



INTEGRATED CORPORATE ACQUISITIONS: COMMENTS ON REV. RUL. 2001-46

By Martin D. Ginsburg and Jack S. Levin

Martin D. Ginsburg (Martin_Ginsburg@ffhsj.com), Professor of Law at Georgetown University Law Center, and Jack S. Levin (Jack.Levin@Kirkland.com), a senior partner at Kirkland & Ellis, Chicago, are co-authors of the three-volume treatise *Mergers, Acquisitions, and Buyouts*, updated and republished semi-annually by Aspen Publishers, Inc.

The authors submitted this report to the IRS in response to recent Rev. Rul. 2001-46's request for comments on the respect properly to be accorded a section 338(h)(10) election timely filed in an otherwise integrated corporate acquisition. When individuals organize new P to acquire 80 percent or more of T's stock in exchange for P stock and cash in a transaction that, viewed independently, constitutes a QSP, and as a second step in the acquisition plan either T merges upstream into P or P merges downstream into T, current Treasury/IRS positions in the main advance general principles of transactional integration that merit applause. The authors urge, however, that with regard to (1) P's downstream merger into T, reg. section 1.338-3(b)(1) should be revised, and (2) T's upstream merger into P, Rev. Rul. 2001-46 should be expanded, in each case to confirm that when a section 338(h)(10) joint election is filed for T, step-transaction principles will not apply to eliminate the first-step QSP. The authors support their conclusion, that the IRS in both merger configurations should respect the parties' section 338(h)(10) election, highlighting the significant whipsaw risk the IRS otherwise faces, in particular when T is an S corporation.

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Rev. Rul. 2001-46, 2001-42 IRB 1, *Doc 2001-24676* (9 original pages), 2001 TNT 186-7 (situation 1), considers P's multistep plan to acquire T where (1) P's first-step acquisition of all T's stock (for 30 percent cash and 70 percent P stock), viewed independently, constitutes a QSP but (2) the integrated plan (including T's upstream merger into P) satisfies section 368(a)'s statutory as well as nonstatutory (for example, continuity of interest (or COI), continuity of business enterprise (or COBE), business purpose) reorganization requirements.

Adopting a general principle in favor of step-transaction integration, the IRS treats P's first-step acquisition of T's stock followed by T's second-step pre-planned upstream merger into P as a single statutory two-party T-into-P merger constituting a section 368(a)(1)(A) reorganization. Then, reviewing the effect, if any, on the transaction of an otherwise timely section 338(h)(10) election, the IRS bifurcates: (1) If P's first-step acquisition of T's stock occurred before September 25, 2001 (or pursuant to a written agreement binding on September 24, 2001, and at all times thereafter), the IRS will not challenge the section 338(h)(10) election¹ so long as P does not take a position inconsistent with treating P's threshold acquisition of T's stock as a QSP, but (2) for post-September 24, 2001, transactions, IRS/Treasury "are considering whether to issue regulations . . . reflect[ing] the general principles of this revenue ruling, but . . . allow[ing] taxpayers to make a . . . section 338(h)(10) [election] . . . if such step is pursuant to a written agreement that requires, or permits [P] to cause, a section 338(h)(10) election . . . to be made," and request comments regarding this approach.

This submission responds to the request for comments.

First, the general principles advanced in Rev. Rul. 2001-46 merit applause. The ruling's approach, integrating related acquisition steps to find an encompassing reorganization, sensibly resolves the uncertainty and tension between Rev. Rul. 90-95 (first-step QSP not integrated with subsequent upstream T-into-P merger where integrated transaction lacks adequate COI) and Rev. Rul. 2001-26 (first-step non-QSP T stock acquisition is integrated with subsequent upstream T-

¹Or a section 338(g) election.

into-P merger where integrated transaction demonstrates adequate COI).

Second, Rev. Rul. 2001-46 is commendable in honoring, for past transactions, a section 338(h)(10) election but unfortunate in risking whipsaw for the IRS because the ruling fails to require consistency on the part of T's selling shareholders.

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Third, with respect to a post-September 24, 2001, transaction, IRS/Treasury should promptly advise by regulation that buyer and seller (meaning Bigco where T is a Bigco 80/80 subsidiary but all T shareholders, including non-selling shareholders, where T is an S corporation) may validly elect section 338(h)(10) — and are bound by such election — with respect to a first-step (which viewed independently constitutes a QSP) of a multi-step transaction that, viewed as a whole, constitutes a reorganization, where such first step is pursuant to a written agreement requiring, or permitting, a section 338(h)(10) election.²

Fourth, where P acquires T's stock in a transaction that, viewed independently, constitutes a QSP, and promptly thereafter T and P are combined, either T or P may survive the corporate combination. Rev. Rul. 2001-46 concentrates on an upstream merger in which P survives. However, where T survives — in particular, where P, newly organized as the vehicle to acquire T's stock, merges downstream into T (or new P otherwise disappears, e.g., liquidates) — reg. section 1.338-3(b)(1) presents another tax problem with whipsaw potential for the IRS. The section 338(h)(10) regulation project currently under consideration to deal with the T-into-P upstream merger configuration affords an appropriate opportunity to deal with the P-into-T downstream merger configuration as well.

We explore first the downstream merger case and then the upstream merger case in the examples that follow.

²See M. Ginsburg and J. Levin, "Integrated Acquisitive Reorganizations," *Tax Notes*, June 11, 2001, p. 1909, in particular Part III and Example 15 therein, in support of the conclusion, reiterated here, that where a first-step QSP is present and the parties jointly make a section 338(h)(10) election, their joint expression of purchase intent should privilege Rev. Rul. 90-95, 1990-2 C.B. 67, over the integrated reorganization conclusion adopted in Rev. Rul. 2001-26, 2001-23 IRB 1297, Doc 2001-13580 (6 original pages), 2001 TNT 93-36 (and now in Rev. Rul. 2001-46), but absent such a joint section 338(h)(10) election step-transaction reorganization treatment should prevail.

I. Downstream Merger: Reg. Section 1.338-3(b)(1)

Example 1: New P Makes First Step QSP Acquisition of T's Stock Followed by P's Downstream Merger

T-SCo's 100 outstanding shares, worth in the aggregate \$1,000, are owned 50 shares each by individuals A and B, each of whom holds the shares with a \$100 basis. T-SCo's OI assets are worth \$400 above basis and T-SCo's CG assets also are worth \$400 above basis.

Unrelated individual C seeks (1) to acquire T-SCo with asset basis stepped-up to FV and (2) to continue uninterrupted T-SCo's S status.

To that end C incorporates new P, and new P issues to C 60 P shares in exchange for \$600 cash (that is, \$10 per share). Two months later new P acquires T-SCo's 100 outstanding shares by (1) paying A \$500 cash and (2) delivering to B \$100 cash and 40 P shares (worth \$400). At closing P, A, and B jointly elect under section 338(h)(10) to treat P as purchasing T-SCo's assets and not T-SCo's stock. Pursuant to the overall plan, P immediately merges downstream into T-SCo. In the merger, in exchange for their P shares, B receives 40 T-SCo shares and C receives 60 T-SCo shares.

During its two month existence prior to acquiring T-SCo's shares, P observed normal corporate formalities (e.g., elected directors and officers, opened a bank account), negotiated and entered into a credit facility with Bank as well as a contract with A and B to acquire T-SCo's shares, and borrowed for initial working capital money which P repaid with interest immediately before P merged downstream into T-SCo.

Reg. section 1.338-3(b)(1) identifies "new P's merging downstream into target" as a fact "that may indicate . . . new P does not purchase the target stock," with the result that (1) there has been no QSP (that is, no corporate buyer of at least an 80/80 amount of T's stock), hence (2) there has been no section 338(h)(10) deemed sale of old target's assets.

This no-section 338(h)(10) conclusion would prove of advantage to T's selling shareholders. A, selling T-SCo stock for \$500 cash, would enjoy \$400 CG taxed at 20 percent rather than — pursuant to a valid section 338(h)(10) election — only \$200 CG plus \$200 OI taxed at nearly 40 percent. B would be treated as selling only 10 T-SCo shares and retaining his other 40 T-SCo shares, recognizing \$80 CG — far better than \$200 CG and \$200 OI pursuant to a valid section 338(h)(10) election.

Is new P so ephemeral as to fail as the QSP purchaser of T-SCo's shares under reg. section 1.338-3(b)(1)? If *Moline Properties*³ supplies the test, P likely qualifies as "real" and thus the QSP purchaser of T-SCo's stock. But perhaps *Moline Properties* is not the regulation's touchstone.

³*Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

- In *Moline Properties*, the Supreme Court conflated corporate entity and business activity: “Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creditor’s personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate entity.”⁴
- However, over the past third of a century IRS has published a pride of transitory-subsidary-merges-into-target revenue rulings in which the common denominator is “disregard new S” with never a mention whether S’s pre-merger activity was, or was not, sufficient to support *Moline*-like reality.⁵
- In addition, in Rev. Rul. 90-95, 1990-2 C.B. 67, where the IRS did mention S’s pre-merger activity, the IRS disregarded S (which merged into T) when S “was formed solely for the purpose of acquiring [T’s] stock and did not conduct any activities other than those required for the merger” (emphasis supplied). This is not the test enunciated in *Moline Properties*. Indeed, all of P’s pre-merger activities in Example 1 appear to be “required for the merger,” suggesting that under Rev. Rul. 90-95 the IRS in Example 1 would disregard P as transitory.
- On the other hand, in Field Service Advice 200122007, Doc 2001-15507 (13 original pages), 2001 TNT 107-14, addressing the disregard-of-P issue focused in Example 1, the IRS adopted a *Moline Properties* approach in determining whether to disregard P. In the FSA new P purchased T’s stock (in a transaction which appeared to satisfy all the QSP requirements). Although P remained alive, P promptly transferred T’s only asset of value to the partnership that owned 100 percent of P’s stock, leaving P with no employees, no on-going business, and T’s corporate shell as P’s only asset. The IRS commented that “the requirement of a business activity [necessary to respect P, so that P’s purchase of T’s stock is a QSP] . . . is minimal” and “all that is required . . . is the holding of a minimal amount of assets,” and concluded that P is respected as the QSP purchaser of T’s stock.

The rule in reg. section 1.338-3(b)(1) was first adopted by Treasury in Q&A form when *General Utilities* was still the law and before section 338(h)(10) became operative. In those early days (1) the announced IRS/Treasury view was that the step-transaction doctrine was not “waivable” and (2) disqualifying a QSP could hurt the taxpayer, but would never whipsaw the Treasury. Currently, however (1) IRS/Treasury are

prepared to forego step transaction recharacterization in many appropriate circumstances — see, for example, Rev. Rul. 90-95, 1990-2 C.B. 67 (P’s QSP purchase of T’s stock not integrated with T’s upstream merger into P, as discussed above); Rev. Rul. 98-27, 1998-1 C.B. 1159, Doc 98-15290 (5 pages), 98 TNT 94-8 (under section 355); reg. section 1.368-2(d)(4) (abandoning *Bausch & Lomb*); Rev. Rul. 2001-24, 2001-22 I.R.B. 1290, Doc 2001-12686 (6 original pages), 2001 TNT 87-9 (under section 368(a)(2)(D)) — and (2) reg. section 1.338-3(b)(1) invites taxpayers to whipsaw the fisc when buyer claims section 338(h)(10) stepped-up asset basis while sellers claim CG stock sale treatment with no corporate-level gain recognition.

Section 338(h)(10) is explicitly elective. The code and regulations (1) create a bright-line procedure for making a section 338(h)(10) election and (2) allow taxpayers to decide, by following or avoiding this bright-line procedure, whether to select stepped-up basis with T gain recognition (by electing section 338(h)(10)) or carryover basis with no T gain recognition (by not invoking section 338(h)(10)). Once the relevant taxpayers (P and Bigco where T is a Bigco 80/80 subsidiary or P and all of T’s shareholders where T is an S corporation) have made a joint decision to follow the bright-line procedure, the IRS should not create ephemeral doubts as to whether P constitutes a sufficiently “real” purchaser of T’s stock and hence whether the election is valid, especially when such reg. section 1.338-3(b)(1) doubts invite taxpayers to whipsaw the fisc.

II. Upstream Merger: Rev. Rul. 2001-46

Example 2: P Makes First Step QSP Acquisition of T’s Stock Followed by T’s Upstream Merger

Same facts as Example 1, except that (1) P is an SCo and (2) immediately following P’s acquisition of T-SCo’s 100 shares for 40 P shares (worth \$400) and \$600 cash, T-SCo merges upstream into P-SCo. As in Example 1, P, A, and B jointly elect under section 338(h)(10) to treat P as having purchased T-SCo’s assets and not T-SCo’s stock.

P survives the merger, thus P is certainly a “real” corporation, and the elimination of T-SCo’s separate corporate existence ordinarily would not affect eligibility to elect under section 338 or section 338(h)(10).⁶ But this is not an ordinary case: Where the threshold acquisition of T-SCo’s stock is stepped together with the preplanned upstream merger, the integrated transaction is a reorganization under section 368(a)(1)(A) — a two-party T-into-P forward merger in which 40 percent of the consideration delivered by P is P stock, and 40 percent P stock is certainly sufficient to satisfy the COI reorganization requirement.

In Rev. Rul. 2001-26 the IRS suggested, and in Rev. Rul. 2001-46 the IRS concluded, that when COI is satisfied, step-transaction integration achieves reorganization status for an asset acquisition (that is, carryover asset basis as if the transaction were a T-into-P merger)

⁴319 U.S. at 438-39.

⁵See, for example, Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 79-273, 1979-2 C.B. 125.

⁶See reg. section 1.338-3(c)(1)(i).

and eliminates P's threshold QSP acquisition of T's stock. As applied to Example 2, a lovely outcome, if you are one of the sellers: A's recognized gain remains \$400, but now all CG; B's recognized gain is limited to B's \$100 cash, all CG.

What of C who bargained for (and probably paid for) a section 338(h)(10) election and stepped-up asset basis? Rev. Rul. 2001-46 (under the title "Application") speaks to C's concern, but what it says is unusual (emphasis added below):

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

(1) a timely (including extensions) and valid (without regard to whether there was a qualified stock purchase under the principles of this revenue ruling) election under section 338(h)(10) or section 338(g) (Election) is or was filed with respect to the acquisition of the stock of the target corporation; and

(2) either

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

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

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

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

Applied to Example 2, this is what Rev. Rul. 2001-46 tells us:

- If P's acquisition of T-SCo's stock closed prior to September 25, 2001 (or closes later pursuant to a pre-September 25, 2001, written agreement continuously in force) and P takes the position — even though not "all parties" or "all taxpayers" take this position, *just P* — that the acquisition

of T-SCo's stock was a QSP and (because a timely and valid section 338(h)(10) joint election was filed) is governed by section 338(h)(10), then T-SCo's assets take stepped-up basis. The references in the quoted segment of Rev. Rul. 2001-46 are references to "a taxpayer's position" and to "such taxpayer," each time in the singular, until the ruling reaches IRS/Treasury considerations of the future (when the ruling first refers to "taxpayers"). Thus, nothing in this pronouncement requires, as a condition to the buyer's section 338(h)(10) treatment, that the sellers (A and B) report their side of the transaction under section 338(h)(10). If A and B conclude that integrated reorganization treatment is the correct answer for them, they can report it so while T, under C's control, can report a QSP and stepped-up asset basis. And each of them may be right.

- If P's acquisition of T-SCo closes after September 24, 2001, not under a written agreement binding then and thereafter, but closes before Treasury issues a sensible regulation (1) calling off-step transaction integration when buyer and sellers by written agreement timely file a valid joint section 338(h)(10) election and (2) binding all parties to that election, it appears to be every man, woman, and child for him/her self. Rev. Rul. 2001-46 urges that, until we have a contrary regulation, reorganization treatment trumps and A and B will be pleased to rely. But a revenue ruling is not the Word of the Lord, C is certainly disadvantaged if P is deprived of stepped-up asset basis, and a generalist court — indeed, perhaps even the specialized but not wholly insensitive Tax Court — may prefer aggrieved C to miserable A and B. And if these folk end up in different courts all of them may win.

We believe the IRS may have adopted its unusual approach to pre-September 25, 2001, transactions — inconsistent reporting by a T shareholder does not impair P's right to rely on section 338(h)(10) — because of misplaced concern for a C corporation minority shareholder (Mrs. K):

- Bigco owns at least an 80/80 amount of subsidiary T, with the remainder of T's shares (say 10 percent) owned by Mrs. K. Bigco sells its 90 percent of T's stock to P for \$600 cash and \$300 of P stock, leaving Mrs. K as T's 10 percent minority shareholder. P promptly squeezes out Mrs. K by merging T upstream into P, delivering to Mrs. K \$100 of P stock in exchange for her 10 percent of T's stock.
- Bigco and P agree in writing that they will make a section 338(h)(10) election with respect to P's acquisition of T. Because T is a C (rather than S) corporation, Mrs. K's consent to this election is not necessary.
- However, Mrs. K may well assert that her exchange of T stock for P stock (on T's upstream merger into P) is not taxable because sufficient P stock was issued in total in the integrated transaction to satisfy COI (\$300 of P stock to Bigco and \$100 of P stock to Mrs. K = 40 percent P

stock) and hence the T-into-P merger should be awarded reorganization treatment under Rev. Rul. 2001-46.

The IRS may have believed that Mrs. K's reorganization position would be inconsistent with Bigco's and P's section 338(h)(10) position and hence that requiring consistency from all parties (as a prerequisite to P's section 338(h)(10) election) would allow Mrs. K to play the role of a classic spoiler, able to extract unconscionable payment from P as her price for consistent reporting.

If this unlikely fact pattern — there are not many minority shareholders in Bigco corporate subsidiaries — did concern Rev. Rul. 2001-46's drafters, we suggest that Mrs. K will not have the potential for inconsistent reporting that could elevate her to spoiler status. A section 338(h)(10) election causes T to become "new T" so that P is new T's first and only 80 percent (or greater) shareholder.⁷ Thus, after this section 338(h)(10) election, when new T merges into P there is ample COI⁸ and hence a good "A" reorganization that is not inconsistent with characterizing as a QSP P's purchase of old T's stock. As a result, Mrs. K's exchange of her T stock for P stock in the merger is tax-free under section 354 even though a valid section 338(h)(10) election has been made with respect to T.

III. Conclusion

The two administrative pronouncements reviewed in this comment address technically distinct transactions — preplanned postacquisition mergers in which different constituent corporations (T or P) survive — but one encompassing issue: The role, if any, appropriately to be assigned to "substance over form" recharacterization when the operative tax rule is one of explicit, "check the box," electivity. We do not think it sensible for Treasury by regulation or the IRS by ruling to construct a tax regime that announces "this election, if you choose to make it, yields this specific tax consequence," and then adds "but not if subsequently an IRS auditor concludes that, on balance, the arrangement was not 'really' what it purported to be."

Congress did not construct a taxing scheme so unfortunate. In enacting section 338 and section 338(h)(10) Congress intended to substitute for the historic election-by-corporate-mechanic (that is, liquidation of T) approach of *Kimbell-Diamond* and old section 334(b)(2) a bright line regime of explicit electivity. It best accords with that congressional intent to honor a section 338(h)(10) joint election when the transaction facially qualifies for that treatment.

⁷See the discussion of this point in M. Ginsburg and J. Levin, *Mergers, Acquisitions, and Buyouts* (June 2001 ed.) para. 610.9.

⁸P's exchange in the merger of new T's stock for new T's assets preserves COI. See reg. section 1.368-1(e)(1)(i) and section 1.368-1(e)(6) example (7).