Triangular Mergers. Triangular or subsidiary mergers allow a public or private corporation to acquire a company for acquirer stock by merging it with or into a subsidiary, usually formed just for that purpose. When the smoke clears, the acquirer will own the stock of the subsidiary, which in turn will own the business of the target.

Forward and Reverse Triangular Mergers. In a forward subsidiary merger, the target merges with and into the merger subsidiary. The subsidiary survives and the separate existence of the target ceases. In a reverse merger, the target survives and the separate existence of the merger subsidiary ceases. In both cases, the merger consideration is stock of the parent/acquirer (if it were stock of the merger subsidiary, it would simply be a merger, not a triangular merger).

The tax consequences and risks set the stage for an odd dynamic when considering whether to do a deal as a reverse or a forward merger. The continuity requirements of a reverse merger are more stringent than a forward merger, and require that 80% of all classes of stock of the target be acquired for stock or securities of the acquirer. A forward triangular merger, however, is only subject to lower continuity requirement, so that an acquisition of 50% of the target stock for stock or securities of the acquirer would suffice, and it is not necessary that 50% of every class of stock of the target be acquired for acquirer stock or securities. Thus, it would seem that a forward merger is the safer bet, since it is easier to comply with the requirements.

The consequences of failing to qualify as a merger reverse the tax incentives. A “busted” forward merger is treated as an asset sale followed by a liquidation, which results in two levels of tax – one on the deemed sale of the target’s assets and again on the deemed sale of the target’s stock in liquidation. A “busted” reverse merger, however, is treated as a stock sale with only one level of tax at the shareholder level.

Thus, the seller must either accept a greater risk that the transaction will fail the tax-free reorganization provisions but with a potential of one level of tax (as a reverse merger), or accept a lower risk of failure with a higher potential penalty (two levels of tax) as a forward merger.

This is a tough choice, since valuation issues can make the tax conclusion uncertain. Fortunately, there is a solution that minimizes risk of failure and the penalty. Under a 2001 revenue ruling, a reverse merger followed by a forward merger into another merger subsidiary will be tested under the forward merger rules for continuity (50%). However, if it fails to be a good merger for some reason, it will be taxed as a failed reverse merger, i.e. as a stock sale. The IRS will consider the transaction as a forward merger, despite the first transitory step of merging a subsidiary into the target since at the end of the day, the target does not survive. However, if the transaction fails to qualify as a tax-free reorganization, the first merger is fully taxable (as a stock sale) and the second merger into a subsidiary is a non-taxable merger of two (then) wholly owned subsidiaries. It gets even simpler, as many practitioners will form the second merger subsidiary as an LLC that is treated as a disregarded entity, so if the first merger is busted, they may end up (as a tax matter) with a tax free liquidation of a corporate subsidiary when the

target’s assets are transferred to the disregarded LLC. The revenue ruling has given taxpayers an easy insurance policy against these competing risks and penalties.