OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 23, 1999

CC:DOM:FS:CORP
TL-N-1545-99
Number: **199945006**
Release Date: 11/12/1999
UILC: 368.03-01
368.08-02
368.08-06
368.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Attn: Attorney

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Substantially All The Property

This Field Service Advice responds to your memorandum dated May 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =

C =

Newco =

Ds =

F =

$1x =

$2x	=
$3x	=
$4x	=
$5x	=
$6x	=
$7x	=
$8x	=
$9x	=
$10x	=
$11x	=
$12x	=
$13x	=
$14x	=
$15x	=
$16x	=
$17x	=
$18x	=
$19x	=
$20x	=
$21x	=
$22x	=
$23x	=
#a	=
#b	=
#c	=

#d	=
#e	=
#f	=
#g	=
#h	=
#i	=
#j	=
#k	=
#l	=
#m	=
#n	=
#o	=
#p	=
#q	=
#r	=
#s	=
#t	=
#v	=
#w	=
#x	=
#u	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

State A =

State B =

State C =

City 1 =

City 2 =

YEAR 1 =

YEAR 2 =

a =

b =

Name 1 =

ISSUE(S):

1 Whether X=s acquisition of C Corporation fails to qualify as a tax-free reorganization under I.R.C. ' 368(a)(2)(E) because Asubstantially all@ of the assets of C Corporation were not held by C Corporation after its merger with Newco?

2 Whether X=s acquisition of C Corporation fails to qualify as a tax-free reorganization under the continuity of business enterprise doctrine?

3 Whether X=s acquisition of C Corporation fails to qualify as a tax-free reorganization under the continuity of interest doctrine?

<u>CONCLUSIONS:</u>

1 X=s acquisition of C Corporation will fail to qualify as a tax free reorganization under I.R.C. ' 368(a)(2)(E) because Asubstantially all@ the assets of C Cororation were not held by C Corporation after its merger with Newco.

2 X=s acquisition of C Corporation will not fail to qualify as a tax free reorganization under the continuity of business enterprise doctrine.

3 X=s acquisition of C Corporation will not fail to qualify as a tax free reorganization under the continuity of interest doctrine.

FACTS:

X was incorporated in YEAR 1 in State A. In YEAR 2 X acquired by merger, #a regional companies in the a business. The acquired companies are referred to as the ADs@. As of the merger, all of the Ds were S corporations.

Simultaneously with the acquisition of the Ds, #b million shares of common stock were sold in an initial public offering.

One of X=s Ds was C Corporation. C was incorporated in Date 4, as a State C corporation conducting a operations in City 1 and City 2 State C and State B. An S corporation since its formation, C had #x shares of authorized and issued stock. The principal shareholder was Name 1.

An appraisal dated Date 2, valued the company at $1x. For purposes of determining the fair market value of the company for purposes of the exercise of employee stock options (no more than #c percent of the outstanding stock), this value was discounted #d percent for lack of liquidity to a value of $2x.

As of Date 3, C had net assets of $3x (in thousands) and gross assets of $4x (in thousands). As of Date 1, these amounts (in thousands) were $5x and $6x, respectively. C=s net earnings for YEAR 1 were approximately $7x.

Newco was incorporated as a solely owned subsidiary of X on Date 5, solely for the purposes of completing the merger.

Name 1 was (prior to the exercise of certain employee options) the sole shareholder of C and founder of the company. As a result of certain C employees exercising stock options prior to the merger, Name 1 held #e percent of the C stock at the time of the merger. As of Date 6, Name 1=s stock basis was $8x and his debt basis was $9x. Prior to the merger, Name 1 received certain cash distributions from C, and after the merger, he purchased back the b division of C. Before the merger and offering, Name 1 held or had options to acquire #f percent of X stock to the extent of #f percent of X=s outstanding stock. After the merger and offering, Name 1 became a director of X and held or had options to acquire #g percent of X stock.

On Date 7, X acquired the Ds in separate but simultaneous acquisitions for X common stock, X preferred nonvoting stock and cash. Concurrently and as part of the same transaction, X conducted a registration and public offering of #h voting common shares of its stock.

The merger was designed to be reverse triangular merger under I.R.C ' 368(a)(2)(E). C and its subsidiaries were merged with Newco, with C the surviving entity. Name 1 and the other C shareholders received X stock and cash in exchange for their C stock. Name 1 also received preferred stock in exchange for a C note he held. Thus, C became a wholly owned subsidiary of X, and the former C shareholders became X shareholders.

The total consideration paid for C was #o shares of common stock, valued as of the date of the merger at $12x per share (or $23x), #i shares of convertible preferred stock with a value of $15x (as Name 1 exchanged the $15x note for the convertible stock) and cash of $10x. The total acquisition price was $11x.

Although X considered the cash payment as part of the acquisition price, it was a distribution of #j percent of C=s equity as of Date 3. This equity amount was increased by the proceeds of the exercise of the stock options. This distribution was pursuant to Section #k of the merger agreement.

Under this provision, the shareholder=s of C were entitled to a note from C in the amount of #j percent of its net earnings (defined as the excess of book assets over liabilities plus payments for employee stock options) plus Athe unpaid distribution due the stockholder for taxes due on the income of {C and subsidiaries} for the periods prior to@ the merger. The notes received were to be paid immediately following the closing. Under this provision, #j percent of net equity came to $10x divided proportionately among the C shareholders. Name 1 also received $13x in cash, attributable to the #r part of the agreement=s Section #k formula providing for the payment of state and federal income taxes on the S corporation earnings of C.

Of the consideration transferred to the C shareholders, Name 1 received his proportionate share of the stock, $14x in cash as part of the #j percent of net equity formula, the $13x in additional cash, and all the F convertible preferred stock, valued at $15x. The remaining stock and cash went to the C employees who exercised stock options immediately prior to the merger.

The stock exchanged for the stock of the Ds was subject to restrictions, while the stock offered to the public was freely tradeable. The stock received by the Ds was restricted stock (subject to the limitations on resale of S.E.C. Rule 144). In essence Rule 144 permits the sale of the greater of #u percent of the issued and outstanding stock within a #b month period or the average weekly trading volume beginning #v days after acquisition. The initial X shareholders and the shareholder=s of the Ds were subject to agreements that restricted selling any additional stock for #l days. After that, the shareholders could only sell #w percent of their stock for a #m month period, and then an additional #j percent for a #m month period.

The following is a chronological summary of events shortly before and after the merger: Prior to the merger, on Date 8, Name 1 received a distribution from C in the amount of $16x. This distribution took place while the merger was being negotiated with X. Because this distribution left C with insufficient funds, Name 1 loaned $15x back to C and received a note. Pursuant to section #n of the merger agreement, the note was exchanged for the #i shares of F convertible preferred stock. As part of the merger consideration, Name 1 and the other employees of C (the employees who had exercised their options) received a distribution of $10x pursuant to section #k of the merger agreement. This represented #j percent of the net equity of C at the time of the distribution. In addition, Name 1 received an additional $13x as a distribution to cover the former shareholder=s tax liability stemming from the S corporation earnings.

#u months after the merger, X redeemed #p shares of the F preferred stock from Name 1 for $17x. Name 1 used $18x of the $17x received in the redemption as a down payment on C=s former b division. This payment was made on Date 9. The total purchase price of the division was $19x.

LAW AND ANALYSIS

LAW

I.R.C. ' 368(a)(2)(E) provides that a reverse triangular merger, i.e., a merger using voting stock of a corporation controlling the merged corporation, is not disqualified under I.R.C. ' 368(a)(1)(A) (a statutory merger or consolidation) because stock of the controlling corporation was used in the transaction if: (a) the surviving corporation (Atarget@) holds Asubstantially all@ of its properties and the properties of the merged corporation (Asub@) (other than the controlling corporation=s stock distributed in the transaction); (b) in the transaction, former shareholder=s of the target exchanged, for voting stock of the controlling corporation, stock in the target constituting control, i.e. 80 percent of combined voting power and 80 percent of the number of all classes of stock of the corporation. I.R.C. ' 368(c).

A reorganization under I.R.C. ' 368(a)(1)(A) is a transaction that constitutes a merger or consolidation under state law. Treas. Reg. ' 1.368-2(b)(1). ASubstantially all@ under I.R.C. ' 368(a)(2)(E) has the same meaning as in I.R.C. ' 368(a)(1)(C) (Treas. Reg. ' 1.368-2(j)(3)(iii)), except that it is applied separately to the merged corporation and the surviving corporation. In order to qualify as a reorganization under I.R.C. ' 368(a)(1)(C), a corporation must either acquire substantially all the properties of another corporation solely for its own stock or the stock of a corporation in control of the acquiring corporation.

ASubstantially all@ is not defined in the Code or Regulations. The underlying purpose of the ASubstantially all@ test is to deny I.R.C. ' 368(a)(2)(E) treatment to divisive reorganizations and to insure that they are tested under I.R.C. ' 368(a)(2)(D). A divisive reorganization, such as a spin off, must not be in the nature of a dividend to qualify for tax free treatment. Rev Rul. 88-48, 1988-1 C.B. 117.

The Service has ruled, in Rev. Rul. 57-518, 1957-2 C.B. 253, that where the target corporation transferred 70 percent of its overall assets in a C reorganization, including all of its fixed and other business assets and 97 percent of its inventory, retaining cash, receivables, and three percent of its inventory to pay liabilities, it met the Asubstantially all@ test. The Service has disapproved of a transfer of 75 percent of overall assets when the 25 percent not transferred were operating assets. The ruling notes that, in addition to the percentages of property transferred, the nature of the assets retained and the purpose for their retention must be considered. Where assets were retained to make distributions to shareholders, case law has held that acquisitions of 68 percent and 81 percent of gross assets have been insufficient. *Pillar Rock Packing Co. v. Commissioner*, 90 F.2d 949 (6th Cir.).

For private letter ruling purposes, Rev. Proc. 86-42, 1986-2 C.B. 722, 724 amplifying Rev. Proc. 77-37, 1977-2 C.B. 568, holds that the transfer of 70 percent of the fair market value of gross assets and 90 percent of the fair market value of net assets will be deemed ASubstantially all@. For purposes of Rev. Proc. 86-42, Alinked@ threshold distributions will be considered as assets of the target corporation. *Superior Coach v. Commissioner*, 80 T.C. 895 (1983).

Rev. Proc. 77-37, 1977-2 C.B. 568, states that all redemptions and distributions (except for normal dividends) made immediately before the merger and transfer of assets, and that are part of the plan of reorganization, are to be considered as assets held by the transferor immediately before the transfer. *Wilson v. Commissioner*, 46 T.C. 334 (1966).

Whether a distribution is part of a I.R.C. ' 368(a)(2)(E) merger depends on step transaction principles. *Helvering v. Elkhorn Coal Co.,* 95 F.2d 732 (4th Cir. 1937). A distribution will be linked with a subsequent merger if it is an integral part of the transaction.

Some of the factors considered in determining whether there is a step transaction are proximity in time between the steps, whether the steps are part of an integrated transaction, whether there is a binding commitment and whether the step is contemplated by the parties. *Helvering v. Elkhorn Coal Co.,* 95 F.2d 732 (4th Cir. 1937).

Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction. The tests applied are the Aend result@ test, the Amutual interdependence@ test, and the Abinding commitment@ test. *Penrod v. Commissioner,* 88 T.C. 1415 (1987).

I.R.C. ' 368(a)(2)(E) requires that the surviving subsidiary corporation both acquire and hold Asubstantially all@ of the assets of both the target and subsidiary, rather than merely acquire them, as I.R.C. ' 368(a)(1)(C) requires. Therefore, assets distributed after the merger, and which are part of the plan of reorganization, will reduce the amount of target assets held by target after the merger for purposes of I.R.C. ' 368(a)(2)(E).

Further, in applying the Asubstantially all@ test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of a plan of reorganization are not taken into account. Thus, for example, money transferred from the controlling corporation, to the merged corporation to be used for the following purposes is not taken into account for purposes of the Asubstantially all@ test: (a) to pay additional consideration to the shareholders of the surviving corporation; (b) to pay dissenting shareholders of the surviving corporation; (c) to pay creditors of the surviving corporation; (d) to pay reorganization expenses of the surviving corporation. Treas. Reg. ' 1.368-2(j)(3)(iii).

ANALYSIS

Substantially All The Assets Held-Issue 1

The issue here is whether the acquisition of C by X will fail to qualify as a tax free reorganization under I.R.C. ' 368(a)(2)(E) because substantially all the assets of C were not held by C after it survived its merger with Newco.

Valuation

We must first determine the value of C in order to determine whether C held Asubstantially all@ of its assets after the merger. The initial valuation of C can be set within a range, the low range being set at $21x (this amount was determined by an outside consulting group) and the upper range being the $11x consideration paid by X for C.

<u>Amount of Assets Held</u>

The second determination is the amount of C assets actually held by C after its Merger with Newco. This amount will depend upon whether the distributions to the C shareholders and the post merger acquisitions by Name 1 are to be considered in determining whether C held Asubstantially all@ of its assets after its merger with Newco.

Prior to the merger, in Date 8, Name 1 received a distribution from C in the amount of $16x. This distribution took place while the merger was being negotiated with X. Name 1 then loaned $15x back to C and received a note in exchange. Pursuant to the merger agreement, the note was exchanged for #i shares of preferred stock. In essence, Name 1 received $20x and a $15x note. Therefore, C=s assets were reduced by $16x.

Rev. Proc. 77-37, 1977-2 C.B. 568, states that all redemptions and distributions (except for normal dividends) made immediately before the merger are to be considered as assets held by the transferor immediately before the transfer.

Whether a distribution is part of I.R.C. ' 368(a)(2)(E) merger depends on step-transaction principles. A distribution will be linked with a subsequent merger if it is considered an integral part of the transaction. Some of the factors considered in determining whether there is a step transaction are proximity in time and whether the steps are part of an integrated transaction. *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4^{th} Cir. 1937).

In the instant case, it could be argued that C=s $16x distribution to Name 1, consisting of $20x in cash and a $15x note, should be considered as part of the merger transaction between Newco and C, and therefore, the $16x distribution to Name 1 should be included in the determination of whether C held Asubstantially all@ of its assets after the merger with Newco.

The Aend result@ test could be applied to step C=s $16x distribution to Name 1 with Newco=s merger with C. Under this test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result. *Penrod v. Commissioner*, 88 T.C. 1415, (1987).

In the instant case the $16x distribution took place while the merger was being negotiated with X. This distribution took place within #q months of C=s merger with Newco. Because of the short period of time between the distribution and the merger, it could be argued that the distribution was an integral part of the C and Newco merger transaction. It also could be argued that this distribution and the C and Newco merger were really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result of allowing X to acquire C in a reorganization.

#u months after the merger, X redeemed #p shares of the F preferred for $17x. From the proceeds of the redemption, Name 1 used $18x as a down payment on Date 9, to purchase C=s former b division. The total purchase price of the division was $19x. C took a #u year note from Name 1, renewable for a #r.

In the instant case it could be argued that Name 1=s purchase of C=s b division can be stepped with the merger between C and Newco, and therefore the $19x sales price of the b division should be included in the determination of whether C held Asubstantially all@ of its assets after its merger with Newco.

The Aend result@ test could be applied to step C=s $19x sale of its b division to Name 1 with Newco=s merger with C. Under this test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result.

In the instant case, C=s $19x sale of its b division took place #u months after the merger of Newco and C. Because of the short period of time between the merger and the sale, it could be argued that the distribution was an integral part of the C and Newco merger transaction.

It also could be argued that the b sale and the Newco and C merger were really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result of allowing X to acquire C in a tax-free reorganization.

Therefore, there is an argument that the sale of the b division to Name 1, and the distribution of $16x to the C shareholders should be considered as part of the plan for reorganization under the step transaction doctrine.

<u>The meaning of ›Substantially All=</u>

ASubstantially all@ under I.R.C. ' 368(a)(2)(E) has the same meaning as in I.R.C. ' 368(a)(1)(C) (Treas. Reg. ' 1.368-2(j)(3)(iii)) except that it is applied separately to the merged corporation and the surviving corporation. In order to qualify as a reorganization under ' I.R.C. 368(a)(1)(C), a corporation must either acquire substantially all the properties of another corporation solely for its own stock or the stock of a corporation in control of the acquiring corporation.

The Service has ruled in Rev. Rul. 57-518, 1957-2 C.B. 253, that where the target transferred 70 percent of its overall assets in a C reorganization, including all of its fixed assets, it met the Asubstantially@ all test. The ruling notes that, in addition to the percentages of property transferred, the nature of the assets retained and the purpose for their retention must be considered.

For private ruling purposes, Rev. Proc. 86-42, 1986-2 C.B. 722, amplifying Rev. Proc. 77-37, 1977-2 C.B. 568, holds that the transfer of 70 percent of the fair market value of gross assets and 90 percent of the fair market value of the net assets will be deemed Asubstantially all@.

ASubstantially all@ under I.R.C. ' 368(a)(2)(E) has the same meaning as in I.R.C. ' 368(a)(1)(C) (Treas. Reg. ' 1.368-(j)(3)(iii)). Therefore, Rev. Proc. 86-42, 1986-2 C.B. 722, which holds that the transfer of 70 percent of the fair market value of gross assets and 90 percent of the fair market value of net assets will be deemed Asubstantially all@, can be applied to I.R.C. ' 368(a)(2)(E) transactions. In other words, the 70/90 Asubstantially all@ test can be applied to the C assets held by C immediately after its merger with Newco. In a similar manner, the 70 percent overall asset transfer test of Rev. Rul. 57-518 can be applied to I.R.C. ' 368(a)(2)(E) to determine Asubstantially all@.

The value of C is between $21x and its acquisition price of $11x. The value of C should equal the total possible assets of C, that C could hold after its merger with Newco.

If we assume that $11x are the total possible assets of C, that C could hold immediately after its merger with Newco, then it could be argued, X=s acquisition of C will fail to qualify as a reorganization under I.R.C. 368(a)(2)(E)(i) because C did not hold Asubstantially all@ its assets after it survived its merger with Newco. If the distribution of the $16x dollars by C to its shareholders, and the sale by C of its b division to Name 1 for $19x are included as part of the merger, then it could be argued that the total possible assets that C could hold after the merger with Newco is reduced by $22x. Based on this argument, C held only #s percent of its assets after its merger with Newco. Therefore, even under the most liberal standard of Rev. Rul. 57-518, 1957-2 C.B. 253, the Asubstantially all@ test will not be satisfied.

Continuity of Business enterprise-Issue 2

In addition to meeting statutory requirements, tax-free reorganizations must meet the Acontinuity of business enterprise@ test. This test is satisfied if target=s Ahistoric business@ continues or uses a significant portion of its historic assets in the business. Treas. Reg. ' 1.368-1(d). We agree that since C continued to engage in the a business after its merger with Newco, it has probably met the Acontinuity of business enterprise@ test.

Continuity of interest test- Issue 3

In addition to meeting statutory requirements, tax-free reorganizations must meet the Acontinuity of interest@ test. This test is satisfied if the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and that such retained interest represents a substantial part of the value of the property transferred. *Southwest Natural Gas Co. vs. CIR*, 189 F2d 332 (5th Cir.).

In *Helvering v. Minnesota Tea Co*., 296 US 378 (1935), the court held that the equity mix received by the corporate equity transferor must be a substantial or material part of the value of the transferred assets, and that a 56 percent equity interest was adequate by this standard.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

As part of the merger consideration, Name 1 and the other employees of C (the employees who had exercised their options) received $10x pursuant to the merger agreement. Under the merger agreement, the shareholders of C were entitled to a note from C in the amount of #j percent of their net equity value of C after the exercise of the stock options by the company=s employees. The notes received by the shareholders were to be paid off by X immediately after the closing.

In your memo, you have stated that $10x net equity distribution received by the C shareholders from X should be considered as part of the plan for reorganization under the step transaction doctrine. You have stated that this amount should effect C=s Asubstantially all@ computation under I.R.C. ' 368(a)(2)(E)(i). However, it was X=s assets that were used to pay off the notes the C shareholders received from C. When X paid off the C notes, X=s assets were reduced. C=s assets were never reduced, therefore, C=s Asubstantially all@ computation under I.R.C. 368(a)(2)(E)(i) is not affected.

The stepping of the merger agreement and the actual merger have no effect on C=s Asubstantially all@ computation under I.R.C. ' 368(a)(2)(E)(i). Even though the merger agreement requires that C issue a note to its shareholders for the net equity distribution, the merger agreement requires X to pay off the note. In essence, the note should be disregarded, and X=s payment should be considered as part of the acquisition price for C.

In your memo, you have stated that the redemption of $17x in X preferred stock should be considered as a part of the plan for reorganization under the step transaction doctrine. You have stated that this redemption amount should effect C=s Asubstantially all@ computation under I.R.C. ' 368(a)(2)(E)(i). However, it was X=s assets that were used to redeem the preferred stock subsequent to the merger. When X redeemed the $17x in preferred stock from the C shareholders, X=s assets were reduced. C=s assets were not reduced by X=s redemption of the $17x in preferred stock, therefore, C=s Asubstantially all@ computation under I.R.C. 368(a)(2)(E)(i) is not affected.

If the merger and the post merger redemption of the X preferred stock are stepped together, there will be no effect on C=s Asubstantially all@ computation under I.R.C. 368(a)(2)(E).

However, there is a strong argument that C=s $16x distribution to Name 1, consisting of $20x cash and a $15x note, should be considered as part of the merger transaction between Newco and C, and therefore, the $16x distribution (which reduced C=s assets) should be included in the determination of whether C held Asubstantially all@ of its assets after the merger with Newco.

There is a strong argument that the Aend result@ test of the step transaction doctrine can be applied to step C=s $16x distribution to Name 1 with Newco=s merger with C. The Aend result@ test is based on the results that were actually intended or desired by the taxpayer. C=s $16x distribution took place while the merger was being negotiated with X. This distribution took place within #q months of C=s merger with Newco. Because of the short period of time between the distribution and the merger, it could be argued that the distribution was an integral part of the C and Newco merger transaction. It also could be argued that this distribution and the C and Newco merger were really prearranged parts of a single transaction <u>intended</u> from the beginning to arrive at the ultimate result of allowing X to acquire C in a reorganization.

The taxpayer may argue that the $16x distribution and the merger were really separate and distinct transactions, and were not prearranged parts of a single transaction intended from the beginning to arrive at the result of allowing X to acquire C in a tax free reorganization.

The taxpayer may also argue that the Aend result@ test requires a court to make a factual determination as to a party=s intent. The taxpayer may argue that these type of determinations promote uncertainty and therefore impede effective tax planning. However, we would argue that the Aend result@ test is flexible and bases tax consequences on the real substance of the transaction, not on the formalisms chosen by the participants.

[redacted].

[redacted].

In the instant case you argue that Name 1=s purchase of C=s b division can be stepped with the merger between C and Newco, and therefore the $19x sales price of the b division should be included in the determination of whether C held Asubstantially all@ of its assets after its merger with Newco.

However, it could be argued that the stepping of the sale of the b division to Name 1, and the merger of Newco and C will have no effect on the amount of C assets held by C after the merger. Since the sales proceeds of the b division were retained by C in the form of a note, there has not been a change in the amount of C=s assets, but only a change in their character (a note has been substituted for a b division). Rev. Rul. 88-48, 1988-1 C.B. 117, approved of this substituted asset theory when the transfer of the operating assets were transferred to an unrelated third party.

We could argue that C=s sale of its b division to Name 1 was really a distribution by C to Name 1. We could argue that the note received by C in exchange for the C b division was a renewable note and not likely to be paid by Name 1, and thus, the amount of C assets held by C after the merger with Newco will be decreased.

However, further factual development will be needed to determine [redacted].

The argument that the sale of C=s b division to Name 1 in exchange for a note does not affect the amount of assets held by C after the merger is a strong one. This argument could be overcome by arguing that C=s sale of the b division to Name 1 is really a distribution from C to Name 1 of the b division. (This argument is subject to further factual development.)

Even if can be shown that C distributed the b division to Name 1, the taxpayer may argue that the sale of the b division from C to Name 1 and the merger of Newco and C should not be stepped. The taxpayer may argue that the transactions were separate and not integrated transactions, and therefore the transactions should not be stepped. This appears to be a weak argument, because the sale took place within #u months of the merger, and proximity in time is a factor in determining whether the step transaction doctrine should be applied.

The value of C is an important factor in determining whether X=s acquisition of C Corporation will fail to qualify as a tax free acquisition under I.R.C. ' 368(a)(2)(E).

In order for X=s acquisition of C to fail to qualify as tax free reorganization under I.R.C. ' 368(a)(2)(E), C=s value (total possible assets that C could hold after its merger with Newco) will probably have to be lower than the $11x acquisition price. C=s value will probably have to be lower because of the severe litigating hazards in arguing that the stepping of C=s sale of the b division to Name 1 and Newco=s merger with C will affect the amount of C=s assets held by C after the merger.

If we are not able to include the $19x sale by C of its b division as part of the merger, then the total possible assets that C could hold after its merger with Newco is reduced by only the $16x distribution by C to its shareholders. In order to fail the Asubstantially all@ test under I.R.C. ' 368(a)(2)(E), C=s total possible assets that it could hold after its merger with Newco, should be approximately $21x or lower. (assuming Rev. Rul. 57-18 is used as a determination of Asubstantially all@)

In your memorandum you have stated that X=s acquisition of C fails to qualify as a tax free reorganization under the Acontinuity of interest test@. This test is satisfied if the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and that such retained interest represents a substantial part of the value of the property transferred.

In the instant case, the equity interest received by C shareholders was over 80 percent of the total consideration transferred by C in the merger. Therefore, X=s acquisition of C will not fail to qualify as a tax free reorganization under Athe continuity of interest test@.

If you have any further questions, please call 202 622-7930

Deborah Butler
Assistant Chief Counsel
(Field Service)

By: ______________________________
ARTURO ESTRADA
Branch Chief
Field Service Corporate

cc: Assistant Regional Counsel
Assistant Regional Counsel