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Before being acquired, a target corporation sometimes needs to be moved to a new state, for example, to force all the shareholders to sell in a state law "share exchange." Until recently we had thought we had a clear rule that this kind of reincorporation is tax- free, but now confusion has crept in. Let's see if this confusion is really necessary.

The Problem

Rev. Rul. 96-29, 1996-1 C.B. 50, Doc 96-15358 (4 pages), 96 TNT 102-6, says that a merger of "Target 1" into a new corporation in a different state, "Target 2," will not be stepped together with an acquisition of the stock of Target 2 (in a type-B reorganization), even though the reincorporation merger took place only because of the acquisition. As a result, the reincorporation merger qualifies as a type-F

reorganization of a "single corporation" without a change of its stock ownership. So far, so good.

Recent word from the IRS National Office, though, suggests that, if the merger is followed by a related taxable sale of the Target 2 stock to a corporation ("Buyer"), the merger will flunk the continuity-of-interest test for reorganizations and become taxable at the corporate level (as though Target 1 has sold its assets to Target 2). The 1998 continuity-of-interest regulations are said to lead to this result. /1/ We thought the new continuity regulations were supposed to prevent this kind of "gotcha."

The Issues

The problem raises both technical and policy issues.

The technical issue is whether the continuity regulations really do require the merger to be taxable.

There are two policy issues: One is whether the merger-plus- stock-sale is more similar to a taxable scenario versus a tax-free scenario. We believe it is more similar to a tax-free scenario and that it should also be tax-free. A more general policy concern relates to how the continuity regulations should be interpreted and administered.

Technical Issue

A type-F reorganization must satisfy two different shareholder "continuity" requirements. First, a type F reorganization includes by definition a mere change in place of incorporation of a "single corporation" like our merger, so long as there is no change in shareholders or assets. The "single corporation" language is supposed to preclude a combination of two active corporations in a type F reorganization even if they have the same stockholders.

Second, the continuity-of-interest requirement that applies generally to reorganizations also applies to type F reorganizations. Reg. section 1.368-1(b). It would seem that a merger that satisfies the definitional requirement of section 368(a)(1)(F) necessarily would satisfy the continuity requirement. The IRS seems to be suggesting that the step transaction doctrine can cause continuity to fail when a corporation buys more than half of the outstanding stock of Target 2, even if section 368(a)(1)(F) is satisfied (i.e., no change of shareholders of Target 1) because of Rev. Rul. 96-29.

Under the continuity regulations, the technical issue is whether Buyer is a "related party" to Target 2, so that the Target 1 shareholders are treated as cashing out in the merger. Such treatment makes no sense in this case. The step transaction doctrine should not apply for any purpose when the first step is a "mere reincorporation," as Rev. Rul. 96-29 said (we thought).

More specifically, for our merger to satisfy the continuity test, the shareholders must not sell their Target 2 stock "in connection with the reorganization" to a corporation that is a "related person" as to Target 2. Reg. section 1.368-1(e). /2/ A "related person" can be either a member of an affiliated group with Target 2 or a 50 percent-or-more subsidiary, with the relationship existing either immediately before or

immediately after the merger.

Here Target 2 is a member of an affiliated group with Buyer soon after the merger. Therefore, Buyer may be a "related person." If so there would be no continuity of interest, and Target 1 would be taxable on its asset exchange.

This result is not literally precluded by Rev. Rul. 96-29, but is inconsistent with its spirit. Rev. Rul. 96-29 addressed the "single corporation" requirement to section 368(a)(1)(F) in two situations. In the first situation, a corporation reincorporated in another state before a public offering; the corporation used the proceeds to redeem preferred stock that represented 40 percent of the pre-offering value of the corporation, leaving the historic common shareholders with 40 percent of the **[*104]** common and 60 percent of total equity. In the second situation, a corporation acquired the stock of a target corporation for stock of the acquiring corporation, and the target then changed its state of incorporation by merging into a new corporation. Thus, in neither situation was there a 50 percent-or-more loss of equity by the historic shareholders of the reincorporating entity.

Rev. Rul. 96-29 states that the results are based on the "unique status of reorganizations under section 368(a)(1)(F)...," rather than a general formulation of the step transaction doctrine. For that reason, the ruling modified Rev. Rul. 79-250, 1979-2 C.B. 156, which had reached the same result on essentially the same facts, but had seemed to rely on a particular formulation of the step transaction doctrine. Evidently, the IRS came to dislike the formulation and chose to cut the Gordian knot by simply saying "type F reorganizations are different." /3/

The IRS has cited Rev. Rul. 96-29 regularly in approving type F reorganizations that were parts of larger transactions. A recent example is a private letter ruling, LTR 199902004, Doc 1999-2064 (4 original pages), 1999 TNT 11-36, where a REIT merged into a limited liability company owned by the REIT's disregarded REIT subsidiary to "reincorporate" itself before an acquisition.

Commentators on the continuity regulations did not see the possibility that Rev. Rul. 96-29 might not apply where a reincorporation was followed by a sale of a controlling stock interest to another corporation. For example, in its comments on the proposed regulations the New York State Bar Association (NYSBA) stated:

> Rev. Rul. 96-29 specifically precludes stepping together a change of stock ownership with a formally separate reincorporation, implicitly relying on the fact that the reincorporation itself does not result in the change of stock ownership. /4/

The solution to the technical issue here should be that Buyer is not a "related person" to Target 2 "immediately after" the merger. In the case of a type F reorganization merger, a purchase of Target 2 stock should be "immediately after" the merger only when it occurs in the merger itself (as would be the case if Buyer were the parent of Target 2 before a "triangular" merger). Just as the step transaction doctrine did not apply in Rev. Rul. 96-29 to cause a violation of the section 368(a)(1)(F) definition, so also should it not apply to cause a break of continuity, because the type F reorganization is "unique."

Must there be an independent business purpose for a type F reorganization? We do

not think so. Rev. Rul. 96-29 Situation 1 states that the corporation desired to use the favorable laws of the new state of incorporation, but that the corporation would not have reincorporated in the new state without the IPO. In other words, the ruling was intended to address instances where the reincorporation was required by the other step treated as separate.

Policy

The main policy issue is presented by considering the following continuum of scenarios, in addition to our case stated above:

Scenario 1: Target 1 reincorporates in another state by merging into Target 2; two years later Buyer buys all of the Target 2 stock in an unrelated transaction. The merger is clearly a type F reorganization.

Scenario 2: Target 1 reincorporates in another state by merging into Target 2; immediately, Mr. A buys all of the stock of Target 2. A is not a "related person" as to Target 2 under the continuity regulations, and so the merger evidently qualifies as a type F reorganization.

Scenario 3: Buyer buys all the stock of Target 1 for cash (a "qualified stock purchase" under section 338) and then causes Target 1 to merge into Buyer's wholly owned subsidiary, Target 2. The merger is tax-free under temporary reg. section 1.338-3T(c)(3)(ii), which states that for continuity purposes the qualified stock purchase is separate from the merger. The purpose is to presume a continuity of ownership of Target 1 in the case of its merger within Buyer's group after the "qualified stock purchase." /5/

Scenario 4: Buyer organizes Target 2; Target 1 merges into Target 2 for cash paid to the Target 1 shareholders for their Target 1 stock. The merger is a taxable sale of Target 1's assets because the Target 1 shareholders cashed out in the merger and continuity failed.

Rev. Rul. 96-29 had it right: form should control in this area. In the case at issue here, because Buyer does not own Target 2 at the outset, the merger is not a forward subsidiary merger that flunks section 368(a)(2)(D). Rather it is a reincorporation followed by a separate stock sale. There is no reason to force an unexpected and unintended result on taxpayers who take Rev. Rul. 96-29 at its word.

The fact that a corporate Buyer might get some of the cash to make the stock purchase from Target 2 at no tax or reduced tax (under consolidated return rules or section 243) is not a countervailing policy concern. In Scenario 3, Buyer also can get the cash from Target 2, but the merger there is not a taxable event. (In Scenario 2, Mr. A can also get the cash from Target 2; the fact that Mr. A may have to pay tax on a dividend to get the cash makes it no less a stepped transaction.) The bottom line should be that the asset transfer deemed to occur in the merger is a nonevent, because it is a "mere" type F reorganization.

Finally, treating our merger as taxable would be perilously close to analyzing Buyer's purchase of the Target 2 stock as a purchase of assets from Target 1. To do so would be to resurrect the Kimbell-Diamond **[*105]** doctrine, which Congress intended to avoid by enacting section 338. /6/

Peroration

"Gotchas" go with the territory in subchapter C, and corporate tax practitioners have to live and die by the sword of form-over- substance. But at some point enough is enough.

One of those points is continuity of interest. The 1998 regulations went a long way to making the rules more objective, and recent administrative pronouncements similarly have reflected a concern for commercial reality. See, e.g., Rev. Rul. 99-58, 1999-52 IRB 701, Doc 1999-39238 (4 original pages), 1999 TNT 241-2, allowing most stock repurchase programs to go forward alongside acquisitive reorganizations. In other words, gotchas are being eliminated. Introducing a new one, especially one involving type-F reorganizations, seems like a real step backward.

Penultimate Point: Similar Gotcha

A similar gotcha involves the continuity of business enterprise (COBE) regulation and the famous "K rule" (reg. section 1.368-2(k)). The COBE regulations allow assets acquired in a tax-free reorganization to be transferred to any corporation that is a member of a "qualified group under the "issuing corporation." (The issuing corporation is the corporation whose stock is issued; a qualified group is composed of the issuing corporation and chains of subsidiaries connected by stock ownership meeting the 80 percent tests of section 368(c).) Thus, if S is a wholly-owned subsidiary of P, and T is merged into S for P stock in a qualifying forward triangular merger, S may transfer the T assets to any P subsidiary, including a P subsidiary in another ownership chain, all without a COBE problem.

The K rule, however, restates section 368(a)(2)(C), to the effect that assets acquired in an acquisitive reorganization may be transferred to lower-tier section 368(c) subsidiaries of the acquiring corporation. As we understand it, the IRS may read the K rule as canceling out the permission to make a cross-chain asset transfer, because it is not a downstream transfer that the K rule describes. Technically this result may be defensible, but it makes no sense as a policy matter. More important, it does not seem fair to "customers" for the IRS to allow the transfer explicitly in one part of the regulations and then to disallow it (by a negative inference, no less) elsewhere.

Conclusion

Our type F reorganization problem could be a reason to raise a larger issue: Should a corporate asset transfer attached to a substantial shift in corporate stock ownership be either a recognition or nonrecognition transaction, at the election of the new owners? Such ground has been plowed by others, to no avail to date. /7/

In the here and now, this problem should be put to rest with a revenue ruling making clear that a reincorporation followed by a stock purchase is covered by Rev. Rul. 96-29. Clarification of the K rule to allow cross-chain transfers also would be welcome.

Coverage of the Financial Accounting Standards Board will resume next week with news on the March 29 board meeting.

FOOTNOTES

/1/ Apparently the regulation would not upset a type-F reorganization followed either by a second, acquisitive reorganization or (as discussed in footnote 2) by a sale of the Target 2 stock to an individual.

/2/ T.D. 8760 states: "Because the final regulations focus generally on the consideration P exchanges, related persons do not include individual or other noncorporate shareholders. Thus, the IRS will no longer apply the holdings of South Bay Corporation v. Commissioner, 345 F.2d 698 (2d Cir. 1965), and Superior Coach of Florida Inc. v. Commissioner, 80 T.C. 895 (1983), to transactions governed by these regulations." (For the full text or a summary of the final regs, T.D. 8760, see Doc 98-4301 (10 pages) or 98 TNT 28- 26.)

/3/ See Cummings, "Service Sheds New Light on Its Approach to Step Transaction Doctrine," Tax Notes, June 17, 1996, p. 1700.

/4/ Later, in its comments on Rev. Proc. 86-42 (representations for reorganization rulings), the NYSBA made essentially the same point.

/5/ This regulation is known as the "anti-Yoc Heating regulation." See Yoc Heating Corp., 61 T.C. 168 (1973).

/6/ See Cummings, "Current Developments in Tax Free Reorganizations," 54th NYU Institute on Federal Taxation, Section 12.01 (Matthew Bender & Co. 1996).

/7/ See George Yin, "A Carryover Basis Asset Acquisition Regime?: A Few Words of Caution," Tax Notes, Oct. 26, 1987, p. 415; Samuel C. Thompson, Jr., The Merger Puzzle: Reform of the Taxation of Mergers, Acquisitions, and LBOs (Carolina Academic Press, 1993).