Recent Trends in Structuring Corporate Acquisitions

1. *Being Acquired? Be Careful!*

2. *Stock Option Cashouts*

3. *The Two-Step Merger*

4. *C Corp Target, S Corp Acquiror, QSub Election – Revenue Ruling 2008-25*

5. *Merger Stock Subject to Vesting Conditions – Revenue Ruling 2007-49, Situations 2 and 3*

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EAST BAY TAX CLUB
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I. Being Acquired? Be Careful!

A. The Silicon Valley Market for Engineering Talent.

1. Corporate acquisition with principal focus on acquiring workforce in place.
2. Favorable tax consequences for stockholders of target corporation.
3. Favorable GAAP consequences for acquiring corporation – even under "purchase" accounting.

B. Stripping the Target Corporation Prior to Closing.

1. Acquiror's desire to acquire a "clean slate."
2. Target's gain on distribution of assets.
   a. NOLs?
   b. Disposition prior to imposition of Section 382 limits.
   c. California NOL limits for 2011.
3. "Sub all" reorgs – reverse triangular, forward triangular and C.
4. Continuity of business enterprise.
   a. A reorg into acquiror's LLC sub.
   b. B reorg – stock for stock.
5. Transfer of vestigial intellectual property.

C. Structure for New Vesting Conditions on Shares of Acquiring Corporation.

1. Allocating forfeiture shares among all target stockholders.
2. Section 83(b) elections.

II. Stock Option Cashouts.

A. Acquiror Might Not Want To Assume Target's Outstanding Options.

1. Acquiror may want to shed target's option structure and issue new option packages to target employees that are consistent with acquiror's policies.

2. Standard option plan language often provides for accelerated vesting on acquisition if acquiror fails to assume.

B. Exercise Prior to Closing.

1. Optionees participate in merger consideration as stockholders.

    a. Tax results of option exercise:

        i. ISO – AMT income equal to excess of stock FMV over exercise price. Disqualifying disposition issues in taxable acquisitions. Note that boot in a reorg would be short-term capital gain, not ordinary income.

        ii. NQO – compensation income equal to excess of stock FMV over exercise price. Withholding and employment tax issues.

    b. Need to pay exercise price – beware of ISO "modification" resulting from new and more generous payment terms.

2. No installment reporting of option spread income – problems withholdbacks and earnouts.

C. Cashout in Lieu of Exercise.

1. Requires consent from each affected optionee.

2. Ordinary compensation income, subject to withholding if optionee is employee.

3. Timing benefit – tax applies only upon payment (unless funds are set aside in trust or escrow protected from corporate creditors).

4. Payment schedule should comply with 409A – need precise payout schedule.

5. Cashout will only work with "409A exempt" options – not with "409Acompliant" options.

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III. The Two-Step Merger.

A. The Problem – Direct Merger or Forward Triangular Merger with Compliance Issues.

1. Reorg under IRC Section 368(a)(2)(D) must satisfy (i) sub all requirement, (ii) continuity of interest test and (iii) continuity of business enterprise test.

2. A “direct” merger under IRC Section 368(a)(1)(A) must satisfy (i) continuity of interest test and (ii) continuity of business enterprise test.

3. A “busted” forward triangular merger or direct merger is treated as a taxable sale of corporate assets – subject to corporate-level tax and stockholder-level tax.

B. The Solution – A Two-Step Merger That Will Be Treated as a Taxable Stock Sale if the Integrated Mergers Fail To Qualify as a Reorg.

1. Ginsburg & Levin at Paragraph 802.8. Inapplicability of step transaction doctrine to taxable stock acquisitions – the legacy of Section 338 and the 1982 legislative reversal of the Kimbell-Diamond doctrine.

2. First step – acquiror’s merger sub 1 merges into target in a reverse triangular merger.

3. Second step – target, now a sub of acquiror, merges into either (i) a second corporate sub of acquiror or (ii) an LLC wholly-owned by acquiror. Result will be either a forward triangular merger (if merger sub 2 is a corporate entity) or a direct A reorg (if merger sub 2 is a wholly-owned LLC).

4. Merger documents will recite that the parties intend that the two steps are part of a single, integrated transaction.

5. If the overall integrated transaction qualifies as a reorg, the normal nonrecognition rules associated with reorgs will apply. If the overall integrated transaction fails to qualify as a reorg, the holdings of Revenue Ruling 90-95 (copy attached as Attachment A) and Revenue Ruling 2008-25 (copy attached as Attachment B) appear to block the application of the step transaction doctrine – and the initial reverse triangular merger will stand on its own as a taxable stock acquisition (with a stockholder-level tax and no corporate-level tax).

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IV. C Corp Target, S Corp Acquiror, QSub Election – Revenue Ruling 2008-25.

A. S Corporation Acquiror Seeks To Add C Corporation Target to QSub Group.

1. Rules of Section 368 apply to both S corporations and C corporations.

2. QSub election effective as of date of closing.

B. Deemed Liquidation of Target as a Result of QSub Election.

1. QSub becomes a disregarded entity.

2. All assets and operations treated as owned by parent S corporation.

C. Revenue Ruling 2008-25 – No A Reorg, But Possible C Reorg.

1. Revenue Ruling 2008-25 (copy attached as Attachment B) -- assets of target do not transfer to acquiror as a result of merger – so no A reorg.

2. Integrated transaction can qualify as a C reorg, if (i) sub all requirement is satisfied and (ii) the acquiror provided sufficient voting stock as consideration to stockholders of target corporation.

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V. Merger Stock Subject to Vesting Conditions – Revenue Ruling 2007-49, Situations 2 and 3.

A. Situation 1 – Re-Vesting.

1. Good news – if stock was previously owned and fully vested, subjecting stock to new vesting conditions will not trigger application of Section 83 – no “transfer” of property.

2. Common situation where founders are required to accept vesting conditions in order to obtain new VC or institutional equity investment.

B. Situations 2 and 3 – Unvested Stock Received in Taxable Acquisition or Reorg in Exchange for Fully Vested Shares.

1. In either a taxable acquisition or a tax-deferred reorg, issuance of stock subject to a service-related vesting condition is treated as a Section 83 transfer.

2. Recipients should file a Section 83(b) election within 30 days of closing.

3. Ruling seems not to allow for an argument that such stock is not issued “in connection with the performance of services.”

4. In taxable deal, capital gain treatment permitted for taxable exchange of shares, but future appreciation could be treated as ordinary income in the absence of a Section 83(b) election.

5. In a reorg, nonrecognition treatment permitted for the reorg exchange of shares, but future appreciation could be treated as ordinary income in the absence of a Section 83(b) election.

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ATTACHMENT A

Revenue Ruling 90-95, 1990-2 C.B. 67

Initial ***taxable*** reverse triangular merger ***is not*** integrated with follow-up liquidation of target corporation – protect the exclusivity of the Section 338 election.

Source: IRS Documents > Revenue Rulings > 1990 > REV. RUL. 90-95, 1990-2 C.B. 67

REV. RUL. 90-95, 1990-2 C.B. 67

Distinguished by Rev. Rul. 2001-46

ISSUES

(1) If a corporation organizes a subsidiary solely for the purpose of acquiring the stock of a target corporation in a reverse subsidiary cash merger, is the corporation treated on the occurrence of a merger as having acquired the stock of the target in a qualified stock purchase under section 338 of the Internal Revenue Code?

(2) If the corporation makes a qualified stock purchase of the target stock and immediately liquidates the target as part of a plan to acquire the assets of the target, is the corporation treated as having made an asset acquisition pursuant to the Kimbell-Diamond doctrine or a section 338 qualified stock purchase followed by a liquidation of the target?

FACTS

Situation 1. P, a domestic corporation, formed a wholly owned domestic subsidiary corporation, S, for the sole purpose of acquiring all of the stock of an unrelated domestic target corporation, T, by means of a reverse subsidiary cash merger. Prior to the merger, S conducted no activities other than those required for the merger.

Pursuant to plan of merger, S merged into T with T surviving. The shareholders of T exchanged all of their T stock for cash from S. Part of the cash used to carry out the acquisition was received by S from P; the remaining cash was borrowed by S. Following the merger, P owned all of the outstanding T stock.

Situation 2. The facts are the same as in Situation 1, except that P planned to acquire T's assets through a prompt liquidation of T. State law prohibited P from owning the stock of T. Pursuant to the plan, T merged into P immediately following the merger of S into T. The merger of T into P satisfied the requirements for a tax-free liquidation under section 332 of the Code. The liquidation was not motivated by the evasion of avoidance of federal income tax.

LAW AND ANALYSIS

In Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as one transaction, namely, a purchase of the target's assets with the purchaser receiving a cost basis in the assets. Old section 334(b)(2) of the Code was added in 1954 to codify the principles of Kimbell- Diamond. See S. Rep. No. 1622, 83d Cong. 2d Sess. 257 (1954).

In 1982, Congress repealed old section 334(b)(2) of the Code and enacted section 338. Section 338 was “intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.” H.R. Conf. Rep. No. 760, 97th Cong, 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. Under section 338, in the case of any qualified stock purchase, rules are provided governing whether the transaction gives rise to purchase of target stock treatment or purchase of target asset treatment. Under these rules, stock purchase or asset purchase treatment generally results whether or not the target is liquidated, merged into another corporation, or otherwise disposed on by the purchasing corporation. See Section 1.338-4T(d) Question and Answer 1, temporary Income Tax Regulations.

A qualified stock purchase is generally the purchase by a corporation of at least 80 percent of a target's stock, by vote and value, within a 12-month period. Section 338(d)(3). The requirements for a qualified stock purchase may be satisfied through a combination of purchases of target stock by purchasing corporation and redemptions by the target. Section 1.338-4T(c)(4) of the temporary regulations.

Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a section 338 election. If the election is made or deemed made, asset purchase treatment results and section 338 of the Code generally treats all of the assets of the target as having been sold by the target at fair market value on the date of the qualified stock purchase and then repurchased by

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the target on the following day. The basis of the target's asset is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, the stock purchase treatment generally results. In such a case, the basis of the target's assets is not adjusted to reflect the stock purchase price and other relevant items.

Question and Answer 3 of section 1.338-4T(d) of the temporary regulations provides that the parent of the subsidiary corporation in a reverse subsidiary cash merger is considered to have made a qualified stock purchase of the target if the subsidiary's existence is properly disregarded under the step-transaction doctrine and the requirements of a qualified stock purchase are satisfied. A subsidiary used to acquire target stock in a reverse subsidiary cash merger is ordinarily disregarded for federal income tax purposes if it was formed solely for the purpose of acquiring the stock and did not conduct any activities other than those required for the merger. See Rev. Rul. 79-273, 1979-2 C.B. 125; Rev. Rul. 73-427, 1973-2 C.B. 301.

Section 269 of the Code generally provides that the Secretary may disallow certain tax benefits when evasion or avoidance of federal income tax is the principal purpose for the acquisition of a corporation or its assets. The section 269 disallowance may apply to a qualified stock purchase followed by a liquidation of the target pursuant to a plan of liquidation adopted not more than two years after the purchase of the principal purpose of the liquidation was the evasion or avoidance of federal income tax by securing tax benefits that the purchasing corporation would not otherwise enjoy. Section 269(b).

In Situations 1 and 2, the step-transaction doctrine is properly applied to disregard the existence of S for federal income tax purposes. S had no significance apart from P's acquisition of the T stock. S was formed for the sole purpose of enabling P to acquire the T stock, and S did not conduct any activities that were not related to that acquisition. Accordingly, the transaction is treated as a qualified stock purchase of T stock by P.

In Situation 2, the step-transaction doctrine does not apply to treat the stock acquisition and liquidation as an asset purchase. Section 338 of the Code replaced the Kimbell-Diamond doctrine and governs whether a corporation's acquisition of stock is treated as an asset purchase. Under section 338, asset purchase treatment turns on whether a section 338 election is made (or is deemed made) following a qualified stock purchase of target stock and not on whether the target's stock is acquired to obtain the assets through a prompt liquidation of the target. The acquiring corporation may receive stock purchase treatment or asset purchase treatment whether or not the target is subsequently liquidated. A qualified stock purchase of target stock is accorded independent significance from a subsequent liquidation of the target regardless of whether a section 338 election is made or deemed made. This treatment results even if the liquidation occurs to comply with state law. Accordingly, in Situation 2, the acquisition is treated as a qualified stock purchase by P and T stock followed by a tax-free liquidation of T into P.

HOLDINGS

(1) In Situations 1 and 2, P is treated as having acquired stock of T in a qualified stock purchase under section 338 of the Code.

(2) In Situation 2, P is treated as having acquired stock of T in a qualified stock purchase under section 338, followed by a liquidation of T into P, rather than having made an acquisition of assets pursuant to the Kimbell-Diamond doctrine.

DRAFTING INFORMATION

The principal author of this revenue Ruling is Robert M. Casey of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue Ruling contact Mr. Casey on (202) 566-3551 (not a toll-free call).

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ATTACHMENT B

Revenue Ruling 2008-25, 2008-21 IRB 986 (5/27/2008)

Initial ***tax-deferred*** reverse triangular merger ***is*** integrated with follow-up liquidation of target corporation – violates "sub all" requirement – but might be eligible for treatment as C reorg.

Source: IRS Documents > Revenue Rulings > 2008 > REV. RUL. 2008-25, 2008-21 I.R.B. 986 (5/27/2008)

REV. RUL. 2008-25, 2008-21 I.R.B. 986 (5/27/2008)

Section 368.—Definitions Relating to Corporate Reorganizations

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

(Also § 338; 1.338-3; 1.368-2).

Section 338. This ruling discusses an integrated transaction where stock of a target corporation is acquired in a taxable reverse subsidiary merger, followed by liquidation of target. The ruling addresses the proper treatment and application of the step transaction doctrine in light of the policies behind section 338 of the Code.

Rev. Rul. 2008-25

ISSUE

What is the proper Federal income tax treatment of the transaction described below?

FACTS

T is a corporation all of the stock of which is owned by individual A. T has 150x dollars worth of assets and 50x dollars of liabilities. P is a corporation that is unrelated to A and T. The value of P's assets, net of liabilities, is 410x dollars. P forms corporation X, a wholly owned subsidiary, for the sole purpose of acquiring all of the stock of T by causing X to merge into T in a statutory merger (the "Acquisition Merger"). In the Acquisition Merger, P acquires all of the stock of T, and A exchanges the T stock for 10x dollars in cash and P voting stock worth 90x dollars. Following the Acquisition Merger and as part of an integrated plan that included the Acquisition Merger, T completely liquidates into P (the "Liquidation"). In the Liquidation, T transfers all of its assets to P and P assumes all of T's liabilities. **The Liquidation is not accomplished through a statutory merger.** After the Liquidation, P continues to conduct the business previously conducted by T.

LAW

Section 368(a)(1)(A) of the Internal Revenue Code provides that the term "reorganization" means a statutory merger or consolidation. Section 368(a)(2)(E) provides that a transaction otherwise qualifying under § 368(a)(1)(A) shall not be disqualified by reason of the fact that stock of a corporation in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (ii)in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of the surviving corporation. Further, § 1.368-2(j)(3)(iii) of the Income Tax Regulations provides that "[i]n applying the 'substantially all' test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account."

Section 368(a)(1)(C) provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other shall be disregarded. Section 368(a)(2)(B) provides that if one corporation acquires substantially all of the properties of another corporation, the acquisition would qualify under § 368(a)(1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and the acquiring corporation acquires, solely for voting stock described in § 368(a)(1)(C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to § 368(a)(2)(A)) be treated as qualifying under § 368(a)(1)(C). Section 368(a)(2)(B) further provides that solely for purposes of determining whether its requirements are satisfied, the amount of any liabilities assumed by the acquiring corporation shall be treated as money paid for the property.

Section 1.368-1(a) generally provides that in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine.

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Section 1.368-2(k) provides, in part, that a transaction otherwise qualifying as a reorganization under § 368(a) shall not be disqualified or recharacterized as a result of one or more distributions to shareholders(including distribution(s) that involve the assumption of liabilities)if the requirements of § 1.368-1(d) are satisfied, the property distributed consists of assets of the surviving corporation, and the aggregate of such distributions does not consist of an amount of assets of the surviving corporation (disregarding assets of the merged corporation) that would result in a liquidation of such corporation for Federal income tax purposes.

Rev. Rul. 67-274, 1967-2 C.B. 141, holds that an acquiring corporation's acquisition of all of the stock of a target corporation solely in exchange for voting stock of the acquiring corporation, followed by the liquidation of the target corporation as part of the same plan, will be treated as an acquisition by the acquiring corporation of substantially all of the target corporation's assets in a reorganization described in § 368(a)(1)(C). The ruling explains that, under these circumstances, the stock acquisition and the liquidation are part of the overall plan of reorganization and the two steps may not be considered independently of each other for Federal income tax purposes. See also, Rev. Rul. 72-405, 1972-2 C.B. 217.

Rev. Rul. 2001-46, 2001-2 C.B. 321, holds that, where a newly formed wholly owned subsidiary of an acquiring corporation merged into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the step transaction doctrine is applied to integrate the steps and treat the transaction as a single statutory merger of the target corporation into the acquiring corporation**. Noting that the rejection of step integration in Rev. Rul. 90-95, 1990-2 C.B. 67, and § 1.338-3(d) is based on Congressional intent that § 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine,** the Service found that the policy underlying § 338 is not violated by treating the steps as a single statutory merger of the target into the acquiring corporation because such treatment results in a transaction that qualifies as a reorganization in which the acquiring corporation acquires the assets of the target corporation with a carryover basis under § 362, rather than receiving a cost basis in those assets under § 1012. **(In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation's assets with the purchaser receiving a cost basis in the assets.)**

Section 338(a) provides that if a corporation makes a qualified stock purchase and makes an election under that section, then the target corporation (i) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value and (ii) shall be treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. Section 338(d)(3) defines a qualified stock purchase as any transaction or series of transactions in which stock (meeting the requirements of § 1504(a)(2)) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period. Section 338(h)(3) defines a purchase generally as any acquisition of stock, but excludes acquisitions of stock in exchanges to which § 351, § 354, § 355, or § 356 applies.

Section 338 was enacted in 1982 and was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine." H.R. Conf. Rep. No. 760, 97th Cong, 2d Sess. 536(1982), 1982-2 C.B. 600, 632. Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a § 338 election. If the election is made or deemed made, asset purchase treatment results and the basis of the target assets is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, the stock purchase treatment generally results. In such a case, the basis of the target assets is not adjusted to reflect the stock purchase price and other relevant items.

Rev. Rul. 90-95 (Situation 2), holds that the merger of a newly formed wholly owned domestic subsidiary into a target corporation with the target corporation shareholders receiving solely cash in exchange for their stock, immediately followed by the merger of the target corporation into the domestic parent of the merged subsidiary, will be treated as a qualified stock purchase of the target corporation followed by a § 332 liquidation of the target corporation. As a result, the parent's basis in the target corporation's assets will be the same as the basis of the assets in the target corporation's hands. The ruling explains that even though "the step-transaction doctrine is properly applied to disregard the existence of the [merged subsidiary]," so that the first step is treated as a stock purchase, the acquisition of the target corporation's stock is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase regardless of whether a § 338 election is made. Thus, in that case, the step transaction doctrine was not applied to treat the transaction as a direct acquisition by the domestic parent of the assets of the target corporation because such an application would have resulted in treating a stock purchase as an asset purchase, which would be inconsistent with the repeal of the

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Kimbell-Diamond doctrine and § 338.

Section 1.338-3(d) incorporates the approach of Rev. Rul. 90-95 into the regulations by requiring the purchasing corporation (or a member of its affiliated group) to treat certain asset transfers following a qualified stock purchase (where no § 338 election is made) independently of the qualified stock purchase. In the example in § 1.338-3(d)(5), the purchase for cash of 85 percent of the stock of a target corporation, followed by the merger of the target corporation into a wholly owned subsidiary of the purchasing corporation, is treated (other than by certain minority shareholders) as a qualified stock purchase of the stock of the target corporation followed by a § 368 reorganization of the target corporation into the subsidiary. As a result, the subsidiary's basis in the target corporation's assets is the same as the basis of the assets in the target corporation's hands.

ANALYSIS

If the Acquisition Merger and the Liquidation were treated as separate from each other, the Acquisition Merger would be treated as a stock acquisition that qualifies as a reorganization under § 368(a)(1)(A) by reason of § 368(a)(2)(E), and the Liquidation would qualify under § 332. However, as provided in § 1.368-1(a), in determining whether a transaction qualifies as a reorganization under § 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. In this case, because T was completely liquidated, the § 1.368-2(k) safe harbor exception from the application of the step transaction doctrine does not apply. Accordingly, the Acquisition Merger and the Liquidation may not be considered independently of each other for purposes of determining whether the transaction satisfies the statutory requirements of a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E). As such, this transaction does not qualify as a reorganization described in § 368(a)(1)(A) by reason of § 368(a)(2)(E) because, after the transaction, T does not hold substantially all of its properties and the properties of the merged corporation.

In determining whether the transaction is a reorganization, the approach reflected in Rev. Rul. 67-274 and Rev. Rul. 2001-46 is applied to ignore P's acquisition of the T stock in the Acquisition Merger and to treat the transaction as a direct acquisition by P of T's assets in exchange for 10x dollars in cash, 90x dollars worth of P voting stock, and the assumption of T's liabilities.

However, unlike the transactions considered in Revenue Rulings 67-274, 72-405 and 2001-46, a direct acquisition by P of T's assets in this case does not qualify as a reorganization under § 368(a). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(C) because the consideration exchanged is not solely P voting stock and the requirements of § 368(a)(2)(B) are not satisfied. Section 368(a)(2)(B) would treat P as acquiring 40 percent of T's assets for consideration other than P voting stock (liabilities assumed of 50x dollars, plus 10x dollars cash). See Rev. Rul. 73-102, 1973-1 C.B. 186 (analyzing the application of § 368(a)(2)(B)). P's acquisition of T's assets is not a reorganization described in § 368(a)(1)(D) because neither T nor A (nor a combination thereof) was in control of P (within the meaning of § 368(a)(2)(H)(i)) immediately after the transfer. **Additionally, the transaction is not a reorganization under § 368(a)(1)(A) because T did not merge into P.** Accordingly, the overall transaction is not a reorganization under § 368(a).

Additionally, P's acquisition of the T stock in the Acquisition Merger is not a transaction to which § 351 applies because A does not control P (within the meaning of § 368(c)) immediately after the exchange.

Rev. Rul. 90-95 and § 1.338-3(d) reject the step integration approach reflected in Rev. Rul. 67-274 where the application of that approach would treat the purchase of a target corporation's stock without a § 338 election followed by the liquidation or merger of the target corporation as the purchase of the target corporation's assets resulting in a cost basis in the assets under § 1012. Rev. Rul. 90-95 and § 1.338-3(d) treat the acquisition of the stock of the target corporation as a qualified stock purchase followed by a separate carryover basis transaction in order to preclude any nonstatutory treatment of the steps as an integrated asset purchase.

In this case, further application of the approach reflected in Rev. Rul. 67-274, integrating the acquisition of T stock with the liquidation of T, would result in treating the acquisition of T stock as a taxable purchase of T's assets. Such treatment would violate the policy underlying § 338 that a cost basis in acquired assets should not be obtained through the purchase of stock where no § 338 election is made. Accordingly, consistent with the analysis set forth in Rev. Rul. 90-95, the acquisition of the stock of T is treated as a qualified stock purchase by P followed by the liquidation of T into P under § 332.

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HOLDING

The transaction is not a reorganization under § 368(a). The Acquisition Merger is a qualified stock purchase by P of the stock of T under § 338(d)(3). The Liquidation is a complete liquidation of a controlled subsidiary under § 332.

PROSPECTIVE APPLICATION

The Service will consider the application of § 7805(b) on a case-by-case basis.

DRAFTING INFORMATION

The principal author of this revenue ruling is Mary W. Lyons of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Lyons at (703) 622-7930 (not a toll-free call).

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ATTACHMENT C

Revenue Ruling 2007-49, 2007-31 IRB 237 (7/30/2007)

Exchange of vested shares for unvested shares – Section 83 consequences

Source: IRS Documents > Revenue Rulings > 2007 > REV. RUL. 2007-49, 2007-31 I.R.B. 237 (7/30/2007)

REV. RUL. 2007-49, 2007-31 I.R.B. 237 (7/30/2007)

Part I

Section 83.—Property Transferred in Connection with Performance of Services

26 CFR 1.83-3: Meaning and use of certain terms

Post-grant restrictions.

This ruling sets forth the tax consequences under § 83 of the Code when restrictions are imposed on substantially vested stock causing that stock to become substantially nonvested. The ruling holds that if the imposition of such restrictions occurs in the absence of an exchange of stock, the substantially nonvested stock is not subject to § 83. However, if the substantially vested stock is exchanged for substantially nonvested stock, the substantially nonvested stock is subject to § 83.

Rev. Rul. 2007-49

ISSUES

1) Is there a transfer of substantially nonvested stock subject to § 83 of the Internal Revenue Code where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested?

2) Is there a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in § 368(a)?

3) Is there a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition?

FACTS

Investors form Corporation X in 2004, by contributing$1,000 each to Corporation X in exchange for 100 shares of Corporation X stock. In exchange for Individual A's agreement to perform services for Corporation X, Corporation X issues 100 shares of its stock to A. The fair market value of the Corporation X stock on that date is $10 per share. The shares of Corporation X stock transferred to A are "substantially vested" within the meaning of § 1.83-3(b) of the Income Tax Regulations.

For the 2004 taxable year, the amount included in A's income under § 83(a) is$1,000 (the fair market value of the stock ($10 x 100 shares) less the amount paid ($0)). A's basis in the stock is $1,000.

Situation 1. In connection with its plan to start a new business venture, Corporation X seeks financing from Investor M on July 9, 2007. Investor M agrees to invest funds in Corporation X in exchange for a specified number of shares and the further requirement that A agree to subject A's shares to a restriction that will cause the stock to be "substantially nonvested "within the meaning of § 1.83-3(b). Under this restriction, if the employment of A with Corporation X terminates before July 9, 2009, A must sell the shares to Corporation X in exchange for the lesser of $150 per share(the fair market value of Corporation X stock on July 9, 2007) or the fair market value at the time of forfeiture. In addition, the shares are nontransferable before that date. A remains employed with Corporation X, and on July 9, 2009, the fair market value of Corporation X stock is $250 per share.

Situation 2. Corporation Y, a corporation unrelated to Corporation X, agrees to acquire all of the stock of Corporation X. Accordingly, on August 9, 2010, Corporation Y causes Corporation Z (a newly formed wholly-owned subsidiary of Corporation Y) to merge into Corporation X in a transaction that qualifies as a reorganization described in § 368(a). In the merger, the shareholders of Corporation X receive solely Corporation Y voting stock in exchange for their Corporation X stock. The fair market value of the Corporation X stock on August 9, 2010, is $310 per share.

In the merger, A's 100 shares of substantially vested Corporation X stock are exchanged for 100 shares of Corporation Y stock subject to a restriction that will cause the stock to be "substantially nonvested" within the

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meaning of § 1.83-3(b). Under this restriction, if A's employment with Corporation X is terminated for any reason before August 9, 2013, A must sell the substantially nonvested Corporation Y shares to Corporation Y in exchange for the lesser of$310 per share (the fair market value of the shares on August 9, 2010)or the fair market value at the time of forfeiture. In addition, the shares are nontransferable before that date. No other shareholder of Corporation X receives Corporation Y stock subject to a restriction.

A timely files an election under § 83(b) with respect to the substantially nonvested Corporation Y stock A receives in the merger.

A continues to be employed by Corporation X until August 9, 2013 at which time the fair market value of the stock is$500. A sells the stock on October 31, 2014 when the fair market value of the stock is $550 per share.

Situation 3. Assume the same facts as in *Situation 2* except that in the merger half of the Corporation X stock is exchanged for cash and half is exchanged for Corporation Y stock, the transaction is fully taxable, and all of A's Corporation X stock is exchanged for Corporation Y stock.

LAW

Section 83, provides that if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse), on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

Section 1.83-3(f) provides that property transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of, or the refraining from performance of, services is considered transferred in connection with the performance of services within the meaning of § 83. However, the existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering, may indicate that in such circumstances a transfer to the employee is not in recognition of the performance of, or the refraining from performance of, services.

Subjecting stock to a restriction that will cause it to be “substantially nonvested” (within the meaning of § 1.83-3(b))indicates that the property is transferred in connection with the performance of services even if the employee pays fair value for the stock. See *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982).

Section 1.83-1(a)(1) provides that property transferred in connection with the performance of services is not taxable under § 83(a) until it has been transferred (as defined in § 1.83-3(a)) to an employee or independent contractor and becomes substantially vested (as defined in § 1.83-3(b))in such person. Until such property becomes substantially vested, the transferor is regarded as the owner of the property, and any income from such property received by the employee or independent contractor(or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and must be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available.

Section 83(b) provides that any person who has performed services in connection with which property is transferred to any person may elect to include in gross income, for the taxable year in which such property is transferred, the excess of the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount paid for such property.

Section 1.83-2(a) provides, in part, that the fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election under § 83(b). If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property. Thus, with respect to such property, the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse) over the amount (if any) paid for such property is includible in gross income as compensation at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested. An employee who makes an election under § 83(b) is considered to be the owner of the property. See Rev. Rul. 83-22, 1983-1 C.B. 17.

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Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain, and the loss is the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of the property is the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c), provides, except as otherwise provided in Subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of the property shall be recognized.

Section 1.83-3(g) provides that for purposes of § 83 and its regulations, the term "amount paid" refers to the value of any money or property paid for the transfer of property to which § 83 applies.

ANALYSIS – Situation 1

In *Situation 1*, in connection with the new investment, the substantially vested shares of Corporation X stock owned by A are subjected to a restriction causing them to be "substantially nonvested". **Because the substantially vested shares of Corporation X stock are already owned by A for purposes of § 83, there is no "transfer" under § 83. Thus, the imposition of new restrictions on the substantially vested shares has no effect for purposes of § 83.**

When the substantially nonvested Corporation X stock becomes substantially vested on July 9, 2009, A does not recognize compensation income under § 83(a). A's basis in the stock continues to be $1,000.

ANALYSIS – Situation 2

In *Situation 2*, A receives 100 shares of Corporation Y stock with an exchanged basis of $1,000 in the tax-free reorganization. Because the substantially vested Corporation X stock is exchanged for stock that is subjected to a restriction causing the shares to be "substantially nonvested," the substantially nonvested shares are treated as having been transferred in connection with the performance of services, and thus, are subject to § 83. As a result of the § 83(b) election, A becomes the owner of those shares.

The "amount paid" for the stock under § 83 on the transfer of the substantially nonvested shares is the fair market value of the substantially vested Corporation X stock exchanged for the substantially nonvested Corporation Y stock ($31,000) on the exchange date, August 9, 2010. On A's election under § 83(b), $31,000 is treated as the amount paid for the Corporation Y stock for purposes of applying § 83. On A's return for the 2010 taxable year, A does not report any taxable income from the transfer of the Corporation Y stock under the § 83(b) election because the fair market value of the stock less the amount paid is $0. A does not include any amount in compensation income in the 2013 taxable year when the stock becomes substantially vested because of the prior § 83(b) election. A's basis in the Corporation Y stock continues to be $1,000. Upon the sale of the shares in 2014, A recognizes capital gain of $54,000, the amount by which $55,000 ($550, the fair market value of the stock, x 100 shares) exceeds A's $1,000 basis in the shares.

ANALYSIS – Situation 3

In *Situation 3*, A holds substantially vested Corporation X stock with a basis of $1,000 at the time of the merger. A exchanges that substantially vested Corporation X stock for substantially nonvested Corporation Y stock with a fair market value of $310 per share in a taxable transaction. Because A disposed of the substantially vested Corporation X stock in exchange for substantially nonvested Corporation Y stock in an exchange to which § 1001 applies, A recognizes capital gain on the disposition of the Corporation X stock in the amount of $30,000 ($31,000 fair market value of substantially nonvested Corporation Y stock ($310 per share x 100 shares) less $1,000 basis in the Corporation X stock). A's basis in the Corporation Y stock is $31,000.

Because the substantially vested Corporation X stock is exchanged for Corporation Y stock that is subjected to a restriction causing the shares to be "substantially nonvested," the substantially nonvested shares are treated as having been transferred in connection with the performance of services, and thus, are subject to § 83.

As in *Situation 2*, the "amount paid" for the stock under § 83 is $31,000. When A makes an election under § 83(b) with respect to the Corporation Y stock, A does not report any additional amount of income for the 2010 taxable year

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as a result of such election because the fair market value of the stock less the amount paid for the stock is $0. A does not include any amount in compensation income in the 2013 taxable year when the stock becomes substantially vested because of the prior § 83(b) election. A's basis in the Corporation Y stock continues to be $31,000. On the sale of the 100 shares in 2014, A will recognize capital gain of $24,000, the amount by which $55,000 ($550, the sale price, x 100 shares) exceeds A's $31,000 basis in the shares.

If A had not made an election under § 83(b) with respect to the Corporation Y stock, when the stock becomes substantially vested on August 9, 2013, A would include $19,000 in gross income as compensation under § 83(a). This is the amount by which the fair market value of 100 Corporation Y shares ($50,000 or $500 per share) exceeds the amount paid for those shares ($31,000). Consequently, A's basis in the Corporation Y stock would be increased by $19,000 to $50,000. See § 1.83-4(b). On the sale of the 100 shares, A would recognize capital gain of $5,000, the amount by which $55,000 ($550, the sale price, x 100 shares) exceeds A's basis of $50,000 in the shares.

HOLDINGS

1) There is not a transfer of substantially nonvested stock subject to § 83 where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested.

2) There is a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in § 368(a).

3) There is a transfer of substantially nonvested stock subject to § 83 where a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition.

DRAFTING INFORMATION

The principal author of this revenue ruling is Jean Casey of the Office of Division Counsel/Associate Chief Counsel(Tax Exempt & Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue ruling, contact Ms. Casey at (202) 622-6030 (not a toll-free call). For further information regarding issues with respect to subchapter C, contact Ms. Jean Brenner at (202) 622-7790 (not a toll free number).

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