Part I

Section 368.--Definitions relating to corporate reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.
(Also § 338; 1.338-3; 1.368-2).

Rev. Rul. 2008-25

ISSUE

What is the proper Federal income tax treatment of the transaction described below?

FACTS

T is a corporation all of the stock of which is owned by individual A. T has 150x dollars worth of assets and 50x dollars of liabilities. P is a corporation that is unrelated to A and T. The value of P's assets, net of liabilities, is 410x dollars. P forms corporation X, a wholly owned subsidiary, for the sole purpose of acquiring all of the stock of T by causing X to merge into T in a statutory merger (the "Acquisition Merger"). In the Acquisition Merger, P acquires all of the stock of T, and A exchanges the T stock for 10x dollars in cash and P voting stock worth 90x dollars. Following the Acquisition Merger and as part of an integrated plan that included the Acquisition Merger, T completely liquidates into P (the “Liquidation”). In the Liquidation, T transfers all of its assets to P and P assumes all of T’s liabilities. The Liquidation is not accomplished through a statutory merger. After the Liquidation, P continues to conduct the business previously conducted by T.

LAW

Section 368(a)(1)(A) of the Internal Revenue Code provides that the term “reorganization” means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) shall not be disqualified by reason of the fact that stock of a corporation in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of the surviving corporation. Further, §1.368-2(j)(3)(iii) of the Income Tax Regulations provides that “[i]n applying the ‘substantially all’ test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account.”

Section 368(a)(1)(C) provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other shall be disregarded. Section 368(a)(2)(B) provides that if one corporation acquires substantially all of the properties of another corporation, the acquisition would qualify under § 368(a)(1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and the acquiring corporation acquires, solely for voting stock described in § 368(a)(1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to § 368(a)(2)(A)) be treated as qualifying under § 368(a)(1)(C). Section 368(a)(2)(B) further provides that solely for purposes of determining whether its requirements are satisfied, the amount of any liabilities assumed by the acquiring corporation shall be treated as money paid for the property.

Section 1.368-1(a) generally provides that in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine.

Section 1.368-2(k) provides, in part, that a transaction otherwise qualifying as a reorganization under § 368(a) shall not be disqualified or recharacterized as a result of one or more distributions to shareholders (including distribution(s) that involve the assumption of liabilities) if the requirements of §1.368-1(d) are satisfied, the property distributed consists of assets of the surviving corporation, and the aggregate of such distributions does not consist of an amount of assets of the surviving corporation (disregarding assets of the merged corporation) that would result in a liquidation of such corporation for Federal income tax purposes.

Rev. Rul. 67-274, 1967-2 C.B. 141, holds that an acquiring corporation's acquisition of all of the stock of a target corporation solely in exchange for voting stock of the acquiring corporation, followed by the liquidation of the target corporation as part of the same plan, will be treated as an acquisition by the acquiring corporation of substantially all of the target corporation's assets in a reorganization described in § 368(a)(1)(C). The ruling explains that, under these circumstances, the stock acquisition and the liquidation are part of the overall plan of reorganization and the two steps may not be considered independently of each other for Federal income tax purposes. See also, Rev. Rul. 72-405, 1972-2 C.B. 217.

Rev. Rul. 2001-46, 2001-2 C.B. 321, holds that, where a newly formed wholly owned subsidiary of an acquiring corporation merged into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the step transaction doctrine is applied to integrate the steps and treat the transaction as a single statutory merger of the target corporation into the acquiring corporation. Noting that the rejection of step integration in Rev. Rul. 90-95, 1990-2 C.B. 67, and § 1.338-3(d) is based on Congressional intent that § 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine, the Service found that the policy underlying § 338 is not violated by treating the steps as a single statutory merger of the target into the acquiring corporation because such treatment results in a transaction that qualifies as a reorganization in which the acquiring corporation acquires the assets of the target corporation with a carryover basis under § 362, rather than receiving a cost basis in those assets under § 1012. (In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S.

827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation's assets with the purchaser receiving a cost basis in the assets.)

Section 338(a) provides that if a corporation makes a qualified stock purchase and makes an election under that section, then the target corporation (i) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value and (ii) shall be treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. Section 338(d)(3) defines a qualified stock purchase as any transaction or series of transactions in which stock (meeting the requirements of § 1504(a)(2)) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period. Section 338(h)(3) defines a purchase generally as any acquisition of stock, but excludes acquisitions of stock in exchanges to which § 351, § 354, § 355, or § 356 applies.

Section 338 was enacted in 1982 and was “intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.” H.R. Conf. Rep. No. 760, 97th Cong, 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a § 338 election. If the election is made or deemed made, asset purchase treatment results and the basis of the target assets is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, the stock purchase treatment generally results.

In such a case, the basis of the target assets is not adjusted to reflect the stock purchase price and other relevant items.

Rev. Rul. 90-95 (Situation 2), holds that the merger of a newly formed wholly owned domestic subsidiary into a target corporation with the target corporation shareholders receiving solely cash in exchange for their stock, immediately followed by the merger of the target corporation into the domestic parent of the merged subsidiary, will be treated as a qualified stock purchase of the target corporation followed by a § 332 liquidation of the target corporation. As a result, the parent's basis in the target corporation's assets will be the same as the basis of the assets in the target corporation's hands. The ruling explains that even though “the step-transaction doctrine is properly applied to disregard the existence of the [merged subsidiary],” so that the first step is treated as a stock purchase, the acquisition of the target corporation's stock is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase regardless of whether a § 338 election is made. Thus, in that case, the step transaction doctrine was not applied to treat the transaction as a direct acquisition by the domestic parent of the assets of the target corporation because such an application would have resulted in treating a stock purchase as an asset purchase, which would be inconsistent with the repeal of the Kimbell-Diamond doctrine and § 338.

Section 1.338-3(d) incorporates the approach of Rev. Rul. 90-95 into the regulations by requiring the purchasing corporation (or a member of its affiliated group) to treat certain asset transfers following a qualified stock purchase (where no § 338 election is made) independently of the qualified stock purchase. In the example in

§ 1.338-3(d)(5), the purchase for cash of 85 percent of the stock of a target corporation, followed by the merger of the target corporation into a wholly owned subsidiary of the purchasing corporation, is treated (other than by certain minority shareholders) as a qualified stock purchase of the stock of the target corporation followed by a § 368 reorganization of the target corporation into the subsidiary. As a result, the subsidiary's basis in the target corporation's assets is the same as the basis of the assets in the target corporation's hands.

ANALYSIS

If the Acquisition Merger and the Liquidation were treated as separate from each other, the Acquisition Merger would be treated as a stock acquisition that qualifies as a reorganization under § 368(a)(1)(A) by reason of § 368(a)(2)(E), and the Liquidation would qualify under § 332. However, as provided in § 1.368-1(a), in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. In this case, because T was completely liquidated, the § 1.368-2(k) safe harbor exception from the application of the step transaction doctrine does not apply. Accordingly, the Acquisition Merger and the Liquidation may not be considered independently of each other for purposes of determining whether the transaction satisfies the statutory requirements of a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E). As such, this transaction does not qualify as a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E) because, after the transaction, T does not hold substantially all of its properties and the properties of the merged corporation.

In determining whether the transaction is a reorganization, the approach reflected in Rev. Rul. 67-274 and Rev. Rul. 2001-46 is applied to ignore P's acquisition of the T stock in the Acquisition Merger and to treat the transaction as a direct acquisition by P of T's assets in exchange for 10x dollars in cash, 90x dollars worth of P voting stock, and the assumption of T's liabilities.

However, unlike the transactions considered in Revenue Rulings 67-274, 72-405 and 2001-46, a direct acquisition by P of T's assets in this case does not qualify as a reorganization under § 368(a). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(C) because the consideration exchanged is not solely P voting stock and the requirements of § 368(a)(2)(B) are not satisfied. Section 368(a)(2)(B) would treat P as acquiring 40 percent of T's assets for consideration other than P voting stock (liabilities assumed of 50x dollars, plus 10x dollars cash). See Rev. Rul. 73-102, 1973-1 C.B. 186 (analyzing the application of § 368(a)(2)(B)). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(D) because neither T nor A (nor a combination thereof) was in control of P (within the meaning of § 368(a)(2)(H)(i)) immediately after the transfer. Additionally, the transaction is not a reorganization under § 368(a)(1)(A) because T did not merge into P. Accordingly, the overall transaction is not a reorganization under § 368(a).

Additionally, P's acquisition of the T stock in the Acquisition Merger is not a transaction to which § 351 applies because A does not control P (within the meaning of § 368(c)) immediately after the exchange.

Rev. Rul. 90-95 and § 1.338-3(d) reject the step integration approach reflected in Rev. Rul. 67-274 where the application of that approach would treat the purchase of a target corporation's stock without a § 338 election followed by the liquidation or merger of the target corporation as the purchase of the target corporation's assets resulting in a cost basis in the assets under § 1012. Rev. Rul. 90-95 and § 1.338-3(d) treat the acquisition of the stock of the target corporation as a qualified stock purchase followed by a separate carryover basis transaction in order to preclude any nonstatutory treatment of the steps as an integrated asset purchase.

In this case, further application of the approach reflected in Rev. Rul. 67-274, integrating the acquisition of T stock with the liquidation of T, would result in treating the acquisition of T stock as a taxable purchase of T’s assets. Such treatment would violate the policy underlying § 338 that a cost basis in acquired assets should not be obtained through the purchase of stock where no § 338 election is made. Accordingly, consistent with the analysis set forth in Rev. Rul. 90-95, the acquisition of the stock of T is treated as a qualified stock purchase by P followed by the liquidation of T into P under § 332.

HOLDING

The transaction is not a reorganization under § 368(a). The Acquisition Merger is a qualified stock purchase by P of the stock of T under § 338(d)(3). The Liquidation is a complete liquidation of a controlled subsidiary under § 332.

PROSPECTIVE APPLICATION

The Service will consider the application of § 7805(b) on a case-by-case basis.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mary W. Lyons of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Lyons at (703) 622-7930 (not a toll-free call).