

Post-Reorganization Restructuring – Application of Internal Revenue Regulation 1.368-2(k) to Post-Section 368(a)(2)(E) Restructuring¹

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When considering the possibilities of post-reorganization restructuring after a reverse subsidiary merger, the rules established by Regulation 1.368-2(k) are very lenient and provide great flexibility for post-reorganization restructuring. Specifically, following a reverse subsidiary merger, Target's assets can be distributed to shareholders, as long as such distribution does not amount to a liquidation of the Target for federal income tax purposes.² Moreover, all or part of the Target's assets or stock, or a combination of both, can be transferred to Target's subsidiaries, as long as the assets or stock of the Target is moved within the qualified group³ and such restructuring does not cause the Target to terminate.⁴

Statement of Facts

Generally, in a reverse subsidiary merger, a subsidiary of the Acquiring company merges into the Target corporation.⁵ The subsidiary's stock is converted into the Target stock and the former Target shareholders receive merger consideration.⁶ As the result of the transaction,⁷ the Target corporation survives.⁸

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² RIA Federal Tax Coordinator 2d, ¶F-2414. *See also* ¶F-4013.

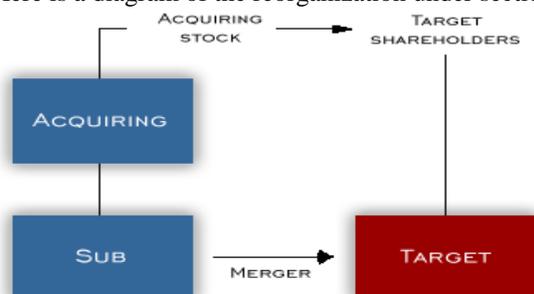
³ "A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, where the issuing corporation owns directly stock representing Code Sec. 368(c) control in at least one other corporation, and stock meeting the requirements of Code Sec. 368(c) in each of the corporations (except the issuing corporation) is owned directly or indirectly ... by one or more of the other corporations." RIA Federal Tax Coordinator 2d, ¶F-3251. Also see *Id.* at ¶F-5501 and ¶F-3708B.

⁴ RIA Federal Tax Coordinator 2d, ¶F-3251.

⁵ RIA Federal Tax Coordinator 2d, ¶F-2414.

⁶ *Id.*

⁷ Here is a diagram of the reorganization under section 368(a)(2)(E) right before the merger.



Consider, for example, that Company X (Acquiring Corporation) is a parent corporation of an affiliated group of corporations engaged in several different lines of business. Moreover, Company X had recently completed an acquisition of a competitor in a reverse subsidiary merger,⁹ which qualified under section 368(a)(2)(E) as a tax-free transaction. In that transaction, Target’s shareholders surrendered their Target’s stock in exchange for consideration amounting to eighty percent of the common voting stock of Company X, the acquiring corporation, and twenty percent of cash. Now that the merger transaction has been completed, Company X wishes to do some internal post-reorganization restructuring to better fit the acquired business with its existing business lines.

Analysis

Generally, a transaction otherwise qualifying as a reorganization under section 368(a) is not disqualified or re-characterized due to one or more successive transfers of assets or stock after the reorganization is complete, as long as the requirements of regulation 1.368-2(k) are satisfied.¹⁰ Under §1.368-2(k), tax-free treatment of the original transaction is preserved even after subsequent successive transfers of assets or stock if 1) continuity of business enterprise requirements are satisfied, 2) transfers fall under the allowed list of actions, and 3) former Target’s shareholders are not involved.¹¹

Section 1.368-2(k) regulations heavily rely on the continuity of business enterprise rules, which must be independently satisfied.¹² Following a tax-free reorganization, the Acquiring company must continue at least one historic line of business of the Target company or must continue to use a significant portion of the Target’s historic assets. Consequently, assets required to satisfy continuity of business enterprise that are subsequently transferred or distributed must remain within the qualified group.¹³ Furthermore, in order to respect the continuity of business enterprise requirements, stock can be transferred to a partnership, in which the qualified group members hold interest equivalent to section 368(c) control.¹⁴ Assets, likewise, can be transferred to a partnership if continuity of business enterprise rules are satisfied.¹⁵

Section 1.368-2(k) regulations outline two types of transactions allowed in post-reorganization restructuring: distributions to shareholders and transfers to non-shareholders.¹⁶ Under the regulations, one or more subsequent distributions to shareholders are allowed of assets or stock of the Target, or a combination of both, if a) acquiring company remains a member of the qualified group, b) such distributions do not amount to a liquidation of the surviving Target for federal income tax purposes, and c) not all stock of Target is distributed that was acquired in the original tax-free transaction.¹⁷ Likewise, one or more transfers to non-shareholders are allowed of part or all of the assets or stock of the Target, or a combination of both, if 1) assets or stock are moved within the qualified group and 2) the surviving Target does not terminate.¹⁸



⁸ Here is a diagram of the reorganization under section 368(a)(2)(E) after the merger transaction.

⁹ For the purposes of this discussion, it is assumed that the Client’s reverse subsidiary merger took place after the latest amendment to the regulations effective May 9, 2008. If not, different rules could apply. See RIA Federal Tax Coordinator 2d, ¶F-2206.

¹⁰ RIA Federal Tax Coordinator 2d, ¶F-3251.

¹¹ *Id.*

¹² RIA Federal Tax Coordinator 2d, ¶F-4013.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ RIA Federal Tax Coordinator 2d, ¶F-3251.

¹⁷ *Id.*

¹⁸ *Id.*

As such, any such subsequent transfers or distributions are not allowed if a) transfers are made to former shareholders of the surviving Target of consideration for a proprietary interest¹⁹ in the Target company or b) transfers made by former shareholders of the surviving Target company of the consideration that was originally received in the reverse subsidiary merger.²⁰ Such transactions are excluded from the safe harbor protection of §1.368-2(k) regulations since the consideration received by the former shareholders of the Target taints continuity of interest requirement, where a significant portion, at least forty percent, of the consideration received by the former Target shareholders must be the stock of the acquiring company.²¹

Finally, if such post-reorganization transfers or distribution do not fall under the safe harbor protection of §1.368-2(k), tax-free treatment of the original transaction will only be preserved if such faulty subsequent transfers will not be considered part of the original transaction under the step transaction doctrine.²² In a fact pattern involving a reverse subsidiary merger, the court would probably apply either an independence test or an end result test to the series of steps or transactions that took place.²³ Under an independence test, the transactions are combined if each step is fruitless without the later steps.²⁴ Under the end result test, the transactions are combined if the end result is intended at the outset.²⁵

In the Revenue Ruling 2005-25, for example, the acquiring company received Target's stock in a reverse triangular merger for a combination of stock and cash that satisfied the requirements of a tax-free reorganization. However, the acquiring company then liquidated the Target. Such fact pattern clearly violated the safe harbor requirements of §1.368-2(k) and, therefore, Internal Revenue Service (IRS) was free to apply the step transaction doctrine. Under the step transaction principles, liquidation of the Target was considered together with the prior merger transaction, where such end result violated the substantially all²⁶ requirement and the transaction taken in total could not qualify as a Type A reorganization.²⁷ IRS treated the transaction as a qualified purchase followed by a tax free liquidation and noted that if, instead of liquidating the Target, the Target were to merge into the acquiring company, the overall transaction would have been a tax-free merger.²⁸

Similarly, in the revenue ruling 2001-46, a reverse subsidiary merger combined with the upstream merger of the Target into the acquiring company was treated by the IRS as one overall Type A reorganization, even though the original reverse subsidiary merger failed to meet the requirements of section 368(a)(2)(E) because it failed to satisfy section 368(c) control requirement. In the original transaction, the Target shareholders received only seventy percent of the acquiring company's stock. However, IRS will only integrate an acquisition merger with the upstream merger, where the reorganization's continuity of interest requirement is satisfied.²⁹ In Revenue Ruling 90-95, for example, where eighty percent of the consideration received by the Target was cash, IRS rejected the step transaction treatment and the overall transaction was held to be a qualified stock purchase.³⁰

Conclusion

In a reverse subsidiary merger, regulations permit a wide variety of post-reorganization transfers of the surviving Target's assets or stock as long as the continuity of business enterprise requirements are satisfied. Specifically, Target's assets can be distributed to shareholders if such distributions do not amount to a liquidation of the Target for federal income tax purposes. Moreover, all or part of Target's assets or stock, or a combination of both, can be transferred to Target's subsidiaries, as long as the assets or stock of the Target is moved within the qualified group and such restructuring does not cause the Target to terminate. Finally, Target's stock can be transferred to a partnership, in which the qualified group members hold interest equivalent to section 368(c) control.

¹⁹ Pro-rata dividend distributions following a reorganization are permissible, since they do not represent an ownership interest. *See Id.* at FN 14.2.

²⁰ RIA Federal Tax Coordinator 2d, ¶F-3251.

²¹ *Id.* at FN 14.2.

²² *Id.*

²³ RIA Federal Tax Coordinator 2d, ¶F-3903.

²⁴ *Id.* at FN 8.

²⁵ *Id.*

²⁶ Since the Target was liquidated, it no longer held substantially all of its assets.

²⁷ RIA Federal Tax Coordinator 2d, ¶F-3903 at FN 9.

²⁸ *Id.*

²⁹ *Id.* at FN 10.4.

³⁰ *Id.*