



# New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

## ATTORNEYS

Robert H. Wellen

## PRACTICE AREAS

Tax

Robert H. Wellen

*Journal of Taxation*

January 1, 1993

### ***New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions***

**Author: ROBERT H. WELLEN**

***ROBERT H. WELLEN is a partner in the Washington, D.C., law firm of Ivins, Phillips & Barker. He lectures and writes frequently on Federal tax subjects, and has served as chair of the ABA Tax Section's Corporate Tax Committee. Thomas S. Dick, a participating associate in the Washington, D.C., office of Fulbright & Jaworski L.L.P., assisted in preparing this article.***

*Under current interpretations, a target may fail the test by distributing property to shareholders or paying transaction expenses before the acquisition.*

In the most common types of tax-free corporate acquisitions, the acquiring corporation must acquire "substantially all" the properties of the target corporation. If this test is not met, the acquisition will be taxable to the target's shareholders. In addition, if the target's assets are transferred, it will be taxed on its gain, and thus two taxes will be paid.<sup>1</sup> In a triangular acquisition (whether a merger or a C reorganization), even a third tax could be involved. The acquiring subsidiary could be viewed as receiving parent stock (with a zero basis) as a capital contribution or a Section 351 exchange and then transferring that stock to the target corporation for the target's assets in a taxable exchange.<sup>2</sup> Here, in addition to the taxes paid by the target and its shareholders, the acquiring subsidiary recognizes gain and pays tax on the full value of its parent's stock used in the acquisition. Furthermore, this gain recognition does not provide a basis increase in



## | 2 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

any property or any other future tax benefit.<sup>3</sup>

Various court decisions discuss "substantially all," but none states a definitive test.<sup>4</sup> Moreover, all the cases discussing this requirement in acquisitive reorganizations date from before 1960.<sup>5</sup> Under the advance ruling guidelines in Rev. Proc. 77-37, 1977-2 CB 568, section 3.01,<sup>6</sup> "substantially all" is satisfied if the assets transferred represent at least 90% of the FMV of the net assets and at least 70% of the FMV of the gross assets held by the target immediately prior to the transfer.<sup>7</sup>

Until the 1980s, the 90/70 test seemed to protect the reorganization system from abuse without interfering unduly with most legitimate transactions. Recently, however, corporate tax law has shifted in basic ways that affect the purpose and role of the "substantially all" requirement. Three developments were particularly important:

- (1.) Congress repealed the General Utilities doctrine. A corporation now recognizes its built-in gain (but often not loss) on nearly all property transfers and distributions other than reorganizations.<sup>8</sup>
- (2.) Reg. 1.368-1(d) set forth a "continuity of business enterprise" requirement, applicable to corporate reorganizations generally.
- (3.) Section 368(a)(2)(G) provided that an acquisition qualifies as a C reorganization only if the target corporation is liquidated as part of the reorganization plan.

In view of these and other developments, the "substantially all" requirement as applied to acquisitions should be reconsidered. New guidance, in the form of Regulations or Revenue Rulings, would be helpful. It would be particularly useful if such guidance consisted of "two-edged" rules, i.e., to indicate when the "substantially all" requirement is and is not satisfied, rather than merely a safe harbor for reorganization treatment.

This first part of the article discusses why acquisitive reorganizations should be specially treated, suggests how an overall rule for "substantially all" in acquisitions might be structured, and considers how the 90/70 test might be clarified if new guidance is not adopted. The second part of this article will examine other problems that arise under current law.

### ACQUISITIONS AND OTHER TRANSACTIONS

The "substantially all" issue arises in four types of corporate transactions in addition to acquisitions: reincorporations, divisions, debt restructurings, and parent-subsidary flips.

**Acquisitions.** Where the target and acquiring corporations are unrelated, the price agreed on is likely to be both (1) a reliable indication of the value of the target and (2) determined by reference to value outside the target—generally, cash or the stock of the acquiring corporation. In addition, an acquisition often involves tension between the parties' interests



### | 3 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

regarding tax consequences. For example, the shareholders of the target may want tax deferral, whereas the acquiring corporation may prefer a step-up in the basis of assets or stock.

By contrast, the other types of transactions generally involve allocations of relative value within the target among its owners and creditors, classes of shareholders, or both. Consequently, it may be difficult to use pricing to indicate the value of any particular group of assets. Also, these transactions often do not involve inconsistent tax goals of the different parties, so that a tax-driven form is more likely.

Principally for these reasons, the "substantially all" requirement should be applied in a special way to acquisitions. Case law arising out of the other types of transactions should be applied to acquisitions only with care. Similarly, any guidance the Service provides on "substantially all" for acquisitions should not be applied to the other types of transactions.

**Reincorporations.** The liquidation-reincorporation technique is used to reduce the burden of corporate and shareholder taxes. Here, an existing corporation "sells" its profitable business to another corporation owned by some or all of the same shareholders, and then liquidates. The shareholders receive the "sale" proceeds and any unsold assets, usually liquid. Before the repeal of the *General Utilities* doctrine, such transactions were tax free to the selling corporation, the purchaser obtained a stepped-up (cost) basis in the assets, and the seller's shareholders got capital gain treatment on the distribution of proceeds and other assets.

The Service generally would contest these results by asserting that the transaction was a nondivisive D reorganization—a transfer by a corporation of "substantially all" its assets to another corporation under common control.<sup>9</sup> If successful, the Service would eliminate the asset basis step-up and tax the distribution to the shareholders as a dividend.

In court decisions involving reincorporations, a prevailing rule developed: the "substantially all" requirement for a nondivisive D reorganization was satisfied if the target's principal business assets were transferred to the acquiring corporation. Distributions of liquid assets and other nonbusiness assets were disregarded for this purpose.<sup>10</sup> Some courts went even further and adopted the view that "substantially all" could be satisfied in a liquidation-reincorporation even if the acquiring corporation obtained the use but not the ownership of the target's business assets (e.g., leases of real property).<sup>11</sup>

Since 1986, with repeal of the *General Utilities* doctrine and reduction in the capital gain benefit, the reasons for the classic liquidation-reincorporation abuse have disappeared. Nevertheless, in particular situations abuses can occur,<sup>12</sup> and precise guidance regarding the scope of the "substantially all" requirement in the liquidation-reincorporation context may be counterproductive as tax policy. The uncertainty surrounding the requirements for a nondivisive D



## | 4 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

reorganization, including "substantially all," probably deters taxpayers from abusive liquidation-reincorporations. In this context, the case law probably is sufficient guidance.

Accordingly, any new IRS guidance on "substantially all" should be limited to acquisitive reorganizations. The liquidation-reincorporation case law should remain in effect to determine whether a transaction is a nondivisive D reorganization.<sup>13</sup>

**Divisions.** A corporate division under Section 355 may involve a "substantially all" requirement. A parent may distribute the stock of a controlled subsidiary to its shareholders tax free if, among other requirements, both corporations are engaged in the active conduct of a trade or business after the distribution.<sup>14</sup> A corporation satisfies this requirement if, after the distribution, either (1) it is directly engaged in an active business, or (2) "substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged" ( Section 355(b)(2)(A) ).<sup>15</sup>

In determining how to satisfy this second test, as in the acquisition area, the principal help is an advance ruling guideline. Under Rev. Proc. 77-37, section 3.04 , the test is satisfied, for advance ruling purposes, if at least 90% of the corporation's gross assets consist of the stock and securities of a subsidiary engaged in active business. This "90% of gross assets" test is simpler than the 90/70 test for acquisitive reorganizations because there is no net asset requirement. There is also no stated restriction on pre-spin-off distributions of other assets. The 90% of gross assets test under Section 355 apparently is satisfied based simply on a static comparison of the value of the qualifying stock and securities versus the value of any other assets after the corporate division. In addition, it should be relatively easy to align assets to meet the "substantially all" test. Nonqualifying assets, including stock of nonqualifying subsidiaries, can be transferred to qualifying subsidiaries, which will continue to qualify even if the nonqualifying assets predominate.<sup>16</sup>

In practice, Section 355(b)(2)(A) generally is not a problem. Especially in view of its simplicity, the 90% of gross assets test seems to provide adequate guidance where needed.

**Debt restructurings.** Section 368(a)(1)(G) allows certain corporate asset transfers in bankruptcy to be tax free. The transferor corporation must either engage in a Section 355 corporate division or transfer "substantially all" of its "assets" to another corporation. Such transfer may be accomplished directly or by a forward triangular merger.

As in acquisitions, these restructurings often have an arm's-length character. On the other hand, as in reincorporations and corporate divisions, the parties likely are persons who already own interests in the corporation. Often the parties wish to avoid reorganization treatment, so that losses may be recognized to the shareholders and creditors. From the



## | 5 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

standpoint of the acquiring corporation, at stake are (1) the ability (or requirement) to recognize loss on the asset transfer, and (2) carryover, as opposed to stepped-down, basis in the transferred assets. In any event, the form of the transaction may be tax driven, with little tension among the parties as to whether taxable or tax-free treatment is desirable. Also, the "substantially all" requirement for debt restructurings is in Section 354(b)(1)(A), the same provision that applies to reincorporations.<sup>17</sup> Consequently, it may be difficult to develop guidance for debt restructurings that does not also govern liquidation-reincorporations.

Accordingly, it would seem that any definitive guidance on "substantially all" for acquisitions should not apply to debt restructurings. On the other hand, because restructurings do not have the inherent abuse potential of liquidation-reincorporations, the case law dealing with the "substantially all" requirement as applied to restructurings could be useful in evaluating acquisitive transactions under current law.<sup>18</sup>

**Parent-subsidiary flips.** In flip transactions, a parent corporation (usually publicly traded) seeks to restructure its group by becoming a subsidiary and making a subsidiary the new group parent. Flips often are accomplished by a triangular merger of the existing parent with a new corporation controlled by the subsidiary. These transactions may be structured so as to qualify under Section 368(a)(2)(D) or (E), both of which, of course, have "substantially all" requirements.<sup>19</sup>

A characteristic of flips raises a unique "substantially all" issue. After the flip, the former parent (now a subsidiary) continues to own stock of its former subsidiary. This circular stock ownership may be eliminated if the old subsidiary stock is cancelled, or if the old parent distributed that stock back to the old subsidiary. Aside from possible gain recognition under Section 311(b), such a cancellation or distribution could result in the former parent holding less than "substantially all" of its pre-flip properties (an issue to be discussed in the second part of this article).

Unlike an acquisition, no outside party is involved in a flip, which is thus more likely to be tax driven. Normally, however, the parties to a flip seek to accomplish a nontax business purpose, albeit with tax-free treatment. Accordingly, any new IRS guidance on "substantially all" for acquisitions might exclude flips or include a safe harbor for reorganization treatment of flips, but not contain a rule as to when flips are taxable.

### **POSSIBLE NEW GUIDANCE**

As indicated above, acquisitions present unique "substantially all" problems, and new guidance could reduce uncertainty in this area. The guidance should tell whether or not a particular acquisition satisfies the requirement, but it should not apply to other transactions with "substantially all" requirements. Those transactions often are not arm's-length and may result in abuse because of attempts to avoid reorganization treatment. There, case law provides adequate direction.



## | 6 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

**Distributions.** Under the advance ruling guidelines, a target corporation may fail "substantially all" by distributing property to its shareholders or paying transaction expenses before the acquisition. Rev. Proc. 77-37, section 3.01 , provides that "[a]ll payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the [target] corporation immediately preceding the transfer and which are part of the plan of reorganization will be considered as assets held by the [target] corporation immediately prior to the transfer."

These guidelines are consistent with the case law concerning the "substantially all" requirement in acquisitive reorganizations. Generally, the courts have compared the target's properties before the acquisition with the properties transferred. If the percentage of properties transferred is too low, tax-free treatment usually is denied, regardless of whether the target retains or distributes the other properties.<sup>20</sup>

In some cases, however, courts have adopted a different approach, one which appears more suitable in light of the current structure of the corporate tax. In these cases, the courts considered the "substantially all" requirement as a limitation on the tax-free acquisition of a target corporation which continues substantial activities in corporate form. Here, target properties that were distributed before the acquisition, even as part of the same plan, were disregarded.<sup>21</sup>

This approach focuses on the distinction between a tax-free reorganization and a taxable sale of corporate properties. If, for example, a corporation transferred 10% of its assets to an unrelated corporation in exchange for that corporation's stock, there should be no reorganization. Such a limited asset transfer should be taxable as a sale. Also, the selling corporation remains in existence and thus should retain its own historic E&P, loss carryovers, asset bases, and other tax attributes. The concern, then, is that there should be no reorganization if the assets and business of the target are divided between the target and the acquiring corporation.<sup>22</sup>

Naturally, however, if the target corporation ceases to exist, it cannot retain historic tax attributes or continue business in corporate form. In that situation there appears to be no reason to deny reorganization treatment, even if a significant portion of target corporation assets have been distributed to shareholders or used to pay debts or expenses.

In the same vein, several court decisions describe the purpose of the "substantially all" requirement as an attempt to ensure that there is a continuity of business enterprise after the acquisition. <sup>23</sup> For many years there was doubt as to whether a separate continuity of business enterprise requirement existed. In 1980, Reg. 1.368-1(d) resolved this issue by treating continuity of business enterprise as a separate requirement, with its own rules. With this provision in place, the "substantially all" requirement should have less ground to cover, and its operating scope can be rethought.



## | 7 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

This type of analysis suggests that property distributed by the target to its shareholders or creditors before or in connection with an acquisition generally should not be taken into account for "substantially all" purposes. "Substantially all" would be satisfied so long as the target does not either retain assets or transfer them to another successor corporation. Property distributed to shareholders (in redemption of their stock, as dividends, or to pay dissenters) and property used to pay creditors would be disregarded.

Under this approach, the only exception would be for transactions where the target distributes stock of a subsidiary tax free under Section 355 and then is itself acquired in an attempted tax-free reorganization. <sup>24</sup> Here, the value of the distributed subsidiary stock should be taken into account for "substantially all" purposes, because such a transaction is truly divisive.<sup>25</sup> Specifically, (1) the former subsidiary continues to conduct part of the target's business in corporate form; (2) the distribution of the subsidiary stock is tax free to both target and its shareholders; and (3) the subsidiary may inherit some tax attributes from the parent.<sup>26</sup>

Under current law, in virtually all acquisitive reorganizations having a "substantially all" requirement, the target's property either passes to the acquiring corporation's control or is distributed to the target's shareholders or creditors. In forward and reverse triangular mergers, the target corporation's property becomes the property of the acquiring corporation's subsidiary by operation of law. In a C reorganization, the target must distribute all its properties, as well as the stock and securities received in the acquisition, to its shareholders or creditors. The target may retain properties only if the Service waives this distribution requirement—a rare event.

Thus, conduct of the target's business could continue in corporate form (other than by the acquiring corporation or its subsidiary) only if there is (1) a Section 355 distribution before the acquisition, or (2) a waiver of the distribution requirement of Section 368(a)(2)(G). Otherwise, the target will be taxed on any built-in gain with respect to property it does not transfer to the acquiring corporation. This property has to be either distributed (to shareholders or creditors), or sold and the sale proceeds distributed. In either situation, the built-in gain on this property will be taxed at the corporate level. Because of the General Utilities doctrine, this tax on built-in gains was not imposed when Rev. Proc. 77-37 was issued and the case law developed. But with General Utilities repeal and the enactment of Section 368(a)(2)(G), tax-free divisions are no longer possible in these situations. Thus, the "substantially all" determination should disregard property distributions by the target corporation before an acquisition.

Other reorganization tests reinforce this conclusion. As stated above, the 1980 Regulations require continuity of business enterprise in all corporate reorganizations. The acquiring corporation must either continue the "historic business" of the target or "use a significant portion of" the target's "historic assets" in a business. Reg. 1.368-1(d)(5), Example 1, suggests that at least one-third of the target's historic assets must be used to satisfy this requirement.



## | 8 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

Consequently, the continuity of business enterprise rule now restrains property distributions to a substantial degree. An additional restraint on excessive property distributions is the traditional continuity of interest requirement—more than 50%, for advance ruling purposes ( Rev. Proc. 77-37, section 3.02 ).<sup>27</sup> Using the "substantially all" rule for the same purpose appears superfluous.

Thus, a restriction on preacquisition taxable property distributions under the "substantially all" rule serves no purpose under current law. New guidance should reverse the approach in Rev. Proc. 77-37 and provide that in acquisitions, aside from acquired property, the only types of property taken into account for "substantially all" purposes are (1) stock distributed under Section 355 as part of the plan of reorganization, and (2) property retained as a result of a waiver under Section 368(a)(2)(G)(ii).

In addition to conforming the "substantially all" requirement to the current corporate tax structure, such a change would simplify difficult aspects of transaction planning. Under the current 90/70 test of Rev. Proc. 77-37 , if target shareholders receive cash boot for part of their stock, the source of the cash is critical. If the cash comes from the acquiring corporation, the transaction may fail the requirement that the shareholders receive "solely" voting stock (in a B or C reorganization) or at least 80% voting stock (in a reverse triangular merger).<sup>28</sup> If the target is the source of the cash, however, "substantially all" is implicated.<sup>29</sup> Often, the source of the cash is hard to identify, particularly if there are intercompany payments or joint financing between the acquiring corporation and the target after the acquisition. If the "substantially all" requirement were clarified to exclude taxable distributions, the target could distribute cash boot to its shareholders, and the acquisition still would qualify as a tax-free reorganization.

Another benefit of new guidance would be to simplify the treatment of the target's liabilities. Under the current approach, the acquiring corporation may assume the target's liabilities without restriction.<sup>30</sup> If, however, the target uses its own properties to pay liabilities and thus reduces its gross assets below the 70% threshold, "substantially all" may not be met. Between these two patterns, there may be enormous business differences. For example, the target's lenders may withhold consent to the acquisition, and these debts will have to be paid. Or, the acquiring corporation may obtain financing for the target's operations on better terms than target's. There seems to be no tax policy reason to favor pre-existing debt over new debt, which, as currently administered, the "substantially all" requirement does.<sup>31</sup> Again, the continuity of business enterprise Regulations would prevent excessive asset sales to finance debt payments. Consequently, debt payments by the target corporation should not affect the "substantially all" requirement.



## | 9 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

### CLARIFYING THE CURRENT APPROACH

The proposal set forth above should vastly simplify and rationalize the planning of tax-free acquisitions. It would no longer be necessary to determine which party made a cash payment, and target assets could be used to pay debts or redeem stock, subject only to continuity of interest and continuity of business enterprise limitations. In addition, because of these limitations and the tax imposed by the General Utilities repeal, no abuse potential would be introduced.

Absent such new rules, Rev. Proc. 77-37 remains the principal guidance. The general 90/70 test probably sets an appropriate level of asset transfer, and one that is consistent with the case law and understood by the commentators.<sup>32</sup> The 90/70 test is also sensible in that it is purely quantitative. No distinction is made between business and nonbusiness assets, presumably in the interest of administrability. The more subjective approach of the liquidation-reincorporation cases is not used.<sup>33</sup>

The 90/70 test remains difficult to apply, however, and in some instances it reaches results that simply do not make sense. The difficulties arise out of the treatment of property distributions, and, as discussed above, these difficulties would be eliminated if such distributions were disregarded. Nevertheless, even without this change the 90/70 test can be made more workable through clarifying guidance.

**The 90/70 test in general.** Under Rev. Proc. 77-37, as stated above, "substantially all" is satisfied if the properties involved in the acquisition represent at least (1) 90% of the FMV of the net assets, and (2) 70% of the FMV of the gross assets held by the target immediately prior to the transfer. This two-pronged approach provides leeway for the target to use some assets to distribute dividends or pay debts before the acquisition.<sup>34</sup>

The only explicit reference by a court to such an approach was in *Smith*, 34 BTA 702. There, the target corporation transferred 71% (\$130,000) of its total assets to the acquiring corporation. The target retained the remaining 29% (\$52,000) and also continued to be responsible for \$46,000 of liabilities. The Board of Tax Appeals concluded that the "substantially all" requirement had been satisfied. In dictum, however, the Board stated that, if the target had gross assets of \$1 million and liabilities of \$900,000 and had transferred to the acquiror assets of only \$100,000, "substantially all" would not be satisfied, even though all of the retained \$900,000 was needed to pay liabilities.

The Service adopted the *Smith* analysis in Rev. Rul. 57-518, 1957-2 CB 233, in which the target corporation transferred 70% of its gross assets to the acquiring corporation in exchange for the acquirer's voting stock. The value of the assets retained (liquid assets and a small quantity of inventory) "was roughly equivalent" to the target's liabilities. The target used the retained assets to pay its liabilities and then liquidated. The Service reviewed the *Smith* decision, including the Board's hypothetical example, and ruled that the "substantially all" test was satisfied, because the retained assets were



## | 10 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

used to pay liabilities. The 90/70 test appears to be derived from this analysis.

**The 90% of net assets prong.** If property distributions continue to be taken into account for "substantially all" purposes, IRS needs to resolve a basic ambiguity in the 90% of net assets part of the 90/70 test.

Example: Corporation T has \$1 million of assets and \$900,000 of liabilities (as in the example in Smith). T distributes \$20,000 to one of its shareholders in redemption of 20% of T's stock. T then merges into S, a subsidiary of P. In the merger, T transfers to S its remaining \$980,000 of assets. S assumes T's \$900,000 of liabilities, and P issues \$80,000 worth of its common stock to the T shareholders.

The transaction clearly satisfies the 70% of gross assets prong of the 90/70 test, because T transfers to S \$980,000, or 98%, of historic gross assets. But is the 90% of net assets prong satisfied? The value of T's equity transferred to S is only \$80,000 (\$980,000 less \$900,000 debt assumed). T's historic net assets are \$100,000. If the \$980,000 of gross assets transferred is compared with the \$100,000 of historic net assets, the 90% prong is satisfied. If, however, the \$80,000 equity transferred is compared with T's \$100,000 of historic equity, only 80% of net assets are transferred, and the 90% prong is not satisfied. Query which is the correct numerator.<sup>35</sup>

At first glance, it appears that net assets transferred (\$80,000) should be compared with historic net assets (\$100,000). Even a second glance, i.e., at the case law, seems to confirm this conclusion. As in Smith, the courts generally compute a proportion of assets transferred and then allow the target corporation to retain assets necessary to pay the debts not assumed in the acquisition, at least up to a point. Here, however, T retains no debt, and so it appears that the full \$20,000 of assets distributed should count against T.

But the results of this treatment are peculiar. That is, the effect is to impose a 90% continuity of interest requirement, at least for stock redemptions and distributions. If the target's equity transferred must be at least 90% of its historic equity, an acquisition will never qualify where the target redeems more than 10% of its stock. Even assuming taxable distributions by T should be taken into account at all, such a restriction seems too confining. The normal continuity of interest requirement prevents an excessive portion of T's equity (more than 50%, for advance ruling purposes) from being cashed out. Relatively small redemptions of minority stockholders should not interfere with otherwise tax-free treatment for the acquisition.

This problem is eliminated if the 90% of net assets prong is viewed as comparing the target's gross assets transferred with its historic equity (in our example, \$980,000/\$100,000). So interpreted, the 90% of net assets prong becomes a test applicable to nonleveraged target corporations, with the 70% of gross assets prong remaining to prevent excessive asset drains from leveraged targets. Thus, in our example T will satisfy the 90/70 test if it transfers to S at least \$700,000



## | 11 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

of its assets ( i.e., 70% of its \$1 million of gross assets, and 700% of its \$100,000 of net assets). If T had only \$100,000 of liabilities, all assumed by S, T would have to transfer at least \$810,000 of assets to S (i.e., 90% of its \$900,000 net equity, and 81% of its \$1 million gross assets).

Using this analysis, the 90/70 test requires in all events that at least 70% of all of the target corporation's properties be involved in the acquisition, but where the target has little or no debt, the required portion of total assets increases to (but never above) 90%.

**The 70% of gross assets prong.** By contrast, the 70% of gross assets prong of the 90/70 test is relatively simple to apply. The total assets transferred are compared to the target's historic assets. Assumed liabilities are disregarded, but debt payments made by the target as part of the plan of reorganization reduce the target's gross assets and thus count against the target's ability to satisfy the 70% prong. Even if distributed assets continue to be relevant, IRS should at least make clear that payment of a debt on its due date generally is not part of the plan of reorganization for purposes of the 90/70 test. Payment of a debt before maturity should be treated the same way, if prepayment is provided for in the debt instrument.<sup>36</sup>

Apart from this problem, there is also an ambiguity in the 70% of gross assets prong. How are liabilities of the target's subsidiaries taken into account?

Example: Corporation T has no liabilities, and its sole asset is the stock of a wholly owned subsidiary, T1, which has \$1 million of assets and \$900,000 of liabilities. T1 pays \$400,000 of its liabilities, and T is then merged into S, a subsidiary of P. In the merger, T transfers the T1 stock to S, and the T shareholders receive \$100,000 worth of P stock for their T stock. The 90/70 test applied to T on a separate basis is satisfied. T1's \$400,000 debt payment does not change T's gross or net assets (both \$100,000). If T and T1 are viewed on a consolidated basis, however, gross assets have declined from \$1 million to \$600,000. T has transferred only 60% of its historic gross assets to S, and the 70% prong is not met.

If the 90/70 test is maintained in its current form (with target distributions taken into account), the Service should make clear that subsidiary debt is treated the same as parent company debt. (The best approach is probably to impute debts of 50%-or-more subsidiaries to the parent.) This result would be consistent with the idea that the "substantially all" requirement is intended to ensure that the target's business is continued by the acquiring corporation. It also would be consistent with the look-through analysis employed in determining continuity of business enterprise.<sup>37</sup>



## | 12 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

### CONCLUSION

In providing guidance on the "substantially all" requirement for acquisitions, the Service may decide to use a version of the generally understood 90/70 test. This test is simple to administer because it is quantitative, and because it rejects any distinction between business and nonbusiness properties.

If the 90/70 test is used as the basis for substantive guidance, IRS should consider disregarding preacquisition property distributions. The only distributions taken into account should be tax-free stock distributions under Section 355 . Otherwise, the Service should at least eliminate the ambiguities now in the 90/70 test. The 90% of net assets prong should provide that the gross assets transferred are compared with the target's historic net assets. The 70% of gross assets prong should state that liabilities paid in accordance with their terms will not affect the "substantially all" requirement. In any event, the 90/70 test should clarify that liabilities of the target and the target's subsidiaries are treated in the same manner.

---

1

Sections 368(a)(1)(C) , (2)(D), and (2)(E). A forward triangular merger not qualifying as a reorganization under Section 368(a)(2)(D) is deemed a taxable sale of assets and liquidation by the target. Rev. Rul. 69-6, 1969-1 CB 104 . A reverse triangular merger not qualifying as a reorganization under Section 368(a)(2)(E) generally is a taxable sale of the stock of the target, with no asset transfer. Rev. Ruls. 78-250, 1978-1978-1 CB 83 , and 73-427, 1973-1973-2 CB 301 .

---

2

Rev. Rul. 74-503, 1974-2 CB 117 (zero basis). To avoid zero basis, the parent might sell its stock to the subsidiary for cash or a note.

---

3

Even though the transaction is not a reorganization, the parent would not be taxed if it had issued its stock directly to the target corporation or its shareholders. Section 1032(a) . The purchaser would have a cost basis in the assets acquired from the target.

---

4

The proportion of assets transferred has been the principal factor, but no judicial rule sets forth a percentage. See, e.g., Smith, 34 BTA 702 (test is "relative"); Peabody Hotel Corp., 7 TC 600 (no percentage is determinative). The case law is discussed in Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, 5th ed. (Warren Gorham Lamont, 1987), at 14.14 ; Ginsburg and Levin, *Mergers, Acquisitions, and Leveraged Buyouts II* (CCH Tax Transactions Library, 1991), at 702.03; Cook and Coalson, "The 'Substantially All of the Properties' Requirement in Triangular



## | 13 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

Reorganizations-A Current Review," 35 Tax Lawyer 303 (1982), at pages 306-312.

---

5

The most recent is National Bank of Commerce of Norfolk, 1 AFTR 2d 894 , 158 F Supp 887 , 58-1 USTC 9278 . Later decisions on "substantially all" deal with either financial restructurings or liquidation-reincorporation transactions, a different application of the requirement (as discussed in the text, below).

---

6

The Procedure's antecedent was Smith, supra Note 4 , discussed in the text, below.

---

7

Several technical issues relating to the 90/70 test, particularly in connection with triangular acquisitions, have never been resolved. On occasion, rulings have described facts that raise a "substantially all" issue, but more typically they state only that the appropriate factual representations have been made. The required representations are set forth in Rev. Proc. 86-42, 1986-2 CB 722 . Generally, IRS will no longer issue advance rulings on acquisitive mergers. Rev. Proc. 90-56, 1990-2 CB 639 , modified by Rev. Procs. 91-54, 1991-2 CB 783 , and 93-3, 1993-3 CB 71 .

---

8

Sections 311(b) (nonliquidating distributions), 336 - 337 (liquidating distributions), 355(c) and (d) (distributions of subsidiary stock), and 361(b) and (c) (certain distributions in reorganizations).

---

9

Notwithstanding the statutory language, IRS and the courts repeatedly concluded that a liquidation-reincorporation could qualify as a D reorganization even if no stock or securities of the acquiring corporation were distributed to the target shareholders. See, e.g., Rose, 47 AFTR 2d 81-1070 , 640 F2d 1030 , 81-1 USTC 9271 ; Rev. Rul. 70-240, 1970-1 CB 81 . More recently, in Ltr. Rul. 9111055 the Service found a nondivisive D reorganization where a corporation controlled indirectly by one individual sold its assets, for installment notes, to a corporation controlled by the individual's child. IRS reached this conclusion even though (1) the individual owned no stock in the purchasing corporation, and the child owned no stock in the selling corporation, and (2) the purchase price consisted entirely of notes that were not securities.

---

10

See, e.g., Atlas Tool Co., Inc., 45 AFTR 2d 80-645 , 614 F2d 860 , 80-1 USTC 9177



## | 14 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

---

11

See, e.g., R. & J. Furniture Co., 20 TC 857 47 AFTR 774 , 221 F2d 795 , 55-1 USTC 9255 .

---

12

For example, a corporation with expiring loss carryovers and built-in gains could liquidate and recognize the built-in gains sheltered by the loss carryovers and so refresh its expiring losses in the form of stepped-up basis. Cash and other liquid assets could be distributed as exchange proceeds for the target stock. The increase in the capital gain rate differential as a result of RRA '93 makes the liquidation reincorporation technique more attractive here.

---

13

The language of the acquisitive reorganization provisions ("substantially all of the properties" (emphasis added)) differs from that of Section 354(b) dealing with nondivisive D reorganizations ("substantially all of the assets" (emphasis added)). The legislative history does not suggest that the difference was deliberate. Some courts, however, have questioned whether this difference supports different tests for the two types of transactions. See, e.g., Gross, 19 AFTR 158 , 88 F2d 567 , 37-1 USTC 9159 (in a liquidation-reincorporation under the Revenue Act of 1928, "properties" excluded cash distributed; the implication was that "assets" might be broader); Moffatt, 17 AFTR 2d 1290 , 363 F2d 262 , 66-2 USTC 9498 (the dissent noted that "assets" was not narrower than "properties").

---

14

The distributing corporation also may satisfy this requirement if, immediately before the distribution, all of its assets consist of stock and securities of subsidiaries that themselves pass the active business test. Section 355(b)(1)(B) . This alternative test is intended to permit a split-up, i.e., a transaction in which the distributing parent liquidates. There is a de minimis exception. Reg. 1.355-3(a)(1)(ii) . See generally Silverman, Keyes, and Berry, "What Is a Business Purpose Under the Section 355 Regs?" and "Satisfying the Continuity of Interest Requirement of the Section 355 Regulations," and .

---

15

The corporation also may satisfy the test if it has more than one qualifying subsidiary. Reg. 1.355-3(b)(1) ; Rev. Rul. 74-382, 1974-2 CB 120 .

---

16

Rev. Rul. 74-79, 1974-1 CB 81 ( Section 332 liquidation of active business corporation into parent permitted); Rev. Rul.



## | 15 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

73-44, 1973-1 CB 182 , clarified by Rev. Rul. 76-54, 1976-1 CB 96 (active business requirement satisfied where less than half the corporation's assets related to the active business); GCM 34238 , 12/15/69 (5% active business assets sufficient).

---

17

See Note 13 , supra.

---

18

The case law on "substantially all" as it pertains to debt restructuring focuses mainly on cash payments to some creditors while other creditors and shareholders of the debtor corporation become creditors and shareholders of the acquiring corporation. Specifically, the issue is whether the cash came from the original debtor (the target) or the acquiring corporation. In *Southwest Consolidated Corp.*, 315 U.S. 194 , 28 AFTR 573 , 86 L Ed 789 , 42-1 USTC 9248 , the Supreme Court concluded that the cash had been paid by the acquiring corporation, not the target, so that the "solely for voting stock" requirement, then applicable to these transactions, was not satisfied. If the cash had been paid by the target, the inquiry would have shifted to "substantially all." In several cases decided shortly after *Southwest Consolidated*, the Tax Court sympathetically treated the cash as paid by the target, so that the "solely" requirement was satisfied. The amount of cash distributed was not great enough to create a "substantially all" problem. See, e.g., *New Jersey Mortgage & Title Co.*, 3 TC 1277 . For a similar "sourcing" issue in the acquisition area, see the text accompanying notes 28-29, *infra*. Other debt restructuring cases involve divisiveness issues. See, e.g., *San Antonio Transit Co.*, 46 AFTR 1659 , 219 F2d 149 , 54-2 USTC 9547 , 55-1 USTC 9240 (no reorganization where only one property out of several was transferred).

---

19

In Rev. Rul. 77-428, 1977-2 CB 117 , the Service concluded that a flip could be structured as either a forward or a reverse triangular merger and qualify, respectively, under Section 368(a)(2)(D) or (E).

---

20

See, e.g., *Britt*, 25 AFTR 575 , 114 F2d 10 , 40-2 USTC 9644 (92% transferred, reorganization); *Arctic Ice Machine Co.*, 23 BTA 1223 67 F2d 983 (68% transferred, no reorganization).

---

21

See, e.g., *First National Bank of Altoona*, 23 AFTR 119 , 104 F2d 865 , 39-2 USTC 9568 ; *Thurber*, 84 F2d 115 .

---



## | 16 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

22

As the legislative history of Section 354(b) (adopting a "substantially all" requirement for nondivisive D reorganizations) makes clear, the purpose for the requirement there is to prevent reorganization treatment for corporate divisions, unless Section 355 is satisfied. S. Rep't No. 1622, 83d Cong., 2d Sess. (1954). See *Wilson*, 46 TC 334 ; Rev. Rul. 57-465, 1957-2 CB 250 ; *Cook and Coalson*, supra Note 4 , at page 309, fn. 20. See also the discussion in Note 13 , supra.

---

23

See, e.g., *Smothers*, 47 AFTR 2d 81-1372 , 642 F2d 894 , 81-1 USTC 9368 .

---

24

See, e.g., *Elkhorn Coal Co.*, 20 AFTR 1301 , 95 F2d 732 , 37-2 USTC 9501 , 38-1 USTC 9238 ; *Morris Trust*, 18 AFTR 2d 5843 , 367 F2d 794 , 66-2 USTC 9718 (tax-free spin-off plus tax-free B reorganization of distributing parent). IRS has adopted the *Morris Trust* position. See Rev. Ruls. 68-603, 1968-2 CB 83 ; 78-251, 1978-1 CB 89 ; Reg. 1.355-2(a)(2)(iii)(E) .

---

25

The courts have held that "substantially all" is not satisfied if a tax-free spin-off occurs as part of the acquisition plan. The objection is that, in effect, the target corporation continues its existence through the distributed subsidiary. See, e.g., *Elkhorn Coal Co.*, supra.

---

26

A distribution qualifying under Section 355 is tax free to the distributing corporation (subject to Section 355(d) ) and to the distributee shareholders, who divide their basis in the stock of the distributing corporation between that stock and the stock they receive. Sections 358(b)(2) and (c). If the distribution is part of a divisive D reorganization, the distributing corporation's E&P is allocated between the corporations. Section 312(h)(1) ; Reg. 1.312-10(a) .

---

27

If, for example, the target's properties consist of \$90 cash and a business worth \$10, the continuity of business enterprise test is satisfied if the target distributes the \$90 and then merges into an acquiring subsidiary. The 50% continuity of interest test, however, would not be satisfied.

---

28

Rev. Ruls. 56-345, 1956-2 CB 380 , and 75-360, 1975-2 CB 110 .



## | 17 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

---

29

See the cases cited in Note 18 , *supra*. See also Rev. Ruls. 55-440, 1955-2 CB 226 ; 56-184, 1956-1 CB 190 ; 68-285, 1968-1 CB 147 ; 68-435, 1968-2 CB 155 ; 69-443, 1969-2 CB 54 ; 70-172, 1970-1 CB 77 ; 73-102, 1973-1 CB 186 .

---

30

Sections 368(a)(1)(C) , 368(a)(2)(B) , and 357(a); Schuh Trading Co., 20 AFTR 1114 , 95 F2d 404 , 38-1 USTC 9171 . The assumption of liabilities by the wrong corporation in a C reorganization (e.g., the subsidiary or parent of the acquiring corporation) will be outside Section 357(a) . The result may be taxable boot to the target, under Section 361(b) , or the transaction may not qualify as a reorganization at all. See, e.g., Rev. Rul. 70-107, 1970-1 CB 78 , where the target transferred its assets to a subsidiary of the acquiring parent for parent stock, and the parent's assumption of the target's liabilities resulted in a failed C reorganization. In this type of transaction, the special treatment for liability assumption in Sections 368(a)(1)(C) and (a)(2)(B) does not apply, because the liabilities are not assumed by the acquiring corporation (the subsidiary). This result is controversial and probably wrong. See GCMs 34483 (4/21/71) and 39102 (11/18/82) . IRS has provided a road map to avoid this outcome. See Rev. Ruls. 64-73, 1964-1 CB 142 , and 70-224, 1970-1 CB 79 (parent acquires target's assets and liabilities, then transfers only the assets to a subsidiary). The Service has also ruled that, in a forward triangular merger, the parent or the subsidiary or both may assume the target's liabilities. Rev. Rul. 73-257, 1973-1 CB 189 .

---

31

Liability assumptions are favored for certain purposes. Usually, a liability assumption will not be taxable boot and will not prevent an asset transfer from satisfying the "solely for voting stock" requirement of a C reorganization. Sections 357(a) , 368(a)(1)(C) , 368(a)(2)(B) . The predecessors to these provisions were adopted to reverse Hendler, 303 U.S. 564 , 20 AFTR 1041 , 82 L Ed 1018 , 38-1 USTC 9215 . By contrast, cash provided by the acquiring corporation to pay the target corporation's liability may adversely affect the "solely for voting stock" requirement. The cash will not be taxed as boot to the target corporation, however, if it is distributed to creditors. Sections 361(b)(1)(A) and (b)(3). In any event, the anti-Hendler provisions of the Code have no application under the "substantially all" requirement.

---

32

See Bittker and Eustice, *supra* Note 4 , at 14.14; Cook and Coalson, *supra* Note 4 , at page 306. Both cite First National Bank of Altoona, *supra* Note 21 (86% was sufficient), and Arctic Ice Machine Co., *supra* Note 20 (68% not enough).

---

33



## | 18 | New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions

See Note 10 , supra. See also Rev. Rul. 70-240 , supra Note 9 . Some acquisition cases adopt a distinction between business and non-business assets. See, e.g., Thurber, 18 AFTR 218 , 84 F2d 815 , 36-2 USTC 9420 . Courts have adopted a similar approach in interpreting the Delaware statute requiring a shareholder vote on a corporate sale of "all or substantially all" of its assets. See, e.g., Gimbel v. Signal Companies, 316 A2d 599 316 A2d 619 (business representing 41% of conglomerate's net worth and producing 15% of its revenues was not "all or substantially all").

---

34

Rev. Proc. 77-37, 1977-2 CB 568 , allows the target to pay "regular, normal distributions," without impact on the "substantially all" requirement. Under Rev. Rul. 74-457, 1974-2 CB 122 , however, a dividend distribution made after the acquisition is a payment of a debt, which can affect the 70% gross assets test, as discussed in the text below.

---

35

Rev. Proc. 77-37 is ambiguous, referring to "assets representing" the required proportions of gross and net assets. This language suggests that only assets are to be taken into account, without regard to the liabilities assumed. Rev. Proc. 77-37 also uses the term "net assets," which is not defined. A similar term, however, "net basis," is defined in Prop. Reg. 1.358-6(a)(4) , dealing with a different reorganization issue (stock basis), as the aggregate basis in a corporation's properties less its liabilities.

---

36

See Prop. Reg. 1.1001-3 .

---

37

See, e.g., Rev. Ruls. 81-247, 1981-2 CB 87 ; 85-197, 1985-2 CB 120 ; 85-198, 1985-2 CB 120 .

Copyright 2005 RIA. All rights reserved.