



INTEGRATED ACQUISITIVE REORGANIZATIONS

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The authors analyze and applaud recent Revenue Ruling 2001-26 in which the IRS, embracing the *King Enterprises* and *Seagram* decisions, applies step-transaction principles to treat as an integrated reorganization a front-end tender offer exchange of T stock solely for P voting stock and a follow-up S-into-T merger for P voting stock and cash.

Pointing out that the ruling's transaction presented (1) adequate continuity of interest (COI) and (2) no possibility of a first-step qualified stock purchase (QSP) — even if P in the tender offer had achieved 80 percent ownership of T's stock, that acquisition, viewed separately, would have qualified as a "B" reorganization and not a section 338 "purchase" — the authors extend the IRS's Rev. Rul. 2001-26 analysis in a series of 15 examples in which COI requirements are met: first to a variety of transactions in which a front-end QSP is not implicated, then to transactions the first step in which, if viewed independently, would constitute a QSP, and finally to such transactions where the parties seek to file a section 338 or section 338(h)(10) election for T.

Where the integrated acquisition involves a first step that, viewed in isolation, would constitute a QSP — a modern-day version of *King Enterprises* — the authors' analysis focuses on the unexplored territory between Rev. Rul. 2001-26, applying (when COI is met) step-transaction principles in the absence of a front-end QSP, and Rev. Rul. 90-95, disavowing (when COI is not met) step-transaction integration following a front-end QSP. The authors conclude that where a first-step QSP is present and the parties jointly make a section 338(h)(10) election, their joint expression of purchase intent should privilege Rev. Rul. 90-95 over Rev. Rul. 2001-26, but absent such a joint election step-transaction reorganization treatment should prevail.

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In this article, P is the purchasing or acquiring corporation, T is the target or acquired corporation, and S is a wholly owned P corporate subsidiary.

In Rev. Rul. 2001-26,¹ the IRS (building on case law²) stepped together (1) P's acquisition of 51 percent of T's stock by tender offer in exchange solely for P voting stock and (2) P's preplanned acquisition of the remaining 49 percent of T's stock, by an S-into-T squeeze-out merger, in exchange for two-thirds P voting stock and one-third cash (so that more than 80 percent of all the consideration to T's shareholders was P voting stock and less than 20 percent was cash). The IRS held that the integrated acquisitive transaction satisfied section 368(a)(2)(E)'s reverse subsidiary merger 80-percent-control-for-voting-stock requirement.

Constrained to its particular facts, the ruling is welcome but unremarkable. Concentrating on its analysis and the authority on which it relies, however, Rev. Rul. 2001-26 promises — although standing alone does not in all respects deliver — extensive transactional efficiency.

Rev. Rul. 2001-26, we think it clear, confirms that the IRS will apply step transaction principles to find a section 368(a) reorganization where (1) there is a factual basis to integrate (e.g., the first-step tender and

¹2001-23 I.R.B. 1297 (6/4/01), Doc 2001-13580 (6 original pages), 2001 TNT 93-36.

²See *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969), and *Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995), Doc 95-1229 (47 pages), 95 TNT 16-11, both cited in Rev. Rul. 2001-26.

follow-up merger are announced as a package), (2) the integrated transaction satisfies shareholder continuity of interest (COI) (i.e., total consideration includes at least 40 percent P stock) and preserves continuity of business enterprise (COBE) with respect to T, (3) the transaction, if integrated, satisfies the technical requirements of a section 368(a) reorganization (e.g., the final step is T's merger with S or P), including "substantially all" for a forward or reverse subsidiary merger or a "C" reorganization (but not a two-party merger) and voting-stock-for-80-percent-control for a reverse subsidiary merger, and (4) the initial transaction step (or steps), if viewed in isolation, would not constitute a qualified stock purchase (QSP).

More broadly, the promise of Rev. Rul. 2001-26 — fulfillment awaits the further IRS pronouncement we hope and indeed expect to see before too long — is that when the first three requirements, above, are met — (1) factual basis to integrate, (2) COI and COBE, and (3) technical section 368(a) reorganization definition satisfied — an integrated reorganization will be found whether or not the threshold step, viewed in isolation, would have been a QSP with respect to which no sections 338 or 338(h)(10) election is made. (We speculate in Part III on the outcome where a section 338 or 338(h)(10) election is filed.)

Concentrating on its analysis and the authority on which it relies, Rev. Rul. 2001-26 promises — although standing alone does not in all respects deliver — extensive transactional efficiency.

Transaction integration, however, is not a one-way street that inexorably travels in the direction of reorganization qualification and tax-free treatment for exchanging T shareholders. As we remind below, there is a subset of cases in which, despite adequate COI and COBE and initial compliance with section 368(a) technicalities, application of step transaction principles may convert, e.g., a good "B" reorganization or reverse subsidiary merger into a failed "C" reorganization. See Rev. Rul. 67-274, 1967-2 C.B. 141.

While our examples below speak of a first-step tender offer for T stock (as does Rev. Rul. 2001-26), the result is the same where the first step is a negotiated purchase of T stock not constituting a tender offer.

The integrated acquisitions we examine in this article have in the main a common first step: P (or S) first acquires T stock and thereafter, as part of P's integrated plan, acquires either T's assets or the balance of T's stock. At appropriate points, however, we intersperse and contrast integrated arrangements in which the acquisition of T's assets, rather than T's stock, is the first step.

Initially, we focus on the specific facts and holding of Rev. Rul. 2001-26 and then survey the slope on which the IRS has embarked but which it has not skied to the bottom quite yet.

I. No First-Step QSP

The transactions we consider in Part I have in common (1) the absence of a first-step QSP, (2) the presence of adequate COI and COBE, and (3) compliance with a technical section 368(a) reorganization definition. (In Parts II and III we review transactions in which the first step, viewed in isolation, would be a QSP.)

Example 1: Tender Offer Exchange Solely for P Voting Stock Plus S-Into-T Reverse Subsidiary Merger for P Voting Stock and Cash

In a tender offer P, solely for voting stock, acquires 51 percent of T's one class of stock. As announced in the tender, P's newly organized subsidiary S promptly thereafter reverse merges into T. In the merger P's S stock is converted into T stock and the 49 percent of T's stock previously unacquired is exchanged for two-thirds P voting stock and one-third cash. As a result, in the integrated transaction P acquires all of T's stock for consideration comprised of 16.33 percent cash (49 percent \times $\frac{1}{3}$) and 83.67 percent P voting stock.

Example 1 presents the precise facts the IRS addressed in Rev. Rul. 2001-26 in which "general principles of tax law, including the step transaction doctrine," were applied to treat the transaction as an integrated acquisition by P of all of T's stock qualifying as a section 368(a)(2)(E) reversed subsidiary merger reorganization (which requires that P voting stock be issued for T stock constituting 80 percent control of T).³ As a result, all of T's shareholders exchanging T stock for P stock in the integrated transaction do so "in pursuance of the plan of reorganization" and are governed by section 354 (where only P stock is received) or section 356 (where P stock and cash are received).

Example 1 presents a plain vanilla case because (1) the S-into-T merger — the example's concluding second step — is the *sine qua non* of section 368(a)(2)(E) and (2) the transaction assures COI and offers no possibility of a QSP since solely P voting stock is delivered in the first-step tender offer exchange for 51 percent of T's stock.⁴

Example 2: Tender Offer Exchange Solely for P Stock Plus T-Into-S Forward Subsidiary Merger for P Stock and Cash

Same as Example 1, except that (1) after the tender offer exchange T forward merges into S for two-thirds P stock and one-third cash, and (2) it does not matter whether the P stock issued in the tender offer and merger is voting or not.

³Rev. Rul. 2001-26 also upholds section 368(a)(2)(E) reverse subsidiary merger treatment where S (rather than P) effectuates the first-step tender offer for 51 percent of T's stock in exchange for P voting stock.

⁴Even if P in Example 1's first-step tender offer acquires 80 percent of T's stock, that acquisition standing alone would not be a QSP because the first-step tender offer independently qualifies as a "B" reorganization (80 percent of T's stock acquired solely for P voting stock) and hence would not be a "purchase." See section 338(h)(3)(A).

Without doubt, the IRS will apply Rev. Rul. 2001-26's "general principles" to treat Example 2 as an integrated acquisition by S of T's assets qualifying as a section 368(a)(2)(D) forward subsidiary merger (which requires that a continuity amount of P stock — whether or not voting — be issued for T stock).⁵ See *Seagram Corp. v. Commissioner*⁶ (S by tender acquired 94 percent of T's stock for P stock and cash, following which T forward merged into S for P stock, held an integrated section 368(a)(2)(D) forward subsidiary merger)⁷ and *King Enterprises, Inc. v. United States*⁸ (P acquired all of T's stock for a COI amount of P stock and cash, following which T merged upstream into P, held an integrated section 368(a)(1)(A) two-party merger). In Rev. Rul. 2001-26 the IRS cites both cases and relies heavily on the *King Enterprises* decision.

Example 3: Tender Offer Exchange Solely for P Stock Plus T-Into-P Upstream Merger for P Stock and Cash

Same as Example 2, except that after the tender offer exchange T merges upstream into P for two-thirds P stock and one-third cash.

Explicitly embraced by Rev. Rul. 2001-26, *King Enterprises* mandates section 368(a)(1)(A) two-party merger qualification (which requires that a continuity amount of P stock — whether or not voting — be issued for T stock) and the application to former T shareholders of section 354 (T shareholders receiving solely P stock) and section 356 (T shareholders receiving both P stock and cash).⁹

Example 4: Tender Offer Exchange Solely for P Voting Stock Plus T-Into-P Upstream Nonmerger Transfer Solely for P Voting Stock

Same as Example 3, except that (1) after the tender offer exchange (when P is T's 51 percent shareholder) T transfers its business, assets, and liabilities upstream (by deed and not by merger) to P solely in exchange for P stock worth in the aggregate 49 percent of T's FV, (2) T promptly liquidates, distributing the P stock received in exchange for its assets to the 49 percent of T's shareholders who had not delivered their T shares to P in the first-step tender, and (3) all of the P stock issued in both the tender offer and asset transfer is voting.

⁵The result would be the same if in the integrated transaction's first step S (rather than P) tenders for T stock, delivering P stock in exchange, following which T forward merges into S.

⁶104 T.C. 75 (1995).

⁷The *Seagram* transaction was carried out prior to the 1982 enactment of section 338 and its QSP concept, hence the decision is not precedent with respect to two-step acquisitions in which a first-step QSP is in the picture.

⁸418 F.2d 511 (Ct. Cl. 1969). The transaction in *King Enterprises*, like the *Seagram* transaction, was carried out prior to the 1982 enactment of section 338.

⁹For those T shareholders who receive only cash, exchange treatment is directed by sections 302(b)(3) or 1001, depending on whether the cash comes from T (section 302 redemption) or from P (section 1001 sale).

We are confident the IRS will apply Rev. Rul. 2001-26's "general principles" to treat Example 4 as an integrated acquisition by P of T's assets qualifying as a section 368(a)(1)(C) reorganization (which requires that P deliver solely voting stock for substantially all of T's assets). See also Rev. Rul. 67-274, 1967-2 C.B. 141. Under section 354 all of T's shareholders exchanging T stock solely for P voting stock in the integrated transaction, whether in the threshold tender or in T's subsequent asset transfer and liquidation, recognize neither gain nor loss.

Were the IRS, contrary to our view of Rev. Rul. 2001-26, not to treat the two steps as part of an integrated "C" reorganization, the second-step transfer of T's assets to P for P voting stock standing alone would qualify as a "C" reorganization, see reg. section 1.368-2(d)(4), but T's shareholders who exchanged T stock for P voting stock in the threshold tender would not receive section 354 nonrecognition treatment on that exchange.

Example 5: Less-Than-80-Percent Tender Offer Exchange for P Voting Stock and Cash Plus S-Into-T Reverse Subsidiary Merger for P Voting Stock and Cash

Same as Example 1, except that in the tender offer P acquires 51 percent of T's stock for 50 percent P voting stock and 1 percent cash (rather than all P voting stock). As a result, in the integrated transaction P acquires all of T's stock for consideration comprised of 17.33 percent cash (16.33 percent plus 1 percent) and 82.67 percent P voting stock.

Integrated under Rev. Rul. 2001-26, the transaction meets the requirements for a section 368(a)(2)(E) reverse subsidiary merger. A T shareholder receiving solely P stock is awarded section 354 nonrecognition treatment, while a T shareholder receiving P stock plus boot is awarded section 356 partial nonrecognition.

If 80 percent or more (rather than 51 percent) of T's shareholders tender in the first-step exchange for P stock and cash, the first step, viewed in isolation, would constitute a QSP (i.e., a broken "B"), and hence would raise the question — dealt with in Parts II and III — whether the first and second steps are integrated to eradicate the first-step QSP. Example 1 does not raise this issue because in Example 1's first-step tender offer P issues solely P voting stock (and no boot). Example 5's tender offer does not raise this issue because P acquires less than 80 percent of T in the tender offer for P stock and boot. Hence, the results in Examples 1 and 5 should not differ with respect to reorganization qualification.

Example 6: Less-Than-80-Percent Tender Offer Exchange for P Stock and Cash Plus T-Into-S Forward Subsidiary Merger for P Stock and Cash

In a first-step tender offer P acquires 51 percent of T's stock for 50 percent P stock and 50 percent cash. As announced in the tender, T promptly forward merges into P's newly organized subsidiary S. In the merger the 49 percent of T's stock previously unacquired is exchanged for 50 percent P stock and 50 percent cash. As a result, in

the integrated transaction S acquires T's assets for consideration comprised of 50 percent cash and 50 percent P stock.

Integrated under Rev. Rul. 2001-26, the transaction meets the requirements for a section 368(a)(2)(D) forward subsidiary merger.

If 80 percent or more of T's shareholders tender in the first step in exchange for P stock and cash, the first step, viewed in isolation, would constitute a QSP (i.e., a broken "B") and hence would raise the question — dealt with in Parts II and III — whether the first and second steps are integrated to eradicate the first-step QSP. However, in Example 6 less than 80 percent of T's shareholders tender. Hence, the results in Examples 2 and 6 should not differ with respect to reorganization qualification.

Example 7: S-Into-T Reverse Subsidiary Merger for P Voting Stock (Which Leaves Outstanding a Class of T Less-Than-20-Percent Voting Preferred Stock) Plus P's Acquisition of T's Voting Preferred Stock for P Nonvoting Stock

T has outstanding 900 voting common shares and 100 voting preferred shares, with each T share casting one vote in the election of directors. In an S-into-T reverse subsidiary merger, T's 900 voting common shares are exchanged for P voting common shares, T's 100 voting preferred shares remain outstanding, and S's shares (owned by P) are exchanged for newly issued T voting common shares. Promptly thereafter, pursuant to a preconceived plan, P acquires T's 100 voting preferred shares, issuing in exchange P nonvoting preferred shares.

The first-step merger, standing alone, is a good section 368(a)(2)(E) reverse subsidiary merger since P in the merger acquires section 368(c) 80 percent control of T in exchange for P voting stock. The second-step acquisition — T voting preferred stock exchanged for P nonvoting preferred stock — whether integrated or not does not affect reorganization qualification, but integration determines the tax treatment to T's exchanging preferred shareholders: Section 354 nonrecognition is available to them only if the exchange for P nonvoting preferred shares is part of the integrated section 368(a)(2)(E) reverse subsidiary merger, i.e., is "in pursuance of the plan of reorganization."

We believe Rev. Rul. 2001-26 applies to integrate Example 7's inverted transaction — a first-step merger followed by, rather than (as in Examples 1 through 6) preceded by, a voluntary stock exchange — and affords T's preferred stockholders section 354 nonrecognition treatment.

Example 8: Nonqualifying S-Into-T Reverse Subsidiary Merger Followed by T-Into-P Upstream Merger

As part of a plan (1) T redeems a 40 percent T shareholder, (2) S merges into T with all of T's remaining shareholders receiving P voting stock, and (3) T merges upstream into P.

The first-step reverse subsidiary merger of S into T, standing alone, does not qualify as a good section

368(a)(2)(E) reorganization because T's 40 percent redemption prevents T from holding substantially all of its assets. However, the reverse subsidiary merger does qualify as a good section 368(a)(1)(B) stock-for-stock reorganization (which imposes no "substantially all" requirement), but only if P issues solely P voting stock for T's stock (i.e., no boot and no P nonvoting stock).

Under Rev. Rul. 2001-26, however, the two mergers are not viewed in isolation but rather are treated as an integrated transaction, explicitly as an integrated section 368(a)(1)(A) two-party merger of T into P. Under Rev. Rul. 2001-26's principles, it does not matter whether the first step, if viewed in isolation, would be taxable or tax-free as long as the integrated transaction qualifies as a good reorganization.

We turn next to a case in which integrating the transaction may disqualify reorganization treatment.

Example 9: Nonqualifying S-Into-T Reverse Subsidiary Merger Followed by T-Into-P Upstream Nonmerger Liquidation

Same as Example 8, except that as step (3) T liquidates (rather than merges) upstream into P.

The first-step reverse subsidiary merger of S-into-T, standing alone, is a good "B" reorganization, but only if P issues solely P voting stock for T's stock (i.e., no boot and no P nonvoting stock). It has long been the IRS's position that if, as part of P's acquisition plan, T is liquidated, so that P acquires T's assets, reorganization qualification must be tested, not under section 368(a)(1)(B), but under section 368(a)(1)(C) (which imposes a "substantially all" requirement). See Rev. Rul. 67-274, 1967-2 C.B. 141.

Rev. Rul. 2001-26 directly addresses transaction integration creating a good reorganization, but the ruling's step-transaction approach, we fear, is no less applicable to transaction integration that destroys an otherwise good reorganization.

Because T's 40 percent redemption prevents T from meeting section 368(a)(1)(C)'s "substantially all" requirement, integrating the transaction to disregard P's transitory ownership of T's stock imposes taxable exchange treatment on T's shareholders although not, we believe, on T itself.¹⁰

Example 10: Nonqualifying T-Into-S Forward Subsidiary Merger Followed by S-Into-P Upstream Merger

As part of a plan (1) T redeems a 40 percent T shareholder, (2) T forward merges into S for P stock, and (3) S merges upstream into P.

T's merger into S, standing alone, does not qualify as a section 368(a)(2)(D) forward subsidiary merger because T's 40 percent redemption prevents S from acquiring "substantially all" of T's assets. Under Rev. Rul. 2001-26 the three steps should be viewed as an integrated transaction but such integration may not assure section 361 nonrecognition to T or section 354

¹⁰See M. Ginsburg and J. Levin, *Mergers, Acquisitions, and Buyouts* para. 702.7 for a discussion of these issues.

nonrecognition to former T shareholders receiving P stock.

If the integrated transaction is viewed as P's acquisition of T's slimmed-down net assets through T's merger into P, section 368(a)(1)(A) (which contains no "substantially all" requirement) assures two-party "A" reorganization nonrecognition. But in fact T does not merge into P — rather, T merges into S and then S merges into P, but T never merges into P. We nevertheless believe (1) the IRS ought to treat the integrated T-S-P transaction as a section 368(a)(1)(A) reorganization — perhaps on the ground that S is T's successor when S merges into P or on the alternate ground that once the T-into-S merger is stepped together with the S-into-P merger, the entire integrated transaction should be viewed as if T merged into P, and (2) the IRS should not disqualify the integrated transaction as a failed T-into-P "C" reorganization.

However, there is no assurance the IRS will and reason to fear the IRS will not.

II. First-Step QSP: No 338 or 338(h)(10) Election

The transactions considered in the balance of this article have in common the presence of both (1) a first step that, standing alone, is a QSP and (2) once the second step is integrated with the first step, COI adequate to support a reorganization. In the examples we review in this Part II, the parties do not attempt to file a section 338 or 338(h)(10) election with respect to T. In Part III we consider the possible impact of such a filing on an otherwise integrated transaction.

We think it likely that in drafting Rev. Rul. 2001-26, the IRS postulated a first-step tender offer solely for P voting stock to avoid any possibility that the integrated transaction's first step viewed alone might constitute a QSP. The issue thereby avoided in Rev. Rul. 2001-26, but addressed here, is how to reconcile (1) Rev. Rul. 2001-26's step-transaction integration directive and (2) the contrary Rev. Rul. 90-95¹¹ directive that a QSP of T's stock is accorded independent significance whether or not a section 338 election is made with respect to T. Explicitly, Rev. Rul. 90-95 announced that the step-transaction doctrine did not apply to integrate (1) P's QSP cash purchase of all T's stock and (2) a planned subsequent transfer of T's assets to P via a section 332 upstream T-into-P merger.

In Rev. Rul. 90-95 no acquisitive reorganization recharacterization was possible because COI was wholly absent: P delivered only cash to T's shareholders in exchange for T's stock.¹² When, however, P (or S) delivers sufficient P stock to T's shareholders to satisfy COI requirements (at least 40 percent of the total consideration is P stock) and the transaction viewed as a whole meets a section 368(a) technical reorganization

definition, we believe step-transaction principles properly apply to integrate the entire transaction and eliminate the threshold QSP. As the IRS stated in Rev. Rul. 2001-26, P's (or S's) "tender offer [acquisition of T stock followed by a] statutory merger . . . is treated as part of the statutory merger [or other form of business combination] for purposes of the reorganization provisions."

Example 11: More-Than-80-Percent Tender Offer Exchange for P Voting Stock and Cash Plus S-Into-T Reverse Subsidiary Merger for P Voting Stock and Cash

P acquires 95 percent of T's one class of stock in a tender offer, delivering in exchange 80 percent P voting stock and 20 percent cash. As announced in the tender, P's newly organized subsidiary S promptly reverse merges into T. In the merger P's S stock is converted into T stock while the 5 percent of T's stock previously unacquired is exchanged for 80 percent P voting stock and 20 percent cash. As a result, in the integrated transaction P acquires all of T's stock for consideration comprised of 20 percent cash and 80 percent P voting stock.

If, following the lead of Rev. Rul. 2001-26, step-transaction principles are applied, the transaction is an integrated acquisition by P of all of T's stock qualifying as a section 368(a)(2)(E) reverse subsidiary merger, and the tax consequences are the same as in Example 1. By treating the two steps as an integrated reorganization, the first step (P's acquisition of 95 percent of T's stock) is denied independent significance and hence status as a QSP. As a result, the facial conflict between Rev. Rul. 90-95 and Rev. Rul. 2001-26 is eliminated.

We believe this to be the right answer and look forward to a confirming revenue ruling or other authoritative IRS pronouncement.

Example 12: More-Than-80-Percent Tender Offer Exchange for P Stock and Cash Plus T-Into-S Forward Subsidiary Merger for P Stock or Cash

In a tender offer S (or P) acquires 95 percent of T's stock, delivering in exchange 50 percent P stock and 50 percent cash. As announced in the tender, T promptly forward merges into S. In the merger the 5 percent of T's stock previously unacquired is exchanged for either P stock or cash or both.

Essentially, Example 11 is *Seagram*¹³ in which the Tax Court integrated the steps and, finding adequate COI, held the entire transaction a section 368(a)(2)(D) forward subsidiary merger. The threshold tender offer exchange was denied independent significance and *Seagram*, a high-basis T shareholder under section 354, was denied loss recognition on exchange of its T stock for P stock.

The *Seagram* transaction arose before 1982 enactment of section 338 and its QSP concept. But the IRS in its Rev. Rul. 2001-26 discussion of step-transaction prin-

¹¹1990-2 C.B. 67.

¹²The threshold transaction in Rev. Rul. 90-95 was a reverse subsidiary cash merger of transitory S into T, but the tax conclusion is the same where the threshold transaction is P's purchase of T's stock. See Rev. Rul. 73-427, 1973-2 C.B. 301.

¹³*Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

ciples cited *Seagram's* transaction integration with manifest approval. We do not think the IRS did so to lay a grand trap for the wary. We are confident that Example 12's threshold tender will not be awarded independent QSP status and, as in *Seagram*, the entire transaction qualifies as a section 368(a)(2)(D) forward subsidiary merger in which T avoids gain recognition under section 361 with asset basis preserved under section 362, and T's shareholders fall within the sections 354/356 regime.

Example 13: More-Than-80-Percent Tender Offer Exchange for P Stock and Cash Plus T-Into-P Upstream Merger for P Stock or Cash

Same as Example 12, except that P (not S) tenders for T's stock and T then merges, not into S, but upstream into P.

Essentially, Example 13 is *King Enterprises*¹⁴ in which, because "the merger was the intended result of the stock acquisition,"¹⁵ the entire transaction was integrated and treated as a section 368(a)(1)(A) two-party merger. In Rev. Rul. 2001-26, the IRS relied strongly on "the principles of *King Enterprises*" to support its conclusion that "the tender offer exchange is treated as part of the statutory merger . . . for purposes of the reorganization provisions."

Like *Seagram*, *King Enterprises* arose prior to 1982 enactment of section 338 and its QSP concept. In our view, that cannot make a difference. It is not credible that the IRS would hereafter disavow *King Enterprises'* "principles" when faced with a case presenting *King Enterprises'* facts.

Example 14: 100-Percent Tender Offer Exchange for P Stock and Cash Followed by Merger

Same as Examples 11, 12, and 13, except that in each case (1) in the tender offer 100 percent of T's stock is acquired for cash plus a continuity amount of P stock, so that (2) in the follow-up merger no further consideration is delivered to any former T shareholder.

As modified in this Example 14, Example 13's T-into-P upstream merger now presents the exact facts of *King Enterprises*. We adhere to our Example 13 conclusion that the IRS, in light of its Rev. Rul. 2001-26 analysis, should and will find an integrated section 368(a)(1)(A) two-party merger that encompasses T's shareholders' exchange of T stock for P stock (section 354) or P stock and cash (section 356).

Nor do we see any principled distinction between modified Example 12 — tender for 100 percent of T's

stock followed by T-into-S merger — and the *King Enterprises* upstream merger with regard to the propriety of step-transaction integration.

Modified Example 11 — tender for 100 percent of T's stock followed by merger of transitory S into T with no P stock or cash delivered to any former T shareholder in the second-step merger (because all T shareholders participate in the first-step tender offer) — is in one respect distinguishable. In modified Examples 12 and 13, although T's shareholders were all taken out in the first-step tender offer, T's second-step merger into S (Example 12) or into P (Example 13) is "real" because T's assets are acquired. In modified Example 11, on the other hand, nothing happens — T's assets remain in T — and the sole intended effect of the S-into-T merger is to make a tax election — good reverse subsidiary merger rather than bad "B" — to place T's shareholders under the sections 354/356 reorganization regime. We do not, however, believe that distinction should make a difference. Whether the IRS will agree integrated reorganization characterization is the right answer in modified Example 11 remains to be seen, but we are very hopeful.

III. First-Step QSP: 338 or 338(h)(10) Election

P's filing of a section 338 election for T, or the joint filing of a section 338(h)(10) election by P and the seller (Bigco if T is part of Bigco's consolidated or affiliated group or, if T is an SCo, T's shareholders including any nonselling shareholders), in theory might impact on the foregoing "integration trumps QSP" analysis in at least three different ways, including:

- (1) **Not at all**, i.e., where the transaction integration principles discussed above cause the first-step QSP to be disregarded and mandate that the integrated transaction be treated as a reorganization, then reorganization treatment prevails and any attempted section 338 or 338(h)(10) election is a nullity.
- (2) **Completely**, i.e., where the first step viewed separately constitutes a QSP, and the parties whose consent is necessary to a section 338 or 338(h)(10) election choose to file such an election, transaction integration should be foreclosed, the first-step QSP accorded independent significance, and the election validated.
- (3) **Partly**, i.e., where the first step viewed separately constitutes a QSP, P's unilateral section 338 election could be treated as a nullity (as in (1) above), but a joint section 338(h)(10) election could be given effect (as in (2) above) to trump transaction integration on the ground that all parties to the transaction, by their joint election, have demonstrated that a sale and not a reorganization was intended from the outset.

We hope the IRS will quickly focus on the election issue here reviewed — there seems to us a clear need for prompt guidance — and will opt for the "Partly" solution in which a joint section 338(h)(10) election is given effect when the transaction's first step, if ac-

¹⁴*King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

¹⁵The quoted language is from Rev. Rul. 2001-26's description of *King Enterprises*.

corded independent significance, would constitute a QSP.¹⁶ The following Example 15 illustrates why.

Example 15: P Acquires T-SCo's Stock for P Stock and Cash (With Section 338(h)(10) Election), Followed by Upstream Merger

T-SCo's sole shareholder (A) sells all of T-SCo's stock to P for 50 percent P stock and 50 percent cash. Simultaneously A and P sign a section 338(h)(10) election with respect to T (which has now become a CCo by virtue of P's ownership of T stock). Promptly thereafter and pursuant to a preconceived plan P liquidates T via an upstream merger of T into P (rather than a state law dissolution).

A and P have bargained for a taxable transaction in which (1) T's asset basis is stepped up to reflect purchase price and (2) T's correlative asset gain is passed through and taxed to A. Absent the joint section 338(h)(10) election that is central to this bargain, however, Example 15 is modified Example 13 — Example 15 is a modern-day version of *King Enterprises* — and, unless the parties' joint section 338(h)(10) election overrides, P will not obtain the asset basis step-up it paid for and A will recognize 50-percent-boot-in-reorganization gain rather than 100-percent asset sale gain. Of course, P can protect itself by foregoing the efficiency of an upstream merger when T liquidates — in which case the integrated transaction would fail as a "C" reorganization — but sensible tax law and tax administration do not reside in rules that, to no revenue purpose, prefer inefficient corporate transactions to more efficient corporate transactions.

¹⁶We think the parties' joint election under section 338(h)(10) should always be given effect when a QSP is facially in the picture, for the reason illustrated in Example 15, but we do not see any reason to allow P, by unilaterally filing a section 338 election, to alter the reorganization-based tax results integrated transaction treatment otherwise affords T's shareholders. Thus, our preference for the "Partly" solution over the "Completely" solution with "Not at all" a distant last.