**REPORT #805**

## TAX SECTION

# New York State Bar Association

REPORT ON REORGANIZATIONS OF TARGET CORPORATIONS FOLLOWING A QUALIFIED STOCK PURCHASE UNDER SECTION 338

October 14, 1994

## Table of Contents

# TAX SECTION
# New York State Bar Association



October 14, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Business Plan: Yoc Heating Following Section 338 Qualified Stock Purchase

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a Report by the New York State Bar Association Tax Section concerning the application of the Yoc Heating case to a merger of a target corporation (T) into a sister corporation (S) following a section 338 qualified stock purchase of T by a parent corporation (P). This issue is on the 1994 Business Plan.

The Report recommends that, notwithstanding Yoc Heating, the merger be tax-free to P, S and T. On the other hand, the Report recommends that minority shareholders of T who receive P or S stock in the merger be subject to tax unless normal tax-free reorganization principles (without regard to the qualified stock purchase) apply. The Report does suggest an expansion of (F) reorganization treatment that would protect minority shareholders in some cases.

I hope this Report is helpful in the

development of the Treasury and Service positions in this complex area. Please let me know if the Tax Section can be of further help.

Sincerely,

Michael L. Schler
Chair, Tax Section

Tax Report #805

NEW YORK STATE BAR ASSOCIATION TAX SECTION

# REPORT ON REORGANIZATIONS OF TARGET CORPORATIONS FOLLOWING A QUALIFIED STOCK PURCHASE UNDER SECTION 338[1]

October 14, 1994

This Report addresses the issue of whether Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973), has any continuing application to the reorganization of a corporation acquired in a "qualified stock purchase" under section 338(d). This subject is included in the Treasury Department-Internal Revenue Service 1994 Priorities for Tax Regulations and Other Administrative Guidance.

## Background

In Yoc Heating, Reliance acquired for cash and notes 84.8% of the stock of Old Nassau. Reliance then formed a new subsidiary, New Nassau, which acquired all the assets (subject to all the liabilities) of Old Nassau at a price payable at the election of each shareholder of Old Nassau in either cash or stock of New Nassau. Only Reliance elected to receive stock and the minority shareholders were cashed out.

The court in Yoc Heating concluded that the assets and liabilities of Old Nassau had not been acquired by New Nassau in

1 This Report was prepared by Steven C. Todrys, Co-Chair of the Committee on Corporations, with assistance from Michael L. Schler and Richard L. Reinhold. Helpful comments were received from William L. Burke, Harvey P. Dale, Robert A. Jacobs, Richard O. Loengard, Jr., Andrew P. Solomon, Willard B. Taylor and Philip R. West.

a reorganization of Old Nassau. The court reasoned that the purchase of 84.8% of the stock of Old Nassau was the first step in an integrated transaction that included the ultimate transfer of assets to New Nassau. As a result, the transaction did not satisfy the “control” requirement of a (D) reorganization (i.e., the historic shareholders of Old Nassau were not in control of New Nassau) or the “continuity of interest” requirement applicable to all reorganizations, including an (F) reorganization. Thus, New Nassau was not permitted to carry back a net operating loss to prior taxable years of Old Nassau and was required to determine its basis in its assets by reference to its cost for the Old Nassau shares. Compare Casco Products Corporation v. Commissioner, 49 T.C. 32 (1967), where, on similar facts, the transferee corporation was treated as a continuation of the transferor.

Yoc Heating was decided before the enactment of section 338. Section 338 does not specifically address the treatment of a reorganization following a qualified stock purchase (i.e., a “purchase” of 80% or more of the stock of a corporation by another corporation within a 12-month period). However, the legislative history to its enactment states that section 338 is “intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.” H.R. Conf. Rep. No. 97-760, 97th Cong., 2d Sess. 536 (1982), reprinted in 1982-2 C.B. 600, 632. The Internal Revenue Service (the “Service”) amplified this statement in Rev. Rul. 90-95, 1990-2 C.B. 67, holding that a liquidation of a target corporation compelled by state law did not convert a qualified stock purchase into an asset acquisition. Citing the legislative history to section 338, the Service reasoned that the qualified stock purchase had “independent significance” from the subsequent liquidation of the target. The ruling also cited Treasury regulations (now Treas. Reg. §1.338-2(c)(1)(i)) for the proposition that stock purchase or asset purchase treatment turns upon the making of a section 338 election “whether or not the target is liquidated, merged into another corporation, or otherwise disposed of by the purchasing corporation.”

While the rejection of the Kimbell-Diamond doctrine in the section 338 legislative history and Rev. Rul. 90-95 addresses the treatment of a liquidation of the target corporation following a qualified stock purchase, no authority (other than private letter rulings, discussed below) deals with a subsequent reorganization of the target. It is not uncommon for a target corporation (“T”) to be merged into another subsidiary (“S”) of the purchasing corporation (“P”) following a qualified stock purchase. For example, regulatory considerations may compel a reincorporation of T in another jurisdiction or, where S is an operating company, contractual or regulatory limitations may prevent S's merger into T.

If Yoc Heating is applied, a merger of T into S immediately following a qualified stock purchase, and as part of a single plan, would not qualify for reorganization treatment because continuity of interest would not be satisfied.[2] As a result, the merger would be treated as an asset purchase by S, with the basis of T's assets determined by reference to their

[2] We assume throughout this Report that the qualified stock purchase and merger would be integrated so that continuity of interest would not be satisfied under existing principles.

cost.[3] This result is inconsistent with the notion that a section 338 election following a qualified stock purchase of T is the exclusive means of obtaining a cost basis in the assets of T.[4]

Yoc Heating was decided, and section 338 was enacted, before the repeal of the General Utilities doctrine. General Utilities repeal has changed the stakes involved in Yoc Heating by eliminating the possibility of a step-up in asset basis without a corporate-level tax. Now, if the asset transfer fails to qualify for tax-free treatment, as a reorganization or otherwise, gain will be recognized by T on any appreciation in its assets, although, where consolidated returns are filed, any gain recognized will be deferred.

Since the enactment of section 338, the Service has issued several private letter rulings holding that a merger of T into S following a qualified stock purchase by P will qualify as a reorganization under section 368 and, more particularly, that the stock purchase does not prevent the merger from satisfying the continuity of interest requirement of Treas. Reg. §1.368-1(b). See e.g., PLR 9436057, 9317011, 9213032, 9113022. In one

---

3 See Rev. Rul. 69-6, 1969-1 C.B. 104. By contrast, a liquidation (or merger) of T into P would be governed by sections 332 and 337, which have no continuity of interest requirement. Such a liquidation (or merger) would result in no recognition of gain to P, no gain to T (except with respect to distributions of assets to minority shareholders, if any) and a carryover basis in the assets to P under section 334(b)(1).

4 Certain other techniques that might also permit a cost basis in T assets without a section 338 election are beyond the scope of this Report. For example, if T adopted a plan of liquidation prior to its acquisition by P in a qualified stock purchase, and the liquidation was completed after the acquisition, section 332 would not apply to the liquidation. As a result, T would recognize gain and P would have a fair market value basis in the assets of T distributed in the liquidation.

ruling, PLR 8849017, the Service also ruled that a 20% minority owner of T recognized no gain or loss on the exchange of his shares of T for shares of S on the basis that the reorganization of T qualified under section 368(a)(1)(F). This ruling seems to conflict with authority holding that minority shareholders who receive stock in the subsequent merger of T into P (or S) are required to recognize gain on the exchange because continuity of interest is lacking. See Kass v. Commissioner, 60 T.C. 218 (1973), affd. without published opinion, 491 F.2d 749 (3d Cir. 1974).[5]

## The Problem

We believe as a policy matter that if P makes a qualified stock purchase of S, P should then be able to merge T into S on a tax-free basis as to P, S and T. On the other hand, we also believe that minority shareholders of T receiving P or S stock on such a merger should generally not be entitled to tax-free treatment.[6]

Our reasons for each of these conclusions are discussed below. Nevertheless, it is difficult to reconcile these positions as a purely theoretical matter. If the qualified stock purchase does not make P a historic shareholder of T, the merger would be taxable at the corporate level under general principles of tax

---

[5] Yoc Heating does not address the treatment of minority shareholders who receive stock of either S or P, since the minority shareholders in that case received cash.

[6] We have assumed in this Report that no section 338 election is made for T. If a section 338 election were made, we believe T would be treated as a newly-formed corporation of which P would be a historic shareholder. See e.g., PLR 8645041.

law. If P is deemed to become a historic shareholder of T, then the merger would be a tax-free reorganization for all purposes, including minority shareholders of T receiving P or S stock.

As a consequence, our recommendations below are somewhat result-oriented. Nevertheless, we believe they reach the proper results and are within the powers of the Treasury and the Service.

## Summary of Recommendations

1. The Treasury should issue a regulation under section 338 stating that if T merges into S[7] after a qualified stock purchase (a) no gain or loss will be recognized by T on the transfer of its assets to S, (b) T's basis in its assets will carry over to S, (c) no gain or loss will be recognized by P on its actual or constructive exchange of T shares for S shares, (d) no gain or loss will be recognized by P, S or T on the issuance of shares of P or S to any minority shareholders of T and (e) T's tax attributes will carry over to S under the principles of section 381. We do not believe that the regulation should characterize the merger of T into S as a reorganization under section 368 for all purposes of the Internal Revenue Code.

2. We recommend the treatment of the minority shareholders of T be governed by the law traditionally applicable to reorganizations. Therefore, an exchange by minority shareholders of their stock of T for stock of P or S would

[7] We are assuming throughout this part of the discussion that S is a wholly-owned subsidiary of P. If, for example, S were only 50% owned by P, general principles of law applicable to reorganizations should govern the tax consequences to P, S and T.

generally result in recognition of gain unless, as discussed below, the merger can be treated as a reorganization under section 368(a)(1)(F).

3. We recommend the Service issue a Revenue Ruling stating that a merger of T into a newly-formed S in a reincorporation transaction will be treated as a reorganization under section 368(a)(1)(F), without regard to continuity of interest. This would permit minority shareholders of T to receive S stock on a tax-free basis. We recognize that this would be a change in law, but we believe it is justified in light of the 1982 amendment limiting the applicability of section 368(a)(1)(F) to reorganizations of "one" corporation.

4. We encourage the Treasury and the Service to consider whether nonrecognition treatment at the corporate level is appropriate in a merger of T into S where P owns at least 80% of S, even in cases not involving a qualified stock purchase.

## Discussion

### 1. Corporate Level Treatment of P. S and T

As a theoretical matter, Yoc Heating may be correctly decided on the issue whether the asset transfer qualified as a reorganization under section 368. If Reliance acquired the stock of Old Nassau for cash with a prearranged plan to cause Old Nassau to transfer its assets to New Nassau in exchange for stock and cash, Reliance's stock ownership of Old Nassau during the interim period from the date of the stock purchase to the date of the asset transfer would not appear to satisfy the continuity of interest requirement. See e.g., Kass, supra; Superior Coach of Florida. Inc. v. Commissioner, 80 T.C. 895 (1983). This conclusion would be technically correct whether (a) Reliance had purchased all of Old Nassau's stock prior to the asset transfer to New Nassau or (b) as was the case, the asset transfer was used to “squeeze out” the minority shareholders.

The most straightforward case which raises the Yoc Heating issue is one in which P, after a qualified stock purchase, owns 100% of the stock of T.[8] T is then merged into S, which is either an operating company (in order to consolidate operations) or a shell (in order to reincorporate in another jurisdiction).[9] If a section 338 election is to be the exclusive means of obtaining asset purchase treatment, the merger must result in nonrecognition of gain to T and carryover basis to S.

We believe this result is justified because it would have been attained if S, rather than P, had made the qualified stock purchase with funds provided by P. In that case, the merger of T into S would be treated as a liquidation, with no gain recognized under section 332 to S, no gain recognized under section 337 to T, a carryover basis in T's assets to S under section 334(b)(l) and a carryover of T's tax attributes under section 381. Differing treatment depending upon whether P purchases T and merges it into S, or S purchases T and liquidates it, is also inconsistent with the spirit of section 338(h)(8),

---

8 P may have acquired all of T's stock in a qualified stock purchase, or may have acquired up to 20% of T's stock in another manner (e.g., in a section 351 transaction or by purchases consummated prior to the 12-month acquisition period).

9 As discussed below, we believe a merger of T into a newly-formed S should be governed by section 368(a)(1)(F). However, the Service has not yet abandoned the continuity of interest requirement in an (F) reorganization and, therefore, this portion of the Report assumes continuity is required.

which aggregates all purchases of T stock by members of an affiliated group as if the purchases were made by a single corporation.[10]

Other constructions of the transaction can also be looked to as analogies for nonrecognition of gain and carryover basis in the merger of T into S. For example, P could be viewed as transferring the T stock to S in a section 351 transaction, followed by a liquidation of T under section 332, although one could question whether S's transitory ownership of T should be regarded as meaningful in analyzing the transaction. Alternatively, T could be treated as having transferred its assets to S in exchange for S stock in a section 351 transaction (assuming the control requirement is satisfied)[11] and, then, having distributed the S stock to P in a section 332 liquidation. While authority exists that would test those transactions as reorganizations[12], the Service is not precluded, in concept, from breaking them into their two tax-free steps.

For the reasons discussed above, we believe the same result for P, S and T should be reached where there are minority

---

[10] The Service might also reach the conclusion that reorganization treatment under section 368 is justified when P owns 100% of T on the basis that P has freedom of action with respect to T (i.e., because there are no other shareholders of T) and that, therefore, continuity of interest is satisfied. But see Superior Coach of Florida. Inc., supra.

[11] Control (as defined in section 368 (c)) would be satisfied if P, S and T are members of an affiliated group that files a consolidated return. Treas. Reg. §1.1502-34. If a consolidated return was not filed, the control requirement would be satisfied only if T was, itself, in control of S immediately after the transfer or if P was also a transferor to S. In either case, T's distribution of the S stock to P would not be taken into account for purposes of the control test. Section 351(c).

[12] See Rev. Rul. 67-274, 1967-2 C.B. 141 ((B) reorganization followed by liquidation treated as (C) reorganization); Rev. Rul. 76-123, 1976-1 C.B. 94 (Section 351 exchange followed by liquidation treated as (C) reorganization).

shareholders of T. However, the existence of a minority raises the issue whether corporate gain should be recognized to the extent of the appreciation in the minority's share of T's assets. If the minority shareholders received their share of T's assets in a liquidation of T, section 337 would not apply to prevent recognition of gain to T on the distribution of those assets. While the stock of P T in the merger might be viewed as an appreciated asset distributed by T, we believe the regulation should provide for nonrecognition of gain to P, S and T on the issuance of such stock under the principles of section 361(c). Alternatively, the transaction might be viewed as if the minority shares had been acquired by P or redeemed by T immediately before the merger so that, for purposes of this analysis, P could be treated as owning 100% of T at the time of the merger.[13]

The merger of T into S involves the actual or constructive exchange by P of its stock of T for stock of S. This exchange would ordinarily result in recognition of gain to P, as it would to the minority shareholders, because of the lack of continuity of interest. While 80% of P's stock in T may be recently purchased (at least within the last 12 months), the T stock may have appreciated since the date of its acquisition or P may have acquired the shares in a bargain purchase. Since P would not have recognized gain on a liquidation of T under section 332, we believe P should not recognize any gain as a result of the merger of T into S.

We recommend the Treasury issue a regulation under section 338 adopting the proposed treatment of P, S and T.

---

[13] See Madison Square Garden Corporation v. Commissioner, 500 F.2d 611 (2d Cir. 1974) and Rev. Rul. 59-412, 1959-2 C.B. 108, in which the minority's shares were not treated as acquired by P, but P was treated as assuming a liability to pay for those shares in computing its basis in T's assets under old section 334(b)(2).

Authority for such a regulation exists in the legislative history to section 338, quoted above, and section 338(i), under which the Secretary has broad regulatory authority. Since the proposed treatment of P, S and T diverges from traditional reorganization principles and differs from the treatment proposed for the minority shareholders of T, we believe that the regulation should not characterize the merger as a reorganization under section 3 68 for all purposes of the Internal Revenue Code.

2. Treatment of Minority Shareholders

We recommend that, in general, the treatment of the minority shareholders of T be governed by general principles of tax law applicable to reorganizations. Thus, if T is merged into S and the minority shareholders of T receive stock of P or S, they should not be entitled to nonrecognition treatment (except as discussed below in an (F) reorganization) since the recent purchase of T stock by P would not contribute to continuity of interest.[14]

We have a number of reasons for this conclusion. First, except in the (F) reorganization case discussed below, the minority shareholders have truly changed the nature of their investment (from T stock to P or S stock). Second, there is considerable existing case law that would deny nonrecognition treatment, and we see no reason why the existing law should be changed solely because of the enactment of section 338. Third, the liquidation analogy discussed above supporting tax-free treatment at the corporate level does not apply to minority shareholders of T, who would recognize taxable gain or loss

[14] In an unusual case, section 351 could apply to the exchange of T stock for P stock where the minority shareholders were in control (or part of a group of transferors in control) of P immediately after the transfer.

under section 331 on a liquidation of T. Fourth, neither the legislative history of section 338 nor Rev. Rul. 90-95 supports reorganization treatment for the minority shareholders; in particular, the ruling merely states that P's acquisition of T stock will not be disregarded if T then merges into S, not that the step transaction doctrine is inapplicable so as to treat P as a historic shareholder of T.

Finally, tax-free treatment for minority shareholders in a merger following a qualified stock purchase would give rise to at least two anomalies:

> (1) the minority shareholders of T would be taxed on the receipt of P or S stock if, without a prior stock purchase by P, T was merged directly into S and at least 80% of the T shareholders received cash from P, but would be entitled to tax-free treatment in the equivalent transaction where P first purchased 80% of the stock of T and then exchanged P or S stock for the remaining T shares in the merger; and
>
> (2) if P bought a portion of T stock and then merged T into S, T shareholders receiving P or S stock would receive tax-free treatment (a) under the general reorganization rule if P initially bought no more than 50% (or 60% under case law) of the stock of T for cash or (b) under the qualified stock purchase rule if P initially bought at least 80% of the T stock for cash; only if P initially purchased between 50% (or 60%) and 80% of T for cash would the minority shareholders be taxed.

These anomalies do not arise with respect to the T shareholders under our proposals.

We recognize the force of the argument that treating P as a historic shareholder of T for all purposes would be a simpler rule than our proposals, and that our proposals create their own anomaly as to P, S and T (discussed below). Nevertheless, we believe on balance that our proposals are more consistent with appropriate tax policy (and the section 338 legislative history) and create fewer anomalies than this more far-reaching approach.

### 3. Section 368(a)(1)(F)

The continuity of interest requirement for (F) reorganizations is an area of confusion under existing law. The Service's position is that continuity in an (F) reorganization requires complete identity in the shareholders and assets of the reorganized corporation, with a 1% de minimis exception. See e.g., Rev. Rul. 66-284, 1966-2 C.B. 115; Rev. Rul. 78-441, 1978-2 C.B. 152.

However, despite this strict standard, the Service has not applied the step transaction doctrine to disqualify (F) reorganizations where it could reasonably conclude that the steps had independent significance, even if they were part of a prearranged plan. Thus, in Rev. Rul. 61-156, 1961-2 C.B. 62, the Service ruled that a liquidation-reincorporation transaction was an (F) reorganization, even where it was immediately followed by a public offering of 55% of the corporation's stock. In Rev. Rul. 79-250, 1979-2 C.B. 156, the Service found an (F) reorganization where the reincorporation was preceded by the issuance of stock in a section 368(a)(2)(D) reorganization. In Rev. Rul. 69-516, 1969-2 C.B. 56, a reincorporation was treated as an (F) reorganization where it was immediately followed by an acquisition of substantially all the assets of the corporation in a reorganization under section 368(a)(1)(C).

We recommend the Service issue a Revenue Ruling, and amend the regulations under section 368 on continuity of interest, to state that a merger of T into a newly-formed S in a reincorporation transaction be treated as an (F) reorganization without regard to traditional continuity of interest principles. As the Service recognized in PLR 8849017, since 1982 (F) reorganizations have been limited to a mere change in identity, form or place of organization of “one” corporation. As a result, an (F) reorganization is similar to a recapitalization under section 368(a)(1)(E) which, because it involves only a single corporation, does not require continuity of interest. Rev. Rul. 77-415, 1977-2 C.B. 311. See also Treas. Reg. §1.381(b)-1(a)(2) (attributes taken into account by the acquiring corporation in an (F) reorganization “as if there had been no reorganization”).

### 4. T Not Acquired in a Qualified Stock Purchase

As a final point, we find it difficult to distinguish the proper tax treatment of P, S and T in cases in which at least 80% of the stock of T is acquired in a qualified stock purchase from those cases in which at least 80% of T is acquired but not in a qualified stock purchase. For example, P could have held 10% of the stock of T for over a year and then acquired by purchase an additional 70%. The acquisition would not constitute a qualified stock purchase, but there does not appear to be any policy reason to treat a subsequent merger of T into S any differently than if there had been a qualified stock purchase.

In fact, such a distinction creates a peculiar anomaly, similar to that discussed above with respect to the minority shareholders of T. Tax-free treatment at the corporate level and carryover basis would apply if P acquired 50% (or 60% under case law) of the stock of T by purchase and the remainder in exchange for P or S stock in the merger. In that case, continuity of interest would be satisfied and the merger would qualify as a reorganization under section 368. Tax-free treatment and carryover basis at the corporate level would also apply if the recommendations of this Report are adopted where P has acquired 80% or more of T's stock by purchase. However, if P acquired between J0% (or 60%) and 80% of T's stock by purchase, the merger of T into S would be taxable at the corporate level. To avoid this anomaly, we believe the Treasury and the Service should consider whether corporate-level nonrecognition treatment is appropriate for all mergers of T into S (whether or not following a qualified stock purchase) provided that P owns 80% or more of T prior to the merger.

## Conclusion

We recognize the difficulty of reconciling all the positions we take in this Report. On the merger of T into S, we support tax-free treatment at the corporate level without regard to traditional continuity of interest principles, while we oppose tax-free treatment for the minority shareholders on the basis of traditional continuity of interest principles.

Ultimately, we believe there is no policy need for corporate level tax (including a tax on P's exchange of T shares) as long as all assets remain in corporate solution and similar results could be achieved by alternative forms of the transaction. We believe the legislative history to section 338 supports this result if a qualified stock purchase has occurred. However, at the shareholder level, if the nature of the shareholder's interest changes, we believe the only exception to recognition treatment should be traditional reorganization principles; in the one situation we discuss where the nature of the shareholder's interest has not significantly changed, we support expansion of the (F) reorganization rules to reach what we believe is the proper result.