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The Acquisition Two-Step

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Can a liquidation transform what preceded it (and what seemed to be a reorganization) into a qualified stock purchase under Internal Revenue Code Section ("Code Sec.") 338? Rev. Rul. 2008-25, IRB 2008-21, 986, considers this question, answering it in the affirmative. The ruling holds that an acquisitive merger and subsequent liquidation should not be integrated. As neither a reorganization nor a Code Sec. 351 transaction, it would be a taxable asset acquisition. If this seems puzzling, read on.

Just the Facts

Parent owned all of the stock of X, a subsidiary formed for the sole purpose of acquiring Target. Individual A was the sole owner of Target, and Target had $150 worth of assets and $50 worth of liabilities. B was unrelated to A and to Target. The value of B's assets (net of liabilities) was $410. B acquired all of the stock of Target in a statutory merger (of X into Target) in exchange for 90-percent Parent stock and 10-percent cash.

Following this merger, and as part of the same plan, Target liquidated into Parent. This was an old-fashioned liquidation, not a statutory merger. Rev. Rul. 2008-25 rules that this overall transaction was not a reorganization. Instead, the merger was treated as a qualified stock purchase, and the liquidation was treated as tax-free under Code Sec. 332.

There is considerable history associated with the step transaction doctrine, when it will be applied, when it will not, when separate steps will be respected as such and when they will be integrated. For example, Rev. Rul. 67-274, 1967-2 CB 141, indicates that an acquisition merger must be integrated with a subsequent liquidation for purposes of determining whether the end result is a reorganization. That makes sense.

Reg. §1.368-1(a) suggests that in determining reorganization status, the transaction must be evaluated under various doctrines, including the step transaction doctrine. Interestingly, Reg. §1.368-2(k) permits certain

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upstream transfers of assets following an otherwise qualifying reorganization to be respected, essentially turning off the step transaction doctrine. Reg. §1.368-2(k), however, does not apply where the *target* is the one liquidated.

Under the facts of Rev. Rul. 2008-25, the integrated transaction was a direct acquisition by Parent of Target's assets in exchange for $10 in cash, $90 worth of Parent voting stock, and the assumption of the target's liabilities. All in all, that simply failed to qualify as a reorganization. It could not be a C reorganization, because there was nonvoting stock consideration. Plus, the liabilities and cash were too much even for the boot relaxation rules; it could not be a D reorganization because neither Target nor A was in control of Parent immediately after the transfer.

Rev. Rul. 2008-25 suggests that using the liquidation two-step makes sense. Yet, is it foolproof?

It could not even be an A reorganization, because Target did not merge into Parent. The IRS also said it was simply not a 351 transaction, because A did not control Parent immediately after the exchange.

The end result of Rev. Rul. 2008-25 was simply that the acquisition merger and liquidation could not be integrated. Viewed as an integrated transaction, it was not a reorganization or a 351 transfer, so what was it?

Well, it had to be a taxable asset acquisition, pursuant to which Parent would obtain a cost basis in the assets. That, said the IRS, would violate the policy underlying Code Sec. 338.

Yet in the end, Rev. Rul. 2008-25 concludes that the acquisition merger *does* count as a qualified stock purchase within the meaning of Code Sec. 338. Because the acquisition merger was not an exchange to which Code Secs. 351, 354, 355 or 356 applied, it had to be a qualified stock purchase for purposes of Code Sec. 338.

Caution?

Ultimately, Rev. Rul. 2008-25 underscores some things most readers already know: watch out for the step transaction doctrine. Suppose you have a set of facts similar to those presented in Rev. Rul. 2008-25, and you want to qualify as a reorganization. Having the second step as a merger rather than a liquidation would clearly make sense. Not only that, but since sometimes pieces of a transaction happen that one does not necessarily intend, the deal documents should be clear what covenants are in effect for post-acquisition transfers (of either target stock or assets).

Yet clearly there are times when you do not want reorganization treatment, and when you want a stepped-up basis at all costs. Rev. Rul. 2008-25 suggests that using the liquidation two-step makes sense. Yet, is it foolproof?

Disturbingly, there is at least one example in the regulations under Code Sec. 338 that seems to address this kind of a fact pattern. Arguably, the example suggests Rev. Rul. 2008-25 may be wrong. In Reg. §1.338(h)(10)-1(e), Example 14, the transaction involved Parent acquiring all of

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the stock of Target in a statutory merger of X into Target, in exchange solely for Parent voting stock. Thereafter, Parent merged Target into Parent.

The example states rather flatly that Target's merger into Parent does not constitute a qualified stock purchase under Code Sec. 338(d)(3). There is a suggestion in this example that it is considering only *that* element of the transaction independently. It does seem to disregard the upstream merger. What is troublesome, though, is that Example 14 seems to assume that the subsequent liquidation did not occur. Conversely, Rev. Rul. 2008-25 suggests that the liquidation must be considered.

In my view, though, Rev. Rul. 2008-25 is clear enough, and states rather flatly that an acquisition merger can (at least under identical facts) constitute a qualified stock purchase.

Besides, isn't Code Sec. 338 complicated enough that it deserves at least a couple of simple rules?