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IRS Guidance Tightens Several Provisions Regarding Tax-Free Corporate Transactions

"The US Treasury and IRS have tightened several rules related to tax-free corporate transactions."

On May 8, 2008, the US Treasury and Internal Revenue Service (IRS) issued new guidance on several transactional tax issues, in the form of two sets of final Treasury Regulations and a Revenue Ruling. One set of final regulations, amending prior final rules, provides that a "safe harbor" protecting tax-free corporate reorganizations under Section 368(a) from disqualification by certain subsequent transfers of stock or assets will not apply in the case of certain transfers to or by former target shareholders.[1]

The second set of new rules, adopting the position of prior temporary and proposed regulations, eliminates the "asset exception" to the basis-reduction rule under Section 358(h) requiring taxpayers to reduce the carried-over basis of stock received in a tax-free exchange by the amount of liabilities assumed. The former exception had applied where substantially all of the assets with which the liability was associated were transferred to the person assuming the liability as part of the transaction.

Finally, the new Revenue Ruling denies tax-free reorganization treatment to an integrated transaction involving the acquisition of a target corporation's stock by means of a reverse subsidiary merger, followed by the liquidation of the target into the acquirer.

New Final Regulations Deny Safe Harbor to Certain Transfers Following Tax-Free Reorganizations

Background

For an acquisition to qualify as a tax-free reorganization, the transaction may be required to satisfy various requirements (depending on the type of reorganization), including the "continuity of interest" requirement. The continuity of interest requirement requires that in substance a significant part of the value of the proprietary interests (generally, equity) in the target corporation be preserved through the issuance of equity in the acquirer.[2]

Existing regulations generally provide that a transaction otherwise qualifying as a reorganization will not be disqualified or recharacterized as a result of certain subsequent transfers of assets or stock. Final regulations issued in October 2007 expanded the circumstances in which transfers would be entitled to the protection of the regulatory safe harbor. If the transfer did not satisfy the requirements for the safe harbor, the transaction would be subject to analysis under other tax principles, including the step-transaction doctrine, to determine if it still qualified as a reorganization.

New Regulations Deny Safe Harbor to Certain Transfers

In a clarifying amendment to the October 2007 final rules, the new final rules provide that transfers of assets or stock ***to*** former shareholders of the target corporation (other than a former shareholder that is also the acquirer) or surviving corporation, to the extent such transfers constitute consideration for their equity in the target or surviving corporation, are not entitled to the protection of the safe harbor. In issuing the new rules, the IRS stated that such a transfer following a transaction otherwise qualifying as a reorganization calls into question whether the transaction satisfies the continuity of interest requirement or limits on the type of consideration that may be used in certain reorganizations (such as the "solely for voting stock" requirement in "B" and "C" reorganizations).

Also falling outside the protection of the safe harbor under the new rules are transfers ***by*** former shareholders of the target corporation (other than a former shareholder that is also the acquirer) or surviving corporation, to the issuing corporation or a person related to it, of consideration the former shareholders received in the potential reorganization.

The new final rules reiterate that the safe harbor still applies to transfers to the former shareholders where those transfers do not constitute consideration for their equity in the target or surviving corporation. These include certain *pro rata* dividend distributions by the acquirer following a reorganization. Furthermore, since the limitation on the safe harbor does not apply to transfers to a shareholder that is also the acquirer, the protection is still extended to certain upstream reorganizations followed by a transfer of acquired assets.

As was the case before the issuance of the new final rules, an otherwise qualifying reorganization followed by a transfer that is not entitled to safe harbor protection must be analyzed under step-transaction and other tax principles to determine if it continues to qualify as a reorganization.

New Final Regulations on Stock Basis Reduction for Assumption of Liabilities Eliminate "Asset Exception"

Background

New regulations have been issued to address certain exchange transactions in which a taxpayer transfers property to a corporation in exchange for stock and the transferee's assumption of certain obligations of the taxpayer. Some taxpayers have asserted that the assumed obligations were not the type of liabilities that would reduce the basis of the stock they received (even though they reduced the stock's value) and claimed a loss upon selling the stock. In response, Congress enacted Section 358(h), requiring that if the basis of the stock received by the taxpayer exceeds its fair market value, the basis is reduced, but not below zero, by the amount of any liability of the taxpayer assumed (if the assumption was not otherwise treated as the receipt of money by the taxpayer, thereby reducing the stock's basis).

New Regulations Confirm Elimination of Asset Exception

The statute contains two exceptions to this basis-reduction requirement—while authorizing the Treasury to limit the exceptions—where either the trade or business with which the liability is associated, or substantially all of the assets with which the liability is associated, are transferred to the person assuming the liability as part of the exchange. The second category is known as the "asset exception." The new final rules confirm Treasury and IRS guidance issued in 2005 that eliminated the asset exception, stating it was necessary to prevent abusive basis transactions.

Revenue Ruling on Tax Treatment of Reverse Subsidiary Merger and Liquidation

In Revenue Ruling 2008-25, 2008-21 I.R.B. 986, the IRS issued its latest guidance in a series of rulings addressing when the step-transaction doctrine applies to treat a two-step acquisition, in which an acquiring company P acquires the stock of a target company T in the first step and then T combines with P in some fashion in the second step, as a single integrated transaction in which P is treated as having acquired T's assets.

Background

In prior rulings involving two-step acquisitions, the IRS has held that where the first step, considered independently, constitutes a qualified stock purchase within the meaning of Section 338, and integrating the two steps results in a ***taxable*** asset purchase, the principles of Section 338 dictate that the step-transaction doctrine not be applied. This is because Section 338 was intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine, and in its place create an elective regime whereby the sole mechanism for P to receive asset-purchase treatment (and hence a cost basis for T's assets) in this context is to make a Section 338 election with respect to its qualified stock purchase of T.[3]

By contrast, where the integration of the two steps would result in a tax-free reorganization and not a taxable asset purchase, the policy under Section 338 was not violated by applying the step-transaction doctrine to treat the two steps as a single, integrated asset acquisition, regardless of whether the first step viewed in isolation was a qualified stock purchase.[4]

The one permutation not squarely addressed by prior rulings was a two-step acquisition in which the first step considered in isolation from the second step was not a qualified stock purchase, and yet fully integrating the two steps would result in a taxable asset purchase rather than a tax-free reorganization. This is the fact pattern addressed by Revenue Ruling 2008-25.

Revenue Ruling Denies Reorganization Treatment

In Revenue Ruling 2008-25, the first step of the transaction consisted of P acquiring the stock of T by forming a merger subsidiary X and merging it into T, with T's shareholder A receiving $10x in cash and $90x of P voting stock in the transaction. The ruling notes that if this first step were viewed in isolation, it would constitute a reorganization under Section 368(a)(2)(E). However, in the second step, which was part of an integrated plan, T completely liquidated into P. Thus, the second step causes the transaction to violate Section 368(a)(2)(E) because, after the integrated transaction, T does not hold substantially all of its assets and the assets of the merger corporation X.

At the same time, the ruling notes that if the step-transaction doctrine were applied so as to treat the two steps as a single integrated transaction in which P acquires T's assets, the transaction would not constitute a reorganization under Section 368. Specifically, the transaction (i) would not qualify under Section 368(a)(1)(A) because T did not merge into P, (ii) would not qualify under Section 368(a)(1)(C) because the consideration is not solely P voting stock and the boot relaxation rule of Section 368(a)(2)(B) is not satisfied due to the liabilities that P assumes in the liquidation of T, and (iii) would not qualify under Section 368(a)(1)(D) because neither T nor A is in control of P immediately after the transfer. In addition, Section 351 would not apply.

Accordingly, because integrating the two steps would turn the purchase of

T's stock into a taxable asset acquisition (with P thereby receiving a cost basis for T's assets), the ruling concludes that Revenue Ruling 90-95, Treasury Regulations Section 1.338-3(d) and the general principles of Section 338 dictate that the two steps not be treated as a single, integrated asset acquisition, but rather as a stock acquisition followed by a separate carryover basis transaction (specifically, a tax-free liquidation under Section 332).

Note that unlike these precedents regarding two-step acquisitions, the first step in isolation would at first glance not seem to be a qualified stock purchase, and hence Section 338 might appear not to be implicated. However, the ruling notes that in determining whether the first step qualifies as a reorganization, one must still apply the step-transaction doctrine and, as noted above, the second step causes the first step not to be treated as a reorganization under Section 368(a)(2)(E) because the second step causes T to fail the requirement that it hold substantially all of its assets after the transaction. In essence, the step-transaction doctrine continues to apply in a limited sense to deny tax-free reorganization treatment to the first step, which results in the first step being treated as a taxable stock purchase (and hence a qualified stock purchase) and the second step being treated as a separate tax-free liquidation under Section 332.

In sum, Revenue Ruling 2008-25 extends the reach of precedents such as Revenue Ruling 90-95 by preventing the step-transaction doctrine from treating P's acquisition of T's stock followed by T's combination with P as a single asset acquisition, where that integrated asset acquisition would be taxable and thereby result in P receiving a cost basis for T's assets even though the stock acquisition viewed in isolation would not be a qualified stock purchase. In particular, the step-transaction doctrine is applied in a limited fashion to treat the first step as a qualified stock purchase, and that treatment, in turn, shuts off the step-transaction doctrine from integrating the two steps as a single, taxable asset acquisition.

This result might cause tax advisors to give further thought to structuring forward merger transactions as two-step acquisitions where the first step viewed in isolation might not be a taxable stock purchase, since if for some reason the integrated transaction does not qualify as a reorganization under Section 368, Revenue Ruling 2008-25 supports disaggregating the two steps so as to avoid triggering the inside gain on T's assets that would otherwise result from a taxable forward merger under Revenue Ruling 69-6.[5]

Endnotes

1 All references herein to "Section" are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2 *See* Latham & Watkins *Client Alert* Number 485, "IRS Issues Final Regulations on Continuity of Interest for Tax-Free Reorganizations," October 7, 2005, available at www.lw.com.

3 *See* Rev. Rul. 90-95, 1990-2 C.B. 67; Treas. Reg. § 1.338-3(d).

4 *See* Rev. Rul. 2001-46, 2001-2 C.B. 321; Rev. Rul. 72-405, 1972-2 C.B. 217; Rev. Rul. 67-274, 1967-2 C.B. 141.

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

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