



# More Problems Complicate the Application of 'Substantially All' to Acquisitions

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Tax

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*Journal of Taxation*

January 1, 1993

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*The use of property not owned by the target and post-acquisition distributions of target assets are some of the issues to be considered.*

The first part of this article described types of tax-free corporate reorganizations that have a "substantially all" requirement, and explained the need for additional guidance in the area for acquisitions. It discussed distributions by a target corporation before an acquisition and proposed that such distributions be disregarded for "substantially all" purposes. In addition, suggestions were made for resolving ambiguities in the advance ruling guidelines relating to these distributions.<sup>1</sup>

This part discusses additional difficulties in the authorities relating to "substantially all." The emphasis is on practical problems with the "substantially all" rule as currently administered. Specifically, this part addresses (1) types of property that should and should not be treated as "properties" of the target corporation for "substantially all" purposes, (2) the types of property substitutions that are permissible, either before or after an acquisition, and (3) the effect of property distributions ("pushups") after triangular acquisitions.

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### **PROPERTY TAKEN INTO ACCOUNT**

In determining whether an acquisition satisfies the "substantially all" requirement, the starting point is to compute the proportion of the target corporation's properties that are acquired. Under the 90/70 test set forth in the advance ruling guidelines, the starting point is also the finish line.<sup>2</sup> The case law is more flexible, with several decisions stating that the proportion of properties transferred is not determinative. Nevertheless, the proportion almost always figures prominently in the analysis.<sup>3</sup> Consequently, it is necessary to determine what is included in the target corporation's "properties" for this purpose.

**Balance sheet properties.** The target corporation's balance sheet, of course, will reflect many but not all of the properties to be considered (with FMV substituted for book value or tax basis). The balance sheet probably will not include some significant assets, e.g., intangibles. In several situations, involving both acquisitions and liquidation-reincorporations, IRS and the courts have taken into account intangibles such as goodwill, going-concern value, contractual relationships, and even a corporate charter.<sup>4</sup> On occasion, intangibles are treated as central to the target's business, and the "substantially all" test is satisfied by a transfer of the intangibles plus only a small percentage of tangible balance sheet properties.<sup>5</sup>

Although this approach adds uncertainty, it is manifestly correct. Intangibles often represent the predominant value of a business. Moreover, in recent years business people and their advisers have become increasingly sophisticated at identifying and valuing intangible assets, so as to separate them from goodwill and amortize them where possible.<sup>6</sup> A "substantially all" test that ignored intangible assets would be unrealistic.

**Shareholder services and goodwill.** In searching for corporate properties, however, some restraint is in order, especially where the target corporation is closely held and engages in a service business. Such a corporation may realize most of its income and value through the skill and energy of its employee-shareholders. Outside the reorganization area, in cases involving corporate liquidations and sales of businesses, courts have concluded that goodwill and other intangible value in a business is not taxed when distributed to a shareholder who created the asset through continuing individual effort.<sup>7</sup> To be taxed as corporate property, this type of goodwill must be "transferable," i.e., not personal but corporate.<sup>8</sup>

Generally, personal attributes of shareholders, even if availed of by the corporation, should not be corporate property. Although a corporation may generate income from a shareholder's services, it generally has no enforceable right to continued access to such services. A long-term employment or non-competition agreement may confer value on the corporation and thus may be corporate property, particularly if the employee-shareholder subject to the agreement is only one of several shareholders who might enforce it. In general, however, it appears that neither shareholder services



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nor goodwill personal to the shareholder should be corporate property for purposes of "substantially all." That is, the value of shareholder participation in the corporate business should not be property of the target, even if the shareholders continue performing services after the acquisition.<sup>9</sup>

**Corporate use of property.** A corporation may use property it does not own. For example, it may lease real property or equipment, or license patents, copyrights, or other intellectual property. The owner of the property could be a shareholder or another related or unrelated person. Neither the Service nor any court has addressed whether property used but not owned by the target corporation should be included for "substantially all" purposes. In some reincorporation cases, courts have taken into account the fact that the acquiring corporation obtained use, but not ownership, of some target properties. In finding a reorganization, these courts concluded that such access to the property indicated that the target had transferred its business to the acquiring corporation.<sup>10</sup>

This approach should not be applied as a general rule so that property that the target merely uses is treated as the target's corporate property. The FMV of the target's right to use property (taking into account its terms), however, should be included as corporate property of the target. The target's obligation to pay full value in rent or royalties for the right to use the property should offset the value of the right, not as a separate liability but as a reduction in the value of this property. That is, only the net value of these rights should be corporate property.

#### **PROPERTY SUBSTITUTIONS**

The 90/70 test in Rev. Proc. 77-37, 1977-2 CB 568, section 3.01, refers to assets "representing" 70% of the target's gross assets and 90% of its net assets, and does not require that any particular assets be transferred in the acquisition. Therefore, the target may substitute some properties for others and get "credit" for the substituted properties toward satisfying the "substantially all" requirement. The Service confirmed this general principle in Rev. Rul. 88-48, 1988-1 CB 117, in which a target sold half its assets before being acquired in a C reorganization, and still satisfied "substantially all."<sup>11</sup>

**Transfers to lower-tier entity.** One common application of property substitution is to transfer target properties to a subsidiary, either before or after the acquisition.<sup>12</sup> Generally, such a transfer should be the simplest form of substitution and should not affect the "substantially all" requirement. Similarly, property sales at FMV will not affect the value of the target corporation and should not affect "substantially all."<sup>13</sup>



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Even these simple property substitutions, however, can create other difficulties. Transfers to lower-tier entities may cause an acquisition to fail requirements such as those relating to continuity of interest or the identity of parties to a reorganization. These problems can arise even though the transferred property remains under the practical control of the acquiring parent company. Property transfers to watch in this regard include transfers to partnerships<sup>14</sup> and to lower-tier corporate subsidiaries.<sup>15</sup> Care is also required to ensure that any assumption of the liabilities of the target corporation is by the correct "party to the reorganization," and not some other related party.<sup>16</sup>

Downstream acquisitions. If a parent corporation is acquired by its own subsidiary, how should the subsidiary stock previously owned by the parent be treated for "substantially all" purposes? Rather than transfer the subsidiary stock back to the subsidiary in exchange for shares of identical stock, the parent may distribute directly to its shareholders the subsidiary stock already owned. In Rev. Rul. 78-47, 1978-1 CB 113, the Service held that such a transaction could qualify as a C reorganization.<sup>17</sup>

**Acquisitions of parent and subsidiary.** A similar but more complex type of asset substitution is the acquisition of a parent and its subsidiary in a single transaction. In *George*, 26 TC 396, the corporate taxpayer issued its own stock in exchange for all the assets of both a parent corporation and its 50%-owned subsidiary. The Service argued that the acquisition of the target parent failed the "substantially all" requirement for a C reorganization because the assets of the subsidiary were acquired, not the subsidiary stock. The Tax Court rejected this argument on the grounds that the taxpayer had acquired the assets that made up the substance of the target parent's equity in the subsidiary. The Service has adopted the Tax Court's view.<sup>18</sup>

The Tax Court's rationale in *George* appears to protect tax-free status if a target subsidiary liquidates or merges upstream into the target parent before the target parent transfers its assets in a C reorganization. Here, the subsidiary assets substitute for the subsidiary stock, and the failure to transfer the subsidiary stock itself should not affect "substantially all." In a similar situation in Rev. Rul. 73-16, 1973-1 CB 186, the Service held that two sequential acquisitions (X stock acquired by Y, and Y stock acquired by Z) were two simultaneous B reorganization acquisitions of the two targets (X and Y) by the ultimate acquirer (Z). By analogy, a transaction in which a target parent and its subsidiary are combined and then acquired may be treated as two simultaneous tax-free acquisitions. This avoids characterizing the acquisition of the subsidiary as a taxable liquidation if the target parent corporation owns less than 80% of the subsidiary corporation's stock.

This treatment raises a possible dilemma, however, where a target parent and its subsidiary are both acquired in a triangular acquisition. Here, the target subsidiary is viewed as transferring its properties to the acquiring subsidiary, and receiving stock in the acquiring parent that it distributes to its shareholder, the target parent. In turn, the target parent



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transfers its properties (other than the acquiring-parent stock just received) to the acquiring subsidiary in exchange for additional acquiring-parent stock.

This fact pattern raises the question of how to view the acquiring-parent stock attributable to the acquisition of the target subsidiary. If the target parent is viewed as retaining this stock, and not transferring it to the acquiring subsidiary, "substantially all" will be affected. This is not the approach adopted by the Tax Court in *George*. There, the target parent did not transfer back to the acquirer the stock that the target subsidiary had received for its assets. Similarly, Rev. Rul. 78-47, citing *George*, held that the parent's failure to transfer its subsidiary stock back to the subsidiary in a downstream acquisition did not defeat a C reorganization. Because the business assets transferred by the target parent in *George* and by the parent in Rev. Rul. 78-47 constituted only 44% and 33%, respectively, of the transferor's net assets, these two authorities appear to contemplate a constructive transfer of the acquirer stock held by the target, with this transfer counting toward "substantially all."<sup>19</sup> Otherwise, the "substantially all" requirement would not be satisfied.<sup>20</sup>

Consequently, *George* and Rev. Rul. 78-47 suggest that the target parent is viewed as transferring, along with its other properties, the acquiring parent stock it received in the acquisition of its target subsidiary. If the acquiring subsidiary had received this stock, it would have taken a carryover basis in the stock attributable to the target parent's historic basis in the stock of the target subsidiary.<sup>21</sup> Since the acquiring subsidiary did not actually receive such stock, what happened to it? Did the subsidiary receive the stock and distribute it to its parent? If so, the subsidiary would have recognized gain on the distribution. The gain would be deferred if the parent and subsidiary file a consolidated return, but could be taxed if the acquiring subsidiary leaves the group.<sup>22</sup>

An alternative explanation resolves the dilemma. Under the Proposed Regulations pertaining to stock basis after a forward triangular merger, the acquiring parent takes a basis in the stock of its subsidiary determined by reference to the net asset basis of the target ( Prop. Reg. 1.358-6(a) ). That is, the triangular acquisition is treated for this purpose as a two-party acquisition followed by a downstream transfer of the target's former properties. Using this analysis, the target parent is viewed as transferring all its properties (including the acquiring-parent stock it receives in the acquisition of the target subsidiary) to the acquiring parent. The acquiring parent then is viewed as transferring these properties (other than its own stock) to the acquiring subsidiary. No gain is recognized to any party on either side of the transaction.

**Acquiring corporation investments in the target.** Property substitution also includes a planning technique that can cure a "substantially all" defect if the target distributes too much of its properties before an acquisition. As discussed in the first part of this article, the "substantially all" requirement should not restrict taxable distributions by the target before the acquisition. Nevertheless, the 90/70 test for advance rulings does so. A court decision and two letter rulings, however, suggest a possible way out of this problem in planning transactions: The target may be able to substitute for

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distributed property by obtaining newly borrowed or invested funds, either from a third party or from the acquiring corporation itself.

In *Reef Corp.*, TC Memo 1965-72 , PH TCM 65072 , 24 CCH TCM 379 18 AFTR 2d 5832 , 368 F2d 125 , 66-2 USTC 9716 , the target corporation distributed its liquid assets (which made up a significant part of its total assets) to shareholders before reincorporating. The target's assets were replenished with cash borrowed from third parties. At the Service's instance, the Tax Court found a D reorganization, and the Fifth Circuit affirmed. For "substantially all" purposes, the borrowed cash was a substituted asset.

As a liquidation-reincorporation case, Reef is suspect as authority for an acquisition. In two letter rulings, however, the Service allowed new investments in the target to substitute for distributed assets in acquisitive transactions subject to the 90/70 test. These rulings are especially interesting in that the substitute assets were in a sense provided by the acquiring corporation.

In Ltr. Rul. 8747038 , T was acquired by P in a forward triangular merger into P's subsidiary, Newco. Shortly before this acquisition, T had borrowed funds from an unrelated lender in order to fund redemptions of some of its stock. P guaranteed the loan. The Service ruled that the acquisition qualified for tax-free treatment under Section 368(a)(2)(D) . The usual representation relating to the 90/70 test was made, but the following language was added: "The redemption loan will be repaid only (1) from future earnings of Newco, or (2) from capital contributions made to Newco.... " Thus it appears that the Service's intent was to allow the redemption loan to replenish and substitute for T's assets that were depleted in the redemption.

In Ltr. Rul. 8817007,<sup>23</sup> P sought to acquire T in a forward triangular merger, but did not want some of the assets owned by T subsidiaries. T used funds borrowed from P to purchase the unwanted assets from the subsidiaries. These assets were transferred to another T subsidiary, the stock of which then was distributed to T's shareholders in a taxable spin-off. Notwithstanding the spin-off, the Service ruled that the acquisition qualified under Section 368(a)(2)(D) . The borrowed funds were allowed to substitute for T's distributed assets. This conclusion is especially noteworthy because the loan came from P itself. Here, too, as the ruling stated, the loan was unusual: "It is expected that the "loans' [from P to T] will constitute part of the contributed capital [of the T subsidiaries]; and that in effect as the loans become due the capital will either be replaced by contributions or new loans."

Because it was understood that the borrowed cash was to remain in the T subsidiaries for a foreseeable period after the acquisition, the Service ruled specifically that the borrowing from P constituted a substitute asset. "For purposes of making the 'substantially all' determination the cash borrowed by [T] from [P] will be considered a substitute asset for the



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Unwanted Assets; [T's] obligation to repay the loan will be considered as a liability of [T]; and the cash received for the sale of [the unwanted assets] will be considered substituted assets to the extent of value (i.e. any amount not received to the extent of full fair market value is not considered substituted therefor)."

In both of these rulings, the Service allowed the target corporation to replace property distributed to shareholders with borrowed funds sourced (either through direct borrowing or loan guarantees) from the acquiring corporation. Nevertheless, this substitution was allowed only because the borrowing would not be repaid out of the target's transferred assets, but only out of future earnings or capital contributions. It thus appears that a direct capital contribution by the acquiring corporation to the target also would qualify.

This type of substitution, however, raises the question of the source of the distributions to the target shareholders. That is, the payments to the shareholders could be considered made by the acquiring corporation to the shareholders in the acquisition itself, with the target being no more than a conduit.<sup>24</sup> Such a recasting should not affect a forward triangular merger.<sup>25</sup> One might speculate that this was the reason the conduit issue was not raised in either of the two rulings discussed above.<sup>26</sup> C reorganization asset transfers and reverse triangular mergers are another matter. In these transactions, the amount of non-stock consideration that the acquiring corporation can pay is subject to the "solely for voting stock" (C reorganization) or "control for voting stock" (reverse triangular merger) limitations. Thus, if the target corporation is a conduit in these situations, the "substantially all" requirement will be satisfied, but the acquisition still could be taxable.

### POST-ACQUISITION PROPERTY DISTRIBUTIONS

One other common situation is a distribution of target corporation properties after the acquisition (a "pushup"). A pushup usually occurs because the acquiring corporation seeks to integrate the target's business into its own financing or business structure.

**Acquire vs. hold.** To obtain an advance ruling that an acquisition qualifies as a reorganization, a taxpayer must represent to the Service that the acquiring corporation has no plan or intention to sell, exchange, or otherwise dispose of the target corporation's properties after the acquisition, except in the ordinary course of business.<sup>27</sup> Nevertheless, the Service views asset pushups as generally permissible, although (because of a linguistic glitch in the Code) they remain problematic in one type of transaction.

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To have a tax-free C reorganization asset transfer or forward triangular merger, the acquiring corporation must "acquire" "substantially all" of the target corporation's properties. The Service has interpreted this language to permit pushups, because the acquiring corporation may push the assets up to its shareholders after "acquiring" them.<sup>28</sup> This interpretation is sensible, especially since pushups, like other property dispositions, must be carried out within the limits of the continuity of business enterprise requirement ( Reg. 1.368-1(d) ).

Another question is whether a pushup is permitted after a reverse triangular merger. Section 368(a)(2)(E) requires that, after a merger in which the target corporation becomes a controlled subsidiary, the target "hold" "substantially all" of its historic properties. It may be argued that the use of "hold" instead of "acquire" prohibits a pushup of target properties, because after the pushup the target would no longer "hold" the properties. Although Reg. 1.368-2(j) reflects a commonsense attitude toward many aspects of Section 368(a)(2)(E) , it does not discuss pushups, and there is no other IRS guidance on this question in an acquisition context.

**Flips and other restructurings.** The only indications of the Service's views on the pushup issue under Section 368(a)(2)(E) appear in letter rulings dealing with flips and similar restructuring transactions. In flip transactions, a subsidiary (S) becomes the parent of the corporate group, and the current parent (P) becomes a subsidiary of S. A common technique is for S to organize a new subsidiary (Newco) that merges with P. Either Newco or P may survive the merger. In the merger, the P shareholders receive S stock for their P stock, and S, now the parent, becomes the sole shareholder of the surviving corporation, either P or Newco. Rev. Rul. 77-428, 1977-2 CB 117 , held that a flip transaction may qualify as either a forward or reverse tax-free triangular merger.

Flips involve one unusual issue. Unless an additional step is taken after the flip, P, now a subsidiary of S, continues to own the S shares it owned before the flip. In several letter rulings on flips structured as reverse triangular mergers, the Service concluded that the flip qualified as a reorganization under Section 368(a)(2)(E) only if the S shares that P held before the merger were not cancelled or otherwise disposed of.<sup>29</sup> The most recent of these rulings goes on to focus on the dilution that P suffers in the S stock as a result of the issuance of new S shares to the former P shareholders in the flip: "In addition, the dilution in value of such [S] stock will not be considered a deemed distribution of [P]'s assets, or otherwise adversely affect the qualification of the proposed transaction under section 368(a)(2)(E)."

The Service is correct to focus attention on the S stock owned by P. If this stock were cancelled or otherwise distributed back to S, P would realize gain that should not be ignored. Whether and when this gain should be taxed is another question.<sup>30</sup> Nevertheless, the cancellation or other distribution of the S stock should not affect the reorganization, nor should any other pushup of target corporation properties after a reverse triangular merger. Because of the representation that the P stock owned by S will not be distributed, the rulings on the flip transactions suggest that a



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pushup of assets after a reverse triangular merger does present a problem.

The Service's position is made explicit in Ltr. Rul. 9025080 , involving an internal corporate restructuring. Here, the target corporation shareholders sought to transfer their stock to a newly organized holding company in exchange for holding company stock. A subsidiary of the holding company was created and merged into the target, which thus became the holding company's subsidiary.

The target's owners became the shareholders of the holding company. Immediately thereafter, the target distributed, or "pushed up," the stock of one of its subsidiaries to the holding company. The Service ruled that the merger was a reverse triangular merger under Section 368(a)(2)(E) . In addition, for purposes of the 90/70 test representation, the "pushed up" subsidiary stock was treated as property of the target.<sup>31</sup>

This position seems particularly objectionable. As other commentators have noted,<sup>32</sup> Section 368(a)(2)(E) uses "hold" instead of "acquire" (which is used in Sections 368(a)(1)(C) and 368(a)(2)(D) ) only because of the mechanics of the transaction. Assets are acquired in C reorganizations and in forward triangular mergers, but in a reverse triangular merger the target corporation retains (or holds) its own assets, while becoming a subsidiary of the acquiring corporation. The use of "hold" in Section 368(a)(2)(E) cannot imply a requirement that the target corporation continue to hold substantially all of its pre-acquisition properties.

Not only is this language inadequate evidence of any Congressional intent to impose such a requirement, the requirement is itself inconsistent with other rules affecting these transactions. Specifically, under Prop. Reg. 1.358-6(c) , the basis of the stock of the target in the hands of its parent after a reverse triangular merger is determined by the target's net asset basis. That is, for this purpose the transaction is viewed as an acquisition by the parent followed by a dropdown of the acquired assets to the surviving subsidiary.<sup>33</sup> Such an approach is completely inconsistent with the idea that none of the target's assets may come to rest in the parent itself.<sup>34</sup> Separately, the Service has also ruled that former corporate shareholders of the target may "push up" to their shareholders the acquiring corporation stock received in a reorganization, without affecting continuity of interest.<sup>35</sup> Finally, pushups will not result in any abuse, because the target corporation is subject to tax on any gain recognized in the pushup.<sup>36</sup>

Accordingly, the Service should consider eliminating the distinction between "acquired" and "held" properties, and permitting post-acquisition pushups in all situations.



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### CONCLUSION

Several corporate tax law developments during the 1980s have changed the role of the "substantially all" requirement for corporate reorganizations. Generally, these developments have preempted this requirement and made it less central to policy considerations involving reorganizations. It is hoped that the IRS will issue comprehensive guidance on "substantially all" as it relates to acquisitive reorganizations.

As discussed in the first part of this article, the Service could build on the familiar test used in the advance ruling guidelines. That is, the 90/70 test could serve as a quantitative analysis to determine whether the "substantially all" requirement is met in acquisitions. At a minimum, however, the ambiguities regarding the treatment of target stock redemptions, debt repayments, and target subsidiary transactions should be resolved. Preferably, the rules should allow some target distributions, stock redemptions, and repayments of debt in accordance with its terms without an adverse effect on "substantially all." Also, in line with general "asset substitution" concepts, the separate existence of the target corporation and its subsidiaries should be disregarded. Assets and liabilities of subsidiaries generally should be treated as property of the target corporation itself, on a consolidated basis.

More broadly, the 90/70 test could be revised to exclude from consideration assets distributed by the target corporation before the acquisition. The only exceptions might be subsidiary stock distributed tax free under Section 355. Assets retained by the target because of a waiver of the liquidation requirement of Section 368(a)(2)(G) also should be taken into account. IRS should consider allowing loans or equity investments by the acquiring corporation or its affiliates to substitute for, or replenish, target corporation assets. Finally, guidance on "substantially all" should include a rule that permits distributions, or "pushups," of target assets after the acquisition, irrespective of whether the acquisition is a C reorganization asset transfer, a forward triangular, or a reverse triangular merger. Guidance on these points will eliminate several sources of complexity in planning tax-free acquisitions, without compromising any meaningful tax policies.

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See Wellen, "New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions," .

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"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 corporation immediately prior to the transfer. Rev. Proc. 77-37, 1977-2 CB 568 , section 3.01.

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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).

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See, e.g., Rev. Proc. 89-50, 1989-2 CB 631 (corporate charter); National Bank of Commerce of Norfolk, 1 AFTR 2d 894 , 158 F Supp 887 , 58-1 USTC 9278 (goodwill); DeGroff, 54 TC 59 (exclusive license to manufacture, sales network, and availability of services of employee-shareholders).

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See, e.g., Moffatt, 17 AFTR 2d 1290 , 363 F2d 262 , 66-2 USTC 9498 (skilled employees as principal asset); Smothers, 47 AFTR 2d 81-1372 , 642 F2d 894 , 81-1 USTC 9368 (only 15% of balance sheet assets transferred, but transferred goodwill was the principal asset).

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See Newark Morning Ledger Co., 71 AFTR 2d 93-1380 , 507 US 546 , 123 L Ed 2d 288 , 93-1 USTC 50228 (taxpayer could amortize newspaper subscriber list), and Levy, MacNeil, and Young, "Supreme Court's Decision on Amortizing Intangibles Removes One Barrier," . Cf. TAM 9317001 (IRS, seeking to disallow investment credits and accelerated depreciation, could not allocate a portion of the purchase price of tangible property to intangibles). Under Section 197 , added by RRA "93, purchased intangibles (including goodwill) generally may be amortized over 15 years.

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See, e.g., MacDonald, 3 TC 720 See also Wilmot Fleming Engineering Co., 65 TC 847 (partnership goodwill).

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See Brooks, 36 TC 1122 (non-personal corporate goodwill sold as capital asset); Ltr. Rul. 8625069 (shareholder's license to practice medicine was not property of the shareholder's association for "substantially all" purposes, because the license was personal). For an example of this approach, see Section 1202(e)(3)(A) , added by RRA "93, which disqualifies from "qualified trade or business" treatment "any trade or business where the principal asset of such trade or business is the reputation of 1 or more of its employees." As a result, stock of a corporation in such a trade or business is not eligible for the 50% capital gain exclusion.

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In analyzing a reincorporation, at least one court held that the availability of shareholder managerial services was a corporate asset, even though there was no employment contract or other continuing corporate right to the services. *Smothers*, supra Note 5 . Another court, however, seems to have disregarded shareholder management as an asset. *Simon*, 22 AFTR 2d 5699 , 185 Ct Cl 291 , 402 F2d 272 , 68-2 USTC 9624 . As an anti-abuse measure, it may be necessary to treat the availability of shareholder services as corporate property in reincorporations. In acquisitions, however, such property should be disregarded. Otherwise, it might not be possible for an employee-shareholder to retire and dispose of his or her business tax free.

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See, e.g., *Armour*, 43 TC 295 ; *Viereck*, Cls. Ct., 11/3/83.

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A target that sells too large a proportion of its business assets, however, may fail to satisfy the "continuity of business enterprise" requirement. Reg. 1.368-1(d) .

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12

See *Corrigan*, TCM, 9/29/44, aff'd on other issues 155 F.2d 164 (CA-6, 1946). Under Section 368(a)(2)(C) , the acquiring corporation in a C reorganization or a forward triangular merger may transfer properties received from the target to one or more controlled subsidiaries. Reg. 1.368-2(j)(4) also permits asset transfers to controlled subsidiaries after a reverse triangular merger. Assets may be transferred to several sister subsidiaries. Rev. Rul. 72-576, 1972-2 CB 217 . IRS has ruled that assets could be dropped two tiers. Ltr. Ruls. 8747038 , 8941068 .

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13

In *Rommer*, 19 AFTR 2d 1545 , 268 F Supp 740 , 67-2 USTC 9481 , a corporation exchanged a building (its principal property) for a less-valuable building plus cash, then liquidated and transferred the new building to a new corporation, pending its sale. The court agreed with the taxpayer that the transaction was a liquidation (as opposed to a D reorganization), partly because it did not view the new building as an operating asset of the liquidating corporation. This case should not be viewed as questioning the property substitution concept. Rather, it is an example of not finding a D reorganization where property is reincorporated as part of a plan to sell it. *Graham*, 37 BTA 623 ; *Standard Realization Co.*, 10 TC 708 .

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GCM 39150 , 10/1/82 (post-acquisition dropdown of one-third of target's assets to partnership permissible); GCM



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35117 , 11/18/72 (post-acquisition dropdown of all of target's assets to limited partnership of which acquiring corporation is sole general partner prevents acquisition from qualifying as reorganization). But see Rev. Rul. 83-156, 1983-2 CB 66 ( Section 351 transfer may be followed by re-transfer of some property to partnership under Section 721 ).

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See Note 12 supra. There apparently are no rulings where IRS has permitted a dropdown of more than two tiers.

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See the discussion in Wellen, supra Note 1 , at fn. 30.

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Structuring a downstream transfer of assets as a merger (an A reorganization) avoids the "substantially all" requirement.

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Rev. Rul. 68-526, 1968-2 CB 156 . The Service has also ruled that the continuity of interest requirement is satisfied if a shareholder of the target parent receives acquiring corporation stock attributable to an acquired target subsidiary. Rev. Rul. 76-528, 1976-2 CB 103 (discussing Rev. Rul. 68-526 ). See generally Rev. Rul. 84-30, 1984-1 CB 114 . See also National Pipe & Foundry Co., 19 BTA 242 .

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See also Rev. Rul. 57-465, 1957-2 CB 250 (D reorganization treatment for merger of foreign parent into its wholly owned subsidiary, when subsidiary stock constituted more than 50% of parent's properties). In Rev. Rul. 78-47, 1978-1 CB 113 , the subsidiary stock held by the parent was "old and cold," whereas in George, 26 TC 396 , the stock of the acquiring corporation was substitute property.

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Other commentators conclude that "substantially all" was satisfied in Rev. Rul. 78-47 , supra, because the parent transferred all of its business assets. Bittker and Eustice, *Federal Income Taxation Of Corporations And Shareholders*, 5th ed. (Warren Gorham Lamont, 1987), at 14.53, fn. 477 ; Ginsburg and Levin, *Mergers, Acquisitions, And Leveraged Buyouts II* (CCH Tax Transactions Library, 1991), at 702.03, fn. 54. This analysis appears to disregard subsidiary stock for "substantially all" purposes in a downstream acquisition.



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Sections 358(a)(1) , 362(b) .

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22

Section 311(b) ; Reg. 1.1502-14(a)(1) ; Temp. Reg. 1.1502-14T(a) . Under GCM 39608 , 3/5/87, deferral of built-in gain in such circumstances may be permanent. If the acquisition is by reverse subsidiary merger, the target parent must continue to hold this acquiring corporation stock. These "historic basis" issues are discussed in the text, below, in the context of "flips."

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23

Supplemented by Ltr. Rul. 8809008 , revoked prospectively on other grounds by Ltr. Rul. 8844038 .

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24

If the distributions to the target shareholders are deemed made directly by the acquiring corporation, "substantially all" would not be implicated. Still, the transaction could 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). Rev. Ruls. 56-345, 1956-1956-2 CB 380 ; 75-360, 1975-1975-2 CB 110 . In Ltr. Rul. 9308025 , a recent example of the conduit analysis, an acquiring corporation invested cash in the target corporation and received target stock. The target used the cash to pay its debts, after which it transferred its properties to the acquiring corporation for acquiring corporation stock and then liquidated. IRS ruled that the transaction was a transfer of the target assets to the acquiring corporation for stock and cash, with the cash then used by the target to pay its debts. Under this view, the target's debt payment would affect "substantially all," but the cash would not be treated as property of the target for "substantially all" purposes.

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25

Cash that the acquiring corporation pays to the target and that is neither used to pay debts nor distributed to shareholders is boot, taxable to the target. Rev. Rul. 72-343, 1972-2 CB 213 . But see Rev. Rul. 72-522, 1972-2 CB 215 (B reorganization unaffected by acquiring corporation's simultaneous cash purchases of target's unissued stock).

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26

If the loans were deemed to be consideration paid by the acquiring corporation, however, the restrictions in the rulings regarding the funds from which the loans were to be repaid would have been unnecessary.

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## | 15 | More Problems Complicate the Application of 'Substantially All' to Acquisitions

Rev. Proc. 86-42, 1986-2 CB 722 , sections 7.027, 7.037, and 7.055.

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28

GCM 36111 , 12/18/74, and Ltr. Rul. 9319017 (forward triangular merger); GCM 39102 , 12/21/83, modifying GCM 37905 , 3/29/79 (triangular C reorganization). A pushup of some but not all of the acquired assets raises the question which is the "acquiring corporation"- the acquiring and pushing-up subsidiary or the parent that receives the pushup. See the discussion in Wellen, supra Note 1 , at fn. 30 and accompanying text.

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29

Ltr. Ruls. 9238009 , 9022038 , and 8827061 (revoking 8824037 ).

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30

Section 311(b) ; GCM 39608 , 3/5/87, discussed in Note 22 supra . The dilution of P's ownership in S also could be viewed as a gain recognition event akin to a distribution. Suppose P owns all 100 outstanding shares of S stock. The total value of P, including S, is \$1 million, and the value of S is \$100,000. P and S wish to flip. S forms a new subsidiary, Newco, and P is merged into Newco. The P shareholders surrender their P stock and receive S stock. P retains its 100 shares of S stock. For the \$100,000 value of P's stock in S to be maintained, the former P shareholders can receive no more than 90% (900 shares) of the S stock. If, for example, they receive 9,900 shares, then P's 100 shares will be worth only \$10,000.

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31

Ltr. Rul. 9025080 also held that the "amount" of the target's distribution, and therefore the holding company's basis in the distributed stock, is "determined as provided in section 301(b)(1)(B)(ii) of the Code as it existed prior to the amendment of section 301(b)(1) by TAMRA." This amount was the target's basis in the distributed stock plus any gain recognized in the distribution. Under this conclusion, if the holding company and the target file a consolidated return, any excess loss account ( Reg. 1.1502-13 ) of the target in the stock of its distributed subsidiary (e.g., because of a prior "strip") would have followed the distributed stock up to the holding company. This could have resulted in the holding company, and not the target, being taxed on the excess loss account if the distributed subsidiary left the consolidated group. Recent changes in the consolidated return Regulations, however, produce a different result. The target is taxed on the gain attributable to the excess loss account (although the gain is deferred until either the target or the subsidiary stock leaves the consolidated group). Reg. 1.1502-14(g) . That is, under current law the target is fully taxed on this pushup. The gain is not diverted to another group member. This result is another reason why IRS should treat the pushup as independent of the merger, with no effect on the "substantially all" requirement. For a discussion of the



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consolidated group rules, see generally Peel, Huber, and Lubozynski, "Consolidated Return Prop. Regs. Revamp Concepts for Basis Adjustments and E&P" and "Consolidated Return Prop. Regs. Revise Income Allocation and Excess Loss Account Rules," .

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32

Cook and Coalson, "The "Substantially All of the Properties' Requirement in Triangular Reorganizations-A Current Review," 35 Tax Lawyer 303 (1982), at pages 325-327.

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33

If this Proposed Regulation is not adopted, the alternative approach to target-stock basis will be carryover basis from the former target shareholders, i.e., the rule for B reorganizations, which do not have a "substantially all" requirement.

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34

This result, however, is consistent with the strict concept of "acquiring corporation" set forth in Rev. Rul. 70-107, 1970-1 CB 78 . See Wellen, *supra* Note 1 , at fn. 30.

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Rev. Rul. 84-30 , *supra* Note 18 .

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36

If the acquiring parent and the target file a consolidated return after the acquisition, this gain will be deferred. Reg. 1.1502-14(a)(1) ; Temp. Reg. 1.1502-14T(a) . When the deferred gain is taxed, it will cause a step-up to the parent's basis in the target stock. Reg. 1.1502-32 . (The stock basis already will have been reduced by the FMV of the distribution.) If the parent's original basis in the target stock is determined by reference to the target's net asset basis, as in Prop. Reg. 1.358-6(c) , this stock basis adjustment will prevent double taxation of the same gain within the group. If the basis of the target stock is determined by carryover, however (as described in Note 33 *supra* ), the stock basis may already include amounts attributable to the built-in gain in the target's assets. In this situation, a further stock basis step-up attributable to the gain recognized could prevent the gain from being taxed. The loss disallowance rule ( Reg. 1.1502-20 ) is intended to deal with this problem. See generally Silverman, Keyes, and McBurney, "Operation of the Final Loss Disallowance Rules in the Consolidated Return Regs.," , and "Maximizing Allowable Losses and Minimizing Problems Under the Consolidated Return Regs.,".

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