Identifying Reverse Acquisitions and the Resulting Tax Consequences
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Anthony J. Nitti provides a step-by-step approach to identifying when a reverse acquisition has occurred, and a detailed look at the consequences to both the acquiring and target consolidated groups resulting from a reverse acquisition, a technique which is often employed by foreign corporations seeking market entry to the US or seeking local public financing, as well as by US-owned corporations.

Overview
Imagine there are two unrelated consolidated groups of corporations, the P-S group and the T-U group.

The P-S group and the T-U group wish to combine into a new consolidated group by having one of the common parent corporations purchase from the shareholders of the other common parent corporation all of its stock, solely in exchange for stock in the acquiring common parent.

Key attributes of the two groups include the following:

- The value of the T-U group is significantly greater than the value of the P-S group.
- The T-U group reports its income using a June 30 year-end, while the P-S group reports its income using a calendar year-end.

The P-S group has a significant net operating loss carryforward.

Assume the shareholders of P and T wish to use a calendar year-end for the resulting group. More importantly, the resulting group would like to utilize the net operating loss carryforwards of the P-S group to offset future income of the new consolidated group without being subject to limitation under the separate return limitation year (SRLY) rules.¹

In furtherance of these objectives, the transaction is structured so that P purchases all of the stock of T from the T shareholders solely in exchange for P stock. Because the value of the T-U group is significantly greater than the value of the P-S group, T’s former shareholders own 60 percent of the fair market value of the P stock immediately after the transaction.

Absent rules to the contrary, the acquisition of T by P would cause the T-U group to terminate.² The resulting group would be required to use the calendar year-end of the P-S group, and the previous net operating losses of the P-S group would not be treated as arising in separate return limitation years.³
Thus, the net operating losses of the P-S group would not be subject to limitation under the SRLY rules in offsetting future income of the resulting group.4

The "reverse acquisition" rules of Reg. §1.1502-75(d)(3) were enacted specifically to remove the flexibility the shareholders of P and T otherwise would enjoy in the hypothetical example above to structure the combination of P and T in the most advantageous manner. The reverse acquisition rules look through the form of the transaction to its substance to determine which group terminates and which group continues, thereby driving many additional tax consequences for the resulting consolidated group.

While in form, P has acquired T, the more-than-50-percent acquisition of P stock by the former T shareholders indicates that P, rather than T, has actually been acquired, as the former T shareholders now control the resulting group. In effect, the substance of the transaction is that the larger T-U group has acquired the P-S group, the "reverse" of its form. As a result, many of the tax consequences to the T group and P group resulting from the transaction must also be reversed.

Definition of a "Reverse Acquisition"
Reg. §1.1502-75(d)(1) provides the general rule that a group remains in existence for a tax year if the common parent corporation remains as the common parent and at least one subsidiary remains affiliated with it.5

By negative inference, a group will terminate when the common parent ceases to be the common parent of that group. For example, if the stock of the common parent of a group (Old Group) is purchased by another corporation, making the former common parent a subsidiary of a new consolidated group, the Old Group would terminate on the acquisition date.6
The reverse acquisition rules of Reg. §1.1502-75(d)(3)(i) provide an exception to this general rule. Pursuant to these regulations, a group may continue in existence notwithstanding the fact that a new corporation has become the common parent of the group. This exception occurs when a transaction constitutes a reverse acquisition.

From a practical perspective, a reverse acquisition occurs when a larger (by fair market value) group (or separate corporation) is taken over in form by a smaller group (or separate corporation), but the shareholders of the larger group obtain control of the smaller group as a result of the transaction (the "minnow swallowing the whale").

Because in substance the larger group has acquired the smaller group through its obtaining of a controlling interest in the smaller group as a result of the transaction, the regulations "reverse" the general rule of Reg. §1.1502-75(d)(1) and provide that the larger group will continue its existence, even though the common parent of the larger group is not the common parent of the resulting group.

From a technical standpoint, the regulations define a reverse acquisition as occurring if:

A corporation (hereinafter referred to as the first corporation) or any member of a group of which the first corporation is the common parent acquires after October 1, 1965—

(a) Stock of another corporation (hereinafter referred to as the second corporation), and as a result the second corporation becomes (or would become but for the application of this subparagraph) a member of a group of which the first corporation is the common parent, or

(b) Substantially all the assets of the second corporation, in exchange (in whole or in part) for stock of the first corporation, and the stockholders (immediately before the acquisition) of the second corporation, as a result of owning stock of the second corporation, own (immediately after the acquisition) more than 50 percent of the fair market value of the outstanding stock of the first corporation, then any group of which the first corporation was the common parent immediately before the acquisition shall cease to exist as of the date of acquisition, and any group of which the second corporation was the common parent immediately before the acquisition shall be treated as remaining in existence (with the first corporation becoming the common parent of the group) …7

In practice, determining if a reverse acquisition has occurred is often a challenging task. The language of Reg. §1.1502-75(d)(3)(i) is particularly cumbersome, requiring one to look to the scores of IRS rulings interpreting the reverse acquisition rules for clarity.

While a step-by-step process has not been established or utilized by the IRS in determining whether a reverse acquisition has occurred, the author finds the following five steps helpful in avoiding traps for the unwary when determining whether a transaction constitutes a reverse acquisition:
1. Identify the first corporation.

2. Identify the second corporation.

3. Determine if the first corporation and second corporation are members of the same affiliated group prior to the transaction.

4. Determine if the shareholders of the second corporation (immediately before the transaction) own more than 50 percent of the fair market value of the first corporation (immediately after the transaction) as a result of owning stock of the second corporation.

5. Determine if an affiliated group exists after the transaction.

**Step 1: Identify the First Corporation**

Simply stated, the "first corporation" is either the common parent or a subsidiary member of the smaller, acquiring group. To comply with the technical requirements of Reg. §1.1502-75(d)(3), however, the first corporation must satisfy dual roles in a reverse acquisition:

1. As part of the transaction, it must be either:

   a. the member of the group that acquires the stock or assets of the target in whole or in part with its own stock (the acquiring corporation), or

   b. the common parent of the group (immediately before the transaction) which contains the acquiring member if stock of the common parent is used.\(^8\) and

   2. It must be the common parent of the resulting group.\(^9\)

   Thus, when a common parent of a group acquires the stock or assets of a target in whole or in part for its own stock, it will satisfy all of the definitions of a first corporation; it will be the acquiring corporation (the corporation acquiring the stock or assets in exchange for its own stock), the common parent of the group immediately prior to the transaction, and the common parent of the resulting group.

In a typical forward triangular merger where a target corporation merges into the subsidiary of a common parent in exchange for stock of the common parent of the acquiring group, the acquiring corporation and the first corporation will be different.

**Example 1.** P is the common parent of a consolidated group, including subsidiary S. T is the common parent of another, larger consolidated group. P acquires T by having T merge into S in exchange for P stock, and immediately after the transaction, T’s former shareholders own more than 50 percent of the value of P stock.

While S is the acquiring corporation (it acquires substantially all of the assets of T in the merger), it cannot meet the definition of the first corporation. Because Stock of P is used to acquire the assets of T, and S is not the common parent of the resulting group. P, however, satisfies both roles required of a first corporation: it is the common parent of the group (immediately before the
transaction) that contains the acquiring member (S) that uses the stock of P to acquire T, and it is the common parent of the resulting group.

For a reverse acquisition to occur, the first corporation must use its own stock, in whole or in part, to acquire the stock or assets of the second corporation. Thus, the reverse acquisition rules do not apply where the acquiring corporation uses cash or other property to acquire the target corporation, even if the substance of the transaction remains a smaller group acquiring a larger group.

**Example 2.** P is the common parent of a consolidated group and has $1,000 worth of stock outstanding. T is the parent of another consolidated group and has $4,000 worth of stock outstanding. P borrows $4,000 and uses the cash to acquire all of the outstanding stock of T.

Even though the smaller P group has acquired the larger T group, a reverse acquisition has not occurred. No stock of P was used to acquire T, thus, T’s shareholders do not effectively control P immediately after the transaction as they do not own any stock in P or T.

The acquisition of the second corporation by the first corporation may occur in a taxable or nontaxable transaction. Thus, any transaction in which an acquiring corporation acquires the stock or assets of a target corporation in exchange for stock of the acquiring corporation must be tested for a reverse acquisition.

**Step 2: Identify the Second Corporation**

In reverse acquisition terms, the "second corporation" is the larger, acquired corporation. To satisfy the definition provided by the regulations, however, the second corporation must either:

1. become a member of the post-transaction consolidated group of which the first corporation is the common parent, or

2. have substantially all of its assets acquired by the first corporation or a subsidiary member of the common group of which the first corporation is the common parent.

**Example 3.** P is the common parent of a consolidated group, including subsidiary S. T is the common parent of another, larger consolidated group. P acquires T by having T merge into S in exchange for P stock, and immediately after the transaction, T’s former shareholders own more than 50 percent of the value of P stock.

T is the second corporation, as substantially all of its assets have been acquired by S, a subsidiary member of the group of which P, the first corporation, is the common parent. If alternatively, the acquisition of T were structured as an acquisition by P of at least 80 percent of T’s stock, T would again satisfy the definition of the second corporation as it would become a member of the consolidated group of which P, the first corporation, is the common parent.
The acquisition of the stock of a nonincludable corporation cannot constitute a reverse acquisition, as the target corporation cannot become a member of the first corporation’s consolidated group.

**Example 4.** P is the common parent of a consolidated group, including subsidiary S. S acquires all the stock of F, a foreign corporation, in exchange for more than 50 percent of the value of P stock.

The transaction is not a reverse acquisition, as F does not satisfy the definition of the second corporation. As a nonincludable corporation, F cannot become a member of the P group.

In determining whether the second corporation becomes a member of the first corporation’s consolidated group, any acquisitions or redemptions of the stock of either corporation made pursuant to a plan of acquisition are taken into account.

A reverse acquisition can also occur when the first corporation acquires substantially all the assets of the second corporation in an exchange in whole or in part for first corporation stock. While the regulations do not define the term "substantially all the assets of the second corporation," the author believes the IRS will apply the same test found in Rev-Proc-01 77-37, in which the "substantially all" requirement for purposes of the reorganization provisions of Code-section 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D) and 368(a)(2)(E) is satisfied if the assets transferred consist of at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the transferring corporation immediately prior to the transaction.

While the acquisition of the stock of the second corporation requires the second corporation to become a member of the consolidated group of which the first corporation is the parent, no such requirement exists for the acquisition of a second corporation’s assets. Thus, a reverse acquisition can occur when the acquiring corporation acquires substantially all of the assets of a nonincludable corporation.

**Step 3: Determine if the First Corporation and Second Corporation Are Members of the Same Affiliated Group Prior to the Transaction**

A reverse acquisition cannot occur between members of the same consolidated group. The literal language of Reg. §1.1502-75(d)(3) requires that the second corporation’s stock or assets be acquired, and as a result of the acquisition, the second corporation becomes a member of the first corporation’s consolidated group. Thus, the reverse acquisition rules do not contemplate a transaction occurring between members of the same consolidated group.

If the first corporation and the second corporation merely share common ownership, but are not members of the same consolidated group, a reverse acquisition can occur between the two parties.

**Example 5.** Mr. A owns all the shares of P, the common parent of a consolidated group. Mr. A
also owns all the shares of T, the common parent of another, larger consolidated group. Mr. A transfers all of the T shares to P in exchange for additional shares of P, and immediately after the transaction, Mr. A owns more than 50 percent of P as a result of his previous ownership of T stock.

A reverse acquisition has occurred. The P group will terminate, and the T group will continue, with P as the common parent.

Step 4: Determine if the Shareholders of the Second Corporation (Immediately Before the Transaction) Own More Than 50 Percent of the Fair Market Value of the First Corporation (Immediately After the Transaction) as a Result of Owning Stock of the Second Corporation

Reg. §1.1502-75(d)(3)(b) requires that the shareholders of the acquired second corporation, immediately prior to the transaction, own more than 50 percent of the value of the first corporation’s stock immediately after the transaction. Because the 50-percent requirement looks purely to the value of the first corporation rather than the ability of the second corporation’s shareholders to participate in the operations of the first corporation, all stock of the first corporation is taken into account. Thus, a reverse acquisition can occur even if the shareholders of the second corporation receive only nonvoting preferred stock of the first corporation, provided the nonvoting preferred stock represents more than 50 percent of the total value of all the first corporation’s outstanding stock.21 Shares of the acquiring corporation’s stock that were acquired by the second corporation’s shareholders in an unrelated transaction are not counted towards the 50-percent test. Thus, the presence of “old and cold” first corporation stock may prevent the occurrence of a reverse acquisition.22 It is the position of the IRS that if the shareholders of the second corporation previously acquired the first corporation stock in an unrelated transaction, such stock is not treated as having been acquired by the shareholders of the second corporation as a result of owning stock of the second corporation.23 Thus, the ”old and cold” stock is not counted in determining if the shareholders of the second corporation have acquired 50 percent of the value of the first corporation’s stock immediately after the transaction.

Example 6. P and T are the common parents of separate consolidated groups. On September 1, T merged into P in exchange for P stock. Prior to the merger, A, an individual, owned 15 percent of the T stock. A also owned 10 percent of the P common stock from a transaction unrelated to the merger.

After the merger, the former shareholders of T, including A, own more than 50 percent of the value of P stock immediately after the acquisition, but only if the value of the 10 percent of P stock previously acquired by A is counted towards that total.

Because A’s previous acquisition of the P stock is unrelated to the merger of T into P, it is not integrated
The shareholders of the second corporation must own more than 50 percent of the value of the first corporation’s stock immediately after the transaction as a result of owning stock of the second corporation. Thus, if a shareholder transfers cash or other property along with stock in a corporation to a holding company, and the value of the nonstock consideration exceeds the value of the stock, a reverse acquisition will not occur because more than 50 percent ownership in the first corporation is not acquired as a result of owning stock in the second corporation.

**Example 7.** A is the sole shareholder of P, the parent of a consolidated group. The P stock is worth $1,000. A transfers cash of $1,200 and the P stock to a newly formed holding company, X, in exchange for all of the X stock. Though A owns 100 percent of the stock of the first corporation (X) immediately after the transaction, a reverse acquisition has not occurred, because A does not own more than 50 percent of the value of the X stock as a result of owning stock in the second corporation (P). A owns only $1,000/$2,200 of the value of X as a result of owning P stock. A owns the remainder of the value of X as a result of paying cash for X stock.

**Example 8.** P is the common parent of a consolidated group. T is the common parent of another, larger consolidated group. Mr. X purchases all of the stock of T shortly before selling the T stock to P in exchange for 60 percent of the P stock.

A reverse acquisition has occurred, as Mr. X owns more than 50 percent of the P stock immediately after the transaction as a result of owning T stock. The fact that Mr. X had recently acquired the T stock does not prevent the transaction from resulting in a reverse acquisition. Thus, the T group continues with P as its common parent, and the P group terminates.

**Step 5: Determine if an Affiliated Group Exists After the Transaction**

There is no requirement that either the first or second corporation be a member of a consolidated group prior to the transaction. Thus, a reverse acquisition can occur between two consolidated groups, a separate corporation and a member of a group, and two separate corporations, if the corporations are affiliated after the transaction.

**Example 9.** P is an unaffiliated corporation. T is a larger unaffiliated corporation. P acquires
all of the T stock in exchange for P stock, and immediately after the transaction, the former T shareholders own more than 50 percent of the value of the P stock. Despite the fact that neither P nor T was a member of a consolidated group prior to the transaction, the reverse acquisition rules apply because P and S are affiliated after the transaction.28

Consequences of a Reverse Acquisition
Reg. §1.1502-75(d)(3) exists primarily to determine which group continues its existence and which group terminates when a reverse acquisition has occurred.29 This determination will further dictate the following consequences for the resulting consolidated group.

Taxable Periods and the Resulting Tax Returns
The tax periods of the parties to a reverse acquisition and the resulting consolidated group are dependent on whether the acquired second corporation was filing as part of a consolidated return prior to its acquisition by the first corporation, and if not, if the resulting group elects to file a consolidated return for the first tax year ending after the date of the acquisition.30

For the following illustrations, assume that SMALLCO is the first corporation and the common parent of the SMALLCO group. SMALLCO acquired all of the stock of BIGCO, the second corporation and common parent of the larger BIGCO consolidated group, in a transaction meeting the definition of a reverse acquisition. As a result, the BIGCO group survived, with SMALLCO as the common parent.

BIGCO Group Filing on Consolidated Basis Prior to the Reverse Acquisition
If the BIGCO group filed on a consolidated basis prior to the reverse acquisition, the resulting group must continue to file on a consolidated basis using BIGCO’s tax year.31 The resulting group will file a full-year consolidated tax return with SMALLCO as the common parent.32 The full-year return will include the income of the former members of the BIGCO group for the entire year, with the income of the former members of the SMALLCO group included only for the short period beginning the day after the acquisition date.33

If the SMALLCO group filed on a consolidated basis prior to the reverse acquisition, it will file a final consolidated return for the short period ending on the close of the acquisition date.34

If the SMALLCO group filed separate returns prior to the reverse acquisition, all members of the SMALLCO group, including SMALLCO, must file final separate returns, or if elected, a final consolidated return, for the short period ending on the close of the acquisition date.

BIGCO Group Filing on Separate Basis Prior to the Reverse Acquisition
If the BIGCO group filed on a separate basis prior to the reverse acquisition, the resulting group may continue to file separate returns. If the group members continue to file separate tax returns, the former SMALLCO members are not required to change to BIGCO’s tax year.35 As a result, if the members of
the SMALLCO group were previously filing separate returns, each member of SMALLCO and BIGCO will file a full year, separate return.

If the SMALLCO group filed on a consolidated basis prior to the reverse acquisition and the resulting group continues to file separate returns, the SMALLCO group must file a final consolidated return, with the common parent including its income for its full tax year and the income of its subsidiaries for the short period ending on the date of acquisition. The former subsidiaries of the SMALLCO group must then file separate tax returns for the short period beginning on the close of the acquisition date, and continue to file separate return until the resulting group elects to file a consolidated return.

If the resulting group elects to file a consolidated return for the first tax year ending after the date of acquisition, however, the resulting group must switch to BIGCO's tax year. The resulting group will file a full year consolidated tax return, which will include the income for the former members of the BIGCO group for the entire year, with the income of the former members of the SMALLCO group included only for the short period beginning the day after the acquisition date.36

If the SMALLCO group filed on a separate return basis prior to the reverse acquisition, and the resulting group elects to file a consolidated return, each member must file final separate returns, or if elected, the group may file a final consolidated return for the short period ending on the close of the acquisition date.

Presentation on the Consolidated Return of the Resulting Group

Reg. §1.1502-75(d)(3)(i)(b) provides that after a reverse acquisition, the group of which the acquiring first corporation is the common parent will terminate, while the group of which the acquired second corporation is the common parent will continue, with the first corporation becoming the common parent of the group.

With the larger group surviving for many purposes of the consolidated regulations, it is easy to lose sight of the fact that the acquiring first corporation is respected as the common parent of the resulting consolidated group for many tax purposes. For example, for purposes of presenting the tax return of the resulting consolidated group, the author believes the employer identification number of the first corporation should be used in the EIN block on the first page of the consolidated tax return. The name of the taxpayer should be presented as "First Corporation" (Successor to or Acquirer of Second Corporation, EIN: XX-XXXXXXX) and Subsidiaries.

In addition, the tax return for the resulting group must be filed with the appropriate Service Center with whom the first corporation would file a separate tax return.37

The Tax Court has held that the first corporation becomes the agent for the group for purposes of Reg. §1.1502-77 with respect to tax years ending both prior to and after the reverse acquisition.38
Consolidated Net Operating Losses

SRLY Losses

Reg. §1.1502-1, which defines key terms relevant to the consolidated return regulations, provides a cross-reference to the reverse acquisition rules. These regulations provide that in the event of a reverse acquisition:

1. All tax years of the first corporation and each of its subsidiaries ending on or before the date of the acquisition shall be treated as separate return limitation (SRLY) years.

2. The tax years of the second corporation and each of its subsidiaries will not be treated as separate return limitation years (unless they were SRLY losses prior to the acquisition).

Consistent with the intent of the reverse acquisition regulations, this rule "reverses" the traditional roles of the acquired and acquiring groups for purposes of determining which group's net operating losses will be subject to SRLY limitations in the post-acquisition period.

The "Lonely Parent" Rule

The acquiring first corporation is, however, respected as the common parent of the resulting group for purposes of the "lonely parent" exception to the SRLY rules. Reg. §1.1502-1(f)(2)(i) provides that SRLY losses do not include a separate return year of a corporation which is the common parent for the consolidated return year to which the net operating loss is carried—the "lonely parent."

Example 10. P is the common parent of a consolidated group, including subsidiary S. T is the common parent of another, larger consolidated group. P acquires T by purchasing all of the stock of T in exchange for P stock, and immediately after the transaction, T's former shareholders own more than 50 percent of the value of P stock.

Several years later, the group breaks apart, and P and T each file a separate tax return, with each company recognizing a net operating loss.

Because P was respected as the common parent of the P-S-T group for purposes of the lonely parent rule, P may carry back its separate net operating loss to offset income earned by the P-S-T group.

T, despite being treated as the common parent of the P-S-T group under the reverse acquisition rules for purposes of determining many of the tax consequences of the group, does...
not meet the definition of the lonely parent, and thus may not carry back its separate net operating loss to offset income earned by the P-S-T group.

The "Offspring Rule"
Confusing matters further, it is the acquired second corporation that is deemed to be the common parent for purposes of the "offspring rule." The offspring rule provides that if a member has been a member of a group since its formation, it may carry back its losses against consolidated taxable income generated by the group prior to the member's existence. Thus, newly created members of the resulting group may carry back its losses to previous consolidated return years of the acquired group prior to its existence, but not to previous consolidated return years of the acquiring first corporation.

Example 11. P is the common parent of a consolidated group, including subsidiary S. T is the common parent of another, larger consolidated group. P acquires T by having T merge into S in exchange for P stock, and immediately after the transaction, T’s former shareholders own more than 50 percent of the value of P stock.

The resulting group forms a new subsidiary, Z, which generates a net operating loss. The net operating losses of Z may be carried back to offset income earned by the previous T group, as Z is treated as T’s offspring. Z’s net operating losses may not be carried back to offset income earned by the previous P group.

Stock Basis Adjustments
Reg. §1.1502-31 provides rules for determining the first corporation’s stock basis in the second corporation when a group structure change has occurred. The regulations define a "group structure change" in part as any transaction in which one corporation succeeds another corporation as the common parent of the group under the principles of the reverse acquisition rules. If stock of the second corporation is acquired, the first corporation’s basis in the second corporation’s stock is determined by reference to the second corporation’s net asset basis.

This can be a particularly damaging result, as the net basis of the assets often does not correlate with the value of the acquired corporation’s stock. Thus, a situation could result where the former shareholders of the acquired corporation have recognized gain on the sale of the acquired corporation’s stock in a fully taxable transaction (e.g., if preferred stock in the acquiring corporation were used to acquire the stock of the second corporation), yet the first corporation will be required under Reg. §1.1502-31 to take a stock basis in the acquired corporation equal to its net asset basis, which may be significantly less than the acquiring corporation’s cost basis. This leaves open the possibility that upon a subsequent disposition of the acquired corporation’s stock, the same economic gain will be taxed twice; once by the former shareholders of the second corporation, and again by the first corporation.

The Importance of Timely Identification of a Reverse Acquisition
The reverse acquisition rules are often a trap for the unwary. When two corporations enter into a
transaction, failing to contemporaneously identify the transaction as a reverse acquisition may result in numerous unintended consequences.

For example, assume P is the common parent of a consolidated group with a May 31 year-end. S is a larger (in terms of value) separate company with a July 31 year-end. On January 12, P acquires all of the S stock in exchange for 60 percent of the P stock.

If P and S are not aware of the reverse acquisition rules and their consequences, P and S will charge blindly down an incorrect path. S will close its book on January 12, and prepare a tax return for a short tax year from August 1 through January 12, unaware that under the reverse acquisition rules, S must file a full year return and the resulting group must adopt S’s tax year-end of July 31.

P, equally unaware that its existence has terminated, will neglect to close its books on January 12, the date its tax year ends under the reverse acquisition rules, necessitating a short period tax return for the P group from June 1 through January 12.

Quite possibly, P and S may not realize that a reverse acquisition has occurred until the August or September following the transaction, as P begins to prepare what it believes is its required full year consolidated tax return for its year ended May 30. By that time, S’s improper short period return may have already been filed, and P will be faced with the administrative burden of retroactively closing its books on January 12 in order to prepare its required short period return. Making matters worse, the resulting group is also required to retroactively close its books on July 31 in order to prepare the required full-year return for the group—which includes the income of S for the full year and the income of the former P group for the period January 13 through July 31—an undertaking the group had not anticipated and thus not prepared for.

**Planning Opportunities**

**Reordering Steps of an Acquisition**

Because the reverse acquisition regulations look through the form of a transaction to its substance to continue the existence of the larger of two consolidated groups (or separate corporations), limited opportunities exist to "manage" the results of a potential business combination.

Any planning considerations must begin with identifying which of the groups is most desirable as the continuing group. Factors such as the tax year utilized by the groups and the presence of net operating loss carryforwards must be given careful consideration.

Once a group is identified as the intended continuing group, steps can be made prior to entering into the transaction to ensure the continued existence of the desired group. In certain situations, merely reordering the steps of the proposed transaction will control the results.

**Example 12.** Mr. A owns the stock of P, the common parent of a consolidated group with a
value of $1,000. Mr. B owns the stock of S, the
common parent of another consolidated group
with a value of $800. Mr. C owns the stock of T,
the common parent of another common group
with a value of $400. Mr. A, Mr. B, and Mr. C
wish to combine the operations of P, S and T.

If S and T merge into P in exchange for P stock, a
reverse acquisition will not occur, as neither the S
shareholders nor the T shareholders will own more
than 50 percent of the value of P immediately after
the transaction (S will own $800/$2,200; T will
own $400/$2,200). Thus, the P group continues,
and the S and T groups terminate.

If Mr. A, Mr. B, and Mr. C determine that they
would prefer to use the tax year of S for the resulting
group, a simple reordering of the steps of the combi-
nation will change the result. If the shareholders
of T contribute their stock to S in exchange for S
stock prior to the acquisition by P, the combined
value of the resulting S-T group will be $1,200.

Thus, if S subsequently merges into P, the former
S shareholders will own more than 50 percent
of the value of P immediately after the transac-
tion ($1,200/$2,200), and a reverse acquisition
will occur. The P group will terminate, and the
S group will continue, with P as its common
parent. The resulting group will be required to
change to the tax year previously used by S.48

When a shareholder owning less than 50 percent
of the value of the outstanding stock of a common
parent of a consolidated group wishes to acquire
the remaining interest and transfer the stock to a
newly formed holding company, careful consider-
ation must be given to the steps of the transaction,
particularly when the common parent has net op-
erating losses that could potentially be subject to
the SRLY limitations.

Example 13. Mr. X owns 40 percent of P, the
common parent of a consolidated group. P has
substantial net operating losses. Mr. X would like
to acquire the remaining shares of P and operate
P through a newly formed holding company, HC.

If Mr. X contributes his 40-percent interest in P
and cash to HC in exchange for all the stock of
HC, and then HC purchases the remaining stock
of P, a reverse acquisition will not occur, as Mr. X
will not own more than 50 percent of HC imme-
diately after the transaction as a result of owning P
stock, because Mr. P transferred cash in excess of
the value of the P stock to HC. Thus, the P group
will terminate, and its prior net operating losses
will be subject to the SRLY limitations.

Alternatively, Mr. X can purchase the remaining P
stock directly, and then contribute all of the stock
of P to HC. In this scenario, a reverse acquisition
has occurred, as Mr. X owns more than 50 per-
cent of the value of HC immediately after the
transaction as a result of his prior ownership of
P stock. Thus, the P group will continue, and
the net operating losses of P will not be subject
to the SRLY limitations.
Conclusion

Reverse acquisitions are an extremely complicated area of the consolidated return regulations. The confusion caused by the regulatory language often results in the failure to identify when a transaction constitutes a reverse acquisition, resulting in improper tax filings by the parties as well as other adverse tax consequences.

By using a five-step approach, the author hopes to provide a road map that can be used to avoid traps for the unwary in recognizing when a reverse acquisition has occurred, thereby ensuring that parties to a reverse acquisition will properly address the ancillary tax consequences of the transaction.

Footnotes

1 A separate return limitation year (SRLY) is any separate tax year of a member or a predecessor member. See Reg. §1.1502-1(f)(1). Generally, losses of a member arising in a SRLY may not offset income generated by other members of the group, but may only offset that member’s cumulative contribution to the consolidated taxable income. See Reg. §1.1502-21(c)(1)(i).

2 Reg. §1.1502-75(d)(1).

3 Reg. §1.1502-1(f).

4 The losses may, however, be subject to limitation under Code-section 382.

5 Reg. §1.1502-75(d)(1).

6 Reg. §1.1502-75(d)(1); Reg. §1.1502-76(b)(1).

7 Reg. §1.1502-75(d)(3)(i).

8 This language accommodates triangular reorganizations where a subsidiary of the common parent acquires the stock or assets of a target in exchange for stock of the common parent. In such a case, the common parent, rather than the acquiring subsidiary, is the first corporation.

9 Reg. §1.1502-75(d)(3)(i); Reg. §1.1502-75(d)(3)(i)(a).


11 Previous proposed regulations at Proposed Reg. §1.1502-75(d)(2)(iii) (1965) provided that a reverse acquisition could only be the result of a reorganization described in Code-section 381(a)(2), which references the reorganization provisions of Code-section 368.


14 See Code-section 1504(b). Includible corporations are all corporations except tax-exempt entities under Code-section 501, insurance companies under Code-section 801, foreign corporations, S corporation, DISCs, regulated investment companies and real estate investment trusts, and corporations with respect to which an election under Code-section 936 is in effect for the tax year.

15 The acquisition of substantially all the assets of a nonincludable corporation should meet the literal requirements of Reg. §1.1502-75(d)(3)(i).

16 Reg. §1.1502-75(d)(3)(i). The reverse acquisition rules cannot be avoided through the use of so-called creeping acquisitions. Thus, where a common parent (the first corporation) acquired 82 percent of the stock of another, larger common parent (the second corporation) over a series of transactions spanning two days, the acquisitions were held be pursuant to a single plan. As the shareholders of the second corporation owned more than 50 percent of the value of the first corporation’s stock immediately after the transaction, the transaction resulted in a reverse acquisition.
Rev-Proc-01 77-37, 1977-2 CB 568 (amplified, modified and partially superseded by later revenue procedures).

However, see Letter-Ruling-01 8619004 (Jan. 31, 1986) and GCM 39528 (July 28, 1986) in which the IRS ruled that merger of a foreign holding company into its subsidiary, the common parent of a U.S. consolidated group, did not constitute a reverse acquisition despite meeting the literal requirements of Reg. §1.1502-75(d). Because the taxpayer could have easily structured the transaction in such a way as to avoid the reverse acquisition rules, the IRS ruled that permitting the form of the transaction to determine whether a reverse acquisition had occurred was clearly contrary to the purpose of the reverse acquisition rules.

Prior to 1982, however, the IRS ruled in a string of private letter rulings that a downstream merger of a common parent into its subsidiary, in which the subsidiary became the common parent of the resulting consolidated group, constituted a reverse acquisition. In these rulings, the IRS adhered to a strict literal interpretation of Reg. §1.1502-75(d)(3), holding that as long as the shareholders of the former common parent owned more than 50 percent of the value of the new common parent after a downstream merger, the requirements for a reverse acquisition were met. In 1982, the IRS reversed its position in Rev-Rule-01 82-152, 1982-2 CB 205, stating, Reg. 1.1502-75(d)(3) deals with situations in which the acquiring and acquired corporations were not affiliated with each other prior to the transaction.” The IRS has maintained this position in the years to follow. See, for example, Letter-Ruling-01 8628040 (Apr. 7, 1986); Letter-Ruling-01 8650053 (Sept. 16, 1986); Letter-Ruling-01 200905001 (Jan. 30, 2009) (reaching the same conclusion as Rev-Rule-01 82-152).


Letter-Ruling-01 8233089 (May 20, 1982) (a reverse acquisition occurred when a foreign corporation transferred all of the stock of its domestic subsidiary to a newly formed holding company in exchange for noncumulative, nonconvertible voting preferred stock). See also Letter-Ruling-01 9534017 (May 30, 1995) (a reverse acquisition occurred when shareholders transferred stock in an insurance corporation to a newly formed holding company solely in exchange for nonvoting convertible preferred stock having no dividends rights.) Note, however, that if a subsidiary member issues only its own Code-section 1504 preferred stock in exchange for the stock or assets of a target, the subsidiary will not deconsolidate from its common parent. Thus, a reverse acquisition will not occur, as the acquiring subsidiary is not the common parent of the resulting consolidated group.


Note, however, that if the previously acquired stock was acquired pursuant to a plan that includes the subsequent acquisition of first corporation stock such that, immediately after both acquisitions, the shareholders of the second corporation owned more than 50 percent of the value of the stock of the first corporation, a reverse acquisition would occur. See Reg. §1.1502-75(d)(3)(i)(b), which requires that in determining whether the shareholders of the second corporation own more than 50 percent of the value of the first corporation immediately after the transaction, any acquisitions or redemptions of the stock of either corporation which are pursuant to a plan of acquisition must be taken into consideration.
Reg. §1.1502-75(d)(3)(i)(b) requires there be taken into account any acquisitions or redemptions of the stock of either corporation that are pursuant to a plan of acquisition described in Reg. §1.1502-75(d)(3)(i)(a) or (b) for purposes of determining if the second corporation becomes a member of the first corporation’s group or if the second corporation’s shareholders own more than 50 percent of the first corporation’s stock immediately after the transaction.

See Letter-Ruling-01 200744006 (July 31, 2007), supplemented by Letter-Ruling-01 200829005 (Apr. 15, 2008) (when an LLC, which owned the stock of a common parent of a consolidated group, merged downstream into the subsidiary of a newly formed holding company, the transaction constituted a reverse acquisition when the value of the parent’s stock constituted more than 50 percent of the value of the LLC’s assets.)

See Letter-Ruling-01 200603009 (Jan. 20, 2006) (when an S corporation acquired the stock of a common parent of a consolidated group and immediately transferred those shares to a newly formed holding company, a reverse acquisition occurred despite the S corporation’s transitory ownership of the parent’s stock. The common parent’s group continued with the holding company as the nominal common parent.)


Reg. §1.1502-75(d)(v)(a).

Reg. §1.1502-75(d)(3)(v). See also Rev-Rule-01 91-70, 1991-2 CB 361 and Rev-Proc-01 2002-32, 2002-1 CB 959 (providing that as a result of the merger of a common parent into an acquiring common parent in a transaction qualifying as a reverse acquisition, Code-section 1504(a)(3)—which generally provides that if a corporation is included in a consolidated return and ceases to be a member, that corporation may not be included in any consolidated return filed by the affiliated group for five years—does not prevent the members of the terminating acquiring group from joining in the consolidated return filed by the continuing group. In fact, if the continuing group filled a consolidated return prior to the reverse acquisition, the members of the acquiring group must join in the filing of the post-acquisition consolidated return.

See discussion at supra regarding the proper reporting of the resulting group on the first page of the corporate tax return.


It is unclear to what extent the reverse acquisition rules affect the due date of the first corporation’s final short period return ending on the date of acquisition. Reg. §1.1502-75(d)(3) contains no cross-reference to Reg. §1.1502-76(c), which contains the general rule for determining the due date of the final separate or consolidated return ending on the date of the reverse acquisition. This leaves unanswered the question of whether the final short period return for the first corporation (or any group in which the first corporation is the common parent) is due two and one-half months after the acquisition date, or if the rules of Reg. §1.1502-76(c) may be used to determine the due date of the final short period returns.

Under Reg. §1.1502-75(d)(3)(v), the first corporation is required to close its tax year on the acquisition date and change to the tax year of the second corporation only if the first corporation elects to file a consolidated return for the first tax year ending after the date of acquisition. Only the tax years of the parties
to the reverse acquisition are driven by the resulting group’s filing of a consolidated return for the first year ended after the acquisition. Thus, other ramifications of a reverse acquisition, such as the characterization of net operating losses as SRLY or the special basis rules of Reg. §1.1502-31, would be triggered upon a subsequent filing of a consolidated return by the resulting group.

37 Reg. §1.1502-75(h).
39 Reg. §1.1502-1(f)(3).
41 Reg. §1.1502-1(f)(3).
42 In many cases, the transfer of a more than 50-per-cent interest in the first corporation from the first corporation’s former shareholders to the second corporation’s former shareholders that is a requirement for a reverse acquisition will trigger an ownership change under Code-section 382 with respect to the first corporation. As a result, the overlap rule may apply pursuant to Reg. §1.1502-21(g). The overlap rule provides that when a corporate acquisition causes the prior net operating losses of a corporation to be subject to both the SRLY limitations and Code-section 382, Code-section 382 prevails.
43 CCA-01 200441026 (Oct. 8, 2004).
44 Reg. §1.1502-75(d)(3)(i).
46 Id.
47 Reg. §1.1502-31(b)(2). See also Letter-Ruling-01 8233089 (May 20, 1982) and Letter-Ruling-01 200028011 (July 17, 2000), which provide that the first corporation is treated as the common parent of the resulting group for purposes of the stock basis adjustment rules.
48 Reg. §1.1502-75(d)(3)(v).