**Class 5 – Reviewing Acquisition Agreements and Planning Integration**

Skim: Sections 951, 951A, and 958.

Skim through the following purchase agreements:

<https://www.sec.gov/Archives/edgar/data/718877/000110465922005154/tm223212d3_ex2-1.htm>

<https://www.sec.gov/Archives/edgar/data/1018724/000119312517205287/d352949dex21.htm>

<https://www.sec.gov/Archives/edgar/data/1326801/000132680114000023/fb-3312014xex21.htm>

**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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%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:\University%20of%20Washington\ACTP%20ZIP%20DRIVE\2008%20ACTP\2008%20updates.doc#SRC_6#SRC_6)See Sections 368(a)(1)(A); 368(a)(2)(E).