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ACQUISITIVE REORGANIZATIONS: THE "OTHER" METHOD OF BUYING OR SELLING A CORPORATE BUSINESS

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The sale or purchase of a corporate business can be accomplished through a sale of stock, a sale of corporate assets, or one of the various acquisitive reorganizations. Most attorneys are familiar with the first two methods but fail to consider the third as a viable alternative for acquiring or disposing of the corporate business either because they are totally unfamiliar with corporate reorganizations or, perhaps more commonly, because they do not feel comfortable with the seemingly formidable requirements of corporate reorganizations as established under the Internal Revenue Code and the applicable provisions of state law. In many instances, however, the objectives of the client can best be accomplished by structuring the acquisition as a tax-free reorganization rather than one of the more common forms of taxable transactions. The purpose of this article is to acquaint the reader with each of the various forms of acquisitive reorganizations and to consider the advantages and disadvantages of each, both in relation to one another and in relation to a sale of stock or a sale of corporate assets.

The Nature of a Tax-free Reorganization

The principal difference between the acquisition of stock or assets in a corporate reorganization and a direct purchase of stock or corporate assets is the nature of the consideration. In a reorganization, the consideration paid by the acquiring party consists primarily (if not solely) of stock and securities of either the acquiring corporation or a corporation in control of the acquiring corporation. In contrast, the purchase of stock or assets may involve the use of cash, notes, bonds or various other forms of property. Examined from another perspective, a sale of stock or assets involves a complete liquidation of the seller's interest, whereas the seller in a corporate reorganization retains a continuing interest in his old corporation by virtue of having received stock of the acquiring corporation.[1]

The procedures and considerations involved in the taxable sale and the

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1. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ch. 16, ¶14.04 (3d ed. 1971).

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tax-free reorganization differ vastly. Generally, if reorganization is selected, four alternative methods are available under the Code:

1. The statutory merger or consolidation under section 368(a)(1)(A).[2]
2. The stock-for-stock "B" reorganization under section 368(a)(1)(B).
3. The stock-for-assets "C" reorganization under section 368(a)(1)(C).
4. The triangular or reverse mergers, sometimes referred to as "hybrid reorganizations," under sections 368(a)(2)(D) and (E).

TYPE "A": STATUTORY MERGERS AND CONSOLIDATIONS

Section 368(a)(1)(A) provides that a statutory merger or consolidation will qualify as a corporate reorganization. This is ordinarily the most facile and flexible of the reorganization routes since the principal requirement for qualification is simply that the merger or consolidation be effected in compliance with the corporate laws of the United States, a state or territory of the United States, or the District of Columbia.[3]

A statutory merger involves the combination of one or more corporations with a single pre-existing corporation that "survives" the merger. The assets and liabilities of the transferor corporation automatically pass to the surviving corporation by operation of law, thus eliminating the necessity of bills of sale, deeds to real property, assignments of mortgages, and other similar instruments ordinarily required in the purchase of a business. A consolidation is the combination of two or more corporations into a newly created corporation that survives the consolidation; it is essentially the same as a merger since the assets and liabilities of the disappearing corporations are absorbed or assimilated by the surviving entity by operation of law.

Permissible Forms of Consideration

Unlike the "B" and "C" reorganizations discussed below, section 368(a)(1)(A) contains no restrictions on the nature of the consideration used by the acquiring corporation. Thus, the acquiring corporation in a statutory merger or consolidation may use nonvoting preferred stock, debentures, or even cash and still comply with the literal language of the Code. As in many instances where broad permissive language seemingly renders a particular Code section susceptible to abuse, however, the courts have grafted onto section 368(a)(1)(A) additional restrictions designed to ensure that a merger or consolidation complies not only with the literal language of that section but also with the courts' general concept of a reorganization. The continuity-of-interest doctrine represents the principal judicial development in this area and may be applied at both the shareholder and the corporate level.

The continuity-of-interest doctrine, as it applies at the shareholder level, requires that the type of consideration received by stockholders of the acquired

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2. All Code sections given refer to the INT. REV. CODE OF 1954.

3. INT. REV. CODE OF 1954, §368(a)(1)(A); Treas. Reg. §1.368-2(b); Rev. Rul. 55-305, 1955-1 CUM. BULL. 345. *See generally* Vesely, *"A" Reorganizations — Statutory Mergers and Consolidations*, 19 CASE W. RES. L. REV. 975 (1968).

or merged corporation provide them with a substantial proprietary interest in the continuing enterprise. For example, if Corporation *X* is merged into Corporation *Y* in exchange for debentures or short-term notes of *Y*, the transaction would not meet the continuity-of-interest test since the stockholders of *X* have no continuing proprietary interest in the combined entities. Thus, an exchange could comply with state merger statutes and with the literal language of section 368(a)(1)(A), yet fail to effect a tax-free "A" merger. The Internal Revenue Service has adopted a rule of thumb that at least 50 percent of the consideration received in the merger or consolidation must consist of stock of the acquiring corporation in order to meet the continuity-of-interest test.[4] The Supreme Court, however, in *John A. Nelson Co. v. Helvering*,[5] held that the continuity-of-interest test was met where the consideration received consisted of 38 percent preferred stock and 62 percent cash. Some cases have sanctioned even lower percentages of stock.[6]

The stock received may be common or preferred, voting or nonvoting. It is clear, however, that short-term notes or even long-term debt securities, which do not have sufficient equity characteristics to meet the continuity-of-interest test, may only be issued in conjunction with a substantial amount of stock of the acquiring corporation if a type "A" reorganization is to be achieved. It is also clear that the stockholders of the acquired corporation, individually, need not receive proportionate amounts of stock of the acquiring corporation, and it has been held that some stockholders may receive all "boot" (consideration other than stock or securities) while other stockholders receive a disproportionate amount of stock.[7] The transfer of nonstock consideration, however, should not be carried to such extremes that only a small number of shareholders receive stock while the majority receive boot.[8]

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4. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232; Rev. Rul. 66-224, 1966-2 CUM. BULL. 114; Rev. Proc. 74-26, 1974-36 INT. REV. BULL. 19, provides that each shareholder of the acquired corporation need not receive stock of the acquiring corporation equal to 50% of the value of his former stock interest as long as at least one shareholder of the acquired corporation has a continuing interest in the acquiring corporation (through stock ownership) equal in value to at least 50% of the value of all of the formerly outstanding stock of the acquired corporation.

5. 296 U.S. 374 (1935).

6. *See* Le Tulle v. Scofield, 308 U.S. 415 (1940); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). *See generally* Sapienza, *Tax Considerations in Corporate Reorganizations and Mergers*, 60 NW. U.L. REV. 765, 780-82 (1966). See note 12 *infra*.

7. Miller v. Commissioner, 84 F.2d 415, 1936-2 U.S.T.C. ¶9324 (6th Cir. 1936). *See* Everett v. United States, 448 F.2d 357, 1971-2 U.S.T.C. ¶9629 (10th Cir. 1971) (the continuity of interest test of a tax-free reorganization does not require that all of the proprietary owners of the transferor corporation become and remain proprietary owners of the transferee corporation); Liddon v. Commissioner, 230 F.2d 304, 1956-1 U.S.T.C. ¶9268 (6th Cir. 1956) (although the interest of a minority shareholder was completely liquidated in the process of dissolution of the old corporation, the creation of a new corporation would nevertheless qualify as a reorganization for income tax purposes); Rev. Rul. 66-224, 1966-2 CUM. BULL. 114. The *Everett* and *Liddon* courts both relied upon *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936), in which no importance was attached to the fact that some of the stockholders in the transferring corporation acquired no interest in the transferee. The *Miller* court found that a controlling interest in the transferee corporation is not a prerequisite to a "reorganization."

8. *Cf.* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (to accept the idea that short term notes are "securities" for purposes of the reorganization requirement

The continuity of interest must be fairly permanent in nature and if, pursuant to a prearranged plan, the stockholders of the acquired corporations dispose of a substantial amount of their stock shortly after the merger, the continuity-of-interest test will not be met. Revenue Ruling 66-23[9] provides that a five-year holding period will satisfy the requirements of permanency, but it appears that stock held less than five years may be sold if not sold pursuant to a preconceived plan.[10]

The continuity-of-interest doctrine has also been applied at the corporate level to require the continuation of business activities after the merger.[11] Although the Service at one time took a contrary view, it is apparent now that the surviving corporation need not continue the *same* business that was conducted by the merged corporations; it is only necessary that it conduct *a* business after the reorganization.[12]

TYPE "B": STOCK-FOR-STOCK REORGANIZATIONS

A type "B" reorganization is defined in section 368(a)(1)(B) as the acquisition of stock of the target corporation *solely* in exchange for voting stock of the acquiring corporation or a corporation in control of the acquiring corporation if the acquiring corporation has control of the target corporation immediately after the exchange. "Control" for the purposes of the reorganization sections 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 all other classes of stock of the corporation,"[13]

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would be to allow an easy evasion of the gains tax); B. BITTKER & J. EUSTICE, *supra* note 1, at 14-21.

9. 1966-1 CUM. BULL. 67.

10. *See, e.g.*, Schweitzer & Conrad, Inc., 41 B.T.A. 533 (1940).

11. *See* Pridemark, Inc. v. Commissioner, 345 F.2d 35, 1965-1 U.S.T.C. ¶9388 (4th Cir. 1965).

12. Becher v. Commissioner, 221 F.2d 252, 1955-1 U.S.T.C. ¶9335 (2d Cir. 1955); Rev. Rul. 63-29, 1963-1 CUM. BULL. 77, based upon *Bentsen v. Phinney*, 199 F. Supp. 363, 1962-1 U.S.T.C. ¶9257 (Ct. Cl. 1961), where the stocks of three corporations that were owned by the Bentsen family and engaged in land development were surrendered for cancellation in exchange for voting stock in a newly formed life insurance company. The Commissioner argued that under Treas. Reg. 118, §39.112(g)-1(b) (1939) (now TREAS. REG. §1.368-1(b)) there must be an identity of type between the old and new business. The court rejected that argument, relying instead upon *Morley Cypress Trust*, 3 T.C. 84 (1944), and held that there must only be a continuity of business activity for the transaction to constitute a §368(a)(1) reorganization. *Compare* Pebble Springs Distilling Co. v. Commissioner, 231 F.2d 288, 1956-1 U.S.T.C. ¶9326 (7th Cir. 1956), *cert. denied*, 352 U.S. 836 (1956) (a new corporation organized for the purchase of real estate and "for such other purpose as incorporators may determine" could be engaged in a similar business as that of the transferor distilling company), *with* Becher v. Commissioner, 221 F.2d 252, 1955-1 U.S.T.C. ¶9335 (2d Cir. 1955) (similarity of business not deemed controlling). *See generally* Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964).

13. INT. REV. CODE OF 1954, §368(c).

"Solely for Voting Stock"

In contrast to the rather broadly worded and flexible requirements of a type "A" reorganization, the type "B" reorganization is very precisely and narrowly defined by the Code. The only type of consideration permissible in a "B" reorganization is voting stock of either the acquiring corporation or a corporation in control of the acquiring corporation – but not a combination of the two.[14] The courts have held that the solely-for-voting-stock requirement means exactly what it says, and no boot or even nonvoting stock may be used.[15]

Thus, the solely-for-voting-stock requirement would be violated upon the receipt of, for example, warrants to purchase voting stock,[16] or options, convertible debentures, and similar rights to acquire voting stock.[17] The payment of cash in lieu of fractional shares has been held allowable, however, if the payment of cash in this manner is not a separately bargained-for consideration.[18] The payment of SEC registration costs has been similarly sanctioned.[19] In Revenue Ruling 75-33,[20] the Service sanctioned an acquisition of all of the

14. Helvering v. Bashford, 302 U.S. 454, 1938-1 U.S.T.C. ¶9019 (1938). In *Bashford,* Atlas Corporation consummated a consolidation of three competing companies into a new corporation, of which it became the owner of all of the preferred and 57% of the common shares. Stockholders in the three consolidated corporations received shares of the new corporation, shares in Atlas, and some cash supplied by Atlas in exchange for their shares. The Commissioner agreed with Bashford, a stockholder in one of the old corporations, that the gain on stock in the new corporation was tax-free under the reorganization exception and that the cash was taxable, but asserted a deficiency based on the acquisition of Atlas stock, arguing that it was "other property" within §112(c)(1) of the Revenue Act of 1928. The Supreme Court applied the rule enunciated in Groman v. Commissioner, 302 U.S. 82, 89, 1937-2 U.S.T.C. ¶9533, at 10,516 (1937): "[W]here, pursuant to a plan, the interest of the stockholders of a corporation continues to be definitely represented in a substantial measure in a new or different one, then to the extent, but only to the extent, of that continuity of interest, the exchange is to be treated as one not giving rise to a present gain or loss." Thus, Atlas was not a "party to a reorganization" and consequently Atlas shares received by stockholders of the consolidated companies were "other property" and gain thereon was taxable. *See* Comment, *Taxation-Income Tax – Stock in a Corporation Inducing a Consolidation,* 17 TEXAS L. REV. 107 (1938). *See generally* Deming, *How "Solely" is "Solely for Voting Stock": Current Problems in "B" and "C" Reorganizations?,* N.Y.U. 29TH INST. ON FED. TAX. 397 (1971).

15. Turnbow v. Commissioner, 368 U.S. 337, 1962-1 U.S.T.C. ¶9104 (1961); Comment, *Income Taxation – Exchange of Voting Stock Plus "Boot" Does Not Qualify as a Tax-Free Reorganization,* 1962 U. ILL. L.F. 129 (1962); Comment, *Turnbow v. Commissioner – Rejection of the "Boot" Exception to a Type B Reorganization?,* 37 WASH. L. REV. 606 (1962). *See also* Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations,* 27 TAX L. REV. 499 (1972); Comment, *Acquiring Corporation Can Assume Acquired Corporation's Expenses in Tax-Free Reorganization,* 38 J. TAXATION 274 (1973).

16. Helvering v. Southwest Consol. Corp., 315 U.S. 194, 1942-1 U.S.T.C. ¶9248 (1942).

17. *See generally* Deming, *How "Solely" is "Solely for Voting Stock": Current Problems in "B" and "C" Reorganizations,* N.Y.U. 29TH INST. ON FED. TAX. 397 (1971).

18. Mills v. Commissioner, 331 F.2d 321, 1964-1 U.S.T.C. ¶9474 (5th Cir. 1964); Rev. Rul. 66-365, 1966-2 CUM. BULL. 116; *cf.* TEMP. REG. §13.10, T.D. 7039; TREAS. REG. §1.305-3(C).

19. Rev. Rul. 67-275, 1967-2 CUM. BULL. 142. See also Rev. Rul. 73-146, 1973-1 CUM. BULL. 61, which held that payments by the acquired corporation to its employees to discharge unexercised stock options preparatory to a "B" reorganization did not violate the "solely for voting stock" requirement.

20. 1975-5 INT. REV. BULL. 10.

outstanding stock of the acquired corporation in exchange for convertible preferred stock of the acquiring corporation that provided for annual dividends of $6.00 per share and an additional dividend of up to $1.50 per share for a period of 10 years after the acquisition. The additional dividend was tied to the dividends paid on the stock of another, unrelated corporation that had made a competing offer to acquire the target company and was designed to insure that the dividends received by the former shareholders of the acquired company would be at least as great as they would have been if they had accepted the competing offer. The Service stated that the additional dividend feature did not constitute "other property" in violation of the solely-for-voting-stock requirements because this right was an attribute of the stock that would apply to whoever held the stock and was not personal to the shareholders of the acquired company. The architect of a "B" reorganization should be very careful to insure that the solely-for-voting-stock requirement is met, and to this end additional "disguised" consideration, such as unreasonably high payments under a noncompetition agreement or for employment, should be avoided. It was previously thought that payment by the acquiring corporation of expenses of the acquired corporation or its shareholders incident to the reorganization would violate the solely-for-voting-stock requirement. In Revenue Ruling 73-54,[21] however, the Service ruled that the payment of, or assumption of liabilities for, reorganization expenses of the acquired corporation or its shareholders (as an entire group but not individually) by the acquiring corporation will be permissible if such expenses are solely and directly related to the reorganization. Although the ruling is somewhat ambiguous, it appears that a *reimbursement* of such expenses by the acquiring corporation will disqualify the transaction.

Creeping Acquisitions

"Creeping control" acquisitions have been permissible in type "B" reorganizations since 1954. Thus, since a corporation need not acquire the requisite 80 percent stock interest in one transaction,[22] Corporation *Y*, which has held 60 percent of the stock of Corporation *X* for five years, may acquire an additional 20 percent or more of the stock of Corporation *X* solely for *Y* voting stock, and such transaction will qualify as a "B" reorganization.[23] If an acquir-

21. 1973-1 CUM. BULL. 187.

22. "Control," as that term is used in the reorganization sections, is defined in §368(c). *Cf.* Rev. Rul. 59-259, 1959-2 CUM. BULL. 115. See text accompanying note 13 *supra*.

23. *Cf.* TREAS. REG. §1.368-2(c). *See also* Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183 (1957); Note, *Corporate Reorganization Under the 1954 Code*, 7 SYRACUSE L. REV. 280 (1956). Under the 1939 Code it was necessary to ascertain how the existing stock interest had been acquired before it could be determined with certainty whether the remainder could be acquired in a type "B" reorganization. *See, e.g.*, Robert A. Pulfer, 43 B.T.A. 677 (1941), *aff'd per curiam*, 128 F.2d 742, 1942-2 U.S.T.C. ¶9495 (6th Cir. 1942). It was generally assumed that a corporation which had acquired more than 20% of another corporation's stock in an unrelated prior transaction could not use a "B" reorganization to increase its ownership to 80% or more. B. BITTKER & J. EUSTICE, *supra* note 1, at 3-33. But the 1954 Code makes it possible for the stockholdings arising out of two or more transfers to be aggregated for the purpose of determining whether the target corporation is

ing corporation already has control of the acquired corporation, a subsequent acquisition of stock of the acquired corporation in exchange for voting stock will still qualify as a "B" reorganization since section 368(a)(1)(B) not only provides that the acquiring corporation must have control of the acquired corporation immediately after the transaction, but also contains the parenthetical statement "(whether or not such acquiring corporation had control immediately before the acquisition)." If the acquisition of control is not consummated in one single transaction, but rather is effected in a series of interrelated voting-stock-for-stock transactions, the series of acquisitions will be considered as one transaction for the purposes of determining whether the requirements of section 368(a)(1)(B) have been met. In order for such treatment to apply, however, the regulations require that the transactions take place "over a relatively short period of time such as 12 months."[24] While it does not appear from the language of the regulation that the Treasury intended the 12-month period to be an absolute outer limit, the Court of Claims has come close to accepting it as such.[25]

A problem often arises when the acquiring corporation has acquired control of the target corporation through a mixture of cash purchases and voting-stock-for-stock exchanges. The solely-for-voting-stock requirement would clearly be violated if the cash purchases and stock-for-stock exchanges took place within a short time of one another. It seems equally clear, however, that if the acquiring corporation purchased stock of the target corporation for cash and, in a completely unrelated subsequent transaction, acquired sufficient additional stock in voting-stock-for-stock exchanges to elevate its holdings above the 80 percent control level, the subsequent transaction should qualify as a type "B" reorganization. Whether the earlier cash purchases are related to the subsequent stock-for-stock exchanges is, of course, a factual determination and anyone faced with such a situation should allow a sufficient insulation period to elapse between the two transactions so that the prior purchase transaction will

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controlled "immediately after the exchange." Thus, "control" need not be acquired through the exchange itself. Accordingly, it appears that even if more than 20% of the stock had been previously acquired for cash, a subsequent acquisition of remaining stock in exchange solely for voting stock would constitute a "B" reorganization if the acquiring corporation has control immediately thereafter. See Darrell, *supra*, at 1232. *See also* Kanter, *Cash in a "B" Reorganization: Effect of Cash Purchases on "Creeping" Reorganization*, 19 TAX L. REV. 441 (1964).

24. TREAS. REG. §1.368-2(c).

25. American Potash & Chem. Corp. v. United States, 402 F.2d 1000, 1967-2 U.S.T.C. ¶9650 (Ct. Cl. 1968). In a series of stock-for-stock transfers over a fourteen months period, American Potash acquired control of another corporation, which was later liquidated. It was alleged that this series of acquisitions qualified as a tax-free "B" reorganization. The court held that all of the separate acquisitions that formed a series of stock-for-stock acquisitions over a period in excess of 12 months did not qualify as tax-free under the reorganization provisions unless the entire series proved to have been part of a continuing offer to purchase. Consequently, the case was remanded to ascertain the facts surrounding the relationship between the two offers, the several exchanges, and the ultimate liquidation. *Cf.* Rev. Rul. 72-354, 1972 CUM. BULL. 216. *See also* Carlson, *supra* note 15; Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725 (1971); King, *How to Combat the Current I.R.S. Attack on Validity of "B" Reorganizations*, 36 J. TAXATION 286 (1972).

be "old and cold" by the time the later stock-for-stock exchanges are consummated. A recent revenue ruling may provide an alternative solution if the acquiring corporation has obtained 20 percent or less of the stock of the acquired corporation by purchase. In Revenue Ruling 72-354,[26] the Service ruled that the solely-for-voting-stock requirement will not be violated if the acquiring corporation unconditionally sells the stock it previously acquired by purchase to an unrelated third party and there is no agreement to reacquire such stock.

The solely-for-voting-stock restrictions of section 368(a)(1)(B) are only applicable to acquisitions of *stock* of the acquiring corporation. Thus, if the acquiring corporation issues its own debt securities in exchange for the debt securities of the acquired corporation, the exchange will not remove the transaction from section 368(a)(1)(B), although it may prove troublesome if debt securities of the acquired corporation are held solely by stockholders of the acquired corporation.[27] The exchange of debt of the acquiring corporation for debt of the acquired corporation may also result in taxable income to the debtholders.[28]

If, after the acquisition of control by means of a voting-stock-for-stock exchange, the acquiring corporation liquidates the acquired corporation, the Service contends that the transactions should be combined and tested as a type "C" reorganization (exchange of voting stock for assets) under the step transaction doctrine.[29]

TYPE "C": STOCK-FOR-ASSETS REORGANIZATIONS

The type "C" reorganization involves a transfer of substantially all of the properties of one corporation solely in exchange for voting stock of either the acquiring corporation or of a corporation in control of the acquiring corporation. The "C" reorganization is sometimes referred to as a "practical merger" since the economic consequences are essentially the same as a merger, although the statutory requirements are far more restrictive.

Nature of Consideration

Just as in a "B" reorganization, section 368(a)(1)(C) requires that the consideration used by the acquiring corporation be solely voting stock of either the acquiring corporation or a corporation in control of the acquiring corporation, but not both.[30] Section 368(a)(1)(C) expressly provides that for the pur-

26. 1972-2 CUM. BULL. 216.

27. *See* Rev. Rul. 69-91, 1969-1 CUM. BULL. 106; Rev. Rul. 69-142, 1969-1 CUM. BULL. 107.

28. See text following note 51 *infra*, and accompanying notes 53-60, *infra*.

29. Rev. Rul. 67-274, 1967-2 CUM. BULL. 141; *cf.* American Potash & Chem. Corp. v. United States, 402 F.2d 1000, 1968-2 U.S.T.C. ¶9650 (Ct. Cl. 1968); Resorts Int'l., Inc. v. Commissioner, 511 F.2d 107, 1975-1 U.S.T.C. ¶9405 (5th Cir. 1975).

30. Helvering v. Bashford, 302 U.S. 454, 1938-1 U.S.T.C. ¶9019 (1938); Groman v. Commissioner, 302 U.S. 82, 1937-2 U.S.T.C. ¶9533 (1937). *See also* Maxwell, *Continuity of Interest in Recapitalizations and Merger*, 40 TAXES 1003 (1962); Pomeroy, *"C" Reorganization-Exchange of Stock for Assets*, 19 CASE W. RES. L. REV. 998 (1968). See note 14 *supra*.

poses of determining whether the exchange is solely for voting stock, the assumption of liabilities by the acquiring corporation or the transfer of property subject to liabilities shall be disregarded. Section 1.368-2(d)(1) of the Regulations cautions, however, that if liabilities are assumed to such a degree as "to place the transactions outside the purposes and assumptions of the reorganization provisions," it may result in the disqualification of the transaction under section 368(a)(1)(C). If, for example, the net worth of the transferor target corporation is negligible and the assumption of liabilities constitutes the primary consideration for the properties of the target corporation, the transaction will lack continuity of interest and may be treated as a taxable purchase rather than a tax-free reorganization.[31]

In contrast to the stringent "B" reorganization solely-for-voting-stock rule, some flexibility is built into the "C" reorganization solely-for-voting-stock requirement by virtue of the "boot relaxation rule" of section 368(a)(2)(B). This section provides that cash or other boot may be used in a "C" reorganization as long as assets having a fair market value equal to at least 80 percent of the total fair market value of *all* assets (whether acquired or not) of the target corporation are acquired solely in exchange for voting stock. Solely for the purposes of making this computation, however, all target corporation liabilities that are assumed, as well as the amount of any liabilities to which any transferred property is subject, will be treated as the equivalent of cash. The treatment of liabilities as cash materially reduces the usefulness of the section 368(a)(2)(B) "boot relaxation" provision since the debt of most corporations exceeds 20 percent of the fair market value of their assets. Thus, if the target corporation has assets with a fair market value of $100,000, subject to liabilities of $25,000, all of which are assumed in the exchange, no boot may be used since, treating the assumption of liabilities as cash consideration paid by the acquiring corporation, it would be impossible to acquire 80 percent (in fair market value), or $80,000, of assets "solely for voting stock." If, on the other hand, the liabilities of the target corporation were only $15,000, then boot could be used to the extent of $5,000. Obviously, an error in computing the fair market value of the target corporation's assets could prove fatal if the assets were undervalued and the parties attempted to use the full 20 percent boot relaxation margin.[32] The prudent tax planner will always be conservative in this area. There is one additional caveat: if any assets are to be retained by the target corporation, as is permissible within certain limits in a "C" reorganization, the retention will reduce the amount of assets that may be acquired for cash or other boot since section 368(a)(2)(B) requires that 80 percent

31. *See* B. BITTKER & J. EUSTICE, *supra* note 1, at 14-46. *Cf.* Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 1942-1 U.S.T.C. ¶9245 (1942), in which creditors of an insolvent corporation acquired its assets through a new corporation which issued stock to the creditors in exchange for that corporation's assets. The court found that the "continuity of interest" test was satisfied even though stockholders of the old corporation were eliminated because the creditors who received the new stock had been in effective control of the corporation at the time of the reorganization.

32. For example, if the assets of the target corporation are valued at $100,000 and, based upon that valuation, the acquiring corporation transfers "boot" of $20,000, the entire reorganization will be disqualified if the assets are worth less than $100,000.

in fair market value of *all* assets of the target corporation be obtained in exchange for voting stock.[33] Thus, in the example above, if $5,000 of assets were retained by the target corporation, only $15,000 of boot (rather than $20,000) could be used under section 368(a)(2)(B) since the acquiring corporation must still obtain $80,000 of assets in exchange for voting stock.

Creeping Acquisitions

As in the "B" reorganization already discussed, a problem may arise in a "C" reorganization with respect to the solely-for-voting-stock requirement when the acquiring corporation already owns stock of the target corporation. In *Bausch & Lomb Optical Co. v. Commissioner*,[34] the acquiring corporation owned 79 percent of the transferor corporation. Voting stock of the acquiring corporation was issued in exchange for substantially all of the properties of the target corporation, and the target corporation was then liquidated, resulting in a distribution of the acquiring corporation's stock to the stockholders of the target corporation (including 79 percent to the acquiring corporation) on a pro rata basis. It was held that the acquiring corporation had not acquired substantially all of the properties of the target corporation *in exchange for its voting stock*, but rather had obtained such assets primarily in exchange for stock of the target corporation that it previously held. In other words, the court held that the transaction was more in the nature of a liquidation than a "C" reorganization and should be taxable as such.

The *Bausch & Lomb* case presents a problem only for the unwary or uninformed since there are several means of accomplishing the desired result without the adverse tax consequences of that case. For example, if the transferor target corporation had been allowed to continue in existence rather than being liquidated, the solely-for-voting-stock requirement would not have been violated. Likewise, pursuant to Revenue Ruling 57-278,[35] the acquiring corporation may transfer its voting stock to a new subsidiary, which then acquires substantially all the assets of the target corporation in exchange

33. This is known as the "substantially all the properties" test. Because "C" transactions were deemed tax-free to accommodate transactions that had the effect of mergers, the possibilities of effecting such a tax-free separation of assets in this area are quite limited. *But see* Rev. Rul. 57-518, 1957-2 CUM. BULL. 253, which provides that the nature and the purpose of the property retained rather than a percentage determines whether it is "substantially all." See note 40 *infra*.

34. 267 F.2d 75, 1959-1 U.S.T.C. ¶9468 (2d Cir. 1959), *cert. denied*, 366 U.S. 835 (1959). This case might well justify a refusal to give independent significance to the transfer of assets for that portion of the parent corporation's stock that was subsequently to be returned as a liquidating dividend, particularly since the agreement permitted the parent to transfer only enough shares to provide for the liquidating distribution to minority shareholders. The court did not speculate on the tax consequences had the subsidiary not been liquidated, but treated the liquidation as the determinative factor in causing the exchange to be taxable. *Compare* Rev. Rul. 54-396, 1954-2 CUM. BULL. 147, which held a similar exchange taxable but emphasized prior purchases of the subsidiary's stock instead of liquidation. *See* Fager, *Acquisition of Partly-Held Corporations*, N.Y.U. 18TH INST. ON FED. TAX. 799 (1960); 72 HARV. L. REV. 1378 (1959).

35. 1957-1 CUM. BULL. 124.

for voting stock of the parent corporation. Following acquisition, the target corporation is liquidated. Revenue Ruling 57-278, however, was later amplified in Revenue Ruling 69-48,[36] which conditioned Service approval of the above-described transaction upon a finding that stock of the target corporation had not been recently acquired by the acquiring corporation as part of a single plan. An additional alternative available to the acquiring corporation might be to sell the stock of the target corporation to an unrelated party prior to the stock-for-asset exchange.[37]

"Substantially All of the Properties"

Section 368(a)(1)(C) requires that the acquiring corporation obtain "substantially all of the properties" of the target corporation. The Service stated in Revenue Procedure 74-26[38] that the substantially-all-of-the-properties requirement will be satisfied if there is a transfer of at least 70 percent of the fair market value of the gross assets, and 90 percent of the net assets of the target corporation. These percentage formulae, intended only to establish a "safe harbor" area for ruling purposes, do not establish the minimum legal requirements to meet the substantially-all-of-the-properties test.[39]

While early court decisions seemed preoccupied with similar percentage tests, the courts have recently taken a less mechanical approach to the problem and have placed primary emphasis upon the nature of the assets *retained* by the target corporation. The prevailing view seems to be that the operating or business assets must be transferred, but that the corporation may retain cash or passive investment-type assets in reasonable amounts.[40] The current posture of the courts can best be appreciated when it is recalled that the "C" reorganization was designed as a practical merger and was intended to have the same economic consequences as a merger, which involves the assimilation of the entire business (or businesses) of the target corporation by the acquiring corpo-

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36. 1969-1 CUM. BULL. 106.

37. Rev. Rul. 72-354, 1972-2 CUM. BUL. 216. Were it not for the limited exception of §368(a)(2)(B), the only permissible type of consideration in a type "C" reorganization would be voting stock plus the assumption of debt. Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1208 (1957). But this is a very limited exception since it imposes a ceiling upon "assumed debts," which are normally unlimited in amount under a type "C" reorganization. For alternatives to the restrictions upon the consideration that may be utilized in a type "C" reorganization, *see* B. BITTKER & J. EUSTICE, *supra* note 1, at 14-8, 14-48. *See also* Rev. Rul. 57-278, 1957-1 CUM. BULL. 124, concerning the use of a subsidiary as the acquiring corporation.

38. Rev. Proc. 74-26 (§3.01), 1974-36 INT. REV. BULL. 19, *superseding* Rev. Proc. 66-34 (§3.01), 1966-2 CUM. BULL. 1232. The only change made by the 1974 Revenue Procedure is the addition of a provision for payments to dissenters. Thus, all payments to dissenters and all redemptions and distributions, excluding regular and normal distributions, made by the corporations immediately preceding the transfer and which are part of the plan of reorganization will be considered assets held by the corporation immediately prior to the transfer.

39. Rev. Proc. 66-34 (§2.03), 1966-2 CUM. BULL. 1232.

40. *See, e.g.*, Gross v. Comm., 88 F.2d 567 (5th Cir. 1937); Western Industries Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936); Milton Smith, 34 B.T.A. 702 (1936) (Acq); and Vrooman, *Corporate Acquisitions — (C) Reorganizations* 79-2d Tax Mgt. (B.N.A.).

ration. Thus, if operating assets are retained by the target corporation – and especially if the target corporation remains in existence, as it is allowed to do in a "C" reorganization – the transaction will have many of the trappings of a divisive reorganization and should, therefore, be subjected to the special restrictions of sections 368(a)(1)(D) and 355, which Congress designed specifically for divisive transactions.[41]

While the nature of the retained assets has been given primary emphasis by the courts, the percentage-of-total-assets test is still alive, and the retention of a significant amount of assets by the target corporation, even if they are only investment assets, may prove fatal. This is especially true if the retained assets are not earmarked for specific and valid business purposes such as the payment of liabilities that were not assumed by the acquiring corporation.[42] Interestingly, the Service recently ruled that the target corporation may remain in existence and retain liquid assets for the purpose of acquiring and operating a new business.[43] The percentage test, however, apparently will be applied more rigorously if the target corporation continues its existence than if it is liquidated immediately after the transfer.[44]

The application of the substantially-all-of-the-properties test takes into account *all* of the assets of the target corporation, including goodwill and other intangible assets. This is true even if existing goodwill is not reflected on the balance sheet.

Ordinarily the substantially-all-of-the-properties requirement is measured at the time of the exchange. However, if the target corporation disposes of part of its assets preparatory to a "C" reorganization, the result may be the failure of the acquiring corporation to obtain substantially all the properties of the target corporation. This result is especially likely if the prior disposition was accomplished in a tax-free transaction. In *Helvering v. Elkhorn Coal Co.*,[45] the target corporation first transferred certain assets to a newly formed corporation and then distributed the stock of the newly formed corporation to its stockholders in a tax-free spin-off under the predecessors of sections 368(a)(1)(D) and 355. According to a prearranged plan, the target corporation then transferred all its remaining assets to another corporation in exchange for stock of that corporation. The court determined that the acquiring corporation had not ob-

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41. *See generally* B. BITTKER & J. EUSTICE, *supra* note 1, at 14-42.

42. Thurber v. Commissioner, 84 F.2d 815, 1936-2 U.S.T.C. ¶9420 (1st Cir. 1936) (combination of two banks was held to be a nontaxable merger notwithstanding the fact that the assets of the merged bank were reduced by a distribution to the stockholders prior to the consummation of a merger); *cf.* National Bank of Commerce v. United States, 158 F. Supp. 887, 1958, 1958-1 U.S.T.C. ¶9278 (E.D. Va. 1958) (in a stock-for-stock transfer from one bank to another where a premium was given in exchange for the target bank's goodwill, the assets retained by that bank were ordinary business assets; the court held the transfer was a sale, not a tax-free reorganization). *See generally* Seplow, *Acquisition of Assets of a Subsidiary: Liquidation or Reorganization?*, 73 HARV. L. REV. 484 (1960).

43. Rev. Rul. 73-552, 1973-2 CUM. BULL. 116.

44. *See, e.g.*, James Armour, 43 T.C. 295 (1964), where retention of 49% of the net assets (all investment assets) did not violate the "substantially all" test of §354 when the target corporation was liquidated. See also Rev. Rul. 57-518, 1957-2 CUM. BULL. 253; B. BITTKER & J. EUSTICE, *supra* note 1, at 14-42 through 14-44.

45. 95 F.2d 732, 1937-2 U.S.T.C. ¶9501 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

tained "substantially all of the properties" of the target corporation under the theory that the prior spin-off was part of one integrated transaction, and that the spun-off assets should still be treated as part of the "properties" of the corporation for the purposes of the substantially-all test.

TRIANGULAR AND REVERSE MERGERS

In the foregoing discussion of type "B" and type "C" reorganizations, it was noted that it is permissible for an acquiring corporation to utilize either its own voting stock or voting stock of its parent corporation as consideration for the stock or assets of the target corporation. In either instance, stock of the parent corporation may be received tax-free since the parent is treated as a "party to a reorganization" under section 368(b). Prior to October 24, 1968, however, if the target corporation was *merged* into the acquiring corporation and stock of the acquiring corporation's parent was utilized as consideration, such stock could not be received tax-free since section 368(b) did not provide for the treatment of the parent as a "party to a reorganization" in type "A" mergers.[46]

Effective October 24, 1968, Congress amended section 368 to provide equal opportunity for statutory mergers (but not consolidations) and added section 368(a)(2)(D) to the Code. This addition to the statutory definition of a reorganization provides that a merger of the target corporation into the acquiring corporation, where stock of a corporation in control of the acquiring corporation is utilized as consideration, will qualify as a type "A" merger if (1) substantially all of the properties of the target corporation are transferred to the acquiring corporation, (2) the transaction would have qualified as a type "A" reorganization if the target corporation had been merged directly into the parent corporation, and (3) no stock of the acquiring corporation is used in the transaction. Simultaneously, section 368(b) was amended to make the parent corporation a "party to a reorganization."

In January 1971 section 368 was again amended to authorize another subsidiary merger technique, sometimes referred to as a "reverse merger," in which the acquiring corporation is merged *into* the target company, and stock of a corporation in control of the acquiring corporation is used as consideration. This is important if business considerations require that the target corporation should continue in existence. Section 368(a)(2)(E) provides that a "reverse merger" will qualify as a type "A" reorganization if (1) after the merger the target corporation holds substantially all of the properties of both the acquiring corporation and itself and (2) stock of the target corporation possessing at least 80 percent of the voting power of that corporation has been exchanged for voting stock of the parent corporation in control of the acquiring corporation.

While both sections 368(a)(2)(D) and (E) purport to be mere modifications of a type "A" reorganization, it is evident from the requirements Congress

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46. *See* Helvering v. Bashford, 302 U.S. 454, 1938-1 U.S.T.C. ¶9019 (1938); Groman v. Commissioner, 302 U.S. 82, 1937-2 U.S.T.C. ¶9533 (1937); see note 14 *supra*. *See also* Sefeire, *Recent Developments in Acquisition and Reorganization*, 48 TAXES 829 (1970).

added to these provisions that they are hybrid reorganizations, incorporating some of the features of types "A," "B," and "C" reorganizations. Realistically they should be considered as separate forms of acquisitive reorganizations.

Section 368(a)(2)(D) Direct Triangular Mergers

The direct triangular merger combines the features of a type "A" merger and a type "C" stock-for-assets reorganization. As noted above, the acquiring corporation must obtain "substantially all of the properties" of the target corporation, just as in a type "C" reorganization. Proposed section 1.368-2(b)(2) of the Regulations provides that the term "substantially all of the properties" in section 368(a)(2)(D) has the same meaning as in section 368(a)(1)(C) (the type "C" reorganization). Unlike the "C" reorganization with its "solely for voting stock" requirement, however, the direct triangular merger permits the use of either voting or nonvoting stock of the parent corporation. In addition, the use of boot is freely permitted, subject only to the continuity of interest limitations that have been judicially grafted onto the type "A" reorganization. The boot may be provided by both the parent corporation and the acquiring (subsidiary) corporation, and both corporations may assume liabilities of the target corporation.[47] Thus, the direct triangular merger has considerably more flexibility than the "C" reorganization.

The provision of section 368(a)(2)(D) requiring that the transaction would have qualified as an "A" reorganization if the acquired corporation had been merged directly into the *parent corporation* (rather than into the subsidiary-acquiring corporation) is interpreted in Proposed Regulation section 1.368-2 (b)(2) to require the transaction to meet the requirements of a type "A" merger (continuity of interest, business purpose, etc.) in addition to the special requirements of section 368(a)(2)(D). The Proposed Regulation goes on to state that "it is not relevant whether the [hypothetical] merger into the controlling corporation could have been effected pursuant to state or Federal corporation law."[48] While the hypothetical merger of the target corporation into the *parent corporation* need not be possible under state law, the direct merger of the acquiring corporation into the target corporation utilizing the stock of the parent corporation (the direct triangular merger) *must* be effected in accordance with the applicable provisions of state law. Unfortunately, the merger statutes of many of our states are not broad enough to encompass such a reorganization transaction.

The requirement that no stock of the acquiring (subsidiary) corporation be used is reminiscent of the similar requirement in a "B" or "C" reorganization when stock of a parent corporation is used. While stock of the acquiring

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47. Proposed Treas. Reg. §1.368-2(b)(2), 37 Fed. Reg. 7163 (1972); Rev. Rul. 73-257, 1973-1 CUM. BULL. 189.

48. In Rev. Rul. 74-297, 1974-1 CUM. BULL. 84, the Service ruled that a merger of a domestic corporation into a domestic subsidiary of a foreign corporation qualifies under §368 (a)(2)(D), notwithstanding that a direct merger of the acquired domestic corporation into the foreign parent corporation could not have been effected under state or federal law.

corporation is not permissible consideration, cash or other nonstock assets of the acquiring subsidiary corporation may be used.[49]

Section 368(a)(2)(E) Reverse Mergers

The reverse merger is similar to types "A," "B," and "C" reorganizations. Just as in the case of the direct triangular merger, the reverse merger incorporates a substantially-all-of-the-properties requirement but broadens it to encompass substantially all of the properties of *both* the target corporation and the acquiring (subsidiary) corporation. In addition, section 368(a)(2)(E) requires that at least 80 percent of the outstanding voting stock of the target company be exchanged for *voting* stock of a corporation in control of the acquiring corporation. This requirement is similar to the voting-stock-for-stock requirement of a "B" reorganization. Unlike the "B" reorganization, however, the use of boot is permissible in a reverse merger so long as stock representing "control"[50] of the target corporation is obtained for voting stock of the parent. On the other hand, the requirement that control be obtained "in the transaction" under section 368(a)(2)(E) is much narrower than even the requirements of the "B" reorganization and would apparently prevent a reverse merger in a situation in which the parent corporation already held more than 20 percent of the stock of the target corporation.

The combination of the substantially-all-of-the-properties requirement of the "C" reorganization, the solely-for-voting-stock requirement of the "B" reorganization, and the general requirements of an "A" reorganization, as well as additional requirements unique to the reverse merger, raises numerous problems beyond the scope of this article. Unfortunately, the Treasury has not yet issued proposed regulations that might shed some light on these problems.[51]

TREATMENT OF SHAREHOLDERS IN A REORGANIZATION — SECTION 354 AND 356

Recognition of Gain or Loss

Section 368, which defines the various types of reorganization, does not provide tax-free treatment to the shareholders who exchange stock pursuant to a reorganization. This function is reserved to sections 354 and 356. Under section 354, if a stockholder exchanges stock or securities of a corporation that is a party to a reorganization *solely* in exchange for stock or securities of another corporation that is also a party to a reorganization, and if the exchange is effected pursuant to a plan of reorganization, the stockholder will recognize neither gain nor loss on the exchange. The requirement that the exchange be made "pursuant to a plan of reorganization" simply means that the transaction must fit within one of the categories defined in section 368(a) — that is, in the case of an acquisitive reorganization, it must be a type "A," "B," or "C"

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49. Proposed Treas. Reg. §1.368-2(b)(2), 37 Fed. Reg. 7163 (1972).

50. See note 22, *supra*.

51. For an excellent discussion of these problems, see Ferguson & Ginsberg, *Triangular Reorganizations*, U. SO. CAL. 1972 TAX INST. 24, 28 TAX L. REV. 159 (1973).

reorganization or a triangular or reverse merger.[52] Although section 354 refers to exchanges of stock *or* securities, section 354(a)(2) considerably tightens this provision by providing that section 354 will not apply to the extent that the principal amount of any securities (bonds or other indicia of debt) received exceeds the principal amount of any securities surrendered or if securities are received and no securities are surrendered.

Section 356(a)(1), picking up where section 354 leaves off, provides that if the stockholder receives excess securities or other boot in an exchange transaction that otherwise would have been within section 354, then his gain will not be recognized *except* to the extent of the boot (including excess securities) received. For the purpose of section 356, "boot" includes the fair market value of the excess of the principal amount of securities received over the principal amount of any securities surrendered.[53] If, however, the stockholder suffers a loss in a reorganization exchange in which he receives boot, his loss will not be recognized.[54]

If gain is recognized under section 356(a)(1), the gain may be treated as a dividend to the extent of the stockholder's ratable portion of the accumulated earnings and profits[55] of the target corporation if the exchange "has the effect of the distribution of a dividend." Any gain to be recognized under section 356(a)(1) that either does not fit within this dividend equivalence category or exceeds the stockholder's ratable share of earnings and profits will generally be treated as capital gain.[56] The Service, relying on *Commissioner v. Bedford's Estate*,[57] for many years took the position that *any* gain recognized by virtue of section 356(a)(1) would automatically be treated as a dividend under section 356(a)(2) to the extent of the stockholder's ratable share of the earnings and profits of the acquired target corporation. However, in two 1974 rulings the Service abandoned this approach and applied the dividend-versus-sale criteria incorporated in section 302, which deals with corporate redemptions, in determining whether the recognized gain should be treated as a dividend.[58] In Revenue Ruling 75-83[59] the Service reaffirmed that the section 302 criteria

52. If the §368 reorganization provisions are not satisfied, the operative provisions are inapplicable. For instance, if the stock of one corporation were exchanged for the stock of another corporation *and* money pursuant to a plan of reorganization, the exchange would not be *solely* for *voting stock* and would thus not be entitled to tax-free treatment.

53. INT. REV. CODE OF 1954, §356(d).

54. INT. REV. CODE OF 1954, §356(c).

55. The term "accumulated earnings and profits" has been construed to include current earnings and profits. Vesper Co., Inc. v. Commissioner, 131 F.2d 200, 1942-2 U.S.T.C. ¶9734 (8th Cir. 1942).

56. One caveat should be noted: INT. REV. CODE OF 1954, §341 (collapsible corporation provision).

57. 325 U.S. 283, 1945-1 U.S.T.C. ¶9311 (1945). In this case the executor of an estate received cumulative preferred stock, common stock, and cash in exchange for other cumulative preferred stock in a plan of recapitalization. The primary issue was whether the cash was taxable as a dividend, as the Service contended, or as a capital gain, as the taxpayer argued. The court held that a distribution of earnings and profits pursuant to a reorganization "has the effect of the distribution of a taxable dividend." *Id.* at 292, 1945-1 U.S.T.C. at 11,185.

58. Rev. Rul. 74-515, 1974-2 CUM. BULL. 118; Rev. Rul. 74-516, 1974-2 CUM. BULL. 121.

59. 1975-11 INT. REV. BULL. 6.

would be applied in testing for dividend equivalency under section 356(a)(2), and also announced that the determination under section 302 would be made as if the *transferor* corporation had redeemed its stock prior to the reorganization. On the other hand, the Eighth Circuit Court of Appeals in *Wright v. United States*[60] held that the section 302 determination should be made as if the *acquiring* corporation had made the redemption. Since substantially different results may flow from these two approaches, the tax planner should be aware of this conflict and what the Service's position is likely to be.

It should be noted that in a type "C" reorganization, if the transferor corporation is liquidated and the stock and securities plus boot of the acquiring corporation are distributed to the stockholders of the transferor corporation pursuant to a plan of reorganization, the stockholder's gain will be governed by the provisions of sections 354 and 356 rather than the general liquidation provisions.

Basis

Section 358(a)(1) provides that the tax basis of stock or securities received without recognition of gain under either section 354 or section 356 will be the same as that of the old stock or securities surrendered, minus the value of the boot (including excess securities) received, plus the amount of recognized gain,[61] whether treated as capital gain or as a dividend under section 356(a)(1). If several classes of stock or securities other than boot are received, the aggregate basis will be allocated among such classes of stock and securities in proportion to their relative fair market values at the time of the exchange.[62]

TREATMENT OF CORPORATE PARTIES TO A REORGANIZATION

Target Corporation — Sections 361 and 358

Section 361(a) bestows nonrecognition (tax-free) treatment upon a target corporation that transfers *property* (as in an "A" or "C" reorganization) solely in exchange for stock or securities of another corporation that is a party to a reorganization. Just as in section 354, nonrecognition treatment under section 361 is conditioned upon the exchange being made "pursuant to a plan of reorganization," meaning one of the categories of reorganizations set forth in section 368. Only stock and securities of a "party to a reorganization" may be received without recognition of gain. Unlike section 354, section 361 provides for nonrecognition of gain upon receipt of securities of the acquiring corporation, or of a corporation in control of the acquiring corporation, even if no securities are surrendered or if the principal amount of the securities received exceeds the principal amount of any securities surrendered.

While section 361(a) purports to provide tax-free treatment to the target corporation only if property is exchanged *solely* for stock or securities, section

60. 482 F.2d 600, 1973-2 U.S.T.C. ¶9583 (8th Cir. 1973).

61. INT. REV. CODE OF 1954, §358(a)(2).

62. INT. REV. CODE OF 1954, §358(b)(1); Treas. Reg. §1.358-2(b)(2).

361(b) relaxes this rule somewhat. Under section 361(b)(1), if boot is received in addition to stock or securities, the target corporation may still escape recognition of gain if all of such boot is distributed to its stockholders pursuant to the plan of reorganization. Gain will be recognized, however, to the extent of the value of any boot retained. The "distribution" that enables the target corporation to escape taxation must be made to its shareholders; the application of any portion of the boot to discharge liabilities not assumed by the acquiring corporation will not suffice but will be treated as having been retained by the target corporation.

Under section 357 the assumption of liabilities of the target corporation will not be treated as taxable boot unless such assumption is motivated by tax avoidance purposes.[63] Moreover, just as in section 354, no loss will be recognized by the target corporation regardless of whether any boot is received.[64]

Where, in a "C" reorganization, a portion of the target corporation's assets are not transferred to the acquiring corporation and are subsequently sold to third parties, some commentators have argued that gain from the sales should go unrecognized under section 337 (negating taxable gain to the corporation in the case of a so-called twelve-month plan of liquidation) if the transferor is to be liquidated under the plan of reorganization.[65] The courts and the Service have thus far rejected this position, however, and have held that any such gains must be recognized by the target corporation even though it is to be liquidated within twelve months.[66]

Basis

If the target corporation is not liquidated, as in a "C" reorganization, its basis for the stock and securities received in the reorganization exchange will be equal to the basis of the property transferred, decreased by any boot received and increased by the amount of gain recognized.[67] If liabilities of the target corporation are assumed by the acquiring corporation, such liabilities will be treated as boot solely for the purposes of determining basis under section 358(d).

Treatment of Acquiring Corporation — Sections 1032 and 362(b)

The acquiring corporation will not recognize any gain or loss upon the exchange of its stock for property or stock of the target corporation by virtue of section 1032.[68] It is noteworthy that the nonrecognition treatment provided under section 1032 is not conditioned upon the existence of a "plan of reorganization." Thus, if for some reason an exchange fails to qualify as a reor-

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63. INT. REV. CODE OF 1954, §357(b).

64. INT. REV. CODE OF 1954, §361(b)(2).

65. *See* B. BITTKER & J. EUSTICE, *supra* note 1, at 14-81.

66. *See, e.g.*, American Mfg. Co., 55 T.C. 204 (1970).

67. INT. REV. CODE OF 1954, §358.

68. For a discussion of §1032 see Carlisle, *Treasury Stock and Section 1032*, 23 GEO. WASH. L. REV. 558 (1955); Comment, *Sale or Exchange by a Subsidiary Corporation of Its Parent Corporation's Stock*, 47 TAXES 146 (1969).

ganization under section 368, the acquiring corporation will nevertheless be protected from recognition of gain under section 1032. While there is no specific statutory authority, it appears clear that the issuance of securities of the acquiring corporation will also be exempt from taxation.[69]

If stock of a parent corporation is transferred to a subsidiary corporation and is subsequently transferred by the subsidiary in exchange for stock or assets of the target corporation, as in the case of a triangular or reverse merger, section 1032 will not be applicable since it provides nonrecognition treatment to a corporation only upon the issuance of *its* stock. However, Revenue Ruling 57-278[70] states, without citing any authority, that the subsidiary will not recognize any gain if the parent's stock is issued and exchanged pursuant to a plan of reorganization. If the transaction should fail to qualify as a reorganization, however, the Service may well refuse to extend the ruling to cover nonrecognition treatment to the subsidiary. Consequently, if state law permits, it is usually better to have the parent corporation issue its stock directly to the target corporation or to its stockholders rather than contribute such stock to the subsidiary preparatory to an exchange by the subsidiary.[71]

Under section 362(b) the acquiring corporation will receive a tax basis in the acquired property equal to the basis of such property in the hands of the target corporation, increased by the amount of gain recognized *by the target corporation* in the exchange. Thus, if any boot is transferred by the acquiring corporation, its basis in the acquired properties will be increased if the target corporation fails to distribute the boot to its stockholders.[72] If, on the other hand, the target corporation distributes all of the boot to its stockholders, the fact that the stockholders of the target corporation must recognize gain under section 356 will *not* result in an increase in basis to the acquiring corporation since any such increase is conditioned upon the *target corporation* (and not its stockholders) recognizing gain.[73]

Section 362(b) would also apply in a type "B" stock-for-stock exchange, but it is explicitly made inapplicable to the target corporation in a type "C" stock-for-assets exchange.

CARRYOVER OF TAX ATTRIBUTES OF TARGET CORPORATION — SECTIONS 381, 382, AND 269

In a type "A" reorganization, including triangular and reverse mergers, or a "C" reorganization, the tax attributes of the target corporation will carry over to the acquiring corporation under section 381. "Tax attributes" include

69. B. BITTKER & J. EUSTICE, *supra* note 1, at 14-83.

70. 1957-1 CUM. BULL. 124. *See also* Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX. L. REV. 155 (1959); MacLean, *Creeping Acquisitions*, 21 TAX L. REV. 345 (1966); Seplow, *Acquisition of Assets of a Subsidiary: Liquidation or Reorganization*, 73 HARV. L. REV. 484 (1960).

71. *See* Ferguson & Ginsburg, *supra* note 51.

72. INT. REV. CODE OF 1954, §361(b).

73. Schweitzer & Conrad, Inc., 41 B.T.A. 553 (1940).

such items as net operating loss carryovers,[74] earnings and profits,[75] methods of accounting,[76] and methods of depreciation.[77] The tax attributes of the target corporation will not be carried over to the acquiring corporation in a type "B" reorganization, however, since the separate existence of the transferor corporation will be preserved.

If the acquiring corporation desires to utilize and preserve the net operating loss carryovers of the target corporation in a type "A" or type "C" reorganization, the stockholders of the loss corporation must receive 20 percent (in terms of fair market value) of the outstanding stock of the acquiring corporation or of a corporation in control of the acquiring corporation.[78] For every percentage point less than 20 percent, the acquiring corporation will lose five percent of the target corporation's net operating loss carryovers. This limitation will not apply, however, if both the acquiring corporation and the target corporation are owned by substantially the same persons and in essentially the same proportions, as would be the case in a merger of two controlled subsidiaries.[79]

If the acquisition of assets pursuant to a type "A" or "C" reorganization is principally motivated by tax avoidance — for example, by the desire to obtain the net operating loss carryovers — the favorable tax attributes of the acquired corporation may be forfeited under section 269(a)(2) even if the mechanical 20 percent test of section 382(b) is met. In addition, the Supreme Court's decision in *Libson Shops, Inc. v. Koehler*,[80] may present a problem. This decision held that net operating losses of one business may not be offset against the income of a separate business following a merger. Revenue Ruling 58-603[81] states that *Libson Shops* is not applicable to a type "A" or "C" reorganization under the 1954 Internal Revenue Code (*Libson Shops* was decided under the 1939 Code), but the Service appears to have backed away from this position in a subsequent ruling.[82] Whether *Libson Shops* has continuing vitality under the 1954 Code appears to be an unsettled question.[83]

74. INT. REV. CODE OF 1954, §381(c)(1). *But see* INT. REV. CODE OF 1954, §§269, 382(b); Swiss Colony Inc., 428 F.2d 49, 1970-1 U.S.T.C. ¶9439 (7th Cir. 1970) (loss carryover disallowed on §269 acquisition to avoid taxation). *See also* INT. REV. CODE OF 1954, §382, which disallows net operating loss carryovers where 50% of the corporate stock changes hands and the corporation changes its trade or business.

75. INT. REV. CODE OF 1954, §381(c)(2); A. Snida, 274 F.2d 165, 1955-1 U.S.T.C. ¶9523 (1st Cir. 1955) (Massachusetts fund with substantial deficit was reorganized into a corporation without a change of shareholders or operation in a tax-free exchange).

76. INT. REV. CODE OF 1954, §381(c)(4).

77. INT. REV. CODE OF 1954, §381(c)(6).

78. INT. REV. CODE OF 1954, §382(b); Commonwealth Container Corp. v. Commission, 393 F.2d 269, 1968-1 U.S.T.C. ¶9319 (3d Cir. 1968) (deduction of only 65% of net operating loss was allowed because stockholders of loss corporation owned less than 20% of fair market value of the acquiring corporation's stock).

79. INT. REV. CODE OF 1954, §382(b)(3). Wofac Corp. v. United States, 269 F. Supp. 654, 1967-2 U.S.T.C. ¶9532 (D.N.J. 1967).

80. 353 U.S. 382, 1957-1 U.S.T.C. ¶9691 (1957).

81. 1958-2 CUM. BULL. 147.

82. Rev. Rul. 63-40, 1963-1 CUM. BULL. 46.

83. *Compare* Maxwell Hardware Co. v. Commissioner, 343 F.2d 713, 1965-1 U.S.T.C. ¶9332 (9th Cir. 1965) (the *Libson Shops* doctrine is wholly inapplicable under the Internal Revenue Code of 1954), *with* Vulcan Materials Co. v. United States, 446 F.2d 690, 1971-1 U.S.T.C.

ELIMINATION OF UNWANTED ASSETS OF THE TRANSFEROR CORPORATION

For various reasons, the acquiring corporation may not want all of the assets of the target corporation or, in the case of a type "B" reorganization, may only be willing to acquire stock of the target corporation if it first disposes of unwanted assets. There are several methods of eliminating unwanted assets, but careful research and planning are always necessary.

Taxable Dispositions

The unwanted assets may be disposed of in several forms of taxable transactions. For example, the transferor corporation might declare a dividend of the unwanted assets and distribute them to its shareholders prior to the reorganization exchange. Such a procedure probably would not affect the status of a type "B" reorganization[84] or a type "A" reorganization, but it may well result in disqualification of a type "C" reorganization or a triangular or reverse merger under the rationale of *Helvering v. Elkhorn Coal Co.*,[85] because of the substantially-all-of-the-properties requirement incorporated into these types of reorganization. With respect to a type "A" or type "B" reorganization, the dividend procedure may be highly desirable if the stock of the target corporation is owned by a domestic corporation that is entitled to either the 85 percent or 100 percent dividends-received deduction under section 243.[86]

Another form of taxable disposition is accomplished by redemption of a portion of the target corporation's stock in exchange for the unwanted assets simultaneously with, or immediately following, the reorganization exchange. This procedure parallels the sale-redemption technique first sanctioned in connection with a taxable purchase of stock in *Zenz v. Quinlivan*.[87] Such a redemption should not endanger a type "A" or "B" reorganization unless the amount of unwanted assets is so substantial that it will result in violation of the continuity of interest requirement at the corporate level. However, a problem may again exist in a type "C" reorganization or a triangular or reverse merger for the same reasons discussed above with respect to dividends.

If a pre-reorganization redemption is utilized by the target corporation in connection with a type "A" or "B" reorganization, the redemption may result in taxable income to the target corporation under section 311(d) if appreciated property is distributed, and also under the recapture provisions of sections 1245, 1250, 1251, and 47 if depreciated property is distributed. If the redemption is part of a plan of reorganization and if all the stock of the target corporation's shareholders is disposed of by redemption or in the reorganization

¶9449 (5th Cir. 1971), *and* Home Constr. Co. v. United States, 439 F.2d 1165, 1971-1 U.S.T.C. ¶9267 (5th Cir. 1971), *and* Clarksdale Rubber Co., 45 T.C. 234 (1965), which indicate that *Libson Shops* may have some vitality, but do not define the scope of its current applicability.

84. *See* Rev. Rul. 70-172, 1970-1 CUM. BULL. 77.

85. 95 F.2d 732, 1937-2 U.S.T.C. ¶9501 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

86. One caveat is the uncertain effect of Casner v. Commissioner, 450 F.2d 379, 1971-2 U.S.T.C. ¶9651 (5th Cir. 1971).

87. 213 F.2d 914, 1954-2 U.S.T.C. ¶9445 (6th Cir. 1954). *See also* Rev. Rul. 55-745, 1955-2 CUM. BULL. 223, in which the Service announced its acceptance of the holding in *Zenz*.

exchange, the stockholders may be entitled to capital gains treatment under section 302(a) on the redemtpion.[88] But if the redemption does not comply with section 302(a), the price tag is dividend treatment to the redeeming shareholders.[89]

A partial liquidation is still another possible, although very limited, means of disposing of unwanted assets in a taxable disposition.[90] The effect of a partial liquidation upon the qualification of a transaction as a reorganization is essentially the same as that of a redemption.

Tax-Free Dispositions

In very limited situations, the transferor corporation may "spin off" its unwanted assets to a new corporation, followed by a pro rata, tax-free disposition of the shares of the new corporation to its shareholders preparatory to the reorganization exchange. If the spin off meets the very stringent requirements of section 355, the target corporation, stripped of its unwanted assets, may then be merged into the acquiring corporation.[91] This procedure, however, may abort any attempted "C" reorganization as well as a triangular or reverse merger because of the substantially-all-of-the-properties limitation contained in sections 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E).[92]

PROS AND CONS OF A TAX-FREE ACQUISITION

One of the primary advantages of a tax-free reorganization is the opportunity afforded the purchaser to make an acquisition without the necessity of using much needed corporate funds or borrowed monies except to the extent that boot may be involved. Viewing the transaction from the seller's standpoint, a tax-free reorganization affords him the opportunity to dispose of his interest in the target corporation without recognition of gain for tax purposes (or with a minimum recognition of gain attributable to boot received in the exchange).[93] A tax-free reorganization is also generally the best method of preserving and utilizing the favorable tax attributes of the target corporation, such

88. Arthur D. McDonald, 52 T.C. 82 (1969); *but see* Rev. Rul. 75-360, 1975-37 INT. REV. BULL. 11, wherein the Service, in lieu of acquiescing in *McDonald*, explains why it does not consider that case to be an appropriate precedent. *See also* United States v. Davis, 397 U.S. 301, 1970-1 U.S.T.C. ¶9289 (1970). INT. REV. CODE OF 1954, §341 may also be applicable in this situation.

89. INT. REV. CODE OF 1954, §302(d); *cf.* United States v. Davis, 397 U.S. 301, 1970-1 U.S.T.C. ¶9289 (1970).

90. Partial liquidations are governed by INT. REV. CODE OF 1954, §346.

91. Commissioner v. Morris Trust, 367 F.2d 794, 1966-2 U.S.T.C. ¶9718 (4th Cir. 1966). The Service announced that it would follow the decision in *Morris Trust* in Rev. Rul. 68-603, 1968-2 CUM. BULL. 148. *Compare* Rev. Rul. 70-225, 1970-1 CUM. BULL. 80, *with* Rev. Rul. 70-434, 1970-2 CUM. BULL. 83.

92. *See* Helvering v. Elkhorn Coal Co., 95 F.2d 732, 1937-2 U.S.T.C. ¶9501 (4th Cir. 1937).

93. *See generally* Chisholm & Phelan, *Corporate Reorganizations: Three Main Routes May be Used to Avoid Tax on the Transaction*, 10 TAXATION FOR ACCOUNTANTS 196 (1973); Marx, *Practitioner's Guide to the Analysis and Structuring of Tax-Free Acquisitions*, 38 J. TAXATION 194 (1973).

as its net operating losses or assets with a basis in excess of fair market value. In addition, a tax-free acquisition may also qualify for "pooling of interests" accounting treatment, which may be extremely important to the acquiring corporation if the target corporation has high earnings that the purchaser would like to have reflected on its financial statements, or if the purchase price exceeds the value of the underlying assets of the target corporation.[94]

There may, however, be less salutary effects of tax-free acquisitions. The use of stock of the acquiring corporation as consideration for the acquisition may result in a substantial dilution of the equity of the acquiring corporation's shareholders. In addition, if the target company was acquired for its potential future earning power (as opposed to its past performance), the immediate result may be a lower earnings per share for the acquiring company. Moreover, the preservation of corporate attributes of the target corporation may be a double-edged sword since unfavorable tax attributes, such as fixed assets whose depreciable basis has been exhausted or excessively high accumulated earnings and profits accounts, will also be preserved within the acquiring corporation.

One major nontax consideration which must often be reckoned with in a tax-free reorganization is the effect of federal and state securities laws upon the issuance of stock and securities in connection with a reorganization exchange and upon the ability of the recipient stockholders of the target corporation to dispose of their stock or securities at a later date. The issuance of stock or securities by the acquiring corporation will generally constitute a "sale" of a security which, unless it falls within one of the exemptions provided under the Securities Act of 1933 and comparable state laws, will require registration.[95] If the target corporation is a small corporation with relatively few stockholders, and if the stockholders intend to hold the stock of the acquiring corporation for investment purposes, the issuance of the acquiring corporation's stock may be exempt from federal registration under the private offering or intrastate offering exemptions.[96] If, on the other hand, the target corporation is either publicly held or has a large number of stockholders, a registration probably will be necessary.

Prior to 1973 the Securities and Exchange Commission took the position that mergers, consolidations, and type "C" stock-for-assets reorganizations were not "sales" within the meaning of the Securities Act of 1933. This position, based upon the theory that the stockholders of the target corporation were involuntarily forced to exchange their shares in a reorganization exchange engineered by the management of the target corporation, was set forth in former Rule 133.[97] Effective January 1, 1973, however, Rule 133 was, with certain exceptions, rescinded. Rule 145 now treats such exchanges as "sales" under the Securities Act, thus requiring a registration unless the issuance of such

94. Opinion Nos. 16, 17 (Aug. 1970), OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD (Amer. Inst. of Certified Public Accountants). *See also Accounting Principles for Pooling of Interests*, 25 TAX LAW. 29 (Fall 1971).

95. Rule 145, 17 C.F.R. §230.145 (1974) provides a simplified federal registration on form S-14.

96. *See* Securities Act of 1933, §§3(a)(11), 4(2), 15 U.S.C. §§77(b)(11), 77(d)(2) (1970).

97. 17 C.F.R. §230.133 (1974).

stock or securities qualifies under one of the exemptions provided under that Act.[98]

If the sellers receive letter stock (requiring investment representations) or a sufficient amount of stock to cause them to be classified as "controlling persons," disposing of unregistered shares in subsequent transactions may be difficult. Rule 144,[99] which became effective in 1972, provides some relief[100] but requires a minimum holding period of two years in most cases and substantially restricts dispositions even after that time. Consequently, it may behoove the sellers to bargain for mandatory registration or "piggy-back" rights from the acquiring corporation.

In addition to the securities law considerations arising out of a tax-free acquisition, there may also be antitrust (in a taxable or nontaxable acquisition), labor and other considerations as well. In this connection, the Federal Trade Commission (FTC) recently issued a release requiring the filing of notification with the FTC in the case of acquisitions involving consideration of $10 million or more.[101]

Planning for Contingencies

Occasionally the parties to a tax-free reorganization may consider it necessary to have the benefit of hindsight in order to establish the value of the acquired or acquiring corporation. This might be the case, for example, where the acquired corporation has substantial contingent liabilities, where a closely held corporation is the subject of the acquisition and its shares are not readily susceptible of valuation, or where the parties simply cannot agree on the value of the common stock to be issued by the acquiring corporation in the transaction.

One method of dealing with these problems in a tax-free reorganization involves the use of contingent stock, which amounts to the issuance of rights to acquire additional stock upon the occurrence of certain specified events. In both *Carlberg v. United States*[102] and *James Hamrick*,[103] it was held that the

98. 17 C.F.R. §230.145 (1974).

99. 17 C.F.R. §230.144 (1974).

100. The two-year holding period applies with respect to "restricted securities" as defined in Rule 144. Rule 145(d) eliminates the holding period for shares acquired in reorganization exchanges pursuant to that rule.

101. Fed. Reg. 35717 (1974).

102. 281 F.2d 507, 1960-2 U.S.T.C. ¶9647 (8th Cir. 1960). In *Carlberg*, the court held that because the "certificate of contingent interest" could produce nothing other than stock and a continuity of interest, the certificate qualified as "stock" under §354(a)(1) rather than "other property" within the meaning of §356(a)(1). *See also* Tillinghost, *Carlberg Shows Possible Ways to Allow for Unsettled Claims in Tax-Free Merger*, 13 J. TAXATION 348 (1960).

103. 43 T.C. 21 (1964), *acquiesced in*, 1966-1 CUM. BULL. 2. Hamrick agreed to transfer his patent rights in return for 25 1/2% of the issued stock as well as the right to receive additional shares if the earnings for a year exceeded 10% of the outstanding stock, up to a limit of 1/3 of the total shares issued. The additional shares received pursuant to this agreement fell within the nonrecognition provision of §351(a). *See also* Tillinghost, *Contingent Stock Pay-Outs in Tax-Free Reorganizations*, 22 TAX LAW. 467 (1969).

issuance of contingent rights to acquire additional stock did not constitute taxable boot in a reorganization exchange. The Service has published guidelines for the issuance of a favorable ruling on the use of contingent stock in Revenue Procedures 66-34,[104] 74-26,[105] and 67-13.[106] These guidelines may be summarized as follows:

1. There must be a valid business reason for the use of contingent stock.[107]
2. All stock must be issued within five years.
3. The maximum number of additional shares which may be issued must be fixed.
4. There must be an initial distribution of at least 50 percent of the maximum number of shares of each class of stock.
5. Either the agreement must prohibit assignment of the rights to receive additional stock[108] or such rights must not be readily marketable.[109]
6. The additional shares may only be those of the acquiring corporation or of a corporation in control of the acquiring corporation.

It should be noted that the issuance of contingent stock rights in a reorganization will be subject to the imputed interest provisions of section 483 unless interest of at least six percent per annum is provided in the exchange agreement.[110] Because of the position taken in Opinion 16 of the Accounting Principles Board of the American Institute of Certified Public Accountants that the use of contingent stock will preclude the availability of pooling of interests accounting, the use of contingent stock in reorganizations has lost much of the popularity it enjoyed in the late 1960's.[111]

If an evaluation of all the circumstances indicates that a tax-free acquisition route is preferable to a taxable transaction, the parties must next determine which of the alternative tax-free routes best suits their needs.

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104. 1966-2 CUM. BULL. 1232.

105. Rev. Proc. 74-26, 1974-2 CUM. BULL. 478.

106. 1967-1 CUM. BULL. 46.

107. An example of a valid business reason is "the difficulty in determining the value of one or both of the corporations involved in the reorganization." Rev. Proc. 74-26, 1974-2 CUM. BULL. 478, 479. This difficulty may be caused, for instance, by the existence of "unresolved but potentially substantial liabilities," Carlberg v. United States, 281 F.2d 507, 510, 1960-2 U.S.T.C. ¶9647, at 77,737 (8th Cir. 1960).

108. Of course, assignments by operation of law are valid. Rev. Proc. 74-26, §3.03(1), 1974-2 CUM. BULL. 478, 479.

109. Also, the right to receive additional stock must not be evidenced by negotiable certificates of any kind. *Id.*

110. Rev. Rul. 70-300, 1970-1 CUM. BULL. 125; Rev. Rul. 73-298, 1973-2 CUM. BULL. 173. The minimum interest rate on deferred payment sales under §483 was recently changed from 4% to 6% under PROPOSED TREAS. REG. §1.483-1.

111. Other procedures for dealing with contingencies and providing for "look-back" adjustments include the use of escrowed shares, back-out rights, put-back rights, and various other rescission techniques. For a discussion of these procedures, *see* B. BITTKER & J. EUSTICE, *supra* note 1, at 14-145 through 14-149. For guidelines regarding advance rulings for reorganizations involving escrow agreements *see* Rev. Proc. 75-11, 1975-8 INT. REV. BULL. 26.

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ACQUIRING CORPORATION'S CONSIDERATIONS IN A TAX-FREE REORGANIZATION

The type "A" reorganization is the most flexible form of tax-free acquisition available to the acquiring corporation for the reasons noted above. The acquiring corporation may use its voting or nonvoting stock, whether common or preferred, and boot of up to 50 percent or more of the total consideration. If the issuance of solely voting stock in the acquisition would result in loss of control of the acquiring corporation, the "A" reorganization would be the best means of effecting the acquisition since the acquiring corporation could use nonvoting stock, boot, or both to the extent necessary to preserve control. Moreover, if it is necessary to dispose of unwanted assets in connection with the reorganization, the parties could utilize either the type "A" or type "B" reorganization methods, although the "A" reorganization may be preferable because of its flexibility.

If the acquiring corporation is a publicly held company, or if its stock is held by a large number of stockholders, the "A" reorganization may prove unworkable because of the requirement of most state corporation codes that the acquiring corporation first obtain the approval of at least a majority of its stockholders. Those burdens might be avoided by the use of a triangular or reverse merger, the so-called hybrid "A" reorganizations, but the additional restrictions built into these reorganization techniques, which are not present in a normal "A" merger or consolidation, may preclude their use. Another potential problem in an "A" reorganization is that the purchaser may be assuming contingent or undisclosed liabilities of the target corporation. It is, of course, possible to obtain warranties from responsible parties to protect against this possibility, but if such protection is not acceptable, the acquiring corporation may be forced to utilize one of the other forms of reorganization that would provide additional protection. A related problem that should be considered is the possible existence of a mortgage with an after-acquired property clause that might expose the combined assets of the acquiring and target corporations to additional financial risks. If the target corporation has such a mortgage with a substantial unpaid balance, the acquiring corporation may opt for a "B" or "C" reorganization utilizing a subsidiary corporation, or even a triangular or reverse merger, that would insulate its assets from the additional risks arising out of such a mortgage.

The type "B" reorganization may be desirable if the acquiring corporation wishes to preserve the target corporation as a separate entity. Possible reasons for such preservation include the following: to insulate its assets from undisclosed liabilities, to avoid the necessity of qualifying to do business in states where the target corporation has operated (which would be necessary in a type "A" or type "C" reorganization), or to preserve valuable leases or other rights that might be nonassignable. Although some of these objectives might also be accomplished by a triangular or reverse merger, the "B" reorganization may provide more flexibility than these forms of reorganization because of the absence of any substantially-all-of-the-properties requirement. The "B" reorganization will also permit the acquiring corporation to deal separately with

different stockholders of the target corporation, if necessary, provided that only voting stock is used as consideration. There must be some commercial justification for any such arrangements, however, and any separate arrangement with individual shareholders of the target corporation should not be tied to compensation for past or future services. The "B" reorganization also lends itself to a prior disposition of unwanted assets in connection with the plan of reorganization.

The disadvantages of a "B" reorganization to the acquiring corporation are primarily attributable to the inflexible restrictions incorporated in section 368(a)(1)(B). Thus the solely-for-voting-stock requirement, as well as the necessity of meeting the 80 percent control test, may render a "B" reorganization impractical. Moreover, the favorable tax attributes of the target corporation will not be directly available to the acquiring corporation.

The "C" reorganization may provide the acquiring corporation with the ability to obtain merger-like results when a formal merger or consolidation is not possible because of either business reasons or the peculiarities of state law. In certain situations the "C" reorganization may produce more desirable results than a merger since the acquiring corporation has the ability to choose which liabilities of the target corporation it will assume, thus affording it protection against contingent or undisclosed liabilities. Although the "C" reorganization does not permit the use of nonvoting stock and securities as in an "A" reorganization, the boot relaxation rules of section 368(a)(2)(D) provide slightly more flexibility than the rigid "B" solely-for-voting-stock requirements. The "C" reorganization may also have the advantage of avoiding the necessity of dealing with dissenting stockholders of the target corporation.

There may be a number of disadvantages to a "C" reorganization insofar as the acquiring corporation is concerned. A type "C" reorganization is ordinarily the most complicated type of transaction in terms of preparing documents of transfer; it may also require compliance with the bulk sale statutes of most states. Since the assets of the target company do not automatically pass to the acquiring corporation by operation of law, as in a merger, the "C" reorganization may require deeds, transfer taxes, and state and local income taxes. If the acquiring corporation has a mortgage with an after-acquired property clause, the "C" reorganization may also be undesirable. In addition, if the acquiring corporation owns stock in the target corporation before the reorganization exchange, the possible effects of the *Bausch & Lomb* decision must be considered.[112] Moreover, the "substantially all" requirement makes it extremely difficult to dispose of unwanted assets in connection with a "C" reorganization.

TARGET CORPORATION'S CONSIDERATIONS IN A TAX-FREE TRANSFER

From the standpoint of the target corporation (and its stockholders), the type "A" reorganization is also appealing in its simplicity and flexibility. The ability to obtain boot in addition to stock might be advantageous, particularly if the dividend consequences of section 356(a)(2) can be avoided.[113] If the stock-

112. See text accompanying notes 34-37 *supra*.

113. See text accompanying notes 55-60 *supra*.

holders of the target corporation want protection against the risks of new management, they might take preferred stock in an "A" reorganization, or even in a triangular merger; if they also desire to share in the growth of the acquiring company, the preferred stock could be made convertible into common stock. One additional feature of an "A" reorganization that may be important to the sellers is that minority stockholders of the target corporation will ordinarily have appraisal rights in an "A" reorganization (which may or may not be considered an advantage). However, a merger or consolidation may not be possible because of restrictions incorporated in various state laws; similarly, various business considerations may force the sellers to use one of the other reorganization methods.

A "B" reorganization may appeal to some selling stockholders since they will deal with the acquiring corporation directly rather than through the management of the target corporation as in an "A" or "C" reorganization. The type "B" reorganization also affords the target corporation the opportunity to dispose of unwanted assets, an opportunity not available in a "C" reorganization or in a triangular or reverse merger. On the negative side, the inflexible solely-for-voting-stock requirements rule out the use of boot or convertible, nonvoting stock, which could be used in an "A" or a triangular merger. In addition, the "B" reorganization is vulnerable to attack by the Service where, for example, excessive salary agreements or noncompetition agreements might be treated as additional consideration that would disqualify the transaction for nonrecognition treatment. Moreover, and perhaps most importantly, if 21 percent or more of the stockholders of the target corporation oppose the reorganization exchange, this will prevent the remaining stockholders from enjoying a tax-free stock-for-stock exchange (unless one of the other forms of reorganization that require a lower percentage of stockholder approval is available) since the acquiring corporation must obtain 80 percent control.

A type "C" reorganization will often enable the sellers to effect a tax-free exchange with merger-like consequences where state law or other business reasons would otherwise make such a transaction impossible. Although limited in scope, the boot relaxation rules of section 368(a)(2)(B) may nevertheless be sufficient to facilitate a cash buy-out of dissenting stockholders of the target corporation, thereby paving the way for an otherwise tax-free exchange. Nevertheless, the complexity of a "C" reorganization with its attendant high legal costs, transfer fees, and state and local taxation problems may be a major drawback to a transfer of assets for stock.

The triangular or reverse mergers often appeal to the sellers since either method will enable the acquiring corporation to maintain the separate existence of the target corporation, while offering the selling stockholders the opportunity to participate in an exchange for stock of the parent of the acquiring corporation in much the same fashion as a "B" reorganization, but without some of the attendant risks or restrictions of a "B" reorganization. However, the additional built-in restrictions in the triangular and, particularly in the reverse merger, may make these methods impractical.

CONCLUSION

Court decisions testify to the many corporate reorganization plans that fail to meet the client's objectives. One is reminded of Gus Scavigligi, who received an award for his civic work and then asked what he could do with an engraved plaque with his name misspelled. The defective plaque can be thrown away without significant loss, but the defective reorganization plan is a *fait accompli* that creates tax liabilities for the corporate parties and their often numerous shareholders. The documents cannot be changed; the exchange transfers cannot normally be reversed. Therefore, at the outset of the negotiations it is important to be aware of the various available means of acquiring or disposing of the corporation business. Selection of the proper route should be made only after careful evaluation of all of the available alternatives.