**Using Section 351 and Acquisition Structuring**

Code: IRC §§ 351, 357(c), 362(a)(1), (e).

Regs: Treas. Reg. § 1.351-1.

B&E: *Suggested* ¶¶ 3.02-3.05; 3.07; 3.19

**Double Dummy Beats IRS**
Elizabeth MacDonald, 10.29.01

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**Is an ancient principle of tax law getting in the way of your merger deal? Go back to your playbook for an end run right around it.**

**Devon Energy** wants to buy gas producer **Mitchell Energy & Development**. The $3.1 billion merger deal announced in mid-August contemplated a mix of Devon stock and cash worth $60.40 per Mitchell share, a handsome premium over the pre-deal $45.65 price for Mitchell shares. The deal got into serious trouble when Devon shares fell. At their present price the value of the Devon shares as a portion of the total package has fallen below a crucial 40% threshold. If a merger deal drops below that level, it becomes taxable. Bad news for both the selling shareholders and, potentially, the acquiring corporation.

All is not lost, however. A rescue plan is afoot, and if it's implemented, it will enable the Devon (nyse: [DVN](http://www.forbes.com/finance/mktguideapps/compinfo/CompanyTearsheet.jhtml?tkr=DVN) - [news](http://www.forbes.com/markets/company_news.jhtml?ticker=DVN) - [people](http://www.forbes.com/peopletracker/results.jhtml?startRow=0&name=&ticker=DVN) )-Mitchell (nyse: [MND](http://www.forbes.com/finance/mktguideapps/compinfo/CompanyTearsheet.jhtml?tkr=MND) - [news](http://www.forbes.com/markets/company_news.jhtml?ticker=MND) - [people](http://www.forbes.com/peopletracker/results.jhtml?startRow=0&name=&ticker=MND) ) merger to proceed as intended, before year-end. The plan involves a strange beast known as a "horizontal double dummy."

To understand what that is, start with a basic principle of merger law. Section 368(A) of the tax code says that if Acquirer Inc. merges with Target Inc. by acquiring Target's assets in return for stock in Acquirer, the transaction is not a taxable event. If it were taxable, Target's shareholders would have a capital gain equal to their paper profit (excess of the value of Acquirer shares received over the tax basis for the Target shares they hand in). Also, the merged company would have to pay corporate tax on the difference between the deal value and the book value (for tax purposes) of Target's assets. In a tax-free deal both shareholder and corporate gains are deferred indefinitely. Target's shareholders carry over their tax basis to their new position in Acquirer shares.

What if Acquirer pays with a mix of cash and stock? If the 40% minimum is observed, Target's shareholders must recognize taxable gain only to the extent that they receive cash. The corporate tax can also be avoided.

That 40% figure is found nowhere in Section 368. It is, rather, a rule of thumb growing out of some ancient Supreme Court decisions interpreting this statute. (To give you an idea how ancient: The original landmark case involved the takeover of some ice companies.) Trying to find a deeper philosophical purpose behind this part of the tax code, the Supremes read into the law a requirement that the shareholders selling out must retain a significant interest in the surviving entity. In this significance test it does not matter what fraction of the surviving company the sellers end up owning. What matters is what fraction of their payout they take as equity.

The horizontal double dummy does a neat end run around the 40% rule, explains Robert Willens, a tax expert at Lehman Brothers. Instead of buying Target directly, Acquirer creates a dummy holding corporation and merges both itself and Target into that dummy. When the dust settles, the dummy can take Acquirer's original name. It looks for all the world like a merger of Target into Acquirer.

In this situation, Target shareholders need recognize a capital gain only to the extent that they take cash, not shares. Corporate taxes are also avoided. And the 40% rule doesn't apply. Why not? Because the deal is done under the aegis of Section 351 of the code, which is entirely separate from Section 368. Section 351 is aimed at this kind of situation: You own the Empire State Building, and you want to incorporate. You transfer the building to Empire Holding Co. and take its shares. It was the intent of Congress not to tax this kind of transaction as a sale.

What's to stop you from using 351 to merge your real estate company with your brother-in-law's ice company? Nothing, if the statute is read literally. It says that if properties are transferred to a new corporation, and if immediately afterward the people who used to own the properties are in control of the corporation, there is no taxable sale. That would be true if shareholders of Devon and Mitchell transfer their respective shares to Dummy Devon--between them, after all, these sets of holders end up owning all of Dummy Devon. There is no requirement that Mitchell's former shareholders have a stake of a particular size.



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| **What the Taxman Doesn't Get** |
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| Too bad for the Internal Revenue Service. Crafty tax lawyers found a way for all these mergers to avoid big tax bills. The threatened hit to earnings can be gigantic, anywhere from $1.1 billion to $5 billion. The savings provide one good reason not to hate lawyers. |
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| **Deal date** | **Acquirer** | **Target** | **Potential tax($bil)** | **Tax hitper share** |
|  |
| **2/9/96** | **Walt Disney** | **Capital Cities/ABC** | $5.0 | $7.47 |
| **11/1/00** | **NiSource** | **Columbia Energy Group** | 1.4 | 6.86 |
| **5/30/01** | **Northrop Grumman** | **Litton Industries** | 1.1 | 9.19 |
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| Note: Federal corporate taxes only. Debt is not included in the deal's value. Tax figures are estimates. Sources: Thomson Financial/ IBES via FactSet Research Systems; company data; Forbes. |

Does all this fancy footwork cut any ice with the taxman? Evidently it does. **Northrop Grumman** (nyse: [NOC](http://www.forbes.com/finance/mktguideapps/compinfo/CompanyTearsheet.jhtml?tkr=NOC) - [news](http://www.forbes.com/markets/company_news.jhtml?ticker=NOC) - [people](http://www.forbes.com/peopletracker/results.jhtml?startRow=0&name=&ticker=NOC) ) used a horizontal dummy in its $3.8 billion acquisition of shipbuilder **Litton Industries** in May. Initially, Northrop wanted to do an all-cash deal. But Unitrin, an insurance company with a 28% stake in Litton, balked and said it wanted the deal to be tax- free. Using a dummy and a mix of cash and stock, Northrop avoided a $1.1 billion tax bill of its own and enabled sellers who took shares to avoid capital gain taxes. "It was a great answer for us," says Gary McKenzie, vice president of tax at Northrop Grumman.

NiSource, the holding company that owns Northern Indiana Public Service, used a horizontal double dummy in its $6 billion deal to acquire Columbia Energy Group a year ago. That move saved it $1.4 billion in taxes.

We don't know what canny tax lawyer can claim authorship of the double dummy, but the invention seems to date back at least to the 1970s, when it was common in reorganizations of small privately held companies. Lately it has been dusted off by the dealmakers handling giant corporations. Their clients often want to pay largely in cash, in order to avoid dilution of existing shares.

In a typical big-company merger, shareholders of the target are a mix of tax-exempt investors (like pension funds) that don't care whether a merger is taxable and taxable ones (like Unitrin) that care a lot. The acquirer can offer shareholders of the target a choice between taking cash and taking stock in the surviving company, without compromising the ability of the ones taking stock to defer taxes.

As cash becomes a bigger component of deal values, merging companies are increasingly in jeopardy of owing fat tax bills. The first nine months of this year saw merger values split 50-50 between cash and stock, whereas cash made up only 37% of deals for the same period last year, says Richard J. Peterson, chief market strategist at Thomson Financial. And if stock prices tank between the time of a deal's announcement and consummation to below 40% of the deal's value, huge tax bills can emerge. Says Daniel Donoghue, cohead of mergers and acquisitions at U.S. Bancorp Piper Jaffray, "Nowadays the tax implications in any of these transactions are potentially huge deal killers."

The big question: How long before the Internal Revenue Service tires of getting beaten by a dummy and appeals to Congress for a new statute. Or persuades the Supreme Court to get philosophical about Section 351.

**Rev. Rul. 77-449, 1977-2 C.B. 110**

Section 351 -- Transfer to Controlled Firm

Amplified by Rev. Rul. 83-156

Amplified by Rev. Rul. 83-34

Advice has been requested whether the transfer of assets by a corporation to its wholly owned subsidiary which in turn transfers the assets to its wholly owned subsidiary under the circumstances described below is governed by section 351 of the Internal Revenue Code of 1954.

Corporation P has a wholly owned subsidiary, S1, which has a wholly owned subsidiary, S2. All of the corporations are domestic corporations. P transferred machinery used in its trade or business to S1 solely in exchange for additional shares of S1 stock. As part of the same plan, S1 transferred the same machinery to S2 solely in exchange for additional shares of S2 stock. S2 retained the machinery for use in its business and P and S1 retained the stock received by them in the exchanges.

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. Section 368(c) defines control to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Under the circumstances described above, the transfers are viewed separately for purposes of section 351 of the Code. See Handbird Holding Corp. v. Commissioner, 32 B.T.A. 238 (1935), and Marcher v. Commissioner, 32 B.T.A. 76 (1935), in which the Board of Tax Appeals recognized successive tax-free transfers under the predecessors of section 351.

Accordingly, since each transfer satisfies the requirements of section 351 of the Code, no gain or loss is recognized by the transferors.

**Rev. Rul. 76-123, 1976-1 C.B. 94**

Advice has been requested concerning the treatment for Federal income tax purposes of the transaction described below.

Individual A owned all the stock of X corporation, which was incorporated in State O. Individual B, who is unrelated to A, owned all the stock of Y corporation, which was incorporated in State P. A and B determined that the businesses operated by X and Y could be improved if their interests in X and Y were combined while at the same time preserving the separate corporate existence of X and Y. A and B also decided that the laws of State P were more favorable to the operation of the combined enterprise. To carry out their plan, A and B transferred all of their stock in X and Y to a newly organized corporation, Z, incorporated in State P, in exchange for, respectively, 60 percent and 40 percent of all of the outstanding stock of Z. In addition, B received from Z 10x dollars in cash. The consideration received by A and B was in each case equal to the fair market value of the stock exchanged. As part of this plan, X then distributed all of its assets to Z in complete liquidation, and Y remained as a wholly owned subsidiary of Z.

Section 351(a) of the Internal Revenue Code of 1954 provides, in general, for the nonrecognition of gain or loss on the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred.

Section 351(c) of the Code provides that, for purposes of determining control under section 351, the fact that any corporate transferor distributes part or all of the stock that it receives in the exchange to its shareholders will not be taken into account.

Section 351(b) of the Code provides, in part, that if section 351(a) would apply to an exchange but for the fact that money is received in addition to the stock received, then any gain recognized will not exceed the amount of money received.

Section 368(c) of the Code provides that the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each of the other classes of stock of the corporation.

Section 368(a)(1)(B) of the Code provides, in part, that the term "reorganization" means the acquisition by one corporation, in exchange solely for shares of its voting stock, of the outstanding stock of another corporation if, immediately after the transaction, the acquiring corporation has control of such other corporation.

Section 368(a)(1)(C) of the Code provides, in part, that a reorganization is the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, is disregarded.

In Rev. Rul. 67-274, 1967-2 C.B. 141, a corporation, pursuant to a plan of reorganization, acquired all the outstanding stock of another corporation from the shareholders in exchange for voting stock of the acquiring corporation and thereafter, as part of the same plan, the acquiring corporation completely liquidated the acquired corporation. Rev. Rul. 67-274 holds that under these circumstances the acquisition of the stock of the acquired corporation and its liquidation by the acquiring corporation are part of the overall plan of reorganization and may not be considered independently of each other for Federal income tax purposes. Rev. Rul. 67-274 concludes that the transaction is not an acquisition of the stock of the acquired corporation qualifying as a reorganization under section 368(a)(1)(B) of the Code but is an acquisition of the assets of the acquired corporation qualifying as a reorganization under section 368(a)(1)(C).

Rev. Rul. 68-357, 1968-2 C.B. 144, holds that section 351 of the Code applies where, as part of an overall plan to consolidate the operations of five businesses, an individual and three corporations transfer property to a corporation that they control immediately after the transfers within the meaning of section 368(c) even though the transfers of property by the corporations are reorganizations within the meaning of section 368(a)(1)(C).

The transfer by A of A's X stock to Z and, as part of the overall transaction, the liquidation of X by Z are interdependent steps in an overall reorganization plan the substance of which is treated for Federal income tax purposes as an acquisition by Z of all of the assets of X solely in exchange for Z voting stock in a transaction qualifying as a reorganization under section 368(a)(1)(C) of the Code, followed by a distribution by X of the Z stock to A in exchange for all of A's X stock. Accordingly, no gain or loss is recognized by X upon the exchange of its property solely for Z stock as provided by section 361(a), and no gain or loss is recognized to A on the exchange of A's X stock solely for voting stock of Z as provided in section 354(a).

Furthermore, the transfer by X of its property to Z in liquidation and the transfer by B of B's Y stock to Z is a transaction within the provisions of section 351(a) of the Code since X and B are in control of Z immediately after the exchanges within the meaning of section 368(c). Pursuant to section 351(c) the distribution by X of the Z stock to A does not violate the control requirement of section 368(c). Accordingly, no loss is recognized to B and no gain is recognized to B in excess of the 10x dollars received by B, as provided in section 351(b), upon the exchange of B's Y stock solely for cash and voting stock of Z. See Rev. Rul. 68-357.

Rev. Rul. 68-349, 1968-2 C.B. 143, holds that the transfer of property by an individual to a newly formed corporation does not qualify under section 351 of the Code where another corporation simultaneously transfers all of its property to the new corporation for the purpose of qualifying the individual's transfer under section 351. Rev. Rul. 68-349 states that the organization of the new corporation is considered under the circumstances to be merely a continuation of the transferor corporation. Rev. Rul. 68-349 is distinguishable from the instant case in that Z was not employed solely for the purpose of enabling B to transfer B's Y stock without the recognition of gain and was not merely a continuation of X. Z was organized to enable X to be reincorporated in State P. Further, the transfer by B of his Y stock to Z effected the combination of A's and B's former business interests in the form of affiliated corporations.

Rev. Rul. 68-349 is distinguished.

**Rev. Rul. 84-44, 1984-1 C.B. 105**

Section 351. - Transfer to Corporation Controlled by Transferor, 26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Transfer to corporation controlled by transferor. Stock of a parent corporation, received by shareholders of a target corporation in a merger under sections 368(a)(1)(A) and 368(a)(2)(D) of the Code, will not be aggregated with stock of the parent received by a transferor of property to the parent in determining whether the control requirement of section 351 is met. Rev. Ruls. 68-357 and 76-123 distinguished.

ISSUE

Under the facts described below, does section 351 of the Internal Revenue Code apply to the transfer of assets from Y to P in exchange for P stock?

FACTS

X, Y and P were unrelated corporations. In a transaction qualifying as a reorganization under sections 368(a)(1)(A) and (a)(2)(D) of the Code, X was merged into S, a wholly owned subsidiary of P. In the transaction, the shareholders of X received shares of P stock in exchange for their shares of X stock. At the same time, as part of an overall plan, Y transferred part (but less than substantially all) of its assets to P in exchange for P stock. While Y did not have the requisite control of P to qualify its transfer of assets within the provisions of section 351, Y together with the former shareholders of X were in control of P within the meaning of section 368(c) of the Code.

LAW AND ANALYSIS

Section 368(a)(2)(D) of the Code provides that the acquisition by one corporation, in exchange for stock of a corporation which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify the transaction under section 368(a)(1)(A) if no stock of the acquiring corporation is used in the transaction and the transaction would have qualified as a reorganization under section 368(a)(1)(A) had the merger been into the controlling corporation.

Section 351(a) of the Code provides that no gain or loss will be recognized if property is transferred to a corporation solely in exchange for its stock and immediately after the exchange the transferors are in control of the corporation (as defined in section 368(c)).

Although P stock was used as the consideration in the merger of X into S, the shareholders of X did not transfer any property to P. Therefore, since P is not the transferee of the stock of X, the P stock received by the shareholders of X is not taken into account with the P stock received by Y in determining whether the requirements of section 351 of the Code have been met. The only assets received by P were transferred by Y, and since Y was not in control of P immediately after the transfer, the transaction does not qualify under section 351. Additionally, since P is not the transferee of the X assets, the receipt of P stock by X upon the transfer of its assets to S cannot be aggregated with the P stock received by Y in determining whether the 80 percent control requirement of section 351 could be met by X and Y.

The instant case should be compared with Rev. Rul. 68-357, 1968-2 C.B. 144, and Rev. Rul. 76-123, 1976-1 C.B. 94. In those rulings, stock received by individual transferors was aggregated with stock received in reorganizations for purposes of the control requirement of section 351 of the Code when the transfers were to the same corporation.

HOLDING

Since the control requirement of section 351 of the Code was not met by Y, any gain or loss realized by Y on the exchange will be recognized as provided by section 1001 of the Code. No gain or loss is recognized to P under section 1032(a) upon the exchange with Y of P stock for assets of Y.

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 68-357 and Rev. Rul. 76-123 are distinguished.

Rev. Rul. 84-44, 1984-1 C.B. 105, 1984-13 I.R.B. 5.

**Rev. Rul. 2003-51, 2003-21 I.R.B. 938**

Section 351.--Transfer to Corporation Controlled by Transferor, 26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Transfer to corporation. This ruling provides guidance regarding the control requirement under section 351 of the Code involving successive transfers of property and stock. Rev. Ruls. 70-140, 70-522, 79-70, and 79-194 distinguished.

Transfer to corporation. This ruling provides guidance regarding the control requirement under section 351 of the Code involving successive transfers of property and stock. Rev. Ruls. 70-140, 70-522, 79-70, and 79-194 distinguished.

ISSUE

Whether a transfer of assets to a corporation (the "first corporation") in exchange for an amount of stock in the first corporation constituting control satisfies the control requirement of section 351 of the Internal Revenue Code if, pursuant to a binding agreement entered into by the transferor with a third party prior to the exchange, the transferor transfers the stock of the first corporation to another corporation (the "second corporation") simultaneously with the transfer of assets by the third party to the second corporation, and immediately thereafter, the transferor and the third party are in control of the second corporation.

FACTS

Corporation W, a domestic corporation, engages in businesses A, B, and C. The fair market values of businesses A, B, and C are $40x, $30x, and $30x, respectively. X, a domestic corporation unrelated to W, also engages in business A through its wholly owned domestic subsidiary, Y. The fair market value of X's Y stock is $30x. W and X desire to consolidate their business A operations within a new corporation in a holding company structure. Pursuant to a prearranged binding agreement with X, W forms a domestic corporation, Z, by transferring all of its business A assets to Z in exchange for all of the stock of Z (the "first transfer"). Immediately thereafter, W contributes all of its Z stock to Y in exchange for stock of Y (the "second transfer"). Simultaneous with the second transfer, X contributes $30x to Y to meet the capital needs of business A after the restructuring in exchange for additional stock of Y (the "third transfer"). After the second and third transfers, Y transfers the $30x and its business A assets to Z (the "fourth transfer"). After the second and third transfers, W and X own 40 percent and 60 percent, respectively, of the outstanding stock of Y. Viewed separately, each of the first transfer, the combined second and third transfers, and fourth transfer qualifies as a transfer described in section 351section 351.

LAW

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in s 368(c)) of the corporation.

Section 368(c) defines control to mean the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

Section 1.351-1(a)(1) of the Income Tax Regulations provides that the phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Courts have held that the control requirement of section 351 is not satisfied where, pursuant to a binding agreement entered into by the transferor prior to the transfer of property to the corporation in exchange for stock, the transferor loses control of the corporation by a taxable sale of all or part of that stock to a third party who does not also transfer property to the corporation in exchange for stock. See, e.g., S. Klein on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951); Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3d Cir. 1937); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976). The Service has reached the same conclusion when addressing similar facts. See Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144; Rev. Rul. 70- 522, 1970-2 C.B. 81.

In Rev. Rul. 70-140, 1970-1 C.B. 73, A, an individual, owns all of the stock of corporation X and operates a business similar to that of X through a sole proprietorship. Pursuant to an agreement between A and Y, an unrelated, widely held corporation, A transfers all of the assets of the sole proprietorship to X in exchange for additional shares of X stock. A then transfers all his X stock to Y solely in exchange for voting common stock of Y. The ruling reasons that because the two steps of the transaction are parts of a prearranged plan, they may not be considered independently of each other for federal income tax purposes. The ruling concludes that A's receipt of the X stock in exchange for the sole proprietorship assets is transitory and without substance for tax purposes because it is apparent that the assets of the sole proprietorship are transferred to X to enable Y to acquire those assets without the recognition of gain to A. Accordingly, the ruling treats A as transferring its sole proprietorship assets directly to Y in a transfer to which section 351 does not apply, and Y as transferring these assets to X, independently of A's transfer of the X stock to Y in exchange for Y voting stock. The exchange by A of the stock of X solely for voting stock of Y constitutes an exchange to which s 354 applies. See also s 1.1361-5(b)(3), Example 9.

In Rev. Rul. 77-449, 1977-2 C.B. 110, amplified by Rev. Rul. 83-34, 1983-1 C.B. 79, and Rev. Rul. 83-156, 1983-2 C.B. 66, a corporation transfers assets to a wholly owned subsidiary, which in turn transfers, as part of the same plan, the same assets to its own wholly owned subsidiary. The ruling states that the transfers should be viewed separately for purposes of section 351. Because each transfer satisfies the requirements of section 351, no gain or loss is recognized by the transferor.

In Rev. Rul. 83-34, corporation P owns 80 percent of the stock of a subsidiary, S1. An unrelated corporation owns the remaining 20 percent. P transfers assets to S1 solely in exchange for additional shares of S1 stock. As part of the same plan, S1 transfers the same assets to S2, a newly formed corporation of which S1 will be an 80 percent shareholder. An unrelated corporation will own the remaining 20 percent of the S2 stock. Citing Rev. Rul. 77-449, the ruling concludes that the transfers should be viewed separately for purposes of section 351 and that each transfer satisfies the requirements of section 351.

In Rev. Rul. 84-111, 1984-2 C.B. 88, Situation 1, a partnership transfers all of its assets to a newly formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The steps undertaken by the partnership were parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. The ruling concludes that, under section 351, the partnership recognizes no gain or loss on the transfer of its assets to the corporation in exchange for the corporation's stock and the corporation's assumption of the partnership's liabilities, notwithstanding the partnership's subsequent distribution of the corporation's stock to the partners and consequent loss of control within the meaning of s 368(c) of the corporation.

ANALYSIS

As described above, if the first transfer were viewed as separate from each of the other transfers, the first transfer would satisfy the technical requirements of a transfer under section 351 because W transfers property to Z in exchange for stock in Z and, immediately after the exchange, W is in control of Z. However, because the first and second transfers are undertaken pursuant to a prearranged binding agreement, it is necessary to determine whether the second transfer causes the first transfer to fail to satisfy the control requirement of section 351.

"Section 351 has been described as a deliberate attempt by Congress to facilitate the incorporation of ongoing businesses and to eliminate any technical constructions which are economically unsound." Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1177 (3d Cir.), cert. denied, 419 U.S. 826 (1974). Section 351(a) is intended to apply to "certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture." Portland Oil Co. v. Commissioner, 109 F.2d 479, 488 (1st Cir.), cert. denied, 310 U.S. 650 (1940). See S. Rep. No. 67-275, at 12 (1921) (explaining that the predecessor to section 351 was enacted in 1921 to "permit business to go forward with the readjustments required by existing conditions"). A transaction described under section 351 "lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, ... the transferors continue to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it." American Compress & Warehouse Co. v. Bender, 70 F.2d 655, 657 (5th Cir.), cert. denied, 293 U.S. 607 (1934).

As described above, courts have held that the control requirement of section 351 is not satisfied where, pursuant to a binding agreement entered into by the transferor prior to the transfer of property to the corporation in exchange for stock, the transferor loses control of the corporation by a taxable sale of all or part of that stock to a third party that does not also transfer property to the corporation in exchange for stock. Treating a transfer of property that is followed by such a prearranged sale of the stock received as a transfer described in section 351 is not consistent with Congress' intent in enacting section 351 to facilitate the rearrangement of the transferor's interest in its property. Treating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in section 351 is not necessarily inconsistent with the purposes of section 351. Accordingly, the control requirement may be satisfied in such a case, even if the stock received is transferred pursuant to a binding commitment in place upon the transfer of the property in exchange for stock. For example, in Rev. Rul. 84-111, Situation 1, the partnership's transfer of property to the transferee corporation qualified as a transfer described in section 351, even though the partnership relinquished control of the transferee corporation within the meaning of section 368(c) pursuant to a prearranged plan to transfer the transferee stock.

In Rev. Rul. 70-140, the transfer of assets to the transferor's wholly owned subsidiary followed by an exchange of stock of the wholly owned subsidiary for stock of another corporation was recast as a direct transfer of assets to the unrelated, widely held corporation in a taxable transaction. In Rev. Rul. 70-140, there was no alternative form of transaction that would have qualified for nonrecognition treatment. In contrast, in this case, W's transfer of the business A assets to Z was not necessary for W and X to combine their business A assets in a holding company structure in a manner that would have qualified for nonrecognition of gain or loss under section 351. A transfer of W's business A assets to Y in exchange for Y stock as part of a plan that included X's transfer of $30x to Y in exchange for Y stock, and Y's transfer of the business A assets and $30x to Z in exchange for all of the Z stock, would have qualified as successive transfers described in section 351. See Rev. Rul. 83-34; Rev. Rul. 77-449. Accordingly, in these circumstances, Rev. Rul. 70-140 is distinguishable.

In this case, even though the first transfer is followed by a transfer of the stock received, treating the first transfer as a transfer described in section 351 is not inconsistent with the purposes of section 351. Accordingly, the second transfer will not cause the first transfer to fail to satisfy the control requirement of section 351.

HOLDING

A transfer of assets to the first corporation in exchange for an amount of stock in the first corporation constituting control satisfies the control requirement of section 351 even if, pursuant to a binding agreement entered into by the transferor with a third party prior to the exchange, the transferor transfers the stock of the first corporation to the second corporation simultaneously with the transfer of assets by the third party to the second corporation, and immediately thereafter, the transferor and the third party are in control of the second corporation.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-194, 1979-1 C.B. 145, Rev. Rul. 79-70, 1979-1 C.B. 144, Rev. Rul. 70-522, 1970-2 C.B. 81, and Rev. Rul. 70-140, 1970-1 C.B. 73, are distinguished.

DRAFTING INFORMATION

The principal author of this revenue ruling is Lisa K. Leong of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Leong at (202) 622-7530 (not a toll-free call).

**Bring in the ‘Tax Guys' Before It's Too Late!**

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Almost since there have been taxes, Tax Guys have been angling to be brought into deal discussions at the earliest possible time, the goal being to structure deals efficiently, not just from a business standpoint, but from a tax standpoint as well. Despite this persistent angling, Tax Guys are often the last to know about a deal and this can make *restructuring* in a tax-efficient manner difficult, at best.

LTR 200049026, although simple in appearance, is a prime example of what proper structuring can do to further both tax and business objectives. The structure described in the LTR could only have been achieved by having the Tax Guys involved early, and it is a structure that avoids some very costly missteps.

The pertinent facts of this LTR are as follows: A and B each own an appreciated asset that is used in Business X. Target is a corporation owned entirely by some 40 shareholders (the 'Group'). Target is engaged in Business X and would like to acquire the assets from A and B. A and B are amenable, provided two conditions can be satisfied: (1) A and B want the transaction to be tax free, and (2) A and B insist on receiving solely stock of Target, which they believe is an attractive investment. The value of the two assets owned by A and B will total approximately 10% of the value of Target.

There are numerous ways one could structure a deal such as this, but as we will see, only one (that chosen in LTR 200049026) weds the business and tax imperatives. Getting there takes careful structuring and small deviations can prove disastrous.

In the LTR the following events occur: A new corporation, Transferee, is formed. Transferee, in turn, forms a new wholly owned subsidiary, Merger Sub. Pursuant to one overall plan, A and B each transfer their appreciated assets to Transferee solely in exchange for voting common stock of Transferee representing, in total, 10% of the value of Transferee. At the same time and pursuant to the same plan, Merger Sub merges, in a statutory merger, with and into Target, with Target as the surviving corporation. In this merger the Group exchanges all of the outstanding Target shares solely for 90% of the voting common stock of Transferee. The result of this merger is that Target has become a wholly owned subsidiary of Transferee. Transferee then takes the two assets it acquired from A and B and contributes them to Target, uniting those assets with Target's Business X.

Relying on the fact that all of the steps have been achieved pursuant to a single plan, LTR 200049026 concludes that A, B, and the Group will be viewed as having transferred assets to Transferee solely in exchange for all of the Transferee voting common stock, placing A, B, and the Group in 'control' of Transferee and giving them tax-free treatment pursuant to Section 351.[1](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_1#FN_1)

The LTR correctly states that A and B have each transferred an asset they owned and that the Group has transferred the stock of Target. It is easily seen how the IRS concluded that A and B transferred an asset to Transferee—they actually did so. But how did the IRS conclude that the Group transferred the stock of Target to Transferee? After all, that's not what 'really' happened. What really happened was a merger between Target and Merger Sub.

The starting point for the analysis is Rev. Rul. 67-448, 1967-2 CB 144. The imperative here is that Merger Sub be a new corporation formed solely to accomplish a stated objective, that it cease to exist by virtue of that objective, and that it never conduct any business except to carry out that objective. In the LTR, the 'objective' is the merger with Target. Therefore, the revenue ruling instructs that the very corporate existence of Merger Sub can be ignored and that the overall transaction can be viewed as a direct transfer by Target shareholders (the Group) of their Target shares to the acquiring corporation (Transferee) in exchange for the stock of the acquiring corporation. Under this view, it becomes clear that A, B, and the Group have all directly transferred assets to Transferee and they have received solely Transferee stock constituting 100% (and, therefore, 'control') of Transferee, thus fulfilling the mandates of Section 351. The subsequent transfer by Transferee of the assets acquired from A and B to Target not only does not disturb the foregoing analysis, it is actually viewed as a separate and distinct tax-free transfer, also under the rules of Section 351.[2](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_2#FN_2)

Although the structure in LTR 200049026 gives A and B the tax-free treatment they insisted upon, it does not give A and B Target stock; instead they receive Transferee stock. But, because Transferee is now a holding company that owns all of Target, the Transferee stock is an acceptable surrogate for Target stock. In addition, the assets formerly held by A and B are now held directly by Target and can be used in Business X. Neat, clean, no problem! So what's all the fuss about needing the Tax Guys for this one?

The answer is that sometimes, indeed often, solutions that seem simple are really just the result of applying a lot of complicated knowledge. As we will see, the business results achieved in LTR 200049026 could have been achieved in many different ways, some tantalizingly similar to the chosen structure, but all radically different with respect to tax results. Hence, the importance of the Tax Guys!

**Alternative 1**

Surely it would have been easier to simply have A and B transfer their respective assets directly to Target solely for Target stock. This is 'shootin' fish in a barrel!' True enough, but alas, A and B have become the fish! In this structure A and B will receive 10% of the Target stock in exchange for transferring their assets, and that quantum of Target stock does not place them in 'control' of Target as required by Section 351. Therefore, their exchange of assets for Target stock would be fully taxable to them. Guess we should 'holster' this easy alternative.

**Alternative 2**

Well then, why not simply have Target set up a new wholly owned subsidiary (Newco) and have Target transfer all its assets to Newco and have A and B each transfer their assets to Newco in exchange for Newco shares. This is a valid Section 351 transfer, because Target, A, and B will have transferred assets to Newco solely for Newco stock and these three transferors will certainly 'control' Newco after the transfers. But this structure fails to give A and B stock of Target. Although one might argue the stock of Newco is, like the stock of Transferee in LTR 200049026, a surrogate for Target stock, it is a far less perfect surrogate. Almost uniformly, investors (such as A and B) want stock of a top-tier corporation and not stock of a subsidiary. There are many reasons for this, but liquidity (any market for shares will typically relate to the stock of the top-tier corporation, and not the stock of a subsidiary) and asset preservation (the top-tier corporation can access (siphon) a subsidiary's profits in a tax-efficient manner, using either the consolidated return regulations or the dividends-received deduction, all to the economic detriment of A and B) are normally the most significant. Thus, although A and B may be quite content to receive stock of Transferee, they will not be content to receive stock of Newco.

**Alternative 2(a)**

Well OK, if A and B insist on receiving only stock of the top-tier corporation, why not implement Alternative 2, but simply give A and B Target shares instead of Newco shares? Great fix, except for a minor detail—the transaction is now taxable. Section 351 requires that those who transfer property receive solely stock of the *transferee* corporation.[3](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_3#FN_3) If A and B transfer their assets to Newco and receive stock of Target, they are not receiving stock of the *transferee* corporation, and therefore the transaction will be taxable. Another 'simple' alternative bites the dust.

**Alternative 3**

All right then, if we must have a merger, why not simply merge Target into Transferee; why fool around with Merger Sub? For those who are stout of heart this one might get the job done. It is, however, a roll of the dice, and on the table are the tax consequences to both A and B. To understand the risk here we need to compare two revenue rulings: Rev. Rul. 68-349, 1968-2 CB 143 (the villain) and Rev. Rul. 76-123, 1976-1 CB 94 (the hero).

Rev. Rul. 68-349 addresses a fact pattern similar to that suggested in this alternative. In the ruling, Newco receives assets from Target in a tax-free asset acquisition, and simultaneously, A transfers an asset to Newco. Clearly, on the facts, we have two parties transferring assets to Newco, and these parties will 'control' Newco after the transaction.[4](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_4#FN_4) Based on this analysis, we seem to have a solid Section 351 transaction. But the ruling concludes that Target's transfer of assets to Newco was done as a mere accommodation to qualify the asset transfer by A under Section 351. The result is that the ruling treats the transaction as if A had directly transferred its asset to Target, and as if no asset transfer to Newco had occurred. The outcome of this recast is that unless A ends up in control of Target (i.e., in control of Newco), A's asset transfer is fully taxable, because the control test of Section 351 will not have been satisfied. Thus, anyone proposing this structure as an alternative to that used in LTR 200049026 will have to worry about the IRS's accommodation transferor argument. Applying that argument to the facts in LTR 2000049026, A and B would own a mere 10% of the surviving corporation, not nearly enough to have 'control,' and therefore their asset transfers would be fully taxable.

Rev. Rul. 76-123 does offer the potential to have this alternative pass muster as a tax-free transaction. Although the facts in that ruling are somewhat cumbersome, the gist of the ruling is that, provided there is a bona fide business reason for the tax-free asset transfer from Target to Newco, that reorganization will be respected, and the overall transaction will not be viewed as one in which A and B simply transferred their assets to Target, thus failing the control test of Section 351. That approach makes sense, because the recast in Rev. Rul. 68-349 assumes that there was only one reason for the reorganization—to accommodate another transferor. If, instead, the reorganization is supported by a bona fide business reason apart from accommodating another party, this assumption, and thus the recast, would be inappropriate.

Nevertheless, if the parties had attempted Alternative 3 in LTR 200049026, they would have needed to get very comfortable vis à vis the restructuring, that there was a bona fide business purpose for the merger of Target with and into Transferee. Given the stakes, prudence might have dictated that this risk simply was not worth taking.

**Alternative 4**

Let's try something else. Suppose we leave the merger as structured in LTR 200049026, but then to get the Business X assets of A and B together with Target's Business X, we liquidate Target into Transferee. Recall that in the LTR, this business objective was accomplished by having Transferee transfer the two assets to Target in a subsequent Section 351 transaction. Here again, this seemingly minor change in the structuring could spell big trouble. The liquidation of Target into Transferee will almost surely be stepped together with its merger with Merger Sub.[5](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_5#FN_5) Stepping the liquidation of Target with the merger of Merger Sub will result in the transaction being treated as one in which Transferee simply acquired the *assets* (not the stock as in the LTR) of Target. But this is the precise concern addressed in Alternative 3—if one concludes that Transferee acquired Target's assets (instead of stock), the transaction must face the challenge of being recast as in Rev. Rul. 68-349. And that, as we concluded above, is a possibility that is almost certainly not worth the risk. Scratch yet another alternative.

**Alternative 4(a)**

A similar problem would arise if one attempted to unite all the Business X assets by simply merging Transferee down into Target following the merger with Merger Sub. Such a downstream merger would mean that Transferee would have come into existence and then gone out of existence all as part of one transaction. Thus, the IRS might reasonably conclude that Transferee's corporate existence (like that of Merger Sub) should be disregarded. A and B would then be treated as having transferred their appreciated assets to Target for 10% of the Target stock; and that, as we know, is a taxable transaction.

**Alternative 5**

In the LTR, the merger between Target and Merger Sub is one in which Target survives. Is it then permissible to do the merger so that Merger Sub survives? Again, a seemingly innocuous tweak of the facts will lead to a dismal tax result. If the merger is one in which Merger Sub survives, we would have virtually the precise facts of Rev. Rul. 84-44 and the *Yamamoto* case cited in Alternative 2(a), and not surprisingly, we would also have the same unfortunate tax result discussed in that alternative. This change in merger direction would produce a transaction in which no one other than A and B will have transferred assets to Transferee, and one in which the Transferee stock received by the Group in the merger portion of the structure would not be counted to help determine if A and B were in 'control' of Transferee. Because A and B would own only 10% of Transferee they would once again fail to qualify for tax-free treatment. Thus, this structure must also be cast aside.

**Alternative 6**

What about the order of events? Is it really necessary to complete the merger involving Merger Sub and Target before Transferee retransfers the assets acquired from A and B? Perhaps it would be more convenient to have Transferee acquire these assets from A and B and then place them into Merger Sub, so that in the ensuing merger of Merger Sub into Target the assets would automatically become Target assets. This minor twist would, like all the others, result in an almost certain inability to achieve A's and B's tax objectives. As discussed above, to have the merger between Merger Sub and Target disregarded (and viewed as if the Group simply transferred their Target shares to Transferee) Merger Sub had to be a new corporation, which was formed solely to accomplish a stated objective, which ceased to exist by virtue of that objective, and which never conducted *any* business apart from participating in the objective. But if Transferee places the assets acquired from A and B into Merger Sub prior to the merger, Merger Sub will own real business assets at the time of its merger. Even the bare ownership of such business assets casts doubt on the IRS's willingness to disregard Merger Sub. If Merger Sub is not disregarded, the good news is that the merger, under these facts, would continue to be tax free,[6](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#FN_6#FN_6) but the bad news is that it will not be possible to view the Group as having transferred their Target shares directly to Transferee. Thus, as before, A and B will have a taxable transaction.

**Conclusion**

By now it should be apparent that the structure chosen in LTR 200049026 was neither simple nor accidental. Instead, it was a carefully chosen path through a potentially devastating minefield. The various alternatives presented here appear to be plausible means of achieving the parties' ends, but as has been shown, one chooses these alternatives at one's peril (or at least at the peril of A and B!). The plea to 'get the Tax Guys involved early' is not frivolous. The foregoing illustrates why.
[1](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_1#SRC_1)

  Control for purposes of Section 351 is defined in Section 368(c) as 80% of the total voting power of all classes of stock entitled to vote and 80% of the total number of shares of each other class of stock. See also Rev. Rul 59-259, 1959-2 CB 115.
[2](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_2#SRC_2)

  See generally Rev. Rul. 77-449, 1977-2 CB 110; Rev. Rul. 83-34, 1983-1 CB 79.
[3](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_3#SRC_3)

  See generally Rev. Rul. 84-44, 1984-1 CB 105; *Yamamoto*, TC Memo 1986-316, PH TCM ¶86316, 51 CCH TCM 1560 .
[4](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_4#SRC_4)

  Although it is true that Target will own no Newco stock after the transaction, because Target will have ceased to exist following the reorganization with Newco, the shareholders of Target do receive Newco stock in the reorganization and this fact satisfies the 'control' mandate of Section 351. See generally Section 351(c)(1); Rev. Rul. 68-357, 1968-2 CB 144.
[5](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_5#SRC_5)

See Rev. Rul. 67-274, 1967-2 CB 141; Rev. Rul. 72-405, 1972-2 CB 217.
[6](file:///J%3A%5CUniversity%20of%20Washington%5CACTP%20ZIP%20DRIVE%5C2008%20ACTP%5C2008%20updates.doc#SRC_6#SRC_6)See Sections 368(a)(1)(A); 368(a)(2)(E).