into Subsidiary if Subsidiary acquires 50 percent or more of Target's stock. As of the expiration of withdrawal rights under its tender offer, Subsidiary has been tendered 50 percent of Target's stock. Subsidiary acquires the tendered shares for cash, and, pursuant to the agreement with Target, Target is merged into Subsidiary, with the non-tendering Subsidiary shareholders receiving Parent stock in exchange for their T stock.[32]

Analysis: The first step tender offer and second step merger will be integrated so that the transaction will be treated as an asset acquisition qualifying for tax-free treatment under section 368(a)(2)(D) because the integrated transaction qualifies as a tax-free asset reorganization. Target's shareholders who receive Parent stock are entitled to nonrecognition treatment. Subsidiary obtains a carryover basis in Target's assets under section 362. Subsidiary is precluded from making a section 338 election because the first step stock acquisition is not a qualified stock purchase.

Example 6. Q is a manufacturing corporation all of the common stock of which is owned by twelve individuals. One class of nonvoting preferred stock, representing 40 percent of

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[32] Fact pattern in King Enterprises v. United States, *supra*.

the aggregate value of Q, is held by a variety of corporate and non-corporate shareholders. Q is incorporated in state M. Pursuant to a plan to raise additional capital immediately and to enhance its ability to raise capital in the future by issuing additional stock, Q proposes to make a public offering of newly issued stock and to cause its stock to become publicly traded. Pursuant to the underwriting agreement, Q changes its place of incorporation by merging with and into R, a newly organized corporation incorporated in state N. Immediately thereafter, R sells additional shares of its stock to the public and redeems all of the outstanding shares of nonvoting preferred stock. The number of new shares sold is equal to 60 percent of all the outstanding R stock following the sale and redemption.[33]

Analysis: The reincorporation by Q in state N qualifies as a reorganization under section 368(a)(1)(F) even though it was a step in the transaction in which Q was issuing common stock in a public offering and redeeming stock having a value of 40 percent of the aggregate value of its outstanding stock prior to the offering.

Example 7. Subsidiary, a newly formed corporation wholly owned by Parent, is merged into Target with Target surviving. One-half of the Target shareholders exchange their Target stock for Parent stock, and the other half exchange their Target stock for cash. Immediately thereafter, Parent causes Target to merge into Subsidiary 2, a newly formed corporation wholly-owned by Parent, with Subsidiary 2 surviving.[34]

Analysis: By itself the first step merger is a qualified stock purchase. Absent an election under section 338(g), the first step merger and second step merger are integrated because the transaction qualifies as tax-free asset reorganization. In this case, Target shareholders who receive Parent stock are entitled to nonrecognition treatment and Subsidiary 2 takes a carryover basis in Target's assets under section 362. On the other hand, Parent could

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33 Fact pattern in Rev. Rul. 96-29, *supra*.

34 The sidewise merger is a variant to Rev. Rul. 2001-46, *supra*, and is supported by the IRS' view in PLR 200043032.

make an election under section 338(g), resulting in Target shareholders' receiving Parent stock in a taxable transaction and Subsidiary 2 taking a stepped-up basis in Target's assets.

Example 8. Same as example 7, except that 30% of Target shareholders receive Parent stock and 70% of Target shareholders receive cash. Parent does not make a section 338 election.

Analysis: The first step merger will be integrated with the second step merger for purposes of determining whether the integrated transaction qualifies as a tax-free asset reorganization. Since it does not, the Target shareholders have a taxable stock sale. The first step merger will not be integrated with the second step merger for purposes of determining whether the transaction is a taxable asset acquisition. The first step merger is a qualified stock purchase. The second step merger of Target into Subsidiary 2 is a tax-free reorganization, with no gain recognition for Parent and Subsidiary 1. Subsidiary 2 takes a carryover basis in Target's assets.