2006

What is a Merger?: The Case for Taxing Cash Mergers Like Stock Sales.

Jeffrey L. Kwall
Loyola University Chicago, jkwall@luc.edu

Recommended Citation

Kwall, Jeffrey L., and Rabin, E. and Rosenthal, What is a Merger?: The Case for Taxing Cash Mergers Like Stock Sales, 32 J. Corp. L. 1 (2006).

What Is a Merger?:

The Case for Taxing Cash Mergers Like Stock Sales

Jeffrey L. Kwall*

ABSTRACT

In a merger, neither the assets nor the stock of one corporation are physically transferred to another corporation. Rather, the two corporations are unified by operation of law. The absence of a physical transfer of assets or stock obscures the tax effects of a merger. To determine these effects, a merger must be analogized to a sale of assets or a sale of stock. These alternative analogies yield significantly different results when the consideration for the merger is cash. When a cash merger is analogized to an asset sale, a 35% corporate tax is normally imposed. By contrast, no corporate tax normally results when a cash merger is analogized to a stock sale. Mergers have long been taxed like asset sales. Although analogizing cash mergers to asset sales was once defensible, changes in the law have eroded all support for this treatment. More significantly, well-counseled taxpayers can easily avoid the corporate tax resulting from the asset sale analogy. Thus, the continued treatment of cash mergers as asset sales merely traps the unwary. If a cash merger were instead analogized to a stock sale, the same tax consequences would apply to all. To level the playing field, therefore, the asset sale analogy should be abandoned and mergers should be taxed like stock sales.

*Harry R. Horrow Visiting Professor of Law, Northwestern University School of Law; Kathleen and Bernard Beazley Professor of Law, Loyola University Chicago School of Law. B.A., Bucknell University; M.B.A., The Wharton School; J.D., University of Pennsylvania Law School. I thank Steve Bank, Glenn Coven, Stuart Duhl, Marty Ginsburg, Kristina Maynard, Ajay Mehrotra, Bud Murdock, and Adam Rosenzweig for reviewing earlier drafts and the faculties of Northwestern University School of Law and Notre Dame Law School for helpful comments at faculty presentations. I also thank Kelley Bender for extensive state law research, my student assistants Greg Nelson, Christine Quigley, Yelena Vayner, Ryan Walsh, and Sam Wieczorek, and librarian Heidi Kuehl. Thanks also to Loyola University Chicago School of Law and Northwestern University School of Law for research support.

"There are few guideposts as to the true character of a cash merger. . . ."[1]

I. INTRODUCTION

Three alternative paths exist for transferring the business of one corporation ("Target") to another corporation ("Acquirer"). First, Target can transfer each of its assets, by assignment or deed, to Acquirer. Second, each and every shareholder of Target can assign to Acquirer the Target stock owned by that shareholder. Third, the parties can dispense with a physical transfer of assets or stock, and instead merge Target into

1. I.R.S. Litig. Bulletin 89-4, 1989 WL 989256 (Apr. 1989).

Acquirer, thereby uniting the two corporations by "operation of law."[2]

The corporate law of every state sanctions the merger of one corporation into another. In a merger, the following events occur:[3]

> 1. The stock of Target's shareholders is converted to the consideration recited in the merger agreement (normally stock of Acquirer and/or cash);
>
> 2. Acquirer becomes the owner of all the properties of Target and responsible for all of Target's obligations; and
>
> 3. The corporate existence of Target is extinguished.[4]

Although the results of a merger are clear, the order in which these results occur is not discernible. Based on state law, the end points seem to be reached by magic. Before the merger, Target's shareholders hold the stock of Target and Target holds assets and bears liabilities. After the merger, the stock of Target's shareholders has been transformed into the consideration delineated in the merger agreement, the contents of Target have shifted to Acquirer, and Target has disappeared. Clearly, Target's shareholders have disposed of their Target stock because they no longer own Target stock. Just as clearly, Target has disposed of its assets because Target no longer owns assets, nor does it even exist. It is impossible, however, to discern which disposition occurred first because, as a matter of law, they occurred simultaneously.

From a corporate law standpoint, it does not matter whether a disposition of Target's stock or its assets occurred first because state law defines the rights and obligations of all parties to a merger.[5] Likewise, from an income tax standpoint, it makes little difference whether the first step in a merger is a stock transfer or an asset transfer if the consideration is stock of Acquirer and the merger qualifies as a tax-deferred reorganization.[6] When a merger is funded with cash, however, the order in which the steps occur determines whether or not a 35% corporate tax is imposed on Target.[7] Target will be taxed if the merger commences with the transfer by Target of its *assets*.[8] By

2. *See generally* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 346 (3d ed. 1983).

3. *See, e.g.*, MODEL BUS. CORP. ACT ANN. § 11.07 (3d ed. Supp. 2005) [hereinafter MBCA]. The merger laws of all states delineate the effects of a merger in similar terms.

4. This Article focuses on the merger of Target into Acquirer, in which Target is extinguished—a transaction referred to as a "forward" merger. By contrast, when a "reverse" merger occurs, Target survives. For a discussion of reverse mergers, see *infra* Part III.D.

5. *See* MBCA § 11.07.

6. If a substantial part of the consideration in a merger is stock of Acquirer, the merger can qualify as a tax-deferred corporate reorganization. *See infra* note 55.

7. I.R.C. § 11(b)(1) (2000). A 34% rate applies to corporate income below $10,000,000 and lower rates apply below $75,000. Target is assumed not to be an S corporation. *See* I.R.C. § 1363(a) (2000) (stating S corporation generally is not a taxpaying entity).

8. I.R.C. § 1001 (2000) (providing that the sale of property causes any realized gain to be recognized in absence of a nonrecognition provision). When Target is taxed, Acquirer is entitled to increase the basis of Target's assets to market value. *See* I.R.C. § 1012 (2000) (providing that buyer takes a cost basis in purchased property). A sale of Target's assets does not always trigger a corporate tax. If the basis of Target's assets exceeds their value, a deductible loss may result, and the basis of the assets is reduced to market value. *See* I.R.C. § 165 (2000). Even when Target sells its assets at a gain, that gain might be absorbed by net operating losses. *See* I.R.C. § 172 (2000). For purposes of this Article, the value of Target's assets is assumed to exceed the basis of its assets, and Target is assumed to have no net operating losses.

contrast, Target will not be taxed if the initial step is the transfer by Target's shareholders of their *stock*.[9] Thus, the stakes are high.[10]

To resolve the conundrum of whether Target's stock or its assets are transferred first, a fictional explanation of the merger must be adopted. Alternative fictions can be devised that treat a merger as commencing with a transfer of Target's stock (the "stock transfer fiction") or a transfer of Target's assets (the "asset transfer fiction").[11] The stock transfer fiction does not cause Target to be taxed.[12] By contrast, the asset transfer fiction triggers a tax on the gain in Target's assets.[13] Unfortunately, neither fiction is strongly supported by federal or state law.[14]

Notwithstanding a dearth of authority for either fiction, the Internal Revenue Service has embraced the asset transfer fiction for almost four decades.[15] This view of a merger is accepted by the leading commentators and has become deeply ingrained in the mindset of academics and practitioners.[16] Indeed, the asset transfer fiction has rarely been questioned.[17]

9. Target is not taxed when its shareholders sell their stock because Target has not transferred its assets. *See* I.R.C. § 1001(a) (2000) (requiring sale or disposition of property to trigger taxable gain). Because Target is not taxed when its stock is sold, the basis of its assets does not change. When Target's stock is sold, an election can be made that causes Target to be taxed on the gain in its assets and to increase the basis of its assets to market value. *See* I.R.C. § 338 (2000); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 10.42 (7th ed. 2002). The cost of the election (a corporate tax on Target), however, normally outweighs the benefits (future tax savings from the increased basis in Target's assets) due to the time value of money. *See* JEFFREY L. KWALL, THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES AND THEIR OWNERS 482-89 (3d ed. 2005).

10. To quantify the cost of taxing Target on the gain in its assets, the tax on Target must be reduced by the present value of the future tax savings derived from the corresponding increased basis in Target's assets. *See* discussion *supra* note 9.

11. *See infra* Part II.

12. The stock transfer fiction entails two steps: 1) Target's shareholders sell their stock to Acquirer, and 2) Target distributes its assets to Acquirer. *See infra* Part II.A. The stock transfer fiction results in no tax to Target and no change in the basis of Target's assets. *See* discussion *supra* note 9.

13. The asset transfer fiction entails two steps: 1) Target sells all its assets to Acquirer, and 2) Target distributes the consideration received from Acquirer to its shareholders. *See infra* Part II.B. The asset transfer fiction taxes Target on the gain in its assets and increases the basis of those assets by a like amount. *See* discussion *supra* note 8. Under both fictions, the Target's shareholders are taxed on the gain in their stock (as a result of the first step of the stock transfer fiction and the second step of the asset transfer fiction).

14. *See infra* notes 50-52; David J. Rachofsky, *The Reorganization that Fails: Tax Consequences of an Involuntarily Taxable Reorganization*, 32d N.Y.U. ANN. INST. ON FED. TAX'N. 639, 643 (1974) (noting "the absence of authority directly in [sic] point" as to whether a merger commences with an asset transfer or a stock transfer).

15. Rev. Rul. 69-6, 1969-1 C.B. 104. This view applies only to forward mergers, the focus of this Article. *See supra* note 4. Reverse mergers are treated for tax purposes as stock transfers. *See, e.g.*, Rev. Rul. 74-564, 1974-2 C.B. 124; Rev. Rul. 67-448, 1967-2 C.B. 144.

16. *See* BITTKER & EUSTICE, *supra* note 9, at 10-86 ("Instead of purchasing the target company's stock, however, the acquirer corporation may purchase its assets . . . . This may occur by transfer of the assets pursuant to a bill of sale or by merging the target into the acquirer for cash."); MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS 3-3 (2006) ("IRS will view this taxable merger as if [Target] had sold its assets to [Acquirer] . . . and as if [Target] had then undergone a complete liquidation.").

17. *But see* John J. Clair, *Accepted Reorganization Concepts After General Utilities Repeal–Familiar Concepts in a Changed World*, 69 TAXES 882 (1991) ("The Rev. Rul. 69-6 analysis has little to recommend it in the . . . merger situation."); Robert R. Tufts, *The Taxable Merger*, 7 J. CORP. TAX'N 342, 350 (1981) (advocating sui generis treatment of taxable mergers); *L.A. Bar Members Advocate Consistent Treatment for*

Initial approval of the asset transfer fiction is not surprising in light of the legal landscape that existed at the time. When this fiction was adopted, asset sales and stock sales were taxed similarly. Target normally did not incur a tax, regardless of whether its assets or its stock was sold.[18] Thus, the question of which fiction should apply to a cash merger was not very important because the merger would be taxed similarly in either case. Furthermore, when the asset transfer fiction was first adopted, the law then in effect did not respect the separate steps of the stock transfer fiction (i.e., a stock sale followed by a liquidation of Target). Rather, those steps were integrated into an asset purchase.[19] Hence, the asset transfer fiction offered the only substantive explanation of a merger at this time. Finally, when the asset transfer fiction was adopted, the tax law governing corporate acquisitions focused principally on Acquirer, not Target, and from Acquirer's perspective, the asset transfer fiction offers a superior explanation of a merger.[20] Hence, it is not surprising that the government initially embraced the asset transfer fiction.

During the 1980s, however, dramatic changes in the law eroded the superiority of the asset transfer fiction. First, the tax treatment of asset sales and stock sales diverged. Now, Target is taxed when it sells its assets.[21] By contrast, Target is still not taxed when its shareholders sell their stock.[22] Thus, the fiction invoked to explain a merger now matters a great deal because it determines whether Target will be taxed. In addition, the tax law no longer treats a stock purchase followed by a liquidation as an asset purchase.[23] Indeed, under current law, substance-over-form principles will *never* be applied to recast a stock purchase followed by a liquidation as an asset purchase.[24] Hence, both fictions now provide equally viable explanations of a cash merger. Finally, the tax law governing corporate acquisitions no longer focuses only on Acquirer; but rather, focuses equally on Acquirer and Target.[25] Although the asset transfer fiction still better explains a merger from Acquirer's perspective, the stock transfer fiction offers a superior explanation of a

Taxable Mergers, 92 TAX NOTES TODAY 120-33 (June 10, 1992) [hereinafter *L.A. Bar Members Report*] (questioning the inconsistent treatment of forward and reverse mergers).

18. *See infra* Part III.B.1. At this time, the "*General Utilities* rule" normally insulated Target from tax in an asset sale. *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935) (finding that corporation did not recognize gain when it distributed appreciated property to its stockholders); *see also* I.R.C. §§ 311, 336(b), 337 (1954). For exceptions to the *General Utilities* rule, see *infra* note 62.

19. *See infra* Part III.B.2. At that time, the "*Kimbell-Diamond* doctrine" recast the purchase of Target's stock followed by a planned liquidation of Target into Acquirer as a purchase of Target's assets. *See* Kimbell-Diamond Milling Co. v. Comm'r, 14 T.C. 74 (1950) (treating the purchase of the Target's stock followed by the pre-planned liquidation of Target as a purchase of Target's assets), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951); *see also* I.R.C. § 334(b)(2) (1954) (treating purchase of Target's stock followed by liquidation of Target within two years of stock purchase as an asset purchase).

20. *See infra* Part III.B.3.

21. *See infra* Part III.C.1. Congress repealed the *General Utilities* rule (*supra* note 18) in 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 631-33, 100 Stat. 2085 (1986) (codified as amended at I.R.C. §§ 311, 336, 337).

22. *See supra* note 9 and accompanying text.

23. *See infra* Part III.C.2. The *Kimbell-Diamond* doctrine, *supra* note 19, was superseded by the enactment of I.R.C. § 338 in 1982. *See* I.R.C. § 338 (1982); H.R. REP. NO. 97-760, at 536 (1982) (Conf. Rep.). Pursuant to I.R.C. § 338, a tax on Target can be elected but the election is not normally made. *See* I.R.C. § 338 (2000); *supra* note 9.

24. *See infra* Part III.C.2; *see also* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2).

25. *See infra* Part III.C.3.

merger from Target's perspective.[26] Hence, none of the elements that originally favored the asset transfer fiction now exists.

The erosion of the asset transfer fiction's superiority would not justify its rejection if the adverse tax consequences of that fiction applied evenly to all taxpayers. However, the tax now imposed on Target in a cash merger can easily be avoided, with the blessing of the Internal Revenue Service, by well-counseled taxpayers who substitute two mergers for one.[27] Hence, the prospect of a corporate tax in a cash merger now plagues only the ill advised.[28]

Current law's disparate treatment of asset sales and stock sales necessarily thwarts the tax policy goal of treating similarly situated taxpayers alike.[29] Ideally, Congress should tax all corporate acquisitions alike regardless of their form, but the prognosis for that reform is poor.[30] A far more realistic goal is to tax all cash mergers alike, regardless of whether the parties utilize one merger or two mergers to achieve their objectives. Unfortunately, continued adherence to the asset transfer fiction undermines this second-best solution.

To equalize the tax treatment of all cash mergers, the stock transfer fiction should be applied in lieu of the asset transfer fiction. By treating all cash mergers as commencing with a stock transfer, cash mergers would be taxed the same as stock sales; Target would not be taxed in either case.[31] Invoking the stock transfer fiction would level the playing field by enabling all taxpayers contemplating a cash merger to avoid a tax on Target, not just the well-advised.

Part II delineates the alternative fictions that might apply to a merger and demonstrates that neither fiction provides an inherently superior explanation. Part III discusses the government's adoption of the asset transfer fiction, explains why the asset transfer fiction was the superior alternative at the time, demonstrates the subsequent erosion of that superiority and, finally, reveals how the continued application of the asset transfer fiction traps only the unwary. Part IV explores alternative reform options.

II. CONCEPTUALIZING A MERGER: TWO VIABLE FICTIONS

Every state's merger statute delineates the effects of a merger. Although these statutes are not identical, they generally track the following language of the Model Business Corporation Act:

> When a merger becomes effective: . . .
>
> (2) the separate existence of [the] corporation . . . merged into the survivor ceases;

26. *Id.*

27. *See infra* Part III.D.

28. *See L.A. Bar Members Report*, *supra* note 17 ("[C]haracterization of a forward merger as a sale of assets is only a trap for the unwary, and could easily be avoided by more sophisticated taxpayers.").

29. The principle of horizontal equity, that taxpayers in similar positions should be treated equally, is "perhaps the most widely accepted principle of equity in taxation." R. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 160, 173 (1959).

30. *See infra* Part IV.A.

31. If mergers were treated as commencing with a stock transfer, a tax on Target could be elected, but that election would not normally be made. *See* discussion *supra* note 9.

> (3) all property owned by . . . [the] corporation . . . that merges into the survivor is vested in the survivor without reversion or impairment;
>
> (4) all liabilities of [the] corporation . . . merged into the survivor are vested in the survivor; . . .
>
> (8) the shares of [the] corporation . . . that are to be converted under the plan of merger into shares, [money] . . . , or any combination of the foregoing, are converted [to the consideration recited in the merger agreement] . . . .[32]

No state's merger statute prescribes an order in which these events occur. Rather, the events occur simultaneously upon the effective date of the merger.

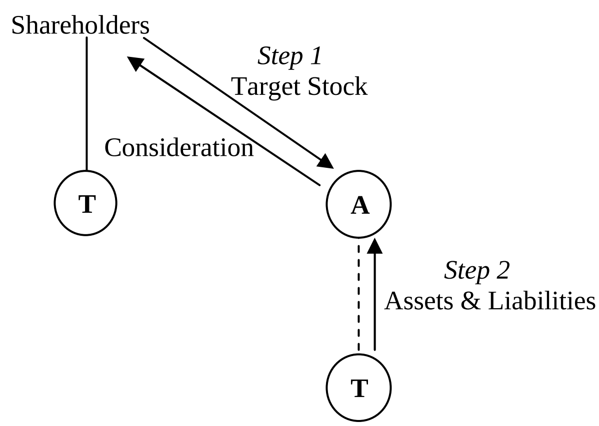
To determine whether Target is taxed in a cash merger, an order must be imposed on the consequences of the merger. Two different fictions can be employed to establish that order: the "stock transfer fiction," which treats the merger as commencing with a transfer of Target's outstanding stock, and the "asset transfer fiction," which treats the merger as commencing with a transfer of Target's assets. Each of these fictions entails the transfer of both Target's stock and its assets; the difference between the fictions is the order in which these transfers occur.

Under the stock transfer fiction (see ILLUSTRATION 1):

1) Target's shareholders transfer all their stock to Acquirer in exchange for the merger consideration, and

2) Target, as a wholly-owned subsidiary of Acquirer, then distributes all its assets and liabilities to Acquirer and dissolves.

ILLUSTRATION 1: STOCK TRANSFER FICTION



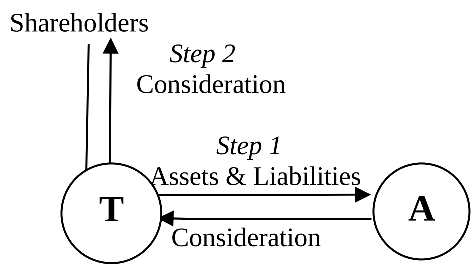
32. MBCA § 11.07. The merger statute of every state provides for similar effects.

By contrast, under the asset transfer fiction (see ILLUSTRATION 2):

1) Target transfers all its assets and liabilities to Acquirer in exchange for the merger consideration, and

2) Target then distributes the merger consideration to its shareholders and dissolves.[33]

ILLUSTRATION 2: ASSET TRANSFER FICTION



Neither fiction represents events that actually transpire in a merger. Rather, the fictions provide artificial explanations of a merger, where an explanation is needed to determine whether Target is taxed.

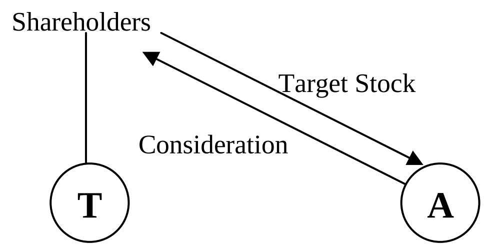
A. Stock Transfer Fiction

When a corporate acquisition is structured as a stock transfer, Target's shareholders transfer their stock (by assignment) to Acquirer in exchange for consideration (usually money or Acquirer stock). Each shareholder of Target decides independently whether to transfer his or her shares. In a merger, by contrast, none of the Target shareholders can retain any Target stock. For a stock transfer to simulate a merger, therefore, every Target shareholder must transfer all of his or her Target shares to Acquirer (see ILLUSTRATION 3).[34]

33. An alternative asset transfer fiction would be to treat Target as distributing its assets and liabilities to its shareholders and then treat those shareholders as transferring the assets and liabilities to Acquirer in exchange for the merger consideration. This view is inconsistent with the legal reality that, when a merger occurs, Target's shareholders are neither entitled to its assets nor exposed to its liabilities. *See* MBCA § 11.07. Hence, this alternative is not a viable explanation of a merger.

34. If a limited number of recalcitrant Target shareholders exist when Acquirer attempts to purchase stock, those shareholders might be compelled to surrender their shares under a "share exchange statute." *See infra* notes 150-154 and accompanying text. The stock transfer fiction, however, envisions the voluntary transfer of

ILLUSTRATION 3: FIRST STEP OF STOCK TRANSFER FICTION



In both a stock transfer and a merger, Target's shareholders receive consideration directly from Acquirer. Moreover, neither a stock transfer nor a merger exposes Target's shareholders to its liabilities. When Target's shareholders transfer their stock, they remain divorced from Target's liabilities because Target, as a corporate entity with its contents intact, gravitates to Acquirer.[35]

When Target's shareholders transfer all their stock to Acquirer, Target remains in existence, holding all its assets and liabilities as a wholly-owned subsidiary of Acquirer.[36] In these circumstances, it is common for Acquirer to retain Target as a wholly-owned subsidiary, rather than cause Target to liquidate[37] and dissolve.[38] For example, this holding company structure might be desired to insulate Acquirer's assets from claims against Target. In a merger, however, Target always disappears and its assets and liabilities shift to Acquirer. For a stock transfer to simulate a merger, therefore, Target must liquidate and dissolve.[39]

In summary, a corporate acquisition structured as a stock transfer differs from a merger in two ways. First, when Acquirer offers to acquire Target's outstanding stock, recalcitrant Target shareholders can refrain from surrendering their shares, an option that does not exist in a merger in which all stock of Target is transformed by operation of law. Second, when Acquirer purchases all the stock of Target, Target need not liquidate and dissolve. For a stock transfer to simulate a merger in which Target is extinguished, however, Target must liquidate and dissolve. Though imperfect, the stock transfer fiction is a viable explanation of a merger. The next question is whether the asset transfer fiction is equally viable.

all Target shares.

35. *See supra* ILLUSTRATION 1.

36. *Id.*

37. Liquidation is a tax law concept that entails the distribution of all the corporation's assets to its shareholders. *See* I.R.C. §§ 331, 336 (2000).

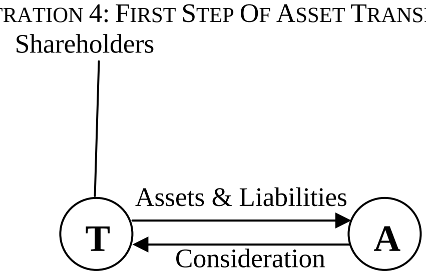
38. Dissolution is a corporate law concept that entails the voluntary filing of documents with the state to terminate the corporation's existence. *See, e.g.*, MBCA §§ 14.01-.05.

39. *See supra* ILLUSTRATION 1, *Step* 2. Alternatively, when the stock of Target is held by Acquirer, Target can be merged upstream into Acquirer. *See, e.g.*, MBCA § 11.05. The asset transfer fiction assumes that Target is liquidated rather than merged, because one merger cannot be explained by another merger.

B. Asset Transfer Fiction

When a corporate acquisition is structured as an asset transfer, Target conveys its assets (by assignment or deed) to Acquirer in exchange for consideration which Acquirer transfers to Target. In addition to tangible consideration, Acquirer can assume some, or all, of Target's liabilities.[40] Thus, Acquirer can pick and choose among both Target's assets and its liabilities. In a merger, however, Acquirer absorbs the entire contents of Target by operation of law.[41] For an asset transfer to simulate a merger, therefore, Target must convey all of its assets and Acquirer must assume all of Target's liabilities (see ILLUSTRATION 4). Even if Acquirer assumes all of Target's liabilities, Target's exposure to those claims is not eliminated. Unless Target's creditors affirmatively release Target, Target will remain contingently liable for all claims.[42]

ILLUSTRATION 4: FIRST STEP OF ASSET TRANSFER FICTION



Just as the transfer of all of Target's outstanding stock to Acquirer is insufficient to simulate a merger,[43] the mere transfer of all of Target's assets and liabilities to Acquirer does not simulate a merger either. After Target transfers its assets and liabilities to Acquirer, Target remains in existence and holds the consideration provided by Acquirer.[44] In a merger, however, Target disappears and the consideration reaches the hands of Target's former shareholders. For an acquisition structured as an asset transfer to simulate a merger, therefore, Target must liquidate by distributing the consideration received from Acquirer to Target's shareholders and then dissolve.[45] By contrast, when Target actually sells its assets, Target is not compelled by law to liquidate and dissolve, though it normally will do so.[46]

40. When Acquirer purchases Target's assets, Acquirer may be exposed to certain Target liabilities such as products liability claims, environmental clean-up liabilities, and pension liabilities, regardless of whether Acquirer expressly assumes these liabilities. *See* WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 4892.75 (discussing circumstances where Acquirer can be held liable for torts of Target without expressly assuming liability), 7122 (discussing application of successor liability doctrine to environmental clean-up actions) (perm. ed. rev. vol. 1990 & Supp. 2004).

41. Of course, any assets of Target not wanted by Acquirer might be distributed by Target in advance of a merger.

42. When Acquirer assumes a liability of Target, Acquirer becomes primarily liable because Target has the right to recover from Acquirer if Target's creditors collect from Target. In the absence of a novation, however, Target's creditors retain the right to proceed against Target. *See* FLETCHER, *supra* note 40, § 7116.

43. *See supra* text accompanying notes 36-39 .

44. *See supra* ILLUSTRATION 4.

45. *See supra* ILLUSTRATION 2, *Step 2*.

46. Target normally liquidates after selling its assets, unless it plans to enter a new business. Typically,

When Target liquidates after selling its assets, Target's shareholders receive the consideration provided by Acquirer, subject to any residual claims against Target.[47] In a merger, by contrast, Target's shareholders are not exposed to any of the former Target's liabilities.[48] Thus, the asset transfer fiction deviates from one of the fundamental effects of a merger, namely, the insulation of Target's shareholders from all liabilities of Target.

In summary, an acquisition structured as an asset transfer differs from a merger in several ways. First, in an asset transfer, Acquirer can pick and choose among the assets it takes from Target. In a merger, by contrast, Acquirer receives all of Target's assets by operation of law. Moreover, in an asset transfer, Acquirer can pick and choose the liabilities it assumes from Target. In a merger, however, all liabilities shift to Acquirer by operation of law. In addition, when assets are transferred, Target is not compelled to liquidate and dissolve. But in a merger, Target is extinguished. Finally, when Target liquidates after transferring its assets, Target's shareholders are residually exposed to Target's liabilities. By contrast, when a merger occurs, Target's shareholders are insulated from Target's liabilities.

For the most part, acquisitions structured as stock transfers and asset transfers deviate from mergers in similar ways. Unlike a merger, stock transfers and asset transfers accommodate partial transfers; a stock transfer accommodates the transfer of less than all of Target's stock, and an asset transfer accommodates the transfer of less than all of Target's assets and liabilities. In addition, a stock transfer and an asset transfer can end after stock or assets are transferred; a liquidation and dissolution of Target is not mandated in either case. In a merger, by contrast, the separate existence of Target necessarily terminates. Asset transfers differ from stock transfers and mergers, however, in one significant respect. When Target is liquidated after an asset transfer, Target's shareholders are residually exposed to Target's liabilities, a result that occurs neither in a merger nor when Target is liquidated after a stock transfer.

Both the stock transfer fiction and the asset transfer fiction offer imperfect explanations of a merger. The asset transfer fiction offers a weaker explanation, however, because that fiction causes Target's shareholders to be exposed to its liabilities, a result that does not transpire from a merger or the stock transfer fiction. Nevertheless, the government has consistently applied the asset transfer fiction to a cash merger. Part III explores the justification for that treatment.

Target's shareholders wish to take possession of the proceeds of the sale of a corporate business, even though the act of liquidation normally triggers a shareholder tax. *See* I.R.C. § 331 (2000) (stating that distributions in a complete liquidation are treated as received in exchange for stock). Even if Target's shareholders were averse to paying this tax, the threat of corporate penalty taxes normally induces a liquidating distribution. *See* I.R.C. §§ 531 (accumulated earnings tax), 541 (personal holding company tax) (2000).

47. The shareholders are liable as transferees for any claims against Target to the extent of the liquidation proceeds. *See* I.R.C. § 6901 (2000). Moreover, Target's shareholders are contingently liable for any Target liabilities assumed by Acquirer (to the same extent that Target would have been liable for such claims had Target not liquidated). HENN & ALEXANDER, *supra* note 2, § 382.

48. If, however, a Target shareholder had contractually guaranteed a liability of Target, that shareholder would remain exposed in the unlikely event the guarantee was not released before the merger.

III. ASSET TRANSFER FICTION WAS ONCE DEFENSIBLE BUT IS NOW A TRAP FOR THE UNWARY

For almost four decades, the Internal Revenue Service (IRS) has consistently applied the asset transfer fiction to a cash merger. At first, the tax law could be seen as supporting this treatment. This support has been eroded, however, by dramatic legislative changes during the 1980s.[49] Under current law, the asset transfer fiction mandates a tax on Target that can easily be avoided by well-counseled taxpayers. Hence, continued use of the asset transfer fiction penalizes only the unwary.

A. Administrative Adoption of Asset Transfer Fiction

Neither common law,[50] nor state corporate law,[51] nor federal tax law[52] strongly

49. I.R.C. §§ 311, 336, 338 (2000).

50. A Supreme Court case involving a federal stamp tax is often cited as authority for favoring the asset transfer fiction; however, that case did not address a merger. *See* Raybestos-Manhattan, Inc. v. United States, 296 U.S. 60 (1935) (treating certain asset sales as triggering a stamp tax to Target, but, although a merger also occurred, the merger was not before the Court). Various lower courts nevertheless applied the *Raybestos* holding to mergers. *See, e.g.*, Am. Processing & Sales Co. v. Campbell, 164 F.2d 918 (7th Cir. 1947) (imposing the stamp tax on Target in a merger); Union Oil Co. of Cal. v. United States, 480 F.2d 807 (Ct. Cl. 1973) (imposing the stamp tax on Target in a merger). *But see* Union Bankers Ins. Co. v. United States, 317 F.2d 598 (5th Cir. 1963) (refusing to impose transfer tax on Target in a merger due to Texas law governing life insurance companies).

In *West Shore Fuel, Inc. v. United States*, 598 F.2d 1236, 1242 (2d Cir. 1979), the court refrained from addressing the global question of whether a merger should be conceptualized as commencing with an asset transfer or a stock transfer, and instead resolved the taxpayers' inconsistent positions by relying on a factual analysis. The court found that, based on the unique facts of the case, "the transaction here, although carried out through the medium of a merger, in substance was a sale of assets followed by a liquidation, not a direct sale of stock by shareholders . . . ." For criticism of *West Shore Fuel*, see Tufts, *supra* note 17, at 350.

51. The evolution of state laws involving mergers, asset transfers and stock transfers proceeded along separate paths. At common law, corporations could not merge. As time passed, industry specific merger laws were enacted. By the late 1800s, merger statutes of general applicability began to appear. *See generally* Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687, 695-96, 746-47 (1998) (describing evolution of corporate combinations in Delaware, New Jersey, North Carolina, and the Model Business Corporation Act); Comment, *Statutory Merger and Consolidation of Corporations*, 45 YALE L.J. 105, 109-10 (1935) (discussing how statutes authorizing mergers have evolved from industry-specific statutes to general statutes). Cash mergers were not allowed until 1925, when Florida first permitted such mergers. Elliot J. Weiss, *The Law of Take-Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 632 (1981). Every state now has a merger statute and all but Alaska permit cash mergers, but none delineate a specific order for the consequences of a merger. *See* MBCA § 11.02 (comparing states' statutes).

In contrast to mergers, asset transfers have always been based on contractual agreements between the corporate parties. Comment, *supra* note 51, at 107. Today, all states have statutes delineating the necessary procedures to carry out an asset sale focusing principally on shareholder consent. *See* FLETCHER, *supra* note 40, § 2949.20 (noting that all states have statutes that govern the sale of assets by a corporation). Regarding stock transfers at common law, one corporation was generally not permitted to purchase stock in another corporation. All states now allow one corporation to hold stock in another corporation. *Id*. §§ 2825, 2832.

52. No Internal Revenue Code provision addresses a cash merger. In the case of a merger that qualifies as a tax-deferred reorganization, neither the definitional provision nor the corporate tax-deferral provision reveals any indication of Congress's conception of a merger. *See* I.R.C. § 361 (2000) (nonrecognition rule that applies to the target corporation in a reorganization); § 368(a)(1)(A) (statutory merger can be treated as a reorganization). A 1954 Code provision delineating the secondary effects of certain reorganizations; namely,

favors either of the fictions that might be used to explain a cash merger. The income tax regulations confirm that the tax consequences of a merger occur *simultaneously*.[53] This view undermines the legitimacy of any fiction attempting to order the consequences of a cash merger. Nevertheless, the IRS has consistently applied the asset transfer fiction to a cash merger.

The IRS first publicly applied the asset transfer fiction to a cash merger in 1969. In Revenue Ruling 69-6,[54] a stockholder-owned savings and loan association merged into a non-stock (depositor-owned) savings and loan association. Savings accounts in the non-stock institution served as the consideration for the merger. The principal issue was whether savings accounts constituted permissible consideration for the merger to qualify as a tax-deferred reorganization.[55] The IRS ruled that the savings accounts were impermissible consideration for a reorganization and, therefore, treated the merger as a taxable cash merger.[56]

After a painstaking analysis of whether the merger qualified as a reorganization, the ruling summarily states: "[t]he transfer [by Target] of all of its assets to [Acquirer] will be considered a sale by [Target] of all of its assets to [Acquirer]."[57] By treating the

---

the shifting of Target's historic tax attributes to Acquirer, can be seen as applying the asset transfer fiction to certain mergers. *See* I.R.C. § 381(a)(2) (2000) (awkward provision implicating the asset transfer fiction by suggesting that corporate tax-deferral provision (section 361) can apply to certain mergers). When enacting section 381, Congress focused on drafting a provision broad enough to capture a merger; any subsidiary effects of the drafting effort (including the implicit adoption of the asset transfer fiction) was likely unintended. *See* H.R. REP. NO. 83-1337. Section 381 was designed to

> enable the successor corporation to step into the 'tax shoes' of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law. Tax results of reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise. At the same time the new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as . . . merger into another corporation.

Id. Even if Congress viewed certain mergers qualifying as reorganizations through an asset transfer fiction lens, no indication exists that Congress viewed a cash merger through that same lens. Indeed, it is unlikely that Congress even contemplated the implications of a cash merger on Target while the *General Utilities* rule applied. *See infra* Part III.B.1.

53. Treas. Reg. § 1.368-2(b)(1)(ii) (2006).

54. Rev. Rul. 69-6, 1969-1 C.B. 104. The view had previously been applied to mergers that qualified as tax-deferred reorganizations. *See, e.g.*, Rev. Rul. 67-326, 1967-2 C.B. 143 (analyzing forward triangular merger as a type "C" reorganization, a transaction that commences with a transfer of Target's assets to Acquirer).

55. For a merger to qualify as a tax-deferred reorganization, certain common law requirements must be satisfied including the continuity of proprietary interest doctrine. *See* I.R.C. § 368(a)(1)(A) (2000) (including statutory merger in the definition of reorganization); Treas. Reg. § 1.368-1 (2001) (delineating common law continuity of proprietary interest, continuity of business enterprise and business purpose requirements). To satisfy the continuity of proprietary interest requirement, a substantial part of the consideration must constitute "stock" of Acquirer. *See* John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (continuity requirement satisfied when Acquirer stock represented 38% of the consideration). A non-stock savings and loan association cannot issue stock.

56. The ruling held that no proprietary interest in a mutual savings and loan is deep enough to constitute stock thereby rendering the merger taxable. The Supreme Court subsequently upheld this view. *See* Paulsen v. Comm'r, 469 U.S. 131 (1985).

57. Rev. Rul. 69-6, 1969-1 C.B. 104, 105.

merger as commencing with an asset sale, the IRS implicitly invoked the asset transfer fiction.[58] The ruling offers neither supporting authority nor an explanation of why a cash merger should be viewed as commencing with an asset sale.[59] Even the IRS has privately conceded the dearth of authority and the absence of a rationale for this view.[60] Nevertheless, the IRS has consistently adhered to this position.[61]

In light of the law governing asset sales and stock sales in 1969, the IRS's casual adoption of the asset transfer fiction to explain a cash merger is not surprising. At that time, the asset transfer fiction represented a superior explanation of a cash merger. Part II.B explores the sources of this superiority.

B. Superiority of Asset Transfer Fiction Prior to the 1980s

When Revenue Ruling 69-6 surfaced, the law governing taxable acquisitions was conducive to the adoption of the asset transfer fiction. Asset sales and stock sales were generally taxed alike. Thus, the choice of a fiction for explaining a cash merger did not matter very much. More importantly, the steps of the stock transfer fiction were not accorded independent effect. Thus, the asset transfer fiction was the only viable choice for explaining a cash merger. Finally, the tax law governing corporate acquisitions focused principally on the buyer during this period and, from the buyer's perspective, the asset transfer fiction provides a superior explanation of a merger. It is not surprising, therefore, that the IRS initially embraced the asset transfer fiction.

1. Neutral Tax Treatment of Asset Sales and Stock Sales

The IRS's casual invocation of the asset transfer fiction in Revenue Ruling 69-6 can largely be explained by the neutral tax treatment accorded asset sales and stock sales during this period. If Target sold its assets and then liquidated, Target would generally not be taxed under the well-known *General Utilities* rule.[62] Although Target was not taxed, Acquirer was nevertheless entitled to increase the basis of Target's assets to market value.[63] If, instead of selling its assets, Target's shareholders sold their stock,

58. S*ee supra* Part II (demonstrating that the asset transfer fiction commences with the transfer of Target's assets to Acquirer).

59. The ruling supports its finding with the following obtuse reference: "See section 1.368-1(b) of the regulations which provides in part that a sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up." Rev. Rul. 69-6, 1969-1 C.B. 104, 105.

60. *See* I.R.S. Litig. Bull. 89-4, 1989 WL 989256 (Apr. 1989) ("There are few guideposts as to the true character of a cash merger. . . . Rev. Rul. 69-6 offers no rationale for its conclusion that the cash merger was an asset sale . . . ."); I.R.S. Nondocketed Serv. Adv. Rev. 8938, 1989 WL 1172948 (1989) (expressing similar sentiment).

61. For recent applications, see, e.g., I.R.S. Priv. Ltr. Ruls. 200628008 (Mar. 28, 2006); 200606009 (Feb. 10, 2006); 200214016 (Apr. 5, 2002).

62. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935). If, within twelve months of adopting a plan, Target sold its assets, liquidated, and met certain other requirements, Target was accorded nonrecognition treatment. *See* I.R.C. § 337 (1954). Certain exceptions existed to the *General Utilities* rule. *See, e.g.*, I.R.C. §§ 1245, 1250 (1954) (establishing that gain attributable to certain depreciation deductions is always recognized); Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 401 (1983) (finding tax benefit rule overrides *General Utilities* rule in certain circumstances).

63. I.R.C. § 1012 (1954).

Target would not incur a tax.[64] When Target's stock was purchased, however, Acquirer could increase the basis of Target's assets to market value by liquidating Target.[65] Hence, regardless of whether a cash merger was explained by the asset transfer fiction (i.e., as an asset sale followed by the liquidation of Target) or by the stock transfer fiction (i.e., as a stock sale followed by the liquidation of Target), the same tax consequences normally resulted. Specifically, no corporate tax was imposed on Target, and the basis of Target's assets was increased to market value.

Revenue Ruling 69-6 treated a cash merger as commencing with an asset sale.[66] Because an asset sale alone does not extinguish Target's existence, the ruling by necessity then treated Target as liquidating.[67] Moreover, the ruling explicitly acknowledged that by viewing the merger as a sale of Target's assets followed by the liquidation of Target, the *General Utilities* rule insulated Target from tax.[68] Consequently, it is clear that the IRS did not expect the asset transfer fiction to cause Target to be taxed.

Due to the neutral tax treatment of stock sales and asset sales, the IRS could have invoked either fiction to explain a cash merger without creating controversy. The IRS had previously applied the asset transfer fiction to mergers that qualified as tax-deferred reorganizations.[69] Hence, it was logical for the IRS to extend that fiction to cash mergers.

2. Stock Sales Recharacterized as Asset Sales

A more compelling reason for the IRS to have favored the asset transfer fiction stems from the tax treatment of stock sales. When Acquirer purchased Target's outstanding stock and, within two years, liquidated Target, the stock purchase was recast as an asset purchase pursuant to the *Kimbell-Diamond* doctrine.[70] This doctrine enabled Acquirer to treat a stock purchase as an asset purchase simply by liquidating Target. When these events occurred, the basis of Target's assets was increased to market value,[71] but no tax was imposed on Target.[72] Thus, it was common practice for a corporate purchaser of Target's stock to liquidate Target with the objective of enjoying a tax-free increase in the basis of Target's assets.

64. I.R.C. § 1001(a) (1954) (requiring sale or disposition of property to trigger a taxable gain).

65. I.R.C. § 334(b)(2) (1954) (treating purchase of Target's stock followed by liquidation of Target within two years as an asset purchase). For further discussion, see *infra* Part III.B.2.

66. *See supra* text accompanying note 57.

67. Rev. Rul. 69-6, 1969-1 C.B. 104, 105.

68. *Id.* "Since [Target] will be dissolved, [the merger consideration] will be distributed to [Target] shareholders in complete liquidation of [Target. Target] may avail itself of the provisions of section 337 of the Code if the liquidation meets the requirements of that section." *Id.* The "provisions of section 337" sanctioned the deferral of Target's tax. *See supra* note 62.

69. *See supra* note 54.

70. Kimbell-Diamond Milling Co. v. Comm'r, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951). Under this common law doctrine, asset purchase treatment was contingent on a finding that the stock sale and subsequent liquidation were part of a unified plan. In 1954, Congress modified the doctrine to mandate asset purchase treatment when a stock purchaser liquidated Target within two years of the stock purchase, regardless of whether the subsequent liquidation was part of a plan. *See* I.R.C. § 334(b)(2) (1954).

71. *See* I.R.C. § 1012 (1954) (conferring cost basis on Target's assets).

72. *See* I.R.C. § 336 (1954). Under current law, a liquidating subsidiary still does not recognize gain or loss. *See* I.R.C. § 337 (2000).

In light of the *Kimbell-Diamond* doctrine, the asset transfer fiction offered the only viable explanation of a cash merger. If the stock transfer fiction were applied to a merger, the merger would be treated as commencing with a purchase of Target's stock. This fictional stock purchase would be followed immediately by the liquidation of Target because Target is extinguished in a merger. These events (i.e., the purchase of Target's stock followed by the liquidation of Target) would have been recast as an asset purchase under the *Kimbell-Diamond* doctrine.[73] Hence, if the stock transfer fiction had been applied to a cash merger at this time, the fictional sale of Target's stock and the subsequent liquidation of Target into Acquirer would have been taxed as an asset purchase.

By virtue of the *Kimbell-Diamond* doctrine, the steps in the stock transfer fiction were not respected as independent events but were instead integrated into an asset purchase. Thus, the asset transfer fiction served as the only viable explanation for a cash merger. It is not surprising, therefore, that the IRS embraced the asset transfer fiction.

3. Focus on Buyer Reinforced the Asset Transfer Fiction

In addition to undermining the substance of the stock transfer fiction, the *Kimbell-Diamond* doctrine likely fostered the view that a cash merger commenced with an asset sale for a more subtle reason. During this period, the tax consequences to Target were generally benign regardless of whether its assets or its stock was sold. When Target sold its assets, the threat of tax was minimized by the pervasive *General Utilities* rule.[74] This treatment was contingent on Target liquidating, but the liquidation of Target routinely followed the sale of its business.[75] Thus, Target's favorable tax treatment generally resulted from the normal course of events.[76]

By contrast, when the shareholders of Target sold their stock, the *Kimbell-Diamond* doctrine mandated that Acquirer execute a discretionary action, the liquidation of Target, to achieve its favorable tax treatment. When Acquirer purchased Target's stock, Acquirer could increase the basis of Target's assets to market value only by liquidating Target.[77] Otherwise, the basis in Target's assets would not change. Hence, the spotlight was on Acquirer to make a business decision that was far from routine. In many instances, Acquirer might have preferred to operate Target as a wholly-owned subsidiary.[78] Yet, not liquidating Target would deprive Acquirer of the tax benefits offered by the *Kimbell-Diamond* doctrine. This quandary affected only Acquirer. Regardless of whether Target was liquidated, Target was not treated as selling its assets.[79]

---

73. *See supra* ILLUSTRATION 1 (steps in stock transfer fiction). Because Target is extinguished in the merger, the liquidation step of the stock transfer fiction occurs immediately after the stock purchase.

74. *See supra* Part III.B.1.

75. *See supra* note 46.

76. For Target to achieve nonrecognition treatment, certain corporate formalities were required, including the adoption of a plan of liquidation before the asset sale. *See* I.R.C. § 337 (1954).

77. I.R.C. § 334(b)(2) (1954).

78. For example, Acquirer was not exposed to Target's liabilities when Target was operated as a subsidiary, rather than liquidated into Acquirer. *See supra* text accompanying notes 36-39.

79. Dallas Downtown Dev. Co. v. Comm'r, 12 T.C. 114 (1949); I.R.S. Gen. Couns. Mem. 35,267, 1973 WL 34,293 (Mar. 14, 1973) ("[T]he Kimbell-Diamond doctrine has historically been applied only to the acquiring corporation . . . and has been held not to require a recasting of the transaction with respect to the

The *Kimbell-Diamond* doctrine's focus on the buyer may have reinforced the view that the asset transfer fiction is a superior fiction for explaining a merger. When a merger is examined from the buyer's perspective, the asset transfer fiction provides the more efficient means for conceptualizing the transaction. The asset transfer fiction is more efficient than the stock transfer fiction because it achieves the end result of a merger in one step, rather than two. The first step of the asset transfer fiction shifts Target's assets and liabilities to Acquirer.[80] At that point, Acquirer is in the same position as if Target had merged into Acquirer. For an asset sale to simulate a merger, Target must also liquidate.[81] The liquidation is necessary for Target's shareholders to reach the end point of a merger, but it has no bearing on Acquirer.

The stock transfer fiction is not as compelling from Acquirer's perspective as the asset transfer fiction. After the first step of the stock transfer fiction, Acquirer holds Target's stock, not Target's assets and liabilities as it would in a merger.[82] It is only after Target is liquidated into Acquirer that the end point of a merger is achieved.[83] Hence, from Acquirer's perspective, the stock transfer fiction requires two mechanical steps. By contrast, the asset transfer fiction achieves the end result of a merger after a single step. Because the asset transfer fiction is more economical, it could logically be seen as the superior explanation of a merger during the reign of the *Kimbell-Diamond* doctrine.

It is difficult to assess whether the *Kimbell-Diamond* doctrine's focus on the buyer indeed reinforced widespread faith in the asset transfer fiction.[84] In light of the high level of confidence in a fiction with no inherent superiority, however, intangible influences must have been lurking beneath the surface.[85] Otherwise, one would suspect that the asset transfer fiction would have been subjected to greater scrutiny after the tax law's support for this fiction eroded. As will be seen, however, even after the disappearance of the elements that supported the asset transfer fiction, allegiance to that fiction has not wavered.

C. Erosion of Asset Transfer Fiction's Superiority

The asset transfer fiction's apparent superiority has been eroded by dramatic changes in the law. The *General Utilities* rule was repealed, thereby eliminating the uniform tax treatment of asset sales and stock sales. In addition to the repeal of the *General Utilities* rule, the *Kimbell-Diamond* doctrine has been superseded. Finally, the tax law governing corporate acquisitions is no longer principally focused on the buyer

acquired corporation . . . and its shareholders.") (citations omitted).

80. *See* ILLUSTRATION 4.

81. *See* ILLUSTRATION 2.

82. *See* ILLUSTRATION 3.

83. *See* ILLUSTRATION 1.

84. Corporate law might also be seen as disproportionately focused on the buyer, thereby reinforcing the tendency to conceptualize a merger pursuant to the asset transfer fiction. When Target is disposed of in a merger, its shareholders remain fully protected from all claims against Target. *See supra* Part II. Hence, post-merger claimants must pursue their claims against Acquirer. This focus of post-merger litigation on Acquirer might also be fueling the tendency to conceptualize a merger from the buyer's perspective.

85. The tendency to conceptualize a merger as an asset transfer, rather than a stock transfer, might also stem from the fact that the destination of Target's assets in a merger is obvious (namely, Acquirer). By contrast, the destination of the stock of Target's shareholders in a merger is unclear. *See infra* note 116 and ILLUSTRATION 5.

when a stock purchase occurs. Hence, none of the factors that previously favored the asset transfer fiction now exist.

1. Disparate Treatment of Asset Sales and Stock Sales

Congress repealed the *General Utilities* rule in 1986.[86] Now when Target sells its assets, Target is taxed on any resulting gain[87] and Acquirer increases the basis of Target's assets to market value.[88] By contrast, when the shareholders of Target sell their stock, Target is not taxed on the gain in its assets, unless an election is made to tax Target.[89] Moreover, the basis of Target's assets is not increased to market value after a stock purchase, unless the election to tax Target is made.[90] Hence, the tax consequences of a stock sale now mirror those of an asset sale *only* when the requisite election to tax Target is made. Normally, this election will not be made because the cost of the current tax on Target generally exceeds the future tax savings derived from an increase in the basis of Target's assets.[91] Thus, under current law, Target is taxed when its assets are sold but not when its stock is sold.

Now that asset sales and stock sales are taxed differently, the alternative fictions for explaining a cash merger lead to different tax consequences. If the asset transfer fiction applies, the first-step asset sale triggers a tax to Target and a corresponding increase in the basis of Target's assets.[92] The asset transfer fiction thus mandates a tax on Target, a result not anticipated when Revenue Ruling 69-6 was issued.[93] By contrast, if the stock transfer fiction applies, Target is not taxed and the basis of Target's assets does not change.[94] Thus, the IRS's casual invocation of the asset transfer fiction to explain a cash merger can no longer be rationalized as a meaningless choice.

2. Stock Sales Are Never Recharacterized as Asset Sales

When Revenue Ruling 69-6 was issued, the *Kimbell-Diamond* doctrine validated the asset transfer fiction.[95] That doctrine was superseded in 1982, however, when Congress enacted an elective tax regime for stock purchases. Since that time, when Acquirer purchases Target's stock, Target generally is not taxed and the basis of Target's assets does not change, regardless of whether Target is liquidated. However, Acquirer may elect to treat the stock purchase as an asset purchase.[96] If the election is made, Target is

86. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 631-633, 100 Stat. 2085 (1986) (codified as amended at I.R.C. §§ 311, 336, 337).

87. I.R.C. § 1001(c) (2000) (mandating recognition of realized gains unless a nonrecognition provision applies).

88. I.R.C. § 1012 (2000).

89. *See* I.R.C. § 338 (2000) (permitting corporate purchaser of Target's stock to elect to treat Target as selling and repurchasing its assets in a taxable transaction), discussed *supra* at Part III.B.2.

90. *Id.* § 338.

91. *See supra* note 9.

92. I.R.C. §§ 1001, 1012 (2000). *See* ILLUSTRATION 4 (first step in asset transfer fiction).

93. *See supra* text accompanying notes 66-69.

94. These consequences result unless asset sale treatment is elected. *See* I.R.C. § 338 (2000) (stating that if Acquirer elects asset sale treatment, Target is treated as selling and repurchasing its assets).

95. *See supra* Part III.B.2.

96. *See* I.R.C. § 338 (2000).

deemed to sell its assets and then repurchase them.[97] Under current law, the deemed sale triggers a current tax to Target, and the deemed repurchase increases the basis of Target's assets to market value.[98] Although the elective regime enables a stock purchaser to simulate the tax consequences of an asset purchase, the election is rarely made because asset purchase treatment normally results in higher tax costs.[99]

The elective regime for stock purchases was intended to coordinate any increase in the basis of Target's assets with the imposition of a tax on Target.[100] The tax treatment now depends on an election, rather than the requirement of the *Kimbell-Diamond* doctrine that Target be liquidated.[101] The government, however, remained concerned that remnants of the *Kimbell-Diamond* doctrine might support a claim that a stock purchase followed by the liquidation of Target could still permit the basis of Target's assets to be increased without Target being taxed.[102] To eliminate this possibility, the IRS ruled in 1990 that a stock purchase followed by the liquidation of Target will *never* be recast as an asset purchase, unless the requisite election to treat the stock purchase as an asset purchase is made by Acquirer.[103]

The foregoing events injected substance into the stock transfer fiction's explanation of a cash merger. When the *Kimbell-Diamond* doctrine applied, the stock transfer fiction (i.e., the purchase of Target's stock followed by the liquidation of Target) *always* resulted in asset purchase treatment.[104] Because the individual steps of the stock purchase fiction were not respected, the asset transfer fiction provided the only viable explanation for a cash merger. By contrast, after 1990, the stock purchase fiction *never* results in asset purchase treatment in the absence of an election to the contrary. Under current law, therefore, the individual steps of the stock transfer fiction are generally respected. Hence,

97. *Id.*

98. *See* I.R.C. §§ 1001 (providing that the sale of property causes any realized gain to be recognized unless a nonrecognition provision applies), 1012 (providing that the buyer takes a cost basis in purchased property) (2000). Prior to the repeal of the *General Utilities* rule in 1986, the deemed sale normally did not trigger a tax to Target. *See* I.R.C. § 337 (1954). Therefore, from 1982 (when section 338 was enacted) until 1986 (when the *General Utilities* rule was repealed), the section 338 election was generally desirable because it permitted an increase in the basis of Target's assets without triggering a tax to Target. After the repeal of the *General Utilities* rule, however, elective asset purchase treatment was generally shunned because the increase in basis came at the cost of a current tax on Target. *See supra* note 9.

99. *See supra* note 9. The section 338 election is still desirable when Target has a net operating loss carryover that will absorb the gain on the fictional sale of Target's assets. *See* I.R.C. § 172(a) (2000) (allowing a deduction for net operating loss carryovers). In this situation, the basis of Target's assets is increased without a tax on Target. In addition, a special election that may be made under prescribed conditions is also generally desirable. *See* I.R.C. § 338(h)(10) (2000). This special election substitutes a tax on the gain in Target's assets for the tax on the gain in Target's shareholders' stock. As a result, the basis of Target's assets is increased to market value at the cost of a tax on Target, *in lieu of* the tax on Target's shareholders that would otherwise be imposed. For further discussion of § 338(h)(10), see KWALL, *supra* note 9, at 505-06.

100. *See* H.R. REP. NO. 97-760, at 600, 632 (1982) (Conf. Rep.) ("[S]ection 338 was intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.").

101. *See* BITTKER & EUSTICE, *supra* note 9, ¶ 12-73-74 ("Where the parent has recently purchased . . . the stock of a subsidiary for cash in order to obtain the sub's assets, . . . a basis step-up . . . now may be accomplished without an actual liquidation (but at the price of full gain or loss recognition inside the sub) [by making the election] under § 338.").

102. *See supra* Part III.B.2.

103. Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2).

104. *See supra* Part III.B.2.

the two fictions now stand on equal footing and offer equally viable explanations of a merger.

3. Attention to Seller Reinforces the Stock Transfer Fiction

Prior law governing taxable acquisitions focused on the buyer, from whose perspective the asset transfer fiction provides a more compelling explanation of a cash merger.[105] Current law, however, focuses equally on seller and buyer. When an asset sale occurs now, the seller is taxed and the buyer increases the basis of the acquired assets to market value.[106] When a stock sale occurs, current law's elective regime allows for a deemed sale of assets, triggering a tax to the seller, and a deemed repurchase, increasing the basis of Target's assets.[107] Because prior law focused principally on the buyer, the asset transfer fiction offered a superior explanation of a merger. Now that the seller shares the spotlight, the stock transfer fiction is equally compelling.

From the seller's perspective, the stock transfer fiction is the superior explanation of a merger because it achieves the end result in a more economical fashion than the asset transfer fiction. When Target's shareholders transfer their stock to Acquirer, the consideration provided by Acquirer immediately reaches those shareholders.[108] At that point, Target's former shareholders are in the same position as if Target merged into Acquirer. For a stock transfer to simulate a merger, however, Target must subsequently liquidate into Acquirer.[109] The liquidation is necessary to simulate the end point of a merger for the buyer, but it has no bearing on the seller.

The asset transfer fiction is not as compelling from the seller's perspective as the stock transfer fiction. After Target transfers all of its assets, its shareholders continue to hold Target stock, not the consideration they would receive from Acquirer in a merger.[110] When an asset transfer occurs, Target must distribute the consideration received from Acquirer to Target's shareholders to achieve the end point of a merger.[111] Hence, from the seller's perspective, the asset transfer fiction reaches the result of a merger in two steps, whereas the stock transfer fiction requires only one step. Thus, by virtue of its economy, the stock transfer fiction can be seen as the superior explanation of a merger from the seller's perspective.

105. *See supra* Part III.B.3.

106. *See* I.R.C. §§ 1001 (providing that the sale of property causes any realized gain to be recognized unless a nonrecognition provision applies), 1012 (providing that the buyer takes a cost basis in purchased property) (2000).

107. *See* I.R.C. § 338 (2000) (providing for election of asset sale and repurchase treatment); *supra* Part III.C.2. Although "seller's" tax is technically imposed on Target after the stock of Target is held by Acquirer, the cost of the tax is normally extracted by Acquirer from Target's shareholders through a reduction in purchase price. Specifically, the price Acquirer will pay for Target's stock generally represents the price Acquirer would have paid for Target's assets, reduced by the tax that would have been triggered to Target if its assets had been sold. *See* KWALL, *supra* note 9, at 485-89.

108. *See* ILLUSTRATION 3.

109. *See* ILLUSTRATION 1.

110. *See* ILLUSTRATION 4.

111. *See* ILLUSTRATION 2.

Due to dramatic changes in the tax law, any bias that previously existed toward the buyer's perspective of a merger can no longer be rationalized. Under current law, the perspectives of both seller and buyer command equal attention. From the seller's perspective, the stock transfer fiction offers the more logical explanation of a merger. Because current law focuses equally on the seller and the buyer, neither party's perspective should dominate the tax law's view of a merger.

D. Asset Transfer Fiction Is a Trap for the Unwary

All the factors that previously favored the asset transfer fiction have disappeared. The mere loss of the asset transfer fiction's superiority, however, does not justify its rejection. Rather, the asset transfer fiction is arguably entitled to deference for serving as the foundation for a uniform government policy over the past four decades.[112] Taxpayers have come to rely on this position, and its clarity provides desirable predictability. Hence, the asset transfer fiction should be abandoned only if it now has adverse effects.

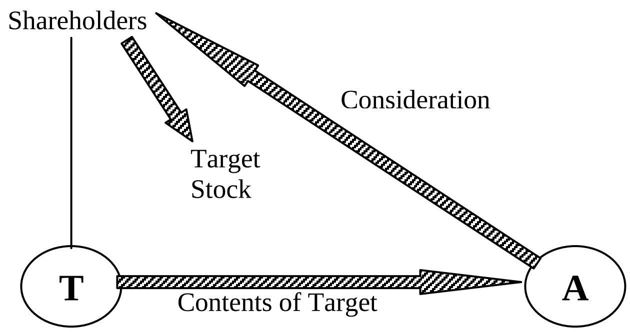
The asset transfer fiction has indeed become problematic. The tax the asset transfer fiction imposes on Target can easily be circumvented with a substantively equivalent transaction sanctioned by the government. Thus, the asset transfer fiction now serves as a trap for the unwary and for those who mistakenly believe that their merger qualifies as a tax-deferred reorganization.[113]

112. *See* Alan Cathcart, *More on Reverse Triangular Mergers*, 64 TAX NOTES 130 (1994) (acknowledging "uniform policy of the IRS to treat a statutory merger as the acquisition by the survivor of the assets of the merged corporation"). In reality, the policy is not all that uniform. *See* I.R.S. Litig. Bull. 89-4, 1989 WL 989256 (Apr. 1989) ("It is not necessarily the Service's position that all cash mergers constitute asset sales.").

113. *See, e.g.,* Paulsen v. Comm'r, 469 U.S. 131 (1985) (finding that a merger of a stock savings and loan into a mutual savings and loan did not qualify as a tax-deferred reorganization because it violated the continuity of proprietary interest requirement); Honbarrier v. Comm'r, 115 T.C. 300 (2000) (finding that a merger of one trucking company into another trucking company failed to qualify as a tax-deferred reorganization because it violated the continuity of business enterprise requirement).

Since 1990, the IRS has sanctioned a relatively simple route for escaping the tax imposed on Target in a cash merger.[114] By substituting two mergers for one, the parties can achieve the end results of a cash merger while securing the tax consequences of a stock sale. Although mergers are still employed to effectuate the acquisition, no corporate tax is imposed on Target unless an election is made.[115] In lieu of a single forward merger of Target into Acquirer (see ILLUSTRATION 5),[116] the tax on Target can be avoided by utilizing two mergers: a "reverse" merger followed by an "upstream" merger.

ILLUSTRATION 5: FORWARD MERGER



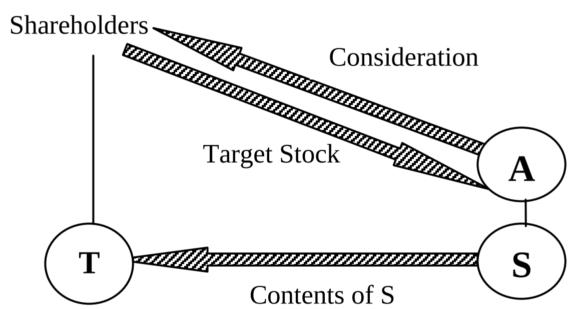
114. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2); Treas. Reg. § 1.338-3(d) (2003).

115. *See* I.R.C. § 338 (2000) (providing for election of asset sale treatment); *supra* Part III.C.2.

116. The thick arrows in ILLUSTRATIONS 5-7 are intended to convey the operation of law effects of a merger, in contrast to the thin arrows in ILLUSTRATIONS 1-4 that depicted actual physical transfers of property, stock and money. In ILLUSTRATION 5, the destination of the arrow attached to the stock of Target's shareholders is not known. Those subscribing to the stock transfer fiction would regard Acquirer as the destination; those who favor the asset transfer fiction would regard Target as the destination. As demonstrated in Part II, the actual destination of Target's stock will inevitably remain a mystery because it is converted to the consideration delineated in the merger agreement by operation of law.

To effectuate a reverse merger (see ILLUSTRATION 6), Acquirer first forms a new subsidiary ("S") and S is then merged into Target. Target's shareholders receive the same cash consideration as in a forward merger of Target into Acquirer. Unlike a forward merger where Target is extinguished, however, Target survives the reverse merger as a wholly-owned subsidiary of Acquirer and S is extinguished.[117]

ILLUSTRATION 6: REVERSE MERGER



After the reverse merger, Acquirer owns all the Target stock. Hence, the reverse merger is substantively equivalent to a stock purchase (the purchase of Target's stock by Acquirer) and is taxed accordingly.[118] As such, no tax is imposed on Target unless an election to the contrary is made.[119]

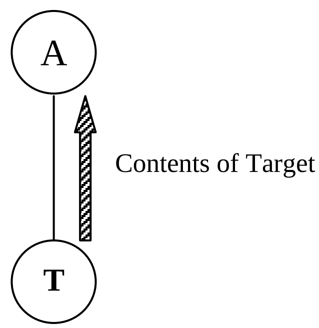
117. *See* FLETCHER, *supra* note 40, at § 6970.149 (explaining reverse mergers).

118. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (treating a reverse merger as a qualified stock purchase); Treas. Reg. § 1.338-3(d) (2003) (implementing Rev. Rul. 90-95). Unlike a stock purchase, however, a reverse merger offers the corporate law convenience of a merger obviating the need to persuade every shareholder to tender shares. Of course, modern share exchange statutes now often provide convenience comparable to a merger. *See infra* text accompanying notes 150-154.

119. Target will be taxed if asset sale treatment is elected under I.R.C. section 338, but that election will not normally be made. *See supra* notes 9, 99.

The reverse merger alone does not reach the end point of a forward merger of Target into Acquirer. To reach that end, a second merger, the upstream merger of Target into its parent, Acquirer, must occur (see ILLUSTRATION 7). This upstream merger is taxed as a liquidation and, therefore, neither Target nor Acquirer is taxed.[120] Consequently, by utilizing two mergers instead of one, the same end results are achieved. However, by utilizing mergers treated as a stock sale and liquidation, the tax on Target is avoided.

ILLUSTRATION 7: UPSTREAM MERGER



Under normal circumstances, substance-over-form principles would cause the two mergers to be integrated into a single forward merger, thereby negating circumvention of the asset transfer fiction and resulting in the imposition of a tax on Target.[121] However, the government has ruled that a purchase of Target's stock (here effectuated through a reverse merger), followed by the liquidation of Target (here effectuated through an upstream merger), will *never* be recast as an asset purchase.[122] Hence, the government has effectively provided a roadmap for avoiding the tax on Target in a cash merger.[123]

120. *See* I.R.C. §§ 332, 337 (2000) (conferring nonrecognition treatment on both corporations when a subsidiary is liquidated into its parent); Treas. Reg. §§ 1.332-2(d), (e) (1955). Unlike a liquidation, however, an upstream merger offers the corporate law convenience of shifting ownership of assets by operation of law, rather than by utilizing documents of conveyance. For tax purposes, however, both transactions are treated alike. No tax is imposed on Target in either case.

121. The common law step-transaction doctrine, a variant of the substance-over-form principle, permits a series of formally separate steps to be amalgamated and treated as a single transaction. Courts employ various tests to determine whether a sufficient factual connection exists to integrate the individual steps. In Rev. Rul. 90-95, the requisite factual connection existed between the reverse merger and the upstream merger to apply the step-transaction doctrine. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (acknowledging that state law prohibited Acquirer from owning the stock of Target, thereby necessitating the upstream merger). For a more detailed overview of the step-transaction doctrine, see Jeffrey L. Kwall & Kristina Maynard, *Dethroning* King Enterprises, 58 TAX LAW. 1, 11-15 (2004).

122. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2) (stating that the step-transaction doctrine will not be applied to treat a purchase of Target's stock followed by its liquidation as a purchase of Target's assets); Treas. Reg. § 1.338-3(d) (2003) (implementing Rev. Rul. 90-95). For a variation on the theme of Rev. Rul. 90-95, see GINSBURG & LEVIN, *supra* note 16, at 8-43 (delineating mechanics for substituting two mergers for forward triangular merger).

123. The government adopted this position to ensure that the basis of Target's assets could not be increased to market value unless the gain in Target's assets was taxed. *See infra* Part IV.

The cost of substituting two mergers for one is normally small relative to the tax on Target that it avoids.[124] Consequently, Target will be taxed in a cash merger only when the parties fail to substitute an indirect path for a direct one.[125] Perpetuating the asset transfer fiction in this environment smacks of unfairness and creates a compelling case for reform.

In summary, it is not surprising that the IRS invoked the asset transfer fiction to explain a cash merger in 1969. However, all the elements previously supporting the asset transfer fiction have since disappeared, and that fiction now imposes a corporate tax that can easily be avoided with the government's blessing by all but the unwary. Consequently, the tax treatment of cash mergers should be reformed. Part IV will explore alternative reform options.

IV. REFORM OPTIONS

Under current law, the three techniques for acquiring a corporate enterprise lead to different tax consequences. When Target sells its assets, a tax on Target is mandated. When the stock of Target is sold, a tax on Target is elective. When Target is acquired in a cash merger, a tax on Target is mandated but that tax can easily be avoided by substituting two mergers for one.

Ideally, the tax system should not influence the business decision of how to structure an acquisition.[126] This ideal cannot be achieved as long as the alternative acquisition techniques are subjected to disparate tax treatment. Congress could neutralize the ill effects of current law by mandating that all taxable acquisitions be taxed uniformly, regardless of form.[127] Disparate tax treatment has existed for more than two decades, however, and it is unlikely that Congress will remedy this situation in the foreseeable future.

Due to the poor prognosis for comprehensive reform, a second-best solution that rectifies the problematic treatment of cash mergers is desirable. Specifically, the IRS should reject the asset transfer fiction and apply the stock transfer fiction to cash mergers. This change in policy would render the tax on Target in a cash merger elective, thereby eliminating the trap that now exists for taxpayers who fail to substitute two mergers for one.

---

124. *See* Glen A. Kohl & Lea Anne Storum, *M&A Double Take: Why Two Mergers Are Better than One*, 5 THE M&A LAW. No. 7 (2002) ("Generally it will not be difficult to interpose a reverse triangular merger in an otherwise forward structure.").

125. *See supra* note 28.

126. When a tax causes an economic decision to be made differently from how it would have been made in the absence of the tax, the taxpayer generally bears a burden in excess of the tax itself. The tax creates an inefficiency because it makes one person worse off without conferring a corresponding benefit on anyone else. *See* R. MUGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 291-312 (4th ed. 1984) (explaining excess burden and its impact on economic efficiency).

127. Even greater systemic benefits would be derived by extending uniformity to acquisitions currently qualifying as tax-deferred reorganizations, but those transactions are beyond the scope of this Article. *See generally* STAFF OF S. FIN. COMM., 99TH CONG., FINAL REPORT ON SUBCHAPTER C (Comm. Print 1985) (proposing to provide uniform tax treatment for all corporate acquisitions, regardless of form and regardless of whether cash or stock of Acquirer serves as the consideration).

A. Restoring Neutral Tax Treatment to Asset Sales and Stock Sales

Congress could eliminate the tax system's influence on the form of a corporate acquisition by taxing asset sales and stock sales uniformly. If that result were achieved, the question of whether the asset transfer fiction or the stock transfer fiction should apply to a cash merger would be relegated to an academic inquiry. Regardless of which fiction applied, all taxable acquisitions would be taxed alike, and tax considerations would no longer influence their structure.

Three alternative systems might be employed to restore neutral treatment to asset sales and stock sales. First, Congress might mandate a tax on Target in all cases and correspondingly, an increase in the basis of Target's assets to market value.[128] Under current law, this approach is manifested by the treatment of asset sales and of those stock sales for which the election to tax Target is made.[129] To extend this treatment to all stock sales, the tax on Target must be mandatory, rather than elective. If Target were taxed in all asset sales and all stock sales, Target would also be taxed in all cash mergers, regardless of which fiction was invoked.

Rather than mandating a tax on Target in all cases, the second alternative would be for Congress to take the opposite approach. Specifically, Target might be relieved from a current tax in all asset sales and all stock sales and, correspondingly, be required to retain the historic basis in its assets.[130] These ends are achieved by current law when a stock sale occurs and no election to tax Target is made.[131] To extend this system to all stock sales, Congress would need to repeal the mechanism to elect a tax on Target. In the case of asset sales, Congress would need to enact legislation insulating Target from tax.[132] If Target were relieved from tax in asset sales and stock sales, Target would likewise not be taxed in a cash merger regardless of which fiction applied.

Finally, rather than implementing a mandatory tax system, Congress's third alternative would be to permit the parties to an asset sale or a stock sale to elect whether Target should be taxed.[133] If the tax were elected, the basis of Target's assets would be adjusted to market value. By contrast, if the tax were not elected, the basis of Target's

128. *See* James Lewis, *A Proposal for a Corporate Level Tax on Major Stock Sales*, 37 TAX NOTES 1041 (1987) (proposing that Target be taxed regardless of whether its assets or its stock is sold); *see also* Lori Farnan, *A Mandatory Section 338: Can It Be Implemented?*, 42 FLA. L. REV. 679 (1990) (advancing guidelines for a mandatory tax on Target when its stock is sold). Target would be taxed and the basis of its assets would be increased only if the market value of Target's assets exceeds their basis. If the basis of Target's assets exceeds their market value, a loss would be triggered and basis would be reduced to market value. This Article generally assumes that the value of Target's assets exceeds the basis of its assets.

129. I.R.C. §§ 338, 1001, 1012 (2000).

130. *See* Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Uniform Mandatory Rules*, 44 TAX L. REV. 145 (1989). Another version of this alternative would be to resurrect the *General Utilities* rule and forego a corporate tax while permitting a step-up in asset basis to market value. *See supra* Part III.B.1. Assuming that the resurrection of the *General Utilities* rule would result in a significant loss of tax revenue, restoration of that rule seems highly unlikely.

131. *See* I.R.C. § 338 (2000) (permitting corporate purchaser of Target's stock to elect to treat Target as selling and repurchasing its assets).

132. *See, e.g.*, I.R.C. § 337 (1954) (noting prior law that insulated Target from tax when it sold its assets and other requirements were satisfied).

133. *See* STAFF OF S. FIN. COMM., 99TH CONG., FINAL REPORT ON SUBCHAPTER C (Comm. Print 1985).

assets would not change. Current law treats stock sales in this manner.[134] To extend this treatment to asset sales, Congress must enact legislation permitting the parties to an asset sale to elect whether Target is taxed. If both stock sales and asset sales were subject to an elective regime, the tax treatment of cash mergers would also be elective regardless of which fiction applied. If Congress implemented this elective system, all cash acquisitions, regardless of form, would be taxed consistently.

The disparate tax treatment of asset sales and stock sales has existed since the repeal of the *General Utilities* rule more than two decades ago.[135] During this period, Congress has shown no interest in restoring uniformity to the tax treatment of taxable acquisitions. Moreover, no reason exists to be optimistic about major tax reform occurring in the foreseeable future.[136] Hence, a less comprehensive solution to the problems posed by the tax treatment of cash mergers should be pursued to increase the likelihood of implementation.

B. Applying the Stock Transfer Fiction to Cash Mergers

If Congress refrains from taxing asset sales and stock sales alike, all cash mergers should be taxed alike, regardless of whether two mergers are substituted for one. At first blush, it would appear that this end could be achieved in either of two ways. First, the asset transfer fiction might be extended to two-step mergers (i.e., a reverse cash merger followed by an upstream merger) in an effort to tax Target even when two mergers are substituted for one. Alternatively, the asset transfer fiction might be abandoned and the stock transfer fiction would instead be applied to all cash mergers. On more careful reflection, however, the only viable option is to abandon the asset transfer fiction because expanding that fiction would make matters worse. If the asset transfer fiction were extended to two-step mergers, the current disparity in tax treatment when two mergers are substituted for one would be exacerbated.[137]

Currently, when a reverse cash merger is followed by an upstream merger, the IRS respects the separate steps and the reverse merger is taxed as a stock sale.[138] As such, the reverse merger is subjected to current law's elective regime that governs stock sales.[139] Specifically, the basis of Target's assets is increased to market value only if a tax on Target is elected.[140] In the absence of such an election, the basis in Target's assets does not change. Although a tax on Target is not mandated in a two-step merger, a link exists between any increase in the basis of Target's assets and a tax on Target.

134. *See* I.R.C. § 338 (2000) (providing that purchase of Target's stock impacts the basis of Target's assets only if Acquirer elects asset purchase treatment).

135. *See supra* Part III.C.1.

136. On November 1, 2005, President Bush's Advisory Panel on Federal Tax Reform submitted two comprehensive tax reform proposals to the Treasury Department. Since the panel's report was delivered "tax reform seems to have fallen off the President's radar screen. Never mind the back burner—tax reform doesn't appear to even be in that warming drawer at the bottom of the stove." Robert J. Wells, *Bush on Tax Reform*, 110 TAX NOTES 565 (2006).

137. If the asset transfer fiction were applied to two-step mergers, the basis of Target's assets might be increased without the imposition of a tax on Target, thereby violating a fundamental tenet of current law. *See infra* text accompanying notes 141-145.

138. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2); *supra* Part III.D.

139. *See* I.R.C. § 338 (2000); *supra* Part III.C.2.

140. *Id.* § 338.

If the asset transfer fiction were applied to two-step mergers, the two mergers would be integrated into an asset purchase.[141] As a result, current law's elective regime would not apply.[142] Instead, the integrated transaction would presumably be governed by a common law which supports an increase in the basis of Target's assets to market value.[143] No common law authority exists, however, to impose a tax on Target in these circumstances.[144] Consequently, if the asset transfer fiction were extended to two-step mergers, the link that now exists between an increase in the basis of Target's assets and a tax on Target would be broken. As a result, taxpayers could potentially enjoy an increased basis in Target's assets without a corresponding tax on Target.[145] Hence, applying the asset transfer fiction to two-step mergers could augment, rather than eliminate, the disparity in tax treatment when two mergers are substituted for one.

The only viable approach for taxing all cash mergers alike, therefore, is to abandon the asset transfer fiction. A tax on Target in a cash merger should not be mandated. Instead, the stock transfer fiction should apply to all cash mergers, and any tax on Target should be elective. To achieve this end, Revenue Ruling 69-6 should be overruled and new IRS guidance should be issued that applies the stock transfer fiction to cash mergers. By treating a cash merger as commencing with a stock purchase, current law's elective regime would apply to cash mergers.[146] Under this system, Target will not be taxed in a cash merger and the basis of its assets will not change, unless an election to tax Target is made.

Although substituting the stock transfer fiction for the asset transfer fiction modifies a longstanding ruling position, it would not adversely affect taxpayers who desire the tax consequences of Revenue Ruling 69-6.[147] Those taxpayers could still achieve the same results simply by making the requisite election for asset sale treatment.[148] Less sophisticated taxpayers, as well as taxpayers who fail in an attempt to qualify a merger as a tax-deferred reorganization, will no longer be burdened by an avoidable tax on Target.[149] In effect, an existing trap is eliminated without disrupting the benefits derived

141. *See supra* Part II.B (delineating asset transfer fiction).

142. I.R.C. § 338 (2000) (elective regime applies only to a stock purchase, not to an asset purchase).

143. *See* Kimbell-Diamond Milling Co. v. Comm'r, 14 T.C. 74 (1950) (treating the purchase of the Target's stock followed by a pre-planned liquidation of Target as a purchase of Target's assets), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951); *supra* Part III.B.2. Although much of the *Kimbell-Diamond* doctrine was superseded, see *supra* Part III.C.2, remnants remain. *See generally* Don W. Bakke, *Dusting Off* Kimbell-Diamond*: The Continued Viability of the Asset Acquisition Doctrine for Non-Corporate Purchasers*, 28 WM. MITCHELL L. REV. 1443 (2002) (identifying areas where the *Kimbell-Diamond* doctrine might still be applied).

144. *See supra* note 79 and accompanying text.

145. In effect, taxpayers could achieve the results of the *General Utilities* rule (no tax on Target and an increased basis in Target's assets) more than two decades after that rule was repealed. *See supra* Parts III.B.1, III.C.1. Congress could of course enact legislation that would eliminate this possibility.

146. *See* I.R.C. § 338 (2000).

147. *See supra* note 112 and accompanying text.

148. *See* I.R.C. § 338 (2000).

149. *See supra* note 113. For an example in the tax law of reversing a system that mandated an election to achieve a result normally desired by less sophisticated taxpayers by making the desired result the norm, see I.R.C. § 453 (2000) (causing the installment method of reporting gain to apply automatically to any sale in which at least one payment is to occur in a later year, unless the taxpayer elects in the year of sale not to apply the installment method, resulting in a reversal of the rules that applied prior to 1980); Martin D. Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 N.Y.U. ANN. INST. ON FED. TAX'N § 43.01 (1981).

from a longstanding ruling position.

Further justification for applying the stock transfer fiction to mergers at this point in time can be derived from the proliferation of state "share exchange" statutes.[150] In a share exchange, Target and Acquirer enter into an agreement that, with shareholder approval, causes the stock of Target's shareholders to be converted by operation of law to the consideration recited in the share exchange agreement.[151] These share exchange statutes extend the corporate law benefits of a merger to stock acquisitions by enabling Acquirer to secure the stock of recalcitrant Target shareholders by operation of law.[152] Share exchanges are taxed as stock purchases, notwithstanding their substantive similarity to a cash merger.[153] Hence, as state law erodes the distinctions between stock transfers and mergers, it becomes increasingly difficult to justify tax law distinctions.[154]

Some might object to the apparent inconsistency of applying the stock transfer fiction to cash mergers and the asset transfer fiction to those mergers qualifying as tax-deferred reorganizations.[155] The application of the asset transfer fiction to mergers qualifying as tax-deferred reorganizations predates its application to cash mergers.[156] While it is superficially appealing to apply a uniform analysis to taxable and non-taxable mergers, analytical disparities between taxable acquisitions and tax-deferred reorganizations have always existed. Moreover, the IRS has reinforced these disparities

150. *See* MBCA § 11.03. The only states that have not enacted share exchange statutes are Delaware, Kansas, Massachusetts, Missouri, Ohio, Rhode Island, and West Virginia.

151. *See* MBCA § 11.07(b) (effect of a share exchange). To accomplish a share exchange, the boards of Target and Acquirer negotiate an agreement and submit the proposal to a vote of each corporation's shareholders. If the proposal is approved by the percentage mandated by the statute, all Target shares are transferred to Acquirer by operation of law.

152. Mergers and share exchanges are governed by the same section or consecutive sections of most statutes. *See, e.g.*, MBCA §§ 11.02 (mergers), 11.03 (share exchanges).

153. Share exchanges are taxed as stock purchases when any cash consideration is utilized. If all the consideration is in the form of Acquirer stock, the share exchange could qualify as a tax-deferred reorganization. *See* I.R.C. § 368(a)(1)(B) (2000). Although share exchange statutes originally confined the permissible consideration to stock of Acquirer, modern statutes normally permit cash and many other forms of consideration. *See, e.g.*, MBCA § 11.03(a)(1) (including "cash" as permissible consideration).

154. For an example of the tax law adapting to the breakdown of state law distinctions, see Treas. Reg. § 301.7701-3(a) (1996) (taxing most non-publicly traded, unincorporated enterprises with at least two owners as partnerships, unless the enterprise elects to be taxed as a corporation). This regulation was promulgated in response to the enactment of limited liability legislation by every state in the late twentieth century that eliminated the most significant state law differences between a corporation and an unincorporated enterprise. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, § 1.2 *The Emergence and History of LLCs* (1992 & supp. 2005). Prior to 1996, an unincorporated enterprise was taxed as a corporation if it possessed certain characteristics historically attributed to corporations. *See* Larson v. Comm'r, 66 T.C. 159 (1976) (applying the corporate resemblance test), *acq. in result*, 1979-1 C.B. 1. The 1996 regulations reflect the government's acknowledgment that it was no longer sensible for the tax law to distinguish partnerships from corporations based on characteristics no longer unique to the corporate form. Applying the stock transfer fiction to both forward and reverse cash mergers would likewise offer the benefit of eliminating a tax law distinction with no foundation in corporate law. *See* L.A. Bar Members Report, *supra* note 17 ("From a legal viewpoint, the corporate mechanic of which of the merger participants survives the merger appears to be a formalistic determinative factor without any economic consequences.").

155. The asset transfer fiction has long been applied to mergers that qualify as tax-deferred reorganizations. *See supra* note 53; Rev. Rul. 72-343, 1972-2 C.B. 213. The proposal in this Article would not change that result.

156. *See supra* note 54.

precisely in this area by limiting its position of not integrating two-step mergers to those instances where integration results in a taxable transaction.[157] When the integration of a two-step merger results in a tax-deferred reorganization, the IRS still applies substance-over-form principles in a traditional fashion and integrates the steps into a reorganization.[158] Hence, no logical impediment exists to utilizing different fictions for explaining taxable and tax-deferred mergers.

Applying the stock transfer fiction to taxable mergers represents only a partial solution to the disparate tax treatment of taxable corporate acquisitions. Although this proposal establishes elective tax treatment for stock sales and cash mergers, a mandatory tax on Target would still occur in an asset sale.[159] The resulting tax system would discourage taxpayers from utilizing asset sales when that acquisition technique might otherwise be desired. Nevertheless, the proposed policy change advances fairness and achieves a desirable incremental reform.

If neither Congress nor the Treasury acts to rationalize the treatment of cash mergers, it is only a matter of time before the government's assertion of a corporate tax in a cash merger will be challenged. A court might question the propriety of mandating a tax on Target in a cash merger due to the absence of a readily identifiable taxable event[160] and reject Revenue Ruling 69-6 as unreasonable.[161] If this occurred, the resulting uncertainty regarding how a cash merger should be conceptualized would likely impede the flow of corporate acquisitions. Hopefully, a legislative or administrative solution will emerge before that day arrives.

V. CONCLUSION

A merger occurs by operation of law, not by mechanical steps. Thus, no one can authoritatively say whether a cash merger should be conceptualized as commencing with an asset sale or a stock sale. As such, no inherent justification exists for favoring one explanation of a merger over another for tax purposes. Nonetheless, because fundamentally different tax consequences now result from asset sales and stock sales, a cash merger must be viewed as one or the other to ascertain its tax effects.

The government has long treated a cash merger as commencing with an asset sale. When that view was articulated, asset sales and stock sales were accorded similar tax treatment. Thus, the government could not possibly have contemplated the implications of its asset sale view in a world where fundamental differences exist between the tax

157. *See* Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2); *see also supra* Part III.D.

158. *See* Rev. Rul. 2001-46, 2001-42 I.R.B. 321 (integrating reverse merger and subsequent upstream merger where resulting transaction qualifies as a tax-deferred reorganization); Treas. Reg. 1.338-3(d) (2003).

159. *See* I.R.C. § 1001 (2000).

160. *See* Paulsen v. Comm'r, 469 U.S. 131, 151 (1985) (O'Connor, J., dissenting) ("[B]ecause a transaction that is a sale rather than a tax-deferred exchange at the shareholder level cannot qualify as a tax-deferred reorganization at the corporate [Target] level, . . . the result of the Court's holding is to discourage an entire class of legitimate business transactions without regard to the desirability of such mergers from an economic standpoint. This result is directly contrary to the intent of Congress. . . .").

161. A revenue ruling merely represents the position of the IRS—it has neither the effect of law nor even the weight of a regulation. *See* Geisinger Health Plan v. C.I.R., 985 F.2d 1210, 1216 (3d Cir. 1993) ("[C]ourts are to give weight to IRS revenue rulings but may disregard them if they conflict with the statute they purport to interpret or its legislative history, or if they are otherwise unreasonable.").

treatment of asset sales and stock sales.

Continuing to treat a cash merger as an asset sale results in uneven treatment of similarly situated taxpayers, thereby offending basic notions of fairness. Ideally, Congress should eliminate the disparate treatment of asset sales and stock sales. The prognosis for congressional action is poor, however, suggesting that a second-best solution is needed. To achieve that end, the government should reverse its historic position and treat a cash merger as commencing with a stock sale so that all parties can access the elective tax treatment now reserved for the well-advised.