COMMENTS ON REVENUE RULING 2001-46

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These comments were prepared by individual members of the Committee on Corporate Tax of the Section on Taxation. Principal responsibility was exercised by Erik H. Corwin. Substantive contributions were made by Julie A. Divola, Glen A. Kohl, William M. Richardson, Michael L. Schler, Mark J. Silverman, Lea Anne Storum, Benjamin G. Wells, Rose L. Williams, Philip B. Wright, and Mark L. Yecies. The comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Contact Person: Erik H. Corwin
(202) 663-6883
ecorwin@wilmer.com

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EXECUTIVE SUMMARY

Revenue Ruling 2001-46 clarifies that the step transaction doctrine will be applied in appropriate cases to treat as a reorganization a transaction in which the first step, viewed independently, would be treated as a qualified stock purchase under section 338(d)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). The Revenue Ruling requests comments on whether the Internal Revenue Service (the “Service”) and the Department of the Treasury (“Treasury”) should issue regulations that would permit taxpayers to make a valid election under section 338(h)(10) of the Code with respect to a step of a multi-step transaction that, viewed independently, constitutes a qualified stock purchase. We support this approach. Permitting a section 338(h)(10) election to “turn off” the step transaction doctrine would provide flexibility to taxpayers, promote certainty as to tax results, and protect the Government against inconsistent reporting. Moreover, there is ample authority for the Service and Treasury to issue such regulations.

We also recommend that any regulations reflecting the principles of Revenue Ruling 2001-46 that are adopted include guidance regarding transactions such as those described in the Revenue Ruling that fail to qualify as reorganizations after application of the step transaction doctrine. Specifically, the Service and Treasury should clarify that, when a stock acquisition is stepped together with a subsequent transaction such that it is tested for qualification under the reorganization rules as an asset acquisition, the failure to qualify as an asset reorganization will in appropriate circumstances result in the transaction being treated not as a taxable asset purchase, but as (1) a stock acquisition that is not eligible for reorganization treatment followed by (2) a separate transaction effecting the transfer of the target’s assets. This approach of respecting the stock acquisition and the subsequent asset transfer as separate transactions follows directly from the reasoning of Revenue Ruling 2001-46 for cases in which the stock acquisition involves an amount of stock that would, if taxable, constitute a qualified stock purchase. It should be extended to cases in which the stock acquisition, even though not meeting qualified stock purchase requirements, results in the acquiring corporation owning stock in the target corporation that meets the requirements of section 332(b)(1) of the Code, and the target is subsequently merged upstream or liquidated into the acquiring corporation.

BACKGROUND

Revenue Ruling 2001-46, 2001-42 I.R.B. 321, was issued on September 24, 2001. The Revenue Ruling addresses two factual situations. In Situation 1, Corporation X acquires all of the stock of Corporation T by means of a reverse subsidiary merger of Corporation Y, a newly-formed wholly-owned subsidiary of X, with and into T (the “Acquisition Merger”). In the merger, the T shareholders exchange their T stock for consideration consisting of 70 percent X voting stock and 30 percent cash. Because of the amount of the cash consideration provided to the T shareholders, the Acquisition Merger would not, standing alone, qualify as a reorganization. Following the Acquisition Merger and “as part of the plan,” T merges upstream into X in a statutory merger (the “Upstream Merger”). The ruling assumes that (1) “absent some prohibition against the application of the step transaction doctrine, the step transaction doctrine
would apply to treat the Acquisition Merger and the Upstream Merger as a single integrated acquisition by X of all of the assets of T,” and (2) “the single integrated transaction would satisfy the nonstatutory requirements of a reorganization under section 368(a) of the Internal Revenue Code.”

Situation 2 involves the same facts, except that the consideration provided to T shareholders in the Acquisition Merger consists solely of X voting stock. As a result, the Acquisition Merger, viewed independently, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Revenue Ruling 2001-46 holds that, in each case, the transaction is treated as a single statutory merger of T into X that qualifies as a reorganization under section 368(a)(1)(A). In its analysis of Situation 1, the Service starts from the premise that, “unless the policies underlying § 338 dictate otherwise,” the Acquisition Merger and the Upstream Merger should be treated as one integrated transaction qualifying as a reorganization under step transaction principles as applied in Revenue Ruling 67-274, 1967-2 C.B. 141, King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), and J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995). The Service then concludes that the policies underlying section 338 do not require a different result. According to the Service, the congressional intent that section 338 “replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine,” H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), should be interpreted as foreclosing application of the step transaction doctrine only when integration of a stock purchase with a subsequent asset transfer would give the acquiring corporation a cost rather than a carryover basis in the target corporation’s assets. Treating the Acquisition Merger and the Upstream Merger as a single integrated section 368(a)(1)(A) reorganization would result in X having a carryover basis in the T assets, and as a result, step transaction treatment remains appropriate. In the words of the Revenue Ruling:

The policy underlying § 338 is not violated by treating Situation (1) as a single statutory merger of T into X because such treatment results in a transaction that qualifies as a reorganization under § 368(a)(1)(A) in which X acquires the assets of T with a carryover basis under § 362, and does not result in a cost basis for those assets under § 1012. Thus, in Situation (1), the step transaction doctrine applies to treat the Acquisition Merger and the Upstream Merger not as a stock acquisition that is a qualified stock purchase followed by a § 332 liquidation, but instead as an acquisition of T’s assets through a single statutory merger of T into X that qualifies as a reorganization under § 368(a)(1)(A). Accordingly, a § 338 election may not be made in such a situation.

The Service relies on this reasoning to distinguish two potentially contrary authorities: Revenue Ruling 90-95, 1990-2 C.B. 67 (Situation 2), and section 1.338-3(d) of the Treasury Regulations. In Revenue Ruling 90-95, the Service held that an all cash reverse subsidiary merger followed by an upstream merger of the target corporation into the acquiring parent corporation should be treated as a qualified stock purchase of the target corporation followed by a section 332 liquidation of the target. Section 1.338-3(d) requires generally that a purchasing corporation and other members of its affiliated group treat certain transfers of a target corporation’s assets following a qualified stock purchase of the target as carryover basis
transactions that are separate and distinct from the initial stock purchase. Revenue Ruling 2001-46 treats each of these authorities as being based on the principle that, when application of the step transaction doctrine would result in the purchasing corporation or its affiliates obtaining a cost basis in the target corporation’s assets, the step transaction doctrine will not be applied.

With respect to Situation 2 of Revenue Ruling 2001-46, the Service simply notes that it does not matter whether the Acquisition Merger would itself qualify as a reorganization. In either case, the step transaction doctrine should be applied to integrate the two transactions as a single section 368(a)(1)(A) reorganization.

Revenue Ruling 2001-46 provides certain transition relief. Specifically, the Revenue Ruling provides that the Service will respect a section 338(h)(10) or a section 338(g) election made with respect to a step of a multi-step acquisition that, viewed independently, would constitute a qualified stock purchase if that step occurred either prior to or pursuant to a binding written agreement entered into prior to issuance of the Revenue Ruling.

Revenue Ruling 2001-46 also requests comments as to whether the Service should issue regulations that would permit taxpayers to make a valid section 338(h)(10) election with respect to a step of a multi-step acquisition that, viewed independently, constitutes a qualified stock purchase if the relevant transaction is undertaken pursuant to a written agreement that requires, or permits the purchasing corporation to cause, a section 338(h)(10) election to be made.

ANALYSIS

Revenue Ruling 2001-46 provides valuable guidance and has already attracted significant attention from commentators.¹ The holding in Situation 2 of the ruling was foreshadowed by numerous recent private letter rulings holding that a first-step stock reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(E), followed by an upstream merger of the target into the acquiring corporation, will be treated as a single integrated section 368(a)(1)(A) reorganization.² The principal concern underlying requests for such rulings was presumably that the integrated transaction would be tested not as a reorganization under section 368(a)(1)(A), but rather under the more stringent requirements applicable to reorganizations


² See PLR 200121010 (Feb. 7, 2001); PLR 200109037 (Dec. 4, 2000); PLR 200102031 (Oct. 11, 2000); PLR 200038039 (June 28, 2000); PLR 200021032 (Feb. 23, 2000); PLR 9831018 (Apr. 30, 1998); PLR 9831013 (Apr. 30, 1998); PLR 9746010 (Aug. 11, 1997); PLR 9539018 (June 30, 1995); PLR 9420027 (Feb. 18, 1994).
under section 368(a)(1)(C). The existence of a published ruling will reduce uncertainty on this point and the need for comparably situated taxpayers to obtain private letter rulings in the future.\(^3\)

More significantly, Situation 1 clarifies the tax treatment of multi-step acquisitions in which the first-step stock purchase would, standing alone, be treated as a qualified stock purchase under section 338(d)(3) of the Code, but the overall consideration mix is such that the combined transaction would qualify as an asset reorganization. The ruling resolves a tension between two divergent lines of authority, each of which might reasonably have been applied to this fact pattern.\(^4\) On one hand, Revenue Ruling 67-274, *King Enterprises*, and *Seagram* indicate that the step transaction doctrine is to be broadly applied to multi-step acquisitions in cases in which integration of the steps would yield a qualifying asset reorganization. On the other hand, Revenue Ruling 90-95 and Treasury Regulation section 1.338-3(d) could each be read to suggest that, following enactment of section 338, a qualified stock purchase will, in effect, cut off the step transaction doctrine. Revenue Ruling 2001-46 resolves the tension between these authorities in favor of broad application of the step transaction doctrine, but based on a clearly defined limiting principle. Specifically, under the Revenue Ruling, the step transaction doctrine will continue to apply in appropriate cases except when application of that doctrine would give an acquiring corporation that has made a stock acquisition a cost rather than a carryover basis in the acquired assets.

By establishing the Service’s view of the appropriate tax treatment of Situation 1 and fact patterns similar to it, the Revenue Ruling reduces the potential for taxpayers to take inconsistent positions with respect to the tax treatment of multi-step acquisitions. In particular, the Revenue Ruling will help to avoid cases in which a purchasing corporation makes a section 338(g) election to obtain a stepped-up basis in the target assets, while the target shareholders treat the same transaction as a reorganization.\(^5\) Nevertheless, because inconsistent reporting remains a possibility when a revenue ruling is the only authority for a controversial position, it would be advisable for Treasury and the Service to adopt regulations consistent with the holding of Revenue Ruling 2001-46 to ensure that their position on the issue is respected.

Moreover, considerable uncertainty – and the potential for taxpayers to claim inconsistent treatment – will remain in some cases. Most prominently, there remain uncertainties as to when the step transaction doctrine is properly applied.\(^6\) The ruling does not purport to answer this

\(^3\) *See Kohl/Storum Letter*, 93 Tax Notes at 426 n.11. If the second-step transaction were a liquidation rather than a merger, the integrated transaction presumably could not qualify as a section 368(a)(1)(A) reorganization and would be treated as a reorganization only if the requirements for a section 368(a)(1)(C) reorganization were satisfied.

\(^4\) *See id.* at 425-26.


\(^6\) *See, e.g., NovaCare, Inc. v. United States*, No. 97-234T, 2002 WL 500252 (Ct. Cl. Mar. 25, 2002) (denying Government’s motion for summary judgment where acquiror contended that
question, and whether two steps are properly considered to be part of the same plan so as to warrant step integration will be easy to determine in some cases but more difficult in others. This issue is so inherently factual that it does not lend itself to comprehensive guidance. The existence of such uncertainty does, however, help to make the case for permitting a binding election to turn off the step transaction doctrine and thereby foreclose inconsistent reporting in appropriate cases, a point discussed in greater detail immediately below.

APPLICATION OF REVENUE RULING 2001-46 WHEN A SECTION 338(h)(10) ELECTION IS MADE

We support adoption of regulations that would permit taxpayers to make a valid section 338(h)(10) election with respect to a step of a multi-step transaction that, standing alone, would be a qualified stock purchase, but that otherwise would be integrated with other steps in the transaction under the principles of Revenue Ruling 2001-46. Such an approach would provide flexibility to taxpayers, while protecting the Government’s interest in avoiding inconsistent reporting.

The advantages of an elective regime from a taxpayer standpoint are readily apparent. Following an acquisition of the stock of a target corporation, there may be any number of business reasons for the acquiring corporation to combine the target corporation with itself or one of its affiliates. Such a combination could, for example, produce cost savings or facilitate efforts by the acquiring corporation to integrate the target’s business with its own. Under the principles of Revenue Ruling 2001-46, however, if the acquiring corporation takes steps that might be integrated with the stock acquisition, it could lose the cost basis in the target assets that it obtained by making a section 338(h)(10) election. Indeed, because of concern that mere temporal proximity of the transactions may result in an assertion that the step transaction doctrine applies, the acquiring corporation may defer or refrain from a second-step transaction even when the reasons for undertaking that transaction, and the intent to do so, emerge only after the initial stock acquisition has been completed. Adopting an elective regime would permit such steps to be taken, regardless of whether a plan existed at the time of the stock acquisition, without the risk of the acquiring corporation losing valuable, and presumably bargained-for, tax benefits.

Moreover, the mechanics of the section 338(h)(10) election would facilitate adoption of an elective regime for transactions in which that election would, absent application of the principles of Revenue Ruling 2001-46, be available. The section 338(h)(10) election is made jointly by the purchasing corporation and the selling shareholder(s). Accordingly, all parties to a stock acquisition must agree for the election to be made.7 Because all parties to the acquisition must join in the election, it can serve the function of binding those parties to report the stock sales by target shareholders of acquirer stock resulted in failure to qualify as a reorganization under the law as it existed prior to issuance of the present continuity of interest regulations).

7 When the target is an S corporation, even those target shareholders who do not sell their stock must consent to a section 338(h)(10) election. See Treas. Reg. § 1.338(h)(10)-1(c)(2).
acquisition consistently as a qualified stock purchase and so eliminate inconsistent reporting of transactions. Without such a provision, a purchasing corporation and the selling shareholder(s) could jointly file a section 338(h)(10) election with respect to a stock acquisition, but the selling shareholder(s) could take the position that, under the principles of Revenue Ruling 2001-46, the election is invalid and the transaction is properly treated as a reorganization due to subsequent actions taken by the purchaser.

Nevertheless, because minority shareholders of a target C corporation may not participate in the section 338(h)(10) election, a regime in which the parties to such an election are bound to report the acquisition as a taxable stock purchase would not, by itself, entirely eliminate inconsistent reporting. Consider, for example, a case in which 85 percent of the stock of a target corporation (T) is owned by the parent of T’s consolidated group (S), with the remainder being owned by the public. In a reverse subsidiary merger, an acquiring corporation (P) acquires all of the T stock for consideration consisting of 50 percent P stock and 50 percent cash. P and S make a section 338(h)(10) election. T is then merged upstream into P. Absent some restriction on doing so, and assuming the other requirements for reorganization treatment are met, the minority T shareholders could take the position that, as to them, the transaction should be treated as a reorganization under section 368(a)(1)(A).

Situations involving the potential for this type of inconsistent reporting by minority shareholders are likely to occur only infrequently. If it is deemed desirable to foreclose the possibility of inconsistent reporting by minority shareholders in such circumstances, however, there appear to be two alternatives. One is to provide that a section 338(h)(10) election will have the effect of “turning off” the step transaction doctrine only if all target shareholders join in that election, including those shareholders who do not exchange their stock in the first-step stock acquisition. Alternatively, the regulations could provide that the making of a section 338(h)(10) election precludes reorganization treatment even for minority shareholders who are not parties to

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8 See Ginsburg & Levin, Integrated Corporate Acquisitions, 93 Tax Notes at 557. Ginsburg and Levin consider an example involving a first-step acquisition of 90 percent of the stock of a target corporation from its parent for a combination of cash and stock of the acquiring corporation, followed by a second-step merger of the target into the acquiror in which the remaining target shareholders receive only stock. The acquiror and the parent of the target’s consolidated group agree to make a section 338(h)(10) election. Ginsburg and Levin observe that under existing law, the minority target shareholders in such circumstances could claim reorganization treatment without relying on the step transaction doctrine. In particular, the fact that the target is treated as a new corporation as of the day after the acquisition date can be viewed as providing the requisite continuity of interest to enable a subsequent squeeze-out merger to qualify as a reorganization. The Service and Treasury may wish to address this fact pattern in developing regulations reflecting the principles of Revenue Ruling 2001-46.

9 As noted above, the regulations already provide that a section 338(h)(10) election is available for the acquisition of an S corporation only if all S corporation shareholders consent, including those who do not sell their stock. See supra note 7.
that election, so that they will receive taxable treatment on the exchange of their shares in the
second-step transaction.

On balance, we favor having the election bind minority shareholders. This approach
would make the section 338(h)(10) election available in a broader number of cases. Indeed,
requiring that minority shareholders join in the election would effectively preclude a section
338(h)(10) election when the minority stock is publicly traded, as in the example above.
Providing that an election would bind even minority shareholders to report the stock acquisition
as a taxable transaction would also avoid conferring on minority shareholders “holdup” power to
extract concessions as a price of securing their consent to a section 338(h)(10) election.10

It is true that such an approach would permit the electing parties to bind others who do
not join in the election, and it presents the issue of how to ensure as an administrative matter that
the minority shareholders are timely and properly informed of the making of the section
338(h)(10) election. With respect to the question of binding those who do not join in the
election, we do not think this situation unfair. The election will in most cases merely confirm
what the minority shareholders expect – that the transfer of their stock to the acquiring
corporation will be taxable. Moreover, the minority shareholders generally have no control over
the second-step asset transaction, which would alter their tax consequences in the absence of an
election. This being so, there is no compelling reason to give the minority shareholders control
over the election. There is also precedent for permitting a section 338 election to affect the tax
consequences for selling shareholders who do not participate in that election. Specifically, a
section 338(g) election made by a purchasing corporation for a foreign target corporation can
have significant and adverse consequences for the target’s U.S. shareholders, even though the
consent of such shareholders is not required for the purchasing corporation to make the election.11
By comparison, according a section 338(h)(10) election binding effect as to the minority
shareholders seems an easier case because the election – at least generally – should not visit
unanticipated consequences upon the minority shareholders.

On the question of notice to minority shareholders, it should not be necessary for the
parties to the election to notify minority shareholders in cases in which those parties have agreed
in writing to make the election and that agreement is readily available (for example, if the
agreement to make the election is described in disclosure materials filed with the Securities and
Exchange Commission). In other cases, however, it seems sensible to require prompt notice to
minority shareholders that such an agreement exists. Moreover, notice to minority shareholders
should also be required in cases in which the parties agreeing to a section 338(h)(10) election

10 It is worth noting, however, that even if minority shareholder consent to a section 338(h)(10)
election were required, there would be limits to such holdup power. In particular, a well-advised
acquiring corporation that is unable to obtain minority shareholder consent could in most cases
protect a section 338(h)(10) election made with respect to a first-step stock acquisition by simply
avoiding a second-step transaction that would result in the transaction as a whole being treated as
a reorganization.

subsequently abandon that agreement, or the election is for some other reason not made by those parties.\textsuperscript{12}

We believe that there is ample authority for the Service and Treasury to adopt regulations under which a valid section 338(h)(10) election would cut off application of the step transaction doctrine. There is express regulatory authority both under section 338(h)(10) and more generally under section 338(i) that is more than sufficient to support adoption of an elective regime. Indeed, the Service has, apparently in reliance on this authority, extended section 338(h)(10) elections to cases in which the target corporation is an S corporation, even though the statute by its terms applies only to cases in which the target corporation is a member of an affiliated group.\textsuperscript{13}

It would, of course, be inappropriate to adopt by regulation an elective regime if the relevant statutory provisions, fairly read, required a different result. That is, however, not the case here. In cases in which step integration would not result in a cost basis in the acquired assets, it is simply not clear whether section 338 of the Code, and more particularly section 338(h)(10), was intended to cut off application of the step transaction doctrine when there is a transaction that, viewed independently, constitutes a qualified stock purchase.

On one hand, it could be argued that section 338 was adopted against a background of judicial and administrative authority, including \textit{King Enterprises} and Revenue Ruling 67-274, that establish what it means to have a cost-basis acquisition and hence a “purchase” for purposes of section 338(h)(3). In the absence of a purchase, there can be no section 338(h)(10) election, and under these authorities there would not be a purchase if a first-step stock purchase followed by an integrated second-step upstream merger of the target corporation were to qualify as a reorganization.

On the other hand, it is possible to read the legislative history of section 338 broadly as precluding any “nonstatutory treatment of a stock purchase as an asset purchase” regardless of the basis consequences of that step integration. Under this reading, a section 338(h)(10) election would always be available when there is a transaction that, viewed independently, would constitute a qualified stock purchase. Revenue Ruling 2001-46 resolves the tension between these two views of the statute by rejecting the broad approach and finding that the step transaction doctrine continues to apply when its application would not result in a cost basis in the target assets. While this a reasoned interpretation, it is not a result that is clearly compelled by the statute. Given the ambiguity, this is an appropriate area for the Service to exercise its regulatory authority in a manner that promotes both the interests of taxpayers and the Government.

\textsuperscript{12} \textit{Cf.} Treas. Reg. § 1.338-2(c)(4) (requiring a purchasing corporation to provide notice to affected U.S. shareholders of a foreign target corporation when a section 338(g) election is made with respect to an acquisition of the stock of the target corporation).

\textsuperscript{13} \textit{See} T.D. 8515, 1994-1 C.B. 89, 91.
It should also be noted that, insofar as adoption of an elective regime would modify and/or restrict application of the judicially-created step transaction doctrine, there are a number of cases in which the Service has by regulation curtailed the application of judicial doctrines in the reorganization area. For example, the continuity of interest regulations, under which transfers of stock received in a purported reorganization will adversely affect continuity only if the transfer is to the issuer or a corporate related party, modify the continuity of interest doctrine, at least as it applied under such cases as *McDonald’s Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982), and *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895 (1983).\(^{14}\) Closer to home, section 1.338-3(d) of the Treasury Regulations effectively cuts off application of the step transaction doctrine with respect to the acquiring corporation and its affiliates when there is a qualified stock purchase with no section 338 election, although in this case the driving concern was to implement the policy of preventing a second-step transaction from producing the prohibited asset basis step up.\(^{15}\)

Finally, Revenue Ruling 2001-46 suggests that, if an elective regime were adopted, the ability to override step transaction principles should be available only when there is a written agreement that requires or permits the purchasing corporation to cause a section 338(h)(10) election to be made. As a practical matter, however, the parties may be uncertain whether the election should be made when the acquisition agreement is drafted and executed. Moreover, the agreement might permit the seller, rather than the purchaser, to require the election. In light of these concerns, it should be sufficient that the section 338(h)(10) election is made, without the requirement of a separate agreement. The only exception should be in cases in which there are minority shareholders of the target corporation that will not join in the section 338(h)(10) election. In such cases, the Service may reasonably require a written agreement at the time of the stock acquisition to make the section 338(h)(10) election in order to ensure that the minority shareholders are given timely notice that an election will be made and can report the gains or losses on the disposition of their stock accordingly. It should also be made clear that the section 338(h)(10) election will override step transaction principles regardless of whether the election is filed before or after the upstream merger (or similar asset transaction) occurs.\(^{16}\)

\(^{14}\) See T.D. 8760, 1998-1 C.B. 804-05.

\(^{15}\) See T.D. 8626, 1995-2 C.B. 34.

\(^{16}\) Certain members of the Section of Taxation participating in the preparation of these comments believe that the approach of permitting an election to turn off the step transaction doctrine should be extended to all cases in which there is a qualified stock purchase, including cases in which the purchasing corporation makes a “regular” section 338(g) election and cases in which no section 338 election is made. These members recognize, however, that implementing a full electivity regime would present additional administrative questions of how an election to turn off the step transaction doctrine should be made and how to bind target shareholders not participating in that election. *See generally Kohl/Storum Letter*, 93 Tax Notes at 426-27.
CONSEQUENCES OF THE FAILURE OF AN INTEGRATED TRANSACTION TO QUALIFY AS AN ASSET REORGANIZATION

In issuing regulations that reflect the principles of Revenue Ruling 2001-46, the Service and Treasury should clarify the tax consequences that apply when a stock acquisition is integrated with subsequent transactions and tested for qualification as a reorganization under the requirements applicable to asset acquisitions, but fails to so qualify under those rules. The regulations should confirm that failure of the integrated transaction to qualify as an asset reorganization will in appropriate circumstances result in the stock acquisition being treated as a stock acquisition that is not eligible for reorganization treatment followed by a separate and independent transaction involving the target assets, rather than the transaction as a whole being treated as a taxable asset purchase. Such treatment follows directly from the reasoning of Revenue Ruling 2001-46 for cases in which the stock acquisition involves an amount of stock that, if taxable, would constitute a qualified stock purchase. We believe, however, that this approach should also apply to cases in which the first-step stock acquisition, even though not meeting qualified stock purchase requirements, results in the acquiring corporation owning an amount of stock in the target corporation meeting the requirements of section 332(b)(1) of the Code and the target is subsequently merged or liquidated into the acquiror.\(^1\)

Under Revenue Ruling 2001-46, a first-step stock acquisition followed by a liquidation or upstream merger of the target will be treated as an asset acquisition for purposes of the reorganization provisions. This is true regardless of whether the stock acquisition, viewed independently, would qualify as a reorganization or as a taxable stock purchase. Suppose, however, that the integrated transaction fails to qualify as a reorganization under the relevant requirements. One might be concerned that the transaction would be treated as a taxable asset purchase together with a distribution by the target of the proceeds – a double tax transaction. It is clear from the reasoning of Revenue Ruling 2001-46, however, this cannot be the outcome in cases in which the first-step stock acquisition involves the acquisition of an amount of stock that would, if taxable, constitute a qualified stock purchase.

As discussed above, Revenue Ruling 2001-46 accepts as a premise that the step transaction doctrine may not be applied to treat a stock acquisition as an asset purchase if the effect is to give the acquiring corporation a cost basis in the target’s assets without a section 338 election. Indeed, this is the central understanding reflected in Revenue Ruling 2001-46 as to the meaning of the repeal of the Kimbell-Diamond doctrine. Accordingly, when such a stock acquisition is properly integrated under step transaction principles with a subsequent liquidation or upstream merger of the target but the integrated transaction fails to qualify as an asset reorganization, the only possible treatment that is consistent with the reasoning of the Revenue Ruling is to respect the stock purchase and the liquidation or upstream merger as independent steps. The taxable asset purchase construct, by contrast, would yield the prohibited result of the

\(^1\) These comments do not address the treatment of cases in which the first-step stock acquisition involves the acquisition of an amount of stock that would not, if taxable, constitute a qualified stock purchase or otherwise result in the acquiring corporation having control of the target corporation within the meaning of section 332(b)(1).
acquiring corporation, without making a section 338 election, receiving a cost basis in the

target’s assets.\textsuperscript{18}

Revenue Ruling 2001-46 itself deals only with acquisitions of an amount of stock that
would, if taxable, constitute a qualified stock purchase. Whether the conclusion that taxable
asset purchase treatment is not appropriate should hold even in cases in which the stock
acquisition does not meet qualified stock purchase requirements is less clear. Such a conclusion
would be consistent with a broad reading of the legislative history of section 338, under which
section 338 was intended to “replace any nonstatutory treatment of a stock purchase as an asset
purchase under the \textit{Kimbell-Diamond} doctrine” (emphasis added). Moreover, from a policy
perspective, the Service should, as a general matter, avoid characterizations that yield a harsh
double tax result when alternative treatments are available that accord with the form of the
transaction and the potential for future taxation of unrealized gains is preserved.

In an earlier published ruling, the Service has treated a first-step stock purchase that did
not meet the qualified stock purchase requirements as separate and independent from a planned
second-step liquidation. Specifically, in Revenue Ruling 75-521, 1975-2 C.B. 120, an acquiring
corporation owned 50 percent of the stock of a target corporation. The acquiring corporation
purchased the remaining 50 percent of the target’s stock for cash and then liquidated the target.
The Service ruled that the transaction would be treated for tax purposes as a taxable stock
purchase followed by a section 332 liquidation. By its terms, Revenue Ruling 75-521 is intended
to provide guidance with respect to the control requirement for section 332 liquidations.
Nevertheless, a similar approach should apply in any case in which the first-step stock
acquisition leaves the acquiring corporation with an amount of stock in the target corporation
meeting the requirements of section 332(b)(1) of the Code, the target corporation is subsequently
liquidated or merged upstream into the acquiring corporation pursuant to a plan, and the
integrated transaction fails to qualify as a reorganization. Even if the amount of stock acquired
in such a case would not be sufficient to constitute a qualified stock purchase, the transaction
should be treated not as an integrated and taxable asset purchase, but rather as a taxable stock
purchase followed by a section 332 liquidation that leaves the acquiring corporation with a
carryover basis in the target’s assets.\textsuperscript{19}

Turning to the treatment of target shareholders selling their stock in the first-step stock
acquisition when the integrated transaction does not meet the requirements of a reorganization, it
seems apparent that such shareholders cannot receive reorganization treatment. For purposes of
the reorganization provisions, the transaction has already been characterized as an integrated
asset acquisition and has failed to satisfy the relevant requirements. There is no basis in the
authorities for then re-testing the stock acquisition as a reorganization. Accordingly, unless the


stock acquisition can qualify for nonrecognition treatment under another provision of the Code (a point discussed in greater detail below), there seems to be no alternative but to treat the first-step stock acquisition as a taxable stock purchase. This is true even if, standing alone, the stock acquisition might have qualified as a section 368(a)(1)(B) reorganization or a reorganization under sections 368(a)(1)(A) and (a)(2)(E). Thus, Revenue Ruling 2001-46 appears to have two aspects for target shareholders who exchange their stock in a first-step stock acquisition. On one hand, Situation 1 demonstrates that a transaction that standing alone would be a taxable stock purchase can be treated instead as a reorganization. But at the same time, the reasoning of Revenue Ruling 2001-46 is such that a transaction that might by itself constitute a stock reorganization can be disqualified from reorganization treatment when integrated with subsequent transactions that cause it to be tested, and to fail, under the asset reorganization rules.

While a first-step stock acquisition should not be eligible to qualify as a stock reorganization if the integrated transaction has failed to qualify under the applicable asset reorganization rules, tax deferral should be available if the stock acquisition would qualify for such treatment under another provision of the Code, including in particular section 351. In private rulings, the Service has held that the tax consequences of a transaction that qualifies as a reorganization will be determined under the reorganization rules, even though the transaction (1) involves a transfer of property that would also qualify under section 351, and (2) will qualify as a transfer of property for purposes of enabling other transferors to satisfy the requirements of section 351. At the same time, it is well-established that a transaction that does not qualify under the reorganization rules is eligible for tax deferral under section 351 if the requirements of that section are satisfied. Once a stock acquisition that is part of a broader multi-step plan has failed to qualify as a reorganization and is treated as an independent transaction, there is no reason to apply a different rule.

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20 Certain members of the Section of Taxation participating in the preparation of these comments disagree with the conclusion that the first-step stock acquisition should be ineligible for reorganization treatment following a failure of the integrated transaction to qualify as an asset reorganization. For this reason, these members disagree with Examples 2, 4, and 5 below to the extent that they conclude that reorganization treatment should not be available for the first-step stock acquisition in each of these examples.

21 See generally Blanchard, Reflections on Rev. Rul. 2001-46, 93 Tax Notes at 1886-88. To the extent that transactions occurring after a stock acquisition that are planned but not disclosed by the acquiror could cause the step transaction doctrine to apply, such actions could cause target shareholders to lose their anticipated tax treatment with respect to the disposition of their stock, whether by converting a tax-free disposition into a taxable one, or vice versa. The potential for this to happen constitutes a significant trap for the unwary, and well-advised sellers will seek appropriate contractual protections against actions that could have this effect.


Questions have arisen, however, under current law as to the characterization of cases in which stock of one corporation (T) is transferred to another corporation (P) in exchange for P stock in a transfer that would otherwise qualify under section 351, and T is then liquidated or merged upstream into P pursuant to a plan, but the integrated transaction does not qualify as a reorganization. Should such a transaction be respected as a transfer by the T shareholders of their T stock to P followed by a section 332 liquidation of T, or should it instead be treated under the step transaction doctrine as a transfer of assets by T to P in exchange for P stock followed by a liquidating distribution by T of the P stock to the T shareholders? In such cases, an integrated asset transfer characterization is not directly foreclosed by the reasoning of Revenue Ruling 2001-46. Because the deemed transfer of the T assets would itself generally qualify as a section 351 transfer, this characterization would not yield the prohibited result of P obtaining a cost basis in the T assets. Rather, P would take a carryover basis in the T assets, while both T and its shareholders would be taxable on the deemed liquidating distribution of the P stock by T.\textsuperscript{24}

We nevertheless recommend that the Service resolve any uncertainty that may exist on this point by providing in regulations that such transactions will be respected as a stock transfer qualifying under section 351 followed by a separate transaction effecting the transfer of the T assets. As discussed above, in cases in which section 351 would not be available, the stock transfer and the asset transaction should be treated as separate transactions to prevent the acquiring corporation from obtaining a cost basis in the target assets without a section 338 election. The availability of section 351 as an additional non-reorganization tax deferral provision should not produce the counterintuitive result of making it more difficult to avoid a double tax transaction. Indeed, applying an integrated asset transfer characterization in these cases would be a significant trap for the unwary. It would be preferable to have one clear and easily administered rule that the form of a stock acquisition will be respected when an acquiring corporation acquires the requisite amount of target stock but the integrated transaction fails to meet the requirements for an asset reorganization.

The foregoing understanding of the tax consequences that apply when an integrated transaction fails to qualify as an asset reorganization is consistent with Revenue Ruling 2001-46 and the authorities on which it is based. Nevertheless, these principles and their effects should not be left implicit, particularly because they are not entirely intuitive and there is considerable room for confusion. Provided below are examples illustrating how these principles should apply in particular cases. The examples provide fact patterns that should be considered by the Service and Treasury as they prepare regulations on this topic.

**EXAMPLE 1:** Corporation P owns all of the stock of Corporation X, a newly-formed wholly-owned subsidiary. P acquires all of the stock of Corporation T, an unrelated corporation, in a statutory merger of X into T with T surviving. In the merger, the T shareholders exchange their T stock for consideration that consists of 50 percent P stock

\textsuperscript{24} The deemed liquidating distribution by T would not affect the ability of the deemed asset transfer to qualify under section 351. See I.R.C. § 351(c)(1).
and 50 percent cash. Following the merger, and pursuant to a pre-arranged written plan, T is liquidated into P. The integrated stock acquisition/T liquidation should be tested for qualification as a section 368(a)(1)(C) reorganization because T is liquidated rather than being merged up into P. However, the transaction will fail to qualify as a reorganization under section 368(a)(1)(C) due to the amount of non-stock consideration provided by P. Accordingly, the transaction is treated as a qualified stock purchase by P of T, followed by a liquidation of T into P that qualifies under section 332 of the Code. A section 338(g) or, if the relevant requirements are met, a section 338(h)(10) election may be made with respect to the acquisition of the T stock.

EXAMPLE 2: Same facts as Example 1, except that the T shareholders receive in the merger consideration consisting of 90 percent P stock and 10 percent cash. Assume further that T has substantial liabilities so that the integrated transaction cannot qualify as a section 368(a)(1)(C) reorganization under the section 368(a)(2)(B) boot relaxation rule. As in Example 1, the stock acquisition is treated as a qualified stock purchase, and a section 338 election may be made, even though standing alone that transaction could have qualified as a reorganization under sections 368(a)(1)(A) and (a)(2)(E) of the Code. The liquidation of T into P is treated as a separate section 332 liquidation.

EXAMPLE 3: Same facts as Example 1, except that following the reverse subsidiary merger, rather than liquidating T, P causes T to merge into Z, a wholly-owned subsidiary of P. Pursuant to a binding written agreement and as part of the same pre-arranged plan, P then causes Z to sell newly-issued shares of its stock to an unrelated third party. Following the Z stock issuance, P owns 75 percent of the outstanding Z stock. Applying the principles of Revenue Ruling 2001-46, the transaction should be tested as a reorganization described in section 368(a)(1)(A) and (a)(2)(D), but it will fail to qualify as such due to the fact that P will lose control of Z as part of the plan (the transaction will fail to qualify as a parenthetical section 368(a)(1)(C) reorganization for the same reason and due to the amount of non-stock consideration provided by P). The acquisition merger constitutes a qualified stock purchase and a section 338 election may be made. The merger of T into Z is treated as a separate and independent transaction that presumably qualifies as a reorganization under both section 368(a)(1)(D) and section 368(a)(1)(A) pursuant to section 1.338-3(d) of the regulations, and potentially also as a section 351 transfer when taken together with the purchase of Z stock by the unrelated third party.

EXAMPLE 4: Corporation T is engaged in two businesses of equal size, the widget business and the gadget business. Corporation P is interested in acquiring T, but not the assets used in the widget business. Pursuant to an agreed-upon written plan, T distributes the widget business assets to its shareholders (perhaps by first contributing those assets to

25 In each of Examples 1 through 5 it is assumed that the T shareholders own, directly and by attribution, less than 50 percent of the outstanding P stock following the transaction.

26 See supra note 3.
a limited liability company ("LLC") that is wholly owned by T and then distributing the
LLC interests to its shareholders; the T shareholders exchange their T stock solely for
voting stock of P; and P liquidates T. Under the principles of Revenue Ruling 2001-46,
the acquisition of T by P is tested for qualification as a reorganization under section
368(a)(1)(C), but it will fail to qualify as such because P has not acquired substantially all
of T’s assets. P’s acquisition of the T stock is treated as a qualified stock purchase, even
though viewed independently it would constitute a section 368(a)(1)(B) reorganization,
and a section 338 election may be made. The liquidation of T will be treated as a
separate section 332 liquidation.27

EXAMPLE 5: As in example 4, Corporation T is engaged in two businesses of equal
size, the widget business and the gadget business. Corporation P has owned 25 percent
of the stock of T for over two years. Pursuant to an agreed-upon written plan, T
distributes the widget business assets pro rata to its shareholders, P acquires all of the
outstanding T stock it does not already own solely for P voting stock, and P liquidates T.
This transaction should be treated as a taxable stock purchase followed by a separate
section 332 liquidation under the same reasoning as applies to Example 4. The fact that a
taxable purchase of 75 percent of the T stock by P would not constitute a qualified stock
purchase should not alter this conclusion.28

EXAMPLE 6: Corporation T’s sole shareholder, A, contributes its T stock to Newco, a
newly-formed corporation, in exchange for $250 in cash (which Newco obtains by
borrowing from a third-party lender) and 40 percent of Newco’s sole class of voting stock
having a fair market value of $300. Simultaneously with A’s transfer, B contributes
business assets to Newco in exchange for the remaining 60 percent of Newco’s stock,
with a fair market value of $450. T is then liquidated into Newco. Neither A nor B is
under any obligation or has any plan or intention to dispose of their Newco stock. A’s
transfer of the T stock to Newco followed by the liquidation of T should be tested as a
section 368(a)(1)(C) reorganization, but it will fail to qualify as such due to the amount of
cash received by A. However, when viewed as a separate transaction, A is eligible under
Code section 351 for deferral on its receipt of Newco stock in exchange for the transfer of
its T stock to Newco to the extent that A has gain in excess of the amount of cash it
receives.

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27 This example is derived from Blanchard, Reflections on Rev. Rul. 2001-46, 93 Tax Notes at 1886-92. Blanchard concludes that the tax consequences of this fact pattern appear to be as
described in the text, although he offers a critique of this result. See also Cummings, Rev. Rul.
2001-46 Revisited, 94 Tax Notes at 642. The conclusion that T’s distribution of its widget
business causes P’s acquisition of T to fail to satisfy the “substantially all” requirement, and
hence not to qualify as a reorganization, is based on Helvering v. Elkhorn Coal, 95 F.2d 732 (4th
Cir. 1937), cert. denied, 305 U.S. 605, reh’g denied, 305 U.S. 670 (1938). Certain members of
the Section of Taxation participating in the preparation of these comments have suggested that
the Elkhorn Coal doctrine should be reconsidered by the Service.

CONCLUSION

For the reasons set forth above, we recommend that any proposed regulations that are issued reflecting the principles of Revenue Ruling 2001-46 provide that a section 338(h)(10) election may be made with respect to a step of a multi-step transaction that, viewed independently, would be a qualified stock purchase. We further recommend that such regulations provide guidance regarding the tax consequences that apply when a transaction such as those described in Revenue Ruling 2001-46 fails to qualify as a reorganization after application of the step transaction doctrine.