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USE OF THE TAX-FREE TRIANGULAR MERGER FOR THE ACQUISITION OF TWO CORPORATIONS WITH CROSS-OWNERSHIP

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BACKGROUND

This paper will explore the use of the tax-free triangular merger provisions of the Internal Revenue Code[1] for the acquisition of two corporations, when one corporation owns a substantial equity interest in the other.

The practical business need for a triangular merger device pre-dated, and indeed was the impetus for, the adoption in 1968 and 1971, respectively, of the tax-free triangular merger provisions of sections 368(a)(2)(D) and 368(a)(2)(E). These two sections of the Internal Revenue Code define a tax-free Type A reorganization[2] to include the acquisition of a target corporation by a parent corporation through the merger of the parent's controlled subsidiary with the target, for stock of the parent. This form of acquisition may be much more advantageous than the more traditional Type A, B, or C reorganization[3] for a number of reasons.

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1. All section references in this paper are to the Internal Revenue Code of 1954, as amended, unless the context expressly indicates otherwise. I.R.C. §§ 368(a)(2)(D) and 368(a)(2)(E) provide that a transaction complying with the triangular merger provisions of those sections shall not be disqualified as a reorganization under I.R.C. § 368(a)(1)(A) if certain conditions are met.

2. I.R.C. § 368(a)(1)(A).

3. A reorganization under I.R.C. § 368(a)(1)(A) is typically referred to as a Type A reorganization, and involves a statutory merger or consolidation. A reorganization under I.R.C. § 368(a)(1)(B) is typically referred to as a Type B reorganization, and involves acquisition by one corporation, in exchange solely for its voting stock (or voting stock of its parent), of stock of the target corporation, if immediately after the acquisition the acquiring corporation is in control of the target corporation. A reorganization under I.R.C. § 368(a)(1)(C) is typically referred to as a Type C reorganization, and involves acquisition by one corporation, in exchange solely for its voting

In the traditional Type A reorganization, the acquiring corporation and the target corporation are both parties to a statutory merger, and accordingly both corporations must obtain stockholder approval. As a consequence, if the acquiring corporation is a large public company (which is often the case) it must go through the expense of preparing and mailing a proxy statement to its stockholders to obtain approval of the transaction.[4] Aside from the heavy costs this procedure imposes upon the transaction, it places the acquiring corporation's ultimate decision whether to proceed with the acquisition in the hands of its stockholders rather than its management. Furthermore, all of the target's liabilities are directly assumed by the acquiring corporation by operation of law because merger statutes typically require that the rights and privileges as well as the liabilities and obligations of the constituent corporations become the rights and privileges and liabilities and obligations of the surviving corporation.[5] Thus, all liabilities of the target company, including undisclosed liabilities, become direct liabilities of the surviving corporation.

The "solely for all or a part of its voting stock" requirement of section 368(a)(1)(B) can make this form of acquisition undesirable in a Type B reorganization,[6] since even the smallest amount of boot can destroy the tax-free nature of the transaction.[7] Similarly, in a Type C reorganization[8] the "solely for all or a part of its voting stock" requirement[9], as well as the fact that liabilities of the target ordinarily are assumed by the acquiring

stock (or voting stock of its parent), of substantially all the properties of another corporation.

4. Merger transactions involving corporations organized under state laws typically require shareholder approval of such transactions. *See, e.g.*, Model Business Corporation Act § 73 (1977). Corporations having more than 500 shareholders and $1 million of assets require registration under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976), and Regulation 14 thereof requires the preparation of a detailed proxy statement when such a company is a party to a merger. Rule 145 under the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (1976), ordinarily requires the use of a Registration Statement when the acquiring corporation issues securities pursuant to a merger-type transaction.

5. *See* Model Business Corporation Act § 76 (1977).

6. I.R.C. § 368(a)(1)(B).

7. *See* Mills v. Commissioner, 39 T.C. 393 (1962) (no de minimis rule applicable to "solely"), *rev'd on other grounds*, 331 F.2d 321 (5th Cir. 1964). *See also* Rev. Rul. 75-123, 1975-1 C.B. 115 (the Internal Revenue Service ruled that the purchase of 20% of the acquired corporation's stock for cash would destroy a Type B reorganization if it were part of the same transaction in which 80% is acquired for voting stock).

8. I.R.C. § 368(a)(1)(C).

9. The requirement is somewhat more relaxed than in a Type B reorganization: I.R.C. § 368(a)(2)(B) permits additional consideration in cer-

corporation and that the target's assets and not the target's corporate entity are acquired, can also make this form of acquisition undesirable.

Most of the disadvantages of the traditional Type A and Types B and C reorganizations can be avoided by a tax-free triangular merger.[10] The corporate mechanics of a triangular merger are straightforward. In both forward and reverse triangular mergers[11] the acquiring corporation (parent) usually forms a wholly-owned subsidiary. In a forward triangular merger, the target corporation is merged into the subsidiary. The subsidiary is the surviving corporation and the stockholders of the target exchange target stock for parent stock. Conversely, in a reverse triangular merger the wholly-owned subsidiary of the parent is merged into the target corporation, the target is the surviving corporation, and the stockholders of the target exchange target stock representing control of the target for voting stock of the parent. In both cases, the surviving corporation must acquire substantially all properties of the target.[12] In the reverse triangular merger, the Internal Revenue Code seems to require the parent to fund its subsidiary with the voting stock to be used in the merger, whereas in the forward triangular merger the consideration may be issued directly by the parent to the target's stockholders in exchange for their stock.[13] Other important differences in tax requirements between forward and reverse triangular mergers are discussed below.

tain Type C reorganizations up to 20% of the fair market value of the target corporation.

10. A tax-free triangular merger, as opposed to a merger in a traditional Type A reorganization, eliminates the need for an acquiring public corporation to seek approval of its stockholders because the merger transaction is between a controlled subsidiary of the acquiring public corporation and the target corporation. The "solely for voting stock" requirement of Type B and C reorganizations is not present in a forward triangular merger under I.R.C. § 368(a)(2)(D), and is somewhat more relaxed in a reverse triangular merger under I.R.C. § 368(a)(2)(E).

11. I.R.C. § 368(a)(2)(D) is often referred to as a forward triangular merger, whereas I.R.C. § 368(a)(2)(E) is referred to as a reverse triangular merger.

12. I.R.C. § 368(a)(2)(D) refers to the acquisition through merger of "substantially all of the properties of another corporation," whereas I.R.C. § 368(a)(2)(E) requires that after the merger the surviving corporation hold "substantially all of its properties and . . . the properties of the merged corporation. . . ."

13. I.R.C. § 368(a)(2)(E)(i), by providing that "the corporation surviving the merger holds substantially all . . . of the properties of the merged corporation (other than stock of the controlling corporation) distributed in the transaction" suggests that the merged corporation [the controlled subsidiary] is funded with stock of the controlling corporation used in the triangular merger. No such suggestion is found in I.R.C. § 368(a)(2)(D).

Some years ago, the states began to amend their corporation laws to permit a wholly-owned or controlled subsidiary to consummate a triangular merger using stock of the subsidiary's parent. This authorization, however, for the most part preceded congressional adoption of sections 368(a)(2)(D) and (E) of the Code. Before the adoption of these provisions, the tax-free nature of reorganizations in the form of triangular mergers was in serious doubt. In *Groman v. Commissioner*,[14] a case involving a triangular type acquisition, the United States Supreme Court held that continuity of proprietary interest did not exist, to the extent that stockholders of the target company received stock of the corporate transferee's parent in exchange for their stock, even though the parent owned all the stock of the corporate transferee which had acquired all the assets of the target. *Helvering v. Bashford*[15] also involved a triangular acquisition, except that the assets were received by the parent and then transferred to a subsidiary as part of a single plan. The Court held that *Groman* was applicable and that the stock of the parent was too remote, and therefore lacking in continuity of proprietary interest. Nevertheless, the Internal Revenue Service later ruled that in certain circumstances triangular-type mergers might qualify as functionally equivalent to either a Type B or Type C reorganization provided the substantive provisions of those reorganization sections were otherwise complied with.[16]

TRIANGULAR MERGERS AND CROSS-OWNERSHIP

In light of this background, this article will examine the applicability of the triangular merger provisions of sections 368(a)(2)(D) and (E) of the Code to the acquisition of two target corporations when one target owns a substantial equity interest in the other. The feasibility of using the tax-free reverse triangular merger provisions of section 368(a)(2)(E) of the Code will be explored first, followed by a discussion of the use of the forward triangular merger provisions of section 368(a)(2)(D).

14. 302 U.S. 82 (1937).

15. 302 U.S. 454 (1938).

16. Prior to the adoption of I.R.C. § 368(a)(2)(E), the Internal Revenue Service ruled in Rev. Rul. 67-448, 1967-2 C.B. 144 that a reverse subsidiary merger, where no boot was involved, was a valid Type B reorganization between the controlling parent of the merged subsidiary and the target's shareholders. The transitory nature of the subsidiary was ignored. In Rev. Rul. 67-326, 1967-2 C.B. 143, the Internal Revenue Service ruled in a transaction where the acquired corporation merged directly into the controlled subsidiary and stock of the parent was given, that the parent was not a party to the reorganization, and therefore its stock was boot, unless the transaction could qualify as a Type C reorganization.

The Reverse Triangular Merger

In analyzing the use of the reverse triangular merger provisions of section 368(a)(2)(E), the following assumptions have been made: For valid business reasons a corporation (parent) will seek to acquire two target corporations, *T-1*, a manufacturing corporation, and *T-2*, *T-1*'s marketing arm. *T-1* owns thirty-five percent of the common stock of *T-2*, which it acquired some years ago to assure a marketing source for *T-1*. Parent will organize two subsidiaries, *S-1* and *S-2*, planning that *S-1* will merge into *T-1* and all the outstanding *T-1* stock will be exchanged for parent voting stock. Immediately after the merger of *S-1* into *T-1*, *S-2* will merge into *T-2* and the stockholders of *T-2* will exchange all their shares in *T-2* for parent voting stock. None of the stockholders of *T-1* or *T-2* intends to sell parent voting stock received in such mergers. Since *T-1* owns thirty-five percent of *T-2*, some of the stock issued by the parent for *T-2* stock in the second merger (*S-2* into *T-2*) will be owned by *T-1*. In addition, the cross-ownership of *T-2* stock by *T-1* will be eliminated at the conclusion of the second merger because the stock of *T-2* owned by *T-1* will be converted into parent voting stock pursuant to the second merger. No other disposition of the operating assets of either *T-1* or *T-2* after these two mergers is contemplated.

Section 368(a)(1)(A) of the Code defines a reorganization to include "a statutory merger or consolidation." Section 368(a)(2)(E) provides:

> A transaction otherwise qualifying under paragraph (1)(A) shall not be disqualified by reason of the fact that stock of a corporation . . . [the parent] which before the merger was in control of the merged corporation [the subsidiary] is used in the transaction, if—
>
> (i) after the transaction, the corporation surviving the merger [the target] holds substantially all of its properties and of the properties of the merged corporation [the subsidiary] (other than stock of the controlling corporation [the parent] distributed in the transaction); and
>
> (ii) in the transaction, former shareholders of the surviving corporation [the target] exchanged, for an amount of voting stock of the controlling corporation, [the parent] an amount of stock in the surviving corporation [the target] which constitutes control of such corporation.

Accordingly, the merger of *S-1*, a wholly-owned subsidiary of the parent, into *T-1* where the stockholders of *T-1* surrender control and receive voting stock of the parent in exchange for *T-1* stock should qualify as a reorganization pursuant to section 368(a)(2)(E). However, this result is dependent on three conditions: (1) *voting* stock of the parent is exchanged with *T-1* stockholders for at least enough *T-1* stock to represent control[17] of *T-1*; (2) after the transaction, *T-1* holds substantially all of its properties and the properties of *S-1*, if any, other than the voting stock of the parent distributed in the transaction; and (3) all of the judicial requirements, including continuity of interest, are met.

In the first merger (*S-1* into *T-1*) these three conditions will be satisfied. However, satisfaction of all of these conditions may prove to be short-lived when the second merger occurs. In anticipation of that discussion, some background regarding the meaning of "substantially all of its properties" and "continuity of interest" is appropriate.

Section 368(a)(2)(E) requires that *T-1*, which survives the merger, *hold "substantially all of its properties"* and the properties of *S-1* (other than stock of the parent distributed in the transaction). "Holds" is a word which does not appear in any of the other reorganization definitions and which may have a special application in triangular mergers, particularly where cross-ownership by one target in another target is eliminated. Further, the phrase "substantially all of its properties" normally conveys a concept of a quantity of assets transferred or retained. Revenue Proceeding 77-37[18] provides that for purposes of certain

17. I.R.C. § 368(c) defines control as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."

18. Rev. Proc. 77-37, 1977-2 C.B. 568-71 provides as follows:

> Sec. 3.02: The "continuity of interest" requirement of section 1.368-1(b) of the Income Tax Regulation is satisfied if there is continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. It is not necessary that each shareholder of the acquired or transferor corporation receive in the exchange stock of the acquiring or transferee corporation, or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation. Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization.

See proposed amendment to Regulation 1.368-1 *reprinted in* [1980] STAND. FED. TAX REP. (CCH) ¶ 8913.

reorganization provisions, expressly including section 368(a)(2)(E), "substantially all of the assets" means "the retention . . . of assets representing at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by the corporation immediately prior to the transfer." This paper assumes that the value of *T-1*'s equity ownership in *T-2* exceeds the ninety-seventy percent test.

Continuity of interest at the *T-1* stockholder level must be maintained in a triangular merger, just as continuity must be maintained in any other reorganization. Thus, if any of the stockholders of *T-1* sells a substantial part of parent stock received, there will be a question whether continuity has been preserved. For ruling purposes, the Internal Revenue Service has required that the former stockholders of the acquired corporation maintain a continuity of proprietary interest through stock ownership in the acquiring corporation (or its controlling parent) which is equal in value at the date of the reorganization "to at least 50% of the value of all of the formerly outstanding stock of the acquired corporation." The test is not to be applied to each stockholder individually, but to stockholders of the acquired corporation as a group. Continuity of proprietary interest at the stockholder level is not to be confused with continuity of business enterprise at the corporate level. Both are needed in a reorganization to assure that the new entity is a substantial continuation of the old and still unliquidated enterprise.[19] To maintain continuity of proprietary interest, it is sufficient that the stockholders of the acquired corporation have five years of unrestricted ownership, even where divestiture is required by court order within seven years.[20]

In summary, the three major elements of a reverse triangular merger under section 368(a)(2)(E) have been met at the conclusion of the first merger of *S-1* into *T-1*. These three conditions are (1) use of voting stock of the parent; (2) holding by the surviving corporation of substantially all of its own properties and the properties of the merged corporation; and (3) compliance with continuity of interest and continuity of business enterprise requirements. However, since the second merger (*S-2* into *T-2*) is part of the overall plan of acquisition of the two target companies, consummation of the second merger will trigger events which will retroactively infect the tax-free nature of the first merger and thereby destroy compliance, for reorganization purposes, of the entire transaction.

19. Rev. Proc. 77-37, 1977-2 C.B. 568, 571.
20. Rev. Rul. 66-23, 1966-1 C.B. 67.

First of all, when the second merger takes place *T-1*'s thirty-five percent stock ownership in *T-2* will be eliminated, since *T-2* stock owned by all of the stockholders of *T-2* will be exchanged for parent stock. Therefore, at the conclusion of the second merger, *T-1* will be holding parent stock in substitution for its former holdings of *T-2*. Under state corporation laws, stock of a parent corporation owned by its subsidiary typically may not be voted.[21] Accordingly, there will be a serious question whether voting stock of the parent held by *T-1* meets the "voting stock" requirements of section 368(a)(2)(E). In the context of a Type B reorganization, the Internal Revenue Service has ruled that under similar circumstances stock may continue to be deemed voting stock even though under state law the right to vote that stock is limited. That ruling regarding this transaction is in doubt.[22]

Second, the elimination by the second merger of the cross-ownership which *T-1* had in *T-2* appears to violate the requirement that *T-1* hold "substantially all of its properties and the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction)." This elimination occurs upon conversion of the *T-2* stock interest owned by *T-1* into parent stock in the second merger. Following the second merger, *T-1* does not continue to hold substantially all of its properties because after the *T-2* stock it owned is transformed into parent stock, *T-1* no longer has a direct cross-ownership in *T-2*, which was a substantial asset of *T-1*.[23]

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21. *See* Model Business Corporation Act § 33 (1977).

22. Rev. Rul. 73-28, 1973-1 C.B. 187. The ruling simply provides that "the X stock received by Y constituted voting stock within the meaning of section 368(a)(1)(B) of the Code regardless of whether, by virtue of state law, it may be voted in the hands of Y." This ruling is not binding, and perhaps may not be totally reliable precedent. Although the voting requirement of a Type B reorganization refers to the issuing corporation, whereas the voting stock requirement of a reverse triangular merger is from the point of view of the consideration received upon surrender of control by the shareholders of the target, it is assumed that the term "voting stock" should have the same meaning in both cases. However, since it is clear that the lack of ability to exercise an inherent vote surrendered by contract, or otherwise, can be an impediment, especially when the vote is lost in the acquisition, Rev. Rul. 72-72, 1972-1 C.B. 104, there may not be a strong basis for the previous ruling in any event.

23. If the merger of *S-2* into *T-2* preceded the *S-1* merger into *T-1*, the issue would not change. *See* Rev. Proc. 77-37, 1977-2 C.B. 568-71. Section 3.01 provides: "All payments to dissenters and all redemptions and distributions (except for regular, normal distributions) made by the corporation immediately preceding the transfer and which are part of the plan of reorganization will be considered as assets held by the corporation immediately prior to the transfer." *See also* Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

Here a cross-ownership at the subsidiary level will be eliminated,[24] and *T-1* will hold in lieu thereof stock of its parent received in conversion of the *T-2* stock owned by it, a unique "property interest."[25] If a ruling is requested under section 368(a)(2)(E), the Internal Revenue Service will require a representation that there is no plan or intention on the part of the parent to cause the target (in this case *T-1* and *T-2*) to *dispose of any of its assets* after the proposed transactions, except in the ordinary course of business. The disposition of the *T-2* stock owned by *T-1* in the second merger will not be in the ordinary course of business, as it will occur in a merger transaction which is part of an overall plan of acquisition.

The Internal Revenue Service has ruled, in the context of a forward triangular merger under section 368(a)(2)(D), that in effect *S-1* could transfer acquired assets (here *T-2* stock) to its newly-created wholly-owned subsidiary.[26] The Internal Revenue Service previously had ruled that the transfer of part of the assets of a wholly-owned second tier subsidiary received in a Type C reorganization by the acquiring corporation was acceptable.[27] These approvals were premised on dropdowns pursuant to section 368(a)(2)(C),[28] and could evaporate in what is in effect the constructive upstream transfer of the *T-2* stock owned by *T-1* to the parent. Again, the key word in section 368(a)(2)(E) is "holds," not "acquires," and "holds" appears to allow no room for a subsequent transfer either constructively or in fact.

Further, retention or holding of the substituted parent stock, which represents the thirty-five percent interest in *T-2* stock and which was part of the control of *T-2*, does not represent the direct and continuing interest in *T-2* that may be required for continuity of business enterprise.[29] It is not clear that the continuity of business enterprise doctrine would be satisfied by *T-1*'s indirect ownership of its former thirty-five percent interest in *T-2* through ownership of parent stock.

Thus, it appears that even though the first merger technically meets all the requirements of a tax-free reorganization

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24. The simultaneous transfers of assets in a Type C reorganization by a parent and its subsidiary to a target which eliminated the parent stock interest in the subsidiary was held to qualify. Rev. Rul. 68-526, 1968-2 C.B. 156; George v. Commissioner, 26 T.C. 396 (1956), *acq.*, 1956-2 C.B. 5. *See* Rev. Rul. 78-47, 1978-1 C.B. 113.

25. *Cf.* Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959).

26. Rev. Rul. 72-576, 1972-2 C.B. 217.

27. Rev. Rul. 64-73, 1964-1 C.B. 142.

28. This is the legislation passed to overcome the rule of Helvering v. Bashford, 302 U.S. 454 (1938).

29. *See* Groman v. Commissioner, 302 U.S. 82 (1937).

under section 368(a)(2)(E), by reason of the second merger, which is an integral part of the entire plan of acquisition, the first merger ceases to meet all the reorganization requirements of a tax-free reverse triangular merger. The second merger will jeopardize compliance under section 368(a)(2)(E) for one or more of the following reasons: (1) what was thought to be voting stock of the parent may no longer be voting stock if it is held as an asset of *T-1* after the second merger; (2) the requirement that *T-1* "hold" substantially all of its properties (including the thirty-five percent equity interest in *T-2*) will be lost; and (3) elimination of *T-1*'s thirty-five percent interest in *T-2* may constitute a loss of some form of continuity of business enterprise. This is so even though the second merger may also meet the requirements of section 368(a)(2)(E) as a stand-alone transaction.

Thus we have the anomalous situation in which each merger separately may meet the requirements of section 368(a)(2)(E), but when both mergers are part of a single plan of acquisition they fail to meet these requirements. This may be the purest example of the application of the step transaction doctrine.[30]

The Forward Triangular Merger

Applicability of the reverse triangular merger provisions has been analyzed to determine that the acquisition of *T-1* and *T-2*, when *T-1* has a substantial equity ownership in *T-2*, cannot safely be consummated under section 368(a)(2)(E). It is now appropriate to determine whether the forward triangular merger provisions of section 368(a)(2)(D) can safely be used for such an acquisition.

In a forward triangular merger, *T-1* first merges into *S-1*, the surviving corporation. That transaction is followed by the merger of *T-2* into *S-2*, *S-2* being the surviving corporation. In each case the stockholders of *T-1* and *T-2* exchange their stock for parent stock. Note, however, that section 368(a)(2)(D) does not have the "voting stock" requirement that section 368(a)(2)(E) has.

It should be obvious that if a forward triangular merger is used in place of a reverse triangular merger to acquire these two targets (*T-1* first merges into *S-1*, followed by *T-2* into *S-2*), our analysis will result in the same conclusion as that regarding the

30. When several transactions are part of a series of steps pursuant to a single plan, the steps are ignored and only the ultimate result is considered for tax purposes. *See* South Bay Corp. v. Commissioner, 345 F.2d 698 (2d Cir. 1965).

use of a reverse triangular merger, insofar as the "substantially all properties" requirement of section 368(a)(2)(D) is concerned. It will be recalled that section 368(a)(2)(D) requires the acquisition by the parent's subsidiary of "substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation (subsidiary)" as a necessary condition to the availability of a reorganization under that section. Although a forward triangular merger does not require that the parent stock be voting stock (a requirement in the reverse triangular merger), nevertheless a plan relying on section 368(a)(2)(D), which contemplates a merger of *T-1* into *S-1*, followed by a merger of *T-2* into *S-2*, will also fail because the ownership by *T-1* of thirty-five percent of the *T-2* stock will also be eliminated in the second merger when such cross-ownership is converted into stock of the parent. For this reason alone, it is impossible to continue to comply with the forward triangular merger provisions of section 368(a)(2)(D) after the second merger. In addition, compliance with the doctrine of continuity of business enterprise may be in jeopardy because of *T-1*'s loss of ownership in *T-2*.

It appears that the only certain way to acquire *T-1* and *T-2* through a tax-free triangular merger is for the parent corporation to use a wholly-owned or controlled subsidiary (*S-1*) and cause *T-1* and *T-2* to merge simultaneously into *S-1*, the surviving corporation, in exchange for stock of the parent. It is clear that if *T-1* and *T-2* were to merge by statute directly into the parent the transaction would qualify as a reorganization under section 368(a)(1)(A). Accordingly, if *T-1* and *T-2* merge into *S-1*, all the requirements of section 368(a)(2)(D) will be satisfied. *S-1* (the acquiring corporation) will acquire substantially all of the properties of both *T-1* and *T-2*, and even though the cross-ownership is eliminated, because *S-1* will acquire the whole of both corporations the cancelled cross-ownership may properly be disregarded.[31] The whole is not less than the sum of its parts.

CONCLUSION

One traveling the byways of the Internal Revenue Code in search of a tax-free solution to this transaction may conceive innovative routes to that end. However, such a traveler should realize that the step transaction doctrine[32] will most assuredly bring him back to the paths, as well as the danger signals and warnings, noted above.

31. *See* Private Ruling 7913088, Dec. 28, 1978 which treats a transaction of this type as a reorganization under I.R.C. §§ 368(a)(1)(A) and 368(a)(2)(D).
32. *See* note 30 *supra*.