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Step Doctrine Ruling Can Cause Consternation For Dealmakers

Abstracted from: *The Acquisition Two-Step*
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The murky facts. As every experienced dealmaker knows, you cannot always get what you want when it comes to tax treatment from the IRS. The step transaction doctrine has long been a contributor in tripping up acquirors hoping to control the tax consequences of a deal. Consider IRS Rev. Rul. 2008-25, which shows that sometimes a liquidation can transform an earlier reorganization into a qualified stock purchase. The ruling rests on the following scenario: Parent formed Company X to acquire Target from Sole Owner A. Company B, which was unrelated to Company A, had four times the net assets of Target. Those are the players, tax attorney Robert Wood explains, and here are the games. Company B bought Target's stock and merged X into the target in exchange for 90% Parent stock and 10% cash. Then, following the plan, Target was liquidated into Parent, in a transaction structured as a plain-vanilla liquidation and not a reorganization.

The foggy conclusion. The IRS found that the sequence was not a reorganization but a qualified stock purchase in which Parent ends up with basis in the assets liquidated into it. Prior rules have indicated that these types of transactions must be evaluated under various reorganization statutes, such as the step doctrine, but the IRS this time dismissed potential scenarios, including an A and D reorganization. It concluded that the acquisition merger and subsequent liquidation could not even be considered an IRC Sec. 351 transaction, because Parent did not have control immediately after the transfer. Since the steps could not be integrated, the Service concluded that the deal must be a qualified stock purchase.

Issues with the ruling. Dealmakers must be wary of the step-transaction doctrine. If parties want a reorganization from the facts indicated in the ruling, the second step in the plan should be a merger rather than a liquidation. Another lesson for dealmakers is that the plan documents must be clear, since unintended events can happen. Under the ruling, the deal resulted in basis for the parent, but it may not always work out that way. The author also points out an inconsistency between the ruling and IRC Sec. 338, which suggested that a similar fact pattern was not a qualified stock purchase. However, the ruling is clear in its objectives and conclusion, and the author is comfortable with the notion that an acquisition merger can, in fact, be a qualified stock purchase despite the inconsistency.

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