CASE STUDY: PRETRANSACTION RESTRUCTURING

Continuity of interest: Avoiding a trap for the unwary. RSM discovers and eliminates significant tax issues through due diligence.

Frequently, when buyers and sellers are negotiating transactions, the parties to the transaction want to structure the deal in a manner that suits their business needs. This makes perfect sense. But, sometimes, these negotiations can cause a tax problem to arise—perhaps a tax problem that is not at all obvious.

Background

In a recent transaction, a RSM client (HC) was in negotiations to sell the stock of its two domestic operating subsidiaries, X and Y, to a foreign corporation (FP). As part of these negotiations, FP realized that if it purchased the stocks of X and Y separately, these two domestic corporations would not be able to file a consolidated U.S. tax return. To eliminate the need to file separately for the businesses of X and Y, FP requested that HC merge X into Y in a tax-free reorganization as permitted under section 368. This request seemed benign and was certainly understandable from a business viewpoint.

Issue

However, as a result of FP's merger request, a question arose: Will the merger of X into Y be tax-free under the rules that apply under section 368? One such rule relates to the continuity of interest (COI) requirement. Under this rule, when X merges into Y, the shareholder of X (HC) must receive, as a significant portion of the total consideration for the merger, stock in the acquiring corporation (Y). In this case, HC would own 100 percent of both X and Y, and when this unity of ownership exists, the rule states that Y will be deemed to have issued its stock to HC as consideration for the merger. Thus, it appeared that all would be well.

But also warranting consideration was the fact that HC would sell the stock of Y immediately after the merger and, in fact, would have a contract with FP to do just that. To satisfy the COI requirement, it was necessary to address the question of whether a sale of the Y stock immediately after the merger was permissible. The answer is generally yes. In fact, the COI rules are rather liberal, stating that sales of the Y stock, even if pursuant to a binding contract entered into before the merger, are permissible. Thus, it continued to appear that all would be well.

But there is a trap for the unwary that RSM discovered through continued due diligence. It is true that the COI rules generally allow all or any portion of the stock received by HC to be sold, but there is an exception. HC may not sell the Y stock to any corporation related to Y. On the face of things, it certainly did seem that FP was unrelated to Y. Yet, herein lies the trap for the unwary that RSM discovered. Due diligence established that the rules underlying COI instruct that in determining which parties are related to Y, any corporation that was related to Y *before* the transaction and any corporation that *becomes* related to Y as a result of the transaction must be taken into account. Because RSM pointed out this exception to the general COI rule, FP was able to avoid a very real and significant issue.

Outcome

In this case, the merger of X into Y would have been done at the request of FP and done solely to facilitate the closing of the sale to FP. Had FP bought 100 percent of the stock of Y post-merger, it is clear that Y would have become related to FP. A conclusion that FP became related to Y as a result of the merger would mean that the COI rule was failed. If the COI rule was failed, then the merger of X into Y would have become a taxable sale of all the assets of X to Y, and X would have owed tax on this sale. In this case, that tax would have been several million dollars. Because X was to be merged into Y, by law Y would assume all liabilities of X, including its tax liabilities. This meant that, in this case, FP might be purchasing a corporation with millions of dollars in tax liabilities, completely altering the economics of the deal it thought it had made.

The solution was simple to implement. RSM advised that FP must purchase the stock of X and Y separately (i.e., no pre-purchase merger). Once this was done, FP would be free to either (1) transfer 100 percent of the X stock to Y, which would allow X and Y to file a consolidated return, or (2) merge X into Y, making moot the filing of a consolidated return. RSM determined that if the merger took place after the purchase of X and Y as two separate corporations, no problem would exist under the COI rules.

In negotiating a deal to fit the business needs of the parties, one must make certain that no tax issues are created that cannot be properly addressed. Small changes in facts can mean large changes in tax consequences.

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