Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception for reorganization exchanges.

Forward triangular merger. A controlling corporation's transfer of the acquiring corporation's stock to another controlled subsidiary as part of the plan of reorganization, following the merger of the acquired corporation with and into the acquiring corporation, will not cause the transaction to fail to qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D) of the Code.

Rev. Rul. 2001–24

ISSUE

Whether a controlling corporation's transfer of the acquiring corporation's stock to another subsidiary controlled by the controlling corporation as part of the plan of reorganization, following the merger of the acquired corporation with and into the acquiring corporation, will cause the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D) of the Internal Revenue Code.

FACTS

Pursuant to a plan of reorganization, corporation X merges with and into corporation S, a newly organized wholly owned subsidiary of P, a corporation unrelated to X, in a transaction intended to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). S continues the historic business of X following the merger. Following the merger and as part of the plan of reorganization, P transfers the S stock to S1, a pre-existing, wholly owned subsidiary of P. Without regard to P's transfer of the S stock to S1, X's merger with and into S qualifies as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D).

LAW AND ANALYSIS

Section 368(a)(1)(A) provides that the term reorganization includes a statutory merger or consolidation. Pursuant to § 368(a)(2)(D), the acquisition by one corporation, in exchange for stock of a corporation (the "controlling corporation") that is in control (as defined in § 368(c)) of the acquiring corporation, of substantially all of the properties of another corporation (the "merged corporation") shall not disqualify a transaction under § 368(a)(1)(A) if -

(i) no stock of the acquiring corporation is used in the transaction, and

(ii) in the case of a transaction under § 368(a)(1)(A), such transaction would have qualified under § 368(a)(1)(A) had the merger been into the controlling corporation.

Section 368(b) provides that a party to a reorganization qualifying under §§ 368(a)(1)(A) and 368(a)(2)(D) includes the merged corporation, the acquiring corporation, and the controlling corporation.

Section 368(a)(2)(C) provides that a transaction otherwise qualifying under § 368(a)(1)(A), (1)(B), or (1)(C) is not disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled (as defined by § 368(c)) by the corporation acquiring such assets or stock.

Under § 1.368–2(f) of the Income Tax Regulations, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to a reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368–2(k). Section 1.368–2(k)(1) restates the general rule contained in § 368(a)(2)(C) but permits the assets or stock acquired in the reorganization to be successively transferred to one or more corporations controlled (as defined under § 368(c)) in each transfer by the transferor corporation without disqualifying the reorganization. Additionally, § 1.368–2(k)(2) provides that a transaction qualifying under §§ 368(a)(1)(A) and 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

To qualify as a reorganization under § 368(a), a transaction must satisfy the continuity of business enterprise requirement. Section 1.368–1(d)(1) requires that the issuing corporation, in this case P, must either continue the target corporation's historic business or use a significant portion of the target's historic business assets in a business in order for a reorganization to satisfy the continuity of business enterprise requirement. The underlying policy of this rule is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. Pursuant to § 1.368–1(d)(4), the issuing corporation (the controlling corporation in the case of a § 368(a)(2)(D) reorganization) is treated as holding all of the businesses and assets of all of the members of its qualified group. Section 1.368–1(d)(4)(ii) defines a qualified group as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of § 368(c) in at least one other corporation, and stock meeting the requirements of § 368(c) in each of the corporations (ex-

cept the issuing corporation) is owned directly by one of the other corporations. Therefore, the issuing corporation is treated as directly holding the businesses and assets of second-tier and lower-tier subsidiaries that are part of the qualified group.

In applying these requirements to the facts, the continuity of business enterprise requirement is satisfied. Because S and S1 are members of P's qualified group, P will be treated as directly holding the businesses and assets of S. Therefore, because S will continue X's historic business following the merger, the transaction will satisfy the continuity of business enterprise requirement of § 1.368–1(d).

The remaining issue is whether P's transfer of the S stock to S1 as part of the plan of reorganization causes P to fail to control S for purposes of § 368(a)(2)(D) and causes P to fail to be a party to the reorganization. Section 368(a)(2)(C) and § 1.368–2(k) do not specifically address P's transfer of the stock of S to S1 following an otherwise qualifying reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D), because assets and not stock were acquired in the reorganization. If the transaction were recast under the step transaction doctrine so that X's assets were viewed as being acquired by a second-tier subsidiary of P, the transaction would not qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D) because P would not control S. For the reasons set forth below, the transaction will not be recast under the step transaction doctrine.

The legislative history of § 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. *See* S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970). As discussed above, pursuant to § 1.368–2(k)(2), a controlling corporation in a merger that qualifies under §§ 368(a)(1)(A) and 368(a)(2)(E) may transfer the stock (or assets) of the surviving corporation to a controlled subsidiary without causing the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(E). The concept that forward and reverse triangular mergers should be treated similarly supports permitting P to transfer the S stock to S1 without causing the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D). This concept also is reflected in the continuity of business enterprise regulations under § 1.368–1(d), which do not distinguish between § 368(a)(2)(D) and § 368(a)(2)(E) reorganizations and do not differentiate between whether stock or assets are acquired.

Section 368(a)(2)(C) does not preclude this transaction from qualifying as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D) because of the stock transfer. By its terms, § 368(a)(2)(C) is a permissive rather than an exclusive or restrictive section. *See, e.g.*, § 1.368–2(k); Rev. Rul. 64–73, 1964–1 C.B. 142. Further, § 368(a)(2)(C) and § 1.368–2(k) similarly do not cause P to fail to be treated as a party to the reorganization. *See* Rev. Rul. 64–73.

Accordingly, for the reasons set forth above, P's transfer of the S stock to S1 as part of the plan of reorganization, following the merger of X with and into S, will not cause P to be treated as not in control of S for purposes of § 368(a)(2)(D). Additionally, P will be treated as a party to the reorganization.

HOLDING

A controlling corporation's transfer of the acquiring corporation's stock to a subsidiary controlled by the controlling corporation as part of the plan of reorganization, following the merger of the acquired corporation with and into the acquiring corporation, will not cause the transaction to fail to qualify as a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D).

DRAFTING INFORMATION

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26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

Reverse triangular merger. A reverse triangular merger qualifies as a tax-free reorganization under sections 368(a)(1)(A) and 368(a)(2)(E) of the Code, notwithstanding that immediately after the merger, and as part of a plan that includes the merger, the surviving corporation sells a portion of its assets to an unrelated party for cash that it retains.