

## New IRS Regulations Permit Acquirors to Elect Tax-Free or Taxable Treatment

### Overview

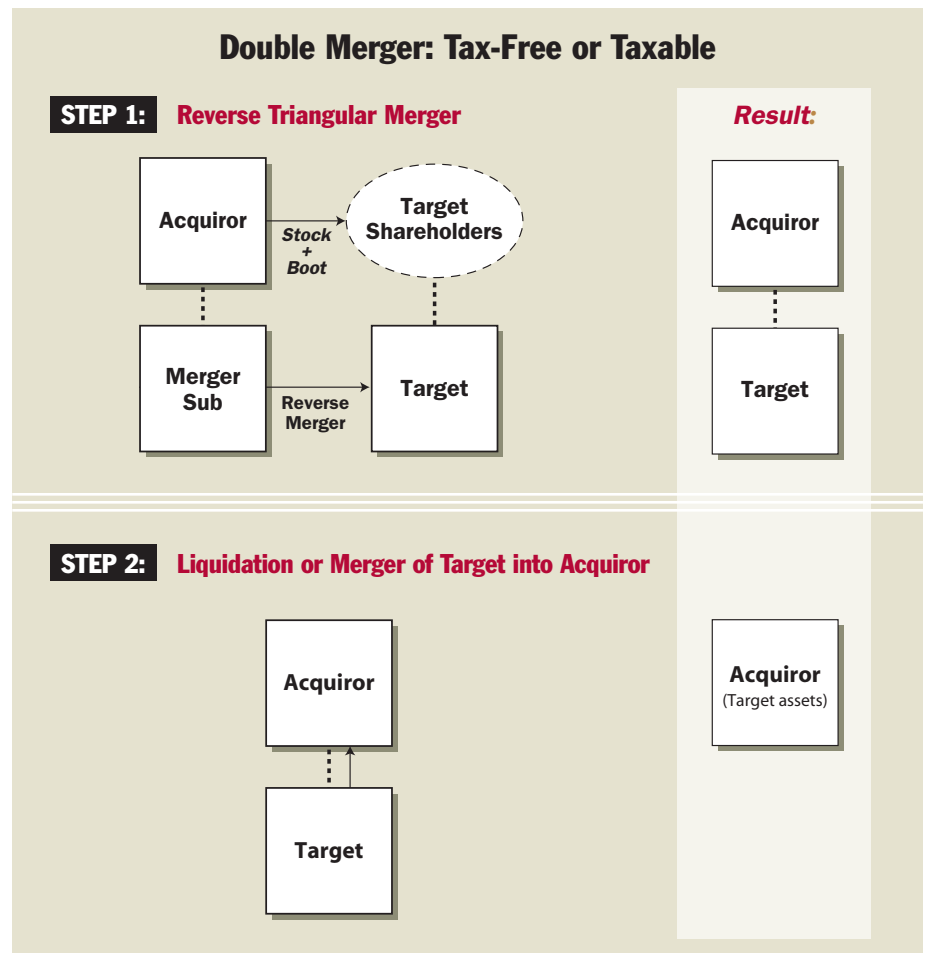
In yet another move to simplify the tax implications of mergers and acquisitions, recently released IRS regulations provide corporate acquirors of corporate subsidiaries and S corporations the flexibility to structure certain back-to-back or “double” mergers as either one integrated tax-free reorganization or a taxable stock purchase followed by a tax-free liquidation.

These new regulations clarify that a corporate purchaser desiring to use a combination of its stock and cash to acquire an appropriate corporate target (i.e., a member of a consolidated group or an S corporation) can successfully employ the double merger structure to derive a basis step-up in the target’s assets without imposing a second level of tax on the target or its stockholders.

### Detailed Analysis

In a double merger, a purchaser typically acquires all of the target’s outstanding stock in a reverse triangular merger and then merges the target either upstream, into the purchaser, or sideways, into a second subsidiary of the purchaser. While the benefits of integrated, tax-free treatment for a double merger are addressed in an earlier Cooley Alert [<http://www.cooley.com/news/alerts.aspx?ID=000037672120>], the new regulations specifically provide certain taxpayers the alternative of treating a double merger as two independent transactions, the first of which is taxable.

Falling stock prices over the last several years have made taxable stock acquisitions



significantly more attractive to stockholders seeking to deploy their built-in losses. Moreover, taxable stock acquisitions have always been attractive to corporate purchasers eligible to make a Section 338(h)(10) election.

### 338(h)(10) Election

A Section 338(h)(10) election allows a purchasing corporation to treat its acquisition

of the stock of a subsidiary corporation or an S corporation as an acquisition of assets followed by a tax-free liquidation, thereby deriving a new (and generally higher) basis for such assets without triggering the double-level tax typically associated with a taxable asset acquisition.

The parties to a transaction may generally make a 338(h)(10) election if the purchaser

is a corporation and the purchaser's acquisition of the target's stock constitutes a qualified stock purchase or "QSP." A QSP requires that the purchaser acquire 80% or more of the target corporation's stock, measured by both vote and value. While a taxable reverse triangular merger can constitute a QSP, a tax-free reorganization is ineligible.<sup>1</sup>

IRS rulings such as Revenue Ruling 90-95 have accorded the two steps of certain double mergers separate significance. Assuming that the first step (an all-cash reverse triangular merger, for example) meets the criteria for a QSP, it is not integrated with the second step (a liquidation of the target into the purchasing corporation). As a result, eligible parties can successfully make a Section 338(h)(10) election with respect to the first step without trepidation that the step-transaction doctrine will change the result.<sup>2</sup>

### The Double Merger Ruling

However, in an effort to expand the scope of the tax-free reorganization provisions, the IRS effectively limited the availability of Section 338(h)(10) with the release of Revenue Ruling 2001-46 (the "Double Merger Ruling"). In that ruling, a purchaser acquired a target corporation by means of two consecutive mergers. First, all of the target's outstanding stock was acquired in a reverse triangular merger (the "Acquisition Merger") in which the merger consideration consisted of 30% cash and 70% stock. Second, the target (then a subsidiary of the purchaser) was merged upstream into the purchaser (the "Upstream Merger").

Viewed in isolation, the Acquisition Merger would not have qualified as a tax-free reorganization, because the cash paid (30%) to the target stockholders exceeded the 20% boot limitation applicable to reverse triangular mergers.<sup>3</sup> Moreover, absent the Double Merger Ruling, the taxable Acquisition Merger could have qualified as a QSP. Nevertheless, the IRS determined that the Acquisition Merger and the Upstream Merger should be collapsed together and viewed as a single merger of target into purchaser for tax purposes. As a result, the transaction qualified as a tax-free reorganization under

Section 368(a)(1)(A) of the Code (also referred to as an "A" reorganization).

Thus, under the Double Merger Ruling, a transaction can generally be tax-free as long as the two mergers, taken together, cause the target stockholders to receive an amount of acquiror stock adequate for a good "A" reorganization (generally, at least 45%), even if the first merger, by itself, might otherwise have qualified as a QSP. On the other hand, where the aggregate stock consideration paid in the two steps of a double merger is insufficient to qualify as an "A" reorganization, and the first step of the transaction qualifies as a QSP, Revenue Ruling 90-95 should continue to prevent integration of the two steps.

However, realizing that the Double Merger Ruling worked against taxpayers seeking to make a Section 338(h)(10) election, the IRS solicited comments as to whether or not it should allow taxpayers to elect out of the new rule. In other words, would it be appropriate for an Acquisition Merger, for which a Section 338(h)(10) election is made, to avoid integration with a subsequent Upstream Merger, notwithstanding that the amount of aggregate consideration paid in the two mergers might otherwise qualify the transaction as an "A" reorganization? As described below, the IRS has answered this question in the affirmative.

### 338(h)(10) Election Facilitates Taxable Treatment

The new regulations provide that eligible parties who make a Section 338(h)(10) election can effect a double merger that avoids integration of the first and second steps, thereby retaining the taxable status of the first step, even if the overall transaction would qualify as a tax-free reorganization absent such an election. Thus, a corporate purchaser desiring to conserve cash by acquiring a corporate target with a mix of stock and cash consideration can, by effecting a Section 338(h)(10) election, successfully employ the double merger structure to derive a basis step-up in the target's assets.

Accordingly, corporations engaging in acquisitive transactions of subsidiaries and

S corporations should carefully consider the structuring options afforded by these new regulations.

Should you have any questions, please contact any of the attorneys listed below. ■

### Notes

<sup>1</sup> A simple stock purchase may also constitute a QSP. Thus, the double merger techniques described in this Cooley Alert may also be available in transactions where the first step is a stock purchase and the second step is a merger. Generally, in a tax-free reorganization, a certain percentage of stock consideration must be paid to the target stockholders. Thus, for example, in a single-step tax-free reverse triangular merger at least 80% of the consideration paid to the target stockholders must consist of acquiror voting stock. If the target stockholders (in such a reverse triangular merger) receive a greater percentage of cash, the transaction will be taxable. The term "tax-free" reorganization is a bit of a misnomer, because only the stock portion of the consideration in a reorganization will be received on a tax-deferred basis. Any cash paid in a "tax-free" deal will nonetheless be taxable to the target stockholders.

<sup>2</sup> The step-transaction doctrine determines whether the separate status of two or more ostensibly independent transactions will be respected, or whether those transactions will be considered, instead, mere steps in a single transaction.

<sup>3</sup> "Boot" refers to any non-stock consideration paid in an acquisition.

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