MULTIPLE STEP ACQUISITIONS: DANCING THE TAX-FREE TANGO©

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TABLE OF CONTENTS

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I. INTRODUCTION

This article explores the rules affecting the taxation of multiple step acquisitions, which have changed considerably in the new millennium, in the context of (i) reorganizations in which two or more sequential stock or asset transfers are combined to produce a single, often tax-free, transaction, (ii) single step tax-free reorganizations followed by stock or asset transfers to affiliates, and (iii) F reorganizations that also involve preceding or subsequent stock or asset transfers.[1] As the discussion of these transactions demonstrates, a consistent policy is beginning to emerge with respect to the taxation of multiple step acquisitions.

The government has begun to utilize step transaction principles selectively, applying the doctrine to create tax-free reorganizations, such as double mergers and F reorganizations, but declining to apply the doctrine when its application would preclude tax-free treatment, as in the case of post-reorganization dropdowns and pushups of stock and assets, in either case as long as the tax-free nature of the resulting transactions is consistent with the policies of the reorganization rules. Considered together, these developments indicate that the government is moving away from a strict formalistic interpretation of the reorganization rules toward a more flexible approach that looks to the policy of the

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[*] I'm very grateful to Dave Feeney, Simon Friedman, Karen Gilbreath and David Miller, whose insightful comments on earlier drafts substantially improved this final product, to Alex Anderson and Yossi Cohen for their research and editorial assistance, and to Lou Freeman for sparking my interest in this topic with his 1996 Tax Club paper *Fun and Games with the Step Transaction Doctrine in Two-Step Acquisitions*.

This article is current as of July 1, 2005. An earlier version of this article was published in the May 2, 2005 issue of Tax Notes.

[1] Except as otherwise described, all references to sections refer to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder. Reorganizations are referred to by reference to their subsections under section 368(a), *e.g.*, a reorganization qualifying under section 368(a)(1)(A) is referred to as an "A reorganization".

reorganization rules. This approach creates additional structuring alternatives for taxpayers and, in particular, related parties, seeking tax-free treatment for their multiple step transactions.

II. TWO STEP TRIANGULAR REORGANIZATIONS

Historically, the Internal Revenue Service (the "IRS") has applied the step transaction doctrine in connection with putative tax-free reorganizations to treat a series of separate steps as a single transaction if the steps are interdependent or simply focused toward a particular end result.[2] Recent developments regarding two step mergers have broadly applied the doctrine, facilitating satisfaction of the requirements for certain tax-free reorganizations and creating flexibility for taxpayers seeking tax-free reorganization treatment. As discussed below, this approach provides an interesting contrast to the more limited application of the step transaction doctrine to post-reorganization dropdowns and pushups of stock and assets in order to protect the tax-free nature of the reorganization.

A. Tender Offers and Back End Mergers

One of the first tacit expansions of the step transaction doctrine by ruling involved a tender offer followed by a back end

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[2] *See generally* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 12.61[3] (6th Ed. 1998); S. Mintz and W. Plumb, Jr., *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. Inst. on Fed. Tax'n 247-48 (1954) ("Mintz and Plumb").

Courts have applied three different tests to determine whether the step transaction doctrine should apply to a series of transactions. *See*, *e.g.*, *Penrod v. Comm'r*, 88 T.C. 1415 (1987). The binding commitment test steps together transactions if, when the first step occurs, there is a binding, legal commitment to undertake the following steps. *See*, *e.g.*, *Comm'r v. Gordon*, 391 U.S. 83 (1968). The mutual interdependence test steps together a series of transactions that are "so interdependent that the legal relations created by one transaction would [be] fruitless without completion of the series." *See*, *e.g.*, *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (1983). The end result test steps together a series of transactions that are prearranged parts of a single transaction intended to reach an ultimate result. *See*, *e.g.*, *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

merger, an approach which is often used when a consensual deal cannot be reached with the target. By way of background, the Tax Court confirmed in 1995 that such a transaction could be effected as an integrated A2D reorganization involving a forward triangular back end merger.[3] However, a forward triangular merger is often not a preferred acquisition structure because a failed A2D reorganization imposes both corporate and shareholder level tax. Acquirers typically prefer to utilize a reverse subsidiary merger whenever possible because a transaction that fails to qualify as an A2E reorganization triggers only a single level of tax for target shareholders. Historically, it had not been clear that a two step acquisition in which stock representing control of the target was not acquired in a second step reverse subsidiary merger would qualify as an A2E reorganization because of the statutory requirement that section 368(c) control must be acquired in exchange for parent voting stock in the A2E transaction itself (the "control for voting stock" requirement).[4]

Revenue ruling 2001-26 finally confirms that a tender offer followed by a back end reverse subsidiary merger will be stepped together and treated as an integrated A2E reorganization for purposes of testing whether 80% control is acquired in the transaction.[5] More specifically, the ruling considered an acquisition by a parent corporation, or its acquisition subsidiary, of 51% of a target's stock in exchange solely for parent stock in a tender offer, followed by a merger of the acquisition subsidiary with and into the target corporation.[6] The ratio of consideration received by historic target shareholders in the two transactions was 85% parent stock and 15% cash. The two transactions were integrated and treated as an acquisition by the parent of all of the target's stock under general step transaction principles.

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3 *See J.E. Seagram Corp. v. Comm'r*, 104 T.C. 75 (1995).

4 *See* Treas. Reg. § 1.368-2(j)(3)(i), (ii).

5 Rev. Rul. 2001-26, 2001-1 C.B. 1297; *citing King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

6 The ruling's similar treatment of acquisitions by a parent and its subsidiary is supported by the tax court's statement that it refers to the acquirer and its "facilitating" subsidiary interchangeably, since the subsidiary "is, of course, simply [the acquirer's] cat's paw in the transactions under scrutiny." *J.E. Seagram Corp.* at 92.

The ruling relies on two principal authorities for its conclusion that the transactions qualify as an A2E reorganization. First, example 3 in Treasury Regulation section 1.368-2(j)(6) is cited for the proposition that, absent an exception, steps preceding a reverse subsidiary merger that are part of the transaction should be considered in determining whether control is acquired in exchange for voting stock in the A2E transaction. Invoking this part of the section 368 regulations to support the integration of the tender offer and back end merger is particularly interesting, given practitioners' reliance on the referenced exception to separate a redemption of stock that occurs immediately prior to an A2E reorganization when such a redemption is necessary to permit the acquisition of control for voting stock in the merger.[7]

In addition, and perhaps more notably, revenue ruling 2001-26 states that "*the principles of King Enterprises*" support the conclusion that the tender offer stock exchange is properly treated as part of the second step reverse subsidiary merger for purposes of determining whether the requirements for an A2E reorganization would be satisfied. The question in *King Enterprises* was whether Minute Maid's acquisition of Tenco's stock and Tenco's subsequent upstream merger into Minute Maid were independent transactions, as the government asserted, or steps in a single reorganization, as the taxpayer intended. If integrated, the transactions would have qualified as an A reorganization, since more than 50% of the target shareholders' consideration was acquirer stock, and the acquirer held the target assets at the conclusion of the transactions.[8]

The *King Enterprises* opinion discusses both the "interdependence" and "end result" step transaction tests and concludes that "there is no universal test applicable to step transaction situations."[9] Believing the operative facts at hand

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[7] A classic example of stock that is often redeemed before a reverse subsidiary merger is nonvoting preferred stock held by parties that do not support the merger.

[8] *King Enterprises*, 418 F.2d 511 (Ct. Cl. 1969).

[9] *King Enterprises* at 516; Mintz and Plumb at 252-253.

The court found that each test "is faithful to the central purpose of the step transaction doctrine; that is, to assure that tax consequences turn on the substance of a transaction rather than on its form." *King Enterprises* at 516.

justified the inferences that the acquirer intended the second step upstream merger from the outset and the two transactions to qualify as tax-free, the court held that the two transactions constituted a unified A reorganization.[10] Notably, the transferring shareholders were apparently not consulted with respect to, and appeared to have no knowledge of, the intended second step upstream merger, but the court was not troubled by the lack of a formal, bilateral plan that included both transactions, since the relevant facts and circumstances demonstrated the existence of the requisite plan.[11] Under this standard, integrated transaction treatment could impact the tax consequences of even target shareholders without knowledge of the second transaction. Well-advised target corporations seeking a tax-free transaction would, of course, limit post-acquisition transfers involving the target corporation's stock or assets to the extent necessary to achieve the desired tax treatment.

Revenue ruling 2001-26 carefully assumes away the question of which step transaction test should be applied by presupposing that the step transaction doctrine would apply to the facts in the ruling, and government officials speaking about the ruling have carefully stated that it is not intended to create any inference about the breadth of the step transaction doctrine.[12] Notwithstanding these caveats, however, the ruling's reference to the principles of *King Enterprises* clearly indicates at least tacit approval of a broad interpretation of the step transaction doctrine, whereby the ability to infer the existence of a unilateral plan provides a sufficient basis to integrate two steps into a single tax-free reorganization. Thus, the step transaction doctrine will apply to create a tax-free reorganization, even if the first step was not conditioned on the occurrence of the second step merger. This result represents a significant expansion of the government's historical approach, which appeared to require a common acquirer and target plan for integration.[13] Notably, this ruling marks the

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[10] *King Enterprises* at 519.

[11] *King Enterprises* at 519, *citing William H. Redfield*, 34 B.T.A. 967 (1936).

[12] *See Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001).

[13] *See*, *e.g.*, Rev. Rul. 72-405, 1972-2 C.B. 217 (citing revenue ruling 67-274 and holding that a forward subsidiary merger followed by a

first of several instances in which the government has applied step transaction principles to facilitate the tax-free treatment sought by taxpayers. By citing "the principles of *King Enterprises*" with approval, the IRS set the stage for its continued integration of transactions to produce tax-free reorganizations.

B. Double Mergers

1. Second Step Upstream Mergers

Revenue ruling 2001-26 did not have to address the difficult questions presented by the integration of a qualified stock purchase ("QSP") with another transaction, since only 51% of the target's stock was acquired in the first step tender offer described in that ruling. In revenue ruling 2001-46, however, the IRS did tackle the more difficult issues involving the integration of a QSP.[14] As discussed in some detail below, the integration of a QSP to produce a tax-free reorganization involves complex issues that require the creation of exceptions within exceptions to the step transaction rules. Like revenue ruling 2001-26, revenue ruling 2001-46 carefully assumes that the step transaction doctrine applies, and government officials have stressed that the ruling should not be read more broadly than its facts and does not warrant assumptions regarding the government's view of the step transaction doctrine.[15] That said, it is fair to conclude the ruling represents the government's view of at least one situation in which step transaction principles will apply.[16] Notably, that application does not appear to depend on a specific connection between the two transactions, since the ruling does not discuss a connection, or even confirm that any connection exists. This apparent reliance on

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liquidation may not be considered independently and will be recast as a C, rather than A2D, reorganization).

[14] Rev. Rul. 2001-46, 2001-2 C.B. 321.

[15] *See Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001).

[16] Revenue ruling 2004-83, 2004-32 I.R.B. 157, is another recent example of the government's application of step transaction principles to reorganizations. This ruling confirms the result in revenue ruling 70-240, 1970-1 C.B. 81, that a parent's cross-chain sale of subsidiary stock for cash will be integrated with a subsequent planned liquidation of the acquired subsidiary and treated as a D reorganization.

the end result step transaction test is consistent with the facts of *King Enterprises*, which the ruling generally tracks.[17]

The two situations described in the ruling each involve the acquisition of all of a target's stock in a reverse subsidiary merger and a subsequent upstream merger of the surviving target into the acquirer as part of a single plan. In the first situation, as in revenue ruling 2001-26, the first step reverse subsidiary merger, considered alone, would not qualify as an A2E reorganization. However, in the second situation it would so qualify. In both cases, the ruling integrates the two transactions and tests them under the less stringent requirements for an A reorganization.[18] The ruling discusses the first situation in detail and holds that the two transactions should be integrated and tested as a single A reorganization by analogy to revenue ruling 67-274, unless doing so would contravene section 338 policy.[19] The description of this policy in the legislative history to section 338 provides that, as Congress intended, section 338 serves as the only means – statutory or otherwise – to recharacterize a stock purchase as an asset purchase.[20]

To protect this section 338 policy, the IRS created an exception to the approach applied by the court in *Kimbell-Diamond* to step together stock purchases and subsequent upstream mergers and liquidations into asset acquisitions.[21] To this end, revenue ruling 90-95 and Treasury Regulation section 1.338-3(d) provide that the step transaction doctrine is turned off after a QSP to prevent integration of the QSP with a subsequent merger that could produce a taxable asset acquisition outside the bounds of

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17 *King Enterprises*, 418 F.2d 511 (Ct. Cl. 1969).

18 *See* Rev. Rul. 2001-46, 2001-2 C.B. 321.

19 Rev. Rul. 2001-46, 2001-2 C.B. 321, *citing King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969), and *J.E. Seagram Corp. v. Comm'r*, 104 T.C. 75 (1995).

Note that section 338 policy was not at issue in revenue ruling 2001-26, since the first step tender offer described in the ruling did not constitute a qualified stock purchase.

20 H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

21 *See, e.g.*, *Kimbell-Diamond v. Comm'r.*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S. 827 (1951).

section 338 (such approach, the "non-integration exception").[22] Revenue ruling 2001-46 considers whether this non-integration exception must prevail even when the application of those principles would produce a tax-free reorganization and observes that an exception to the non-integration exception is warranted unless it would frustrate Congress's intention that section 338 serve as the only means of treating a stock purchase as an asset purchase.[23] The ruling concludes that integrating two mergers to produce a tax-free reorganization would not frustrate this intent, since no step up in asset basis would occur, and therefore applies step transaction principles after the QSP to produce a tax-free reorganization. This result is consistent with the government's broader approach of applying step transaction principles to create tax-free reorganizations except when doing so would frustrate another express policy.

When a QSP and subsequent upstream merger would constitute a taxable asset transfer if integrated, section 338 policy requires the two transactions to be treated as a separate stock acquisition and subsequent upstream merger or liquidation pursuant to the non-integration exception to general step transaction principles.[24] To preserve the integrity of the step transaction regime, a first stock acquisition that would qualify for tax-free treatment as a separate A2E or B reorganization should nonetheless be treated as a taxable stock purchase, although no authority confirms this result.[25] As a taxable stock purchase, the first step acquisition would only trigger corporate level tax if the parties elect pursuant to section 338 to receive a fair market value basis in the acquired assets.[26] If a section 338 election is made, the

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22 Rev. Rul. 90-95, 1990-2 C.B. 67; Treas. Reg. § 1.338-3(d).

23 Rev. Rul. 2001-46, 2001-2 C.B. 321, *citing* H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

24 Rev. Rul. 2001-46, 2001-2 C.B. 321. Revenue ruling 2001-46 refers to a second step liquidation, although the ruling describes the taxpayers therein as actually effecting an upstream merger.

25 *Accord*, New York State Bar Association Tax Section, *Report Responding to Rev. Rul. 2001-46, Dealing with Multi-Step Acquisitions*, 2002 TNT 142-18 (July 23, 2002).

26 *See* Rev. Rul. 90-95, 1990-2 C.B. 67; Treas. Reg. § 1.338-3(d); Rev. Rul. 2001-46, 2001-2 C.B. 321; H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982); Rev. Rul. 73-427, 1973-2 C.B. 301.

second step upstream merger could qualify as an A reorganization for all target shareholders. In order to obtain tax-free treatment in an upstream merger, the minority target shareholders qualify as historic shareholders of the target corporation, because a new target corporation is created by reason of the section 338 election.[27] As historic shareholders of the new target corporation, the minority shareholders' exchange of target stock for acquirer stock in the upstream merger would satisfy the continuity of interest requirement for an A reorganization. By contrast, if a section 338 election is not made, the upstream merger may not qualify as an A reorganization if the amount of cash consideration in the first step merger precludes continuity of interest.[28] In that case, the target and acquirer will receive tax-free treatment under the anti-*Yoc Heating* regulations, but since the regulations do not extend tax-free treatment to minority target shareholders, such shareholders would recognize gain on their exchange of target stock for acquirer stock.[29]

Standing alone, revenue ruling 2001-46 would represent a significant expansion of the government's approach to using step transaction principles to create tax-free reorganizations, but the story doesn't end there. In response to practitioners' concerns, the government created a third-level elective exception to the integration exception provided in revenue ruling 2001-46, which is itself an exception to the original non-integration exception provided in revenue ruling 90-95 and Treasury Regulation section 1.338-3(d). Even when an integrated stock acquisition and subsequent upstream merger or liquidation would qualify as a tax-free reorganization, which might otherwise preclude a section 338 election for a first step QSP under revenue ruling 2001-46, the section 338(h)(10) regulations now permit taxpayers to turn off step transaction and elect taxable treatment for a first step stock

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[27] *See* Treas. Reg. § 1.338-1(b) (target treated as a new corporation for all income tax purposes after section 338 election).

[28] *See* Treas. Reg. § 1.338-3(d)(3) (first step cash purchase would preclude satisfaction of continuity of interest necessary for minority shareholders to obtain tax-free treatment when no section 338 election is made for QSP).

[29] *See* Treas. Reg. §§ 1.368-1(e)(1)(i), (e)(6), Ex. 4; 1.338-3(d); 1.332-5; *Kass v. Comm'r.*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

acquisition that constitutes a QSP.[30] These regulations respond to the concern that revenue ruling 2001-46's integration of a QSP and a subsequent upstream merger precluded a section 338(h)(10) election for the QSP because it was disregarded as part of the integrated reorganization.[31]

Accordingly, the regulations specifically permit a section 338(h)(10) election to be made for a QSP that would be integrated with a second transaction to produce a tax-free reorganization absent such an election. If the election is made, the second step liquidation or upstream merger will generally be treated as a separate transaction, which restores the result in revenue ruling 90-95 and Treasury Regulation section 1.338-3(d) on an elective basis.[32] At least as notable as the number of exceptions within exceptions that these regulations create is their elective nature. Taxpayers can now choose whether to apply step transaction principles simply by filing a form, which certainly gives new meaning to form over substance. This departure from the IRS's broader application of the step transaction principles can be attributed to the important role that Congress accorded section 338. Absent this express policy, one might not have expected the government to introduce an election into the step transaction arena, particularly in light of their apparent discomfort with electivity after instituting the check the box regime.

C. Variations on Double Mergers

1. No First Step Qualified Stock Purchase

No rulings explicitly address whether a first step stock acquisition that does not constitute a qualified stock purchase would be integrated with a subsequent upstream merger of the target into the acquirer.[33] A first step stock acquisition may fail to qualify as a QSP, for example, because less than 80% of the target's stock is acquired, or because stock is acquired from a

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[30] *See* Temp. Reg. § 1.338(h)(10)-1T(c)(2) and (e), Ex. 11-13.

[31] T.D. 9071 and REG-143679-02 (July 9, 2003).

[32] *See* Temp. Reg. § 1.338(h)(10)-1T(c)(2) and (e), Ex. 12.

[33] On a stand-alone basis, such a first step merger could not qualify as an A2E reorganization because control is not acquired in exchange for voting stock in the merger.

related party.[34] Considering the difficulties that minority shareholders could pose for a second step upstream merger, many practitioners may encounter this fact pattern only when a portion of the surviving corporation's shares were acquired before the reverse subsidiary merger, in which case, the acquirer may in fact hold 80% of such stock after the merger, as it did in revenue ruling 2001-26. But for the fact that the taxpayer would be required to disavow its form in a manner that the IRS has not yet blessed, there should be no bar to integrating all three transactions, including a first step tender offer, to produce an A reorganization if the transactions are all part of a single plan. This result would be consistent with the government's broader approach to reorganizations, although no authority so states.[35]

By contrast, if these integrated transactions would not constitute an A reorganization, either because the taxpayer would be held to its form, or because the integrated transaction would not satisfy the requirements for an A reorganization, it is not clear whether section 338 policy would preclude integration to produce a taxable asset transfer.[36] If the non-integration approach of revenue ruling 90-95 and Treasury Regulation section 1.338-3(d) is limited to a first step merger that constitutes a QSP, as some have argued, integration should be permissible under *Kimbell-Diamond* when the first step merger (together with any prior acquisitions of target stock) does not constitute a QSP. Although this approach has logical appeal, it is difficult to square with Congress's intent that section 338 serve as the exclusive governor of recharacterized asset acquisitions, to the exclusion of *Kimbell-Diamond* and other extrastatutory approaches.[37]

This is no longer the same high stakes issue for the IRS that it was in 1985, since an integrated asset transfer no longer produces the free asset basis step up that Congress considered before the repeal of *General Utilities*. Since any step up in asset

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[34] *See* I.R.C. § 338(d)(3); Treas. Reg. § 1.338-3(b)(2).

[35] *Cf.* Rev. Rul. 2001-26, 2001-1 C.B. 1297; Rev. Rul. 2001-46, 2001-2 C.B. 321.

[36] *See* Rev. Rul. 90-95, 1990-2 C.B. 67; H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

[37] *See* H.R. Rep. No. 760, 97th Cong. 2d Sess. 536 (1982); *Kimbell-Diamond v. Comm'r.*, 14 T.C. 74, *aff'd per curiam*, 187 F.2D 718 (1951), *cert. denied*, 342 U.S. 827 (1951).

basis would now have a net present value cost, if *Kimbell-Diamond* survives in the absence of a first step QSP, it may largely as a high stakes trap for unwary taxpayers, although the potential for whipsaw still exists if all parties to the transaction are not subject to the same treatment.[38] The better answer to this difficult question may be that the principles of revenue ruling 90-95 and Treasury Regulation section 1.338-3(d) should be broadly applied even absent a first step QSP to prevent the integration of two mergers into a taxable asset transfer. This separate transaction treatment would be consistent with the IRS's approach in revenue ruling 75-521, in which it treated two sequential stock purchases as separate from a later section 332 liquidation.[39] As discussed above, many subsequent upstream mergers could be structured to qualify as A reorganizations, and, in the case of a then 80% controlled subsidiary, as section 332 liquidations.[40] Upstream mergers that could not qualify as tax-free under either of these sections may be treated as separate taxable asset transfers.[41]

2. Second Step Liquidations

Although well-advised taxpayers will employ second step upstream mergers to take advantage of the benefits of revenue ruling 2001-46, some taxpayers may unwittingly liquidate a target instead. If a reverse subsidiary merger is followed by a second

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[38] There is no requirement of consistent treatment for all parties to a transaction. *See, e.g.*, *Pressed Steel Car Co. v. Comm'r*, 20 T.C. 198 (1953); *Steubenville Bridge Co. v. Comm'r*, 11 T.C. 789 (1948); *Dallas Downtown Dev. Co. v. Comm'r*., 12 T.C. 114 (1949).

[39] *See* Rev. Rul. 75-521, 1975-2 C.B. 120 (corporate shareholder that owned 50% of subsidiary stock acquired balance of stock and then liquidated tax-free in a separate transaction governed by section 332).

[40] *See* I.R.C. §§ 368(a)(1)(A); 332. In the case of a section 332 liquidation, the acquirer, as an 80% corporate shareholder, would receive the target's assets tax-free under section 332(b). Minority shareholders would recognize gain in connection with such a liquidation, but may be able to avoid recognizing gain if an upstream merger qualifies as an A reorganization. *See* I.R.C. § 331(a); Treas. Reg. §§ 1.332-5; 1.338-3(d); *Kass v. Comm'r.*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

[41] *See* Rev. Rul. 69-6, 1969-1 C.B. 104; *West Shore Fuel, Inc. v. U.S.*, 78-1 USTC ¶ 9311 (W.D.N.Y. 1978); IRS Memorandum CC:TL-N-1404-89 (Jan. 30, 1989).

step liquidation rather than an upstream merger, it is not clear that the same A reorganization treatment accorded an integrated reverse subsidiary merger and subsequent upstream merger in revenue ruling 2001-46 would be available. The government has been reluctant to extend A reorganization treatment to situations such as liquidations in which an acquirer is not a party to both the first step (reverse subsidiary) merger and the second step (upstream) merger.[42] However, this formalistic concern should not be applied to prevent A reorganization treatment for integrated transactions that include liquidations. Once the government is prepared to apply step transaction principles to integrate two mergers, whether the same entity is a party to both mergers disregarded in the integration should not be a bar to recasting the transactions as a direct merger of target into acquirer for all tax purposes. In both cases, the relevant entities would be deemed to be parties to a reorganization that did not occur.

If the A reorganization requirements are applied to such a deemed direct merger, the acquirer could qualify as a party to the reorganization, and the merger could generally satisfy all other applicable requirements, without regard to the intervening liquidation. Since deeming a direct merger to occur would create a more direct link between the target shareholders and the target assets, this approach would be consistent with the policy that reorganizations should be limited to readjustments of continuing property interests in modified form that do not "involve the transfer of the acquired stock or assets to a 'stranger'".[43] Accordingly, the government could (and should) ignore both transactions completely and create a third deemed transaction, such as a direct deemed merger in the case of a stock acquisition and subsequent liquidation that reflects the result of the parties' transactions.

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[42] *See* Rev. Rul. 72-405, 1972-2 C.B. 217 (citing revenue ruling 67-274 and holding that a forward subsidiary merger followed by a liquidation must be tested as a C, rather than A2D, reorganization).

[43] *See* REG-165579-02, *citing* H.R. Rep. No. 83-1337 at A134 (1954); Treas. Reg. § 1.368-1(d)(1).

More generally, this reorganization policy has been interpreted as insuring that a sufficient link exists between the target corporation shareholders and the assets or stock acquired in the reorganization. Preamble, COBE Regulations, 1981 Fed. Tax Rep. CCH ¶ 6342, Vol. 10.

If the government continues to believe that A reorganization treatment is not available in the case of a second step liquidation because the acquirer is not a party to an actual second step statutory merger, revenue rulings 67-274 and 72-405 suggest that the transactions may be tested as a single integrated transaction under the more restrictive C reorganization rules.[44] If a tax-free reorganization would result, the transactions would be integrated, consistent with the broader policy in this area. However, the concern, and the opportunity for whipsaw, occurs because many integrated transactions would not qualify for tax-free treatment under the C reorganization rules. Consistent with the IRS's approach of integrating transactions to produce tax-free treatment, the IRS should consider revoking revenue rulings 67-274 and 72-405 and testing a reverse subsidiary merger followed by a liquidation as a deemed direct A reorganization rather than a C reorganization. Nonetheless, until such guidance is issued, cautious taxpayers may assume that a reverse subsidiary merger followed by a liquidation will qualify for tax-free treatment only if the integrated transaction constitutes a C reorganization.[45]

If integration would produce a taxable transaction, the transactions described above presumably should not be integrated to create a taxable asset sale, since that result would be inconsistent with section 338 policy.[46] Instead, revenue ruling 2001-46 suggests that the steps involved in such an acquisition should be separately respected and treated as a taxable stock purchase followed by a separate section 332 liquidation. So treated, the first merger would not trigger corporate level tax, absent a valid section 338 election for a QSP to receive a fair market value basis

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[44] *See* Rev. Rul. 67-274, 1967-2 C.B. 141 (reverse subsidiary merger followed by an upstream liquidation tested as a C reorganization); *see also* Rev. Rul. 72-405, 1972-2 C.B. 217 (citing revenue ruling 67-274 and holding that a forward subsidiary merger followed by a liquidation may not be considered independently and therefore will be tested as a C, rather than A2D, reorganization).

[45] Until the proposed regulations permitting cross-border A reorganizations are finalized, testing the integrated transaction as a C reorganization may, of course, produce a more certain tax-free result for cross-border reorganizations. *See generally* Notice 2005-6, 2005-5 I.R.B. 1; REG-125628-01.

[46] *See* discussion of this issue in Section II.B.1 above.

in the acquired assets.[47] In the subsequent liquidation, the acquirer, as an 80% corporate shareholder, would receive the target's assets tax-free.[48] By contrast, minority shareholders would recognize gain on the liquidation as though they had sold their target stock.[49] The target would also recognize gain with respect to any appreciated corporate assets transferred to the minority shareholders.[50] The government's reliance on C reorganization treatment thus introduces the potential for whipsaw whenever a target has minority shareholders after a first step merger. By arranging for the integrated transaction to fail to qualify as a C reorganization, an easy task to accomplish, minority target shareholders may elect to recognize any losses in their target stock (subject to any other applicable limitations) on a second step liquidation.

3. Second Step Disregarded Entity Mergers

In another variation on revenue ruling 2001-46, a reverse subsidiary merger may be followed by a merger of the target with and into a limited liability company wholly owned by the acquirer (such acquirer LLC, a "disregarded entity"), rather than into the acquirer itself, as part of a single plan.[51] If these mergers are integrated, they should properly be tested as an A reorganization, without regard to whether the government gives some effect to the actual transactions that occur, or simply deems the target corporation to merge directly into the disregarded entity. Even if the government continues to consider the form of the actual transactions to be relevant, A reorganization treatment is appropriate for several reasons. First, since a disregarded entity is disregarded for all U.S. tax purposes, the merger should also be treated in exactly the same manner as an upstream merger into the acquirer.[52] Moreover, a merger with an acquirer's disregarded entity, like an upstream merger, would be tested as an A

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47 *See* Rev. Rul. 90-95, 1990-2 C.B. 67; H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

48 I.R.C. § 332(b).

49 I.R.C. § 331; Treas. Reg. § 1.332-5.

50 *See* I.R.C. § 336(d)(3).

51 Alternatively, a target may merge with a disregarded entity of an acquirer that in turn merges into the acquirer in a second step merger.

52 *See* Treas. Reg. § 301.7701-2(c)(2).

reorganization.[53] In addition, although not determinative, a taxpayer could obtain the same result by merging upstream into the acquirer followed by the acquirer's contribution of the target assets to its disregarded entity.

Although there is no authority directly on point, the preamble to the disregarded entity merger regulations generally supports testing an integrated second step merger into a disregarded entity as an A reorganization. As the preamble notes, the government was asked to confirm that the treatment of an integrated A2D merger and subsequent liquidation of the surviving subsidiary as a C reorganization in revenue ruling 72-405 would not apply to a merger of a target into a disregarded entity followed by an immediate merger of the disregarded entity into its corporate parent. In response, the preamble confirms that, because the merger of a disregarded entity into its sole shareholder does not "alter the tax identity of the tax owner of the former [target] assets", such a merger will be disregarded. This conclusion strongly supports the position that a second step merger into a disregarded entity should be treated as tantamount to an upstream merger into the acquirer that would be tested as an A reorganization.

As discussed in section II.C.2 above with respect to second step liquidations, it would be both advisable and consistent with reorganization policy for the government to disregard the form of the two actual mergers and deem the target to merge directly into the disregarded entity for all tax purposes. Extending A reorganization treatment to upstream mergers into a disregarded entity would be consistent with the government's broader approach, illustrated in revenue ruling 2001-46, of using step transaction principles to encourage the creation of tax-free reorganizations to the extent consistent with reorganization policy.[54] For these reasons, the government should not equate a merger into a disregarded entity with a liquidation of the target

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[53] *See* T.D. 9038, 68 Fed. Reg. 3384 at 3386 (Jan. 24, 2003).

[54] Not treating such mergers as tax-free A reorganizations would also be a particular hardship for certain entities such as real estate investment trusts, whose operational and qualification requirements limit their reorganization options. *See*, *e.g.*, *Association Wants Proposed Regs on Mergers Involving Disregarded Entities Modified*, 2002 TNT 51-31 (Mar. 15, 2002).

corporation.[55] As a practical matter, it is difficult to conceive of the government insisting that these transactions be treated as liquidations that must be tested as C reorganizations, particularly since at least some government officials believe that revenue rulings 2001-26 and 2001-46 have effectively reversed the holding of revenue ruling 67-274 that a B reorganization and subsequent liquidation is properly tested as a C (rather than A) reorganization.[56] Nonetheless, if the IRS were to test the integrated transaction as a C reorganization, a transaction that would not qualify as a C reorganization should be treated as a stock acquisition followed by a separate liquidation; the transactions should not be integrated to produce a taxable asset transfer.[57]

4. Second Step Sideways Mergers

Commentators have suggested extending the integrated transaction treatment provided in revenue ruling 2001-46 to an otherwise taxable reverse subsidiary merger that is followed by a cross-chain merger of the target into another acquirer subsidiary when the integrated transaction would qualify as an A2D

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[55] *See* Temp. Reg. § 1.368-2T(b)(1); *but see* Rev. Rul. 67-274, 1967-2 C.B. 141 (reverse subsidiary merger followed by an upstream liquidation tested as a C reorganization).

Some practitioners have expressed concern that the sequential nature of integrated transactions might cause a second step merger into a disregarded entity to fail to satisfy the A reorganization requirement that the target contemporaneously transfer its assets and cease its corporate existence as a result of the merger. *See* Temp. Reg. § 1.368-2T(b)(1)(ii).

[56] *See Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001).

[57] Consistent with revenue ruling 90-95, the first step reverse subsidiary merger would be treated as a taxable stock acquisition that is not integrated with the subsequent liquidation. *See* Rev. Rul. 2001-46, 2001-2 C.B. 321; *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *see also* Rev. Rul. 90-95, 1990-2 C.B. 67 (providing for separate transaction treatment for first step qualified stock purchases). *See* Section II.C.2. for a discussion of the consequences of a separate second step liquidation for minority target shareholders.

reorganization.[58] By contrast, if the resulting transaction would not qualify as tax-free, the transactions would be treated as a taxable stock purchase followed by a separate transfer of the target's historic assets in a forward merger, which could typically be structured to qualify as a tax-free D reorganization. The separate treatment of a first step stock acquisition as a taxable stock purchase in the case of a failed integrated reorganization would effectively permit taxpayers to utilize forward subsidiary mergers without the risk of corporate level tax.

This approach is consistent with the general principles of the revenue rulings and cases discussed above, as the target is eliminated in the second merger, and would be consistent with the IRS's approach in revenue rulings 2001-26 and 2001-46 to integrate transactions that would qualify as A reorganizations. As in the case of a second step liquidation or merger into a disregarded entity, the government may be concerned that reorganization treatment for the integrated transactions would only obtain if the form of the two actual mergers is disregarded since the parties to the two reorganizations are different. In that case, consistent with reorganization policy, the target should be deemed to merge directly into the acquirer subsidiary that will ultimately hold the target assets.[59]

D. A Single Rule for all Double Mergers

When considering additional guidance on other second step mergers, the government would be well advised to also address second step downstream mergers, liquidations and mergers into disregarded entities. Ideally, this broader consideration would

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[58] *See, e.g.*, Glen Kohl and Lea Anne Storum, *M&A Double Take: Why Two Mergers Are Better Than One*, Vol. 5 No. 7, The M&A Lawyer, at 23 (Jan. 2002).

[59] *See* REG-165579-02, *citing* H.R. Rep. No. 83-1337 at A134 (1954); *See* REG-165579-02, *citing* H.R. Rep. No. 83-1337 at A134 (1954); Treas. Reg. § 1.368-1(d)(1); Preamble, COBE Regulations, 1981 Fed. Tax Rep. CCH ¶ 6342, Vol. 10.

At least one public company indicated its intention to employ this structure if its first step reverse subsidiary merger would not constitute an A2E reorganization. *See* Robert S. Bernstein, *Moore Corporation Ltd.'s Two Step, Cross-Border Acquisition of Wallace Computer Services, Inc.*, Vol. 30 No. 3 J. Corp. Tax'n 32 (May/Jun. 2003).

result in a package of regulations that would address all variations of second step mergers and liquidations. Although additional revenue rulings would be useful in the absence of regulations, the broad scope of this guidance and the importance of these issues would argue in favor of regulations that bear the imprimatur of both the IRS and Treasury. I believe these regulations should provide that, whatever the form or direction of the second step merger (or liquidation) that follows a stock acquisition, step transaction principles would apply to integrate the two transactions whenever the resulting deemed transaction would qualify as a tax-free reorganization.

As discussed above, the government should not adhere to historical treatment that gives some effect to the form of the two transactions because policy concerns do not justify different form-based results. Instead, it would be both advisable and consistent with reorganization policy for the government to disregard the form of the two actual transactions and deem the target to merge directly into the entity that holds the acquired assets after the second merger. The same deemed direct reorganization treatment should apply to liquidations, upstream mergers into the acquirer, and sideways and downstream mergers, since the direction of the second step transaction does not raise any additional reorganization policy issues. In a perfect world, these regulations would be closely followed by another set of regulations confirming that the dropdown and pushup regulations discussed immediately below would apply without change or limitation to integrated reorganizations.[60] This result is critical to preserving the integrity of the reorganization rules, since any other answer would create a parallel system of rules for multiple step acquisitions, thereby introducing confusion and complexity that is not necessary to protect the reorganization policies.[61]

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[60] *See*, *e.g.*, Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger followed by contribution of target's assets to new subsidiary qualified as A reorganization).

[61] Parallel rules may also raise separate liquidation – reincorporation issues if a second step liquidation is given effect.

III. DROPDOWNS AND PUSHUPS AFTER TAX-FREE REORGANIZATIONS

Dropdowns and pushups, and the tax-free reorganizations that precede them, represent another important facet of multiple step acquisitions.[62] At one time, statutory rules and case law effectively limited post-reorganization transfers such that step transaction principles were invoked to police the reorganization definitions only in extreme circumstances.[63] However, the introduction of triangular reorganizations, the erosion, and then *de facto* repeal, of the remote continuity doctrine, and the government's statement that section 368(a)(2)(C) is a permissive safe harbor and not the exclusive authority for dropdowns, have combined to raise new step transaction considerations with respect to post-reorganization transfers.[64]

Post-reorganization transfers implicate three different requirements which must be satisfied for the reorganization to qualify as tax-free. First, the transfers must be consistent with the reorganization's satisfaction of the continuity of business enterprise ("COBE") requirement.[65] Second, the transfers must be consistent with the transferring corporation's continued satisfaction of the relevant statutory requirements for a tax-free reorganization, including qualification as a party to the reorganization. Satisfaction of this requirement is policed by Treasury regulation section 1.368-2(k) ("-2k"), which describes permitted post-reorganization stock and asset transfers, and Treasury regulation section 1.368-2(f) ("-2f"), which provides in part that a taxpayer remains a party to a reorganization after a transfer described in

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62 As a theoretical matter, the rules governing dropdowns and pushups prior to reorganizations, which are beyond the scope of this article, should be consistent with the rules governing post-reorganization dropdowns and pushups.

63 *See*, *e.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization followed by immediate liquidation of target is tested as a C reorganization).

64 *See* Rev. Rul. 2002-85, 2002-2 C.B. 986 (section 368(a)(2)(C) is permissive, not exclusive or restrictive; *citing* revenue ruling 2001-24, 2001-1 C.B. 1290, which permits dropdowns after forward triangular mergers).

65 T.D. 8760, 1998-1 C.B. 803.

-2k.[66] Third, to the extent not subsumed in the first two requirements, the tax-free reorganization must "be evaluated under relevant provisions of law, including the step transaction doctrine."[67] As discussed below, the belief that transactions which satisfy COBE and -2k should not be stepped together with subsequent pushups or dropdowns, coupled with the closer coordination of the proposed -2k and COBE regulations, has prompted questions as to whether, in fact, a single standard should be adopted to govern post-reorganization transfers.[68]

A. COBE Requirement

Under the current regulations, an acquirer may satisfy the COBE requirement for a tax-free reorganization, notwithstanding a post-reorganization transfer of acquired stock or assets to a corporation or partnership if the "issuing corporation" either (i) continues the historic business of the target corporation (business continuity), or (ii) uses a significant portion of the target corporation's historic business assets in the issuing corporation's business (asset continuity).[69] The "issuing corporation" refers to the acquiring corporation, or, in a triangular reorganization, the corporation that controls the acquiring subsidiary.[70] The COBE requirement is applied by analyzing all the facts and circumstances in light of its policy goal, which is to ensure that reorganizations are limited to readjustments of continuing property interests in modified form and do not "involve the transfer of the acquired stock or assets to a 'stranger', which would be inconsistent with reorganization treatment."[71] More generally, this has been interpreted to refer to whether a sufficient link exists between the

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66 T.D. 8760, 1998-1 C.B. 803; REG-165579-02 (Mar. 2, 2004); REG-130863-04 (Aug. 18, 2004).

67 Treas. Reg. § 1.368-1(a).

68 *See, e.g.*, *NYSBA Tax Section Suggests Changes to Proposed Regs on Post-Reorganization Transfers*, 2004 TNT 142-16 (Jul. 23, 2004) (COBE rules and step transaction guidance should be aligned for purposes of determining whether post-reorganization restructurings affect qualification under section 368).

69 Treas. Reg. § 1.368-1(d)(1).

70 Treas. Reg. § 1.368-1(b).

71 *See* REG-165579-02, *citing* H.R. Rep. No. 83-1337 at A134 (1954); Treas. Reg. § 1.368-1(d)(1).

target corporation shareholders and the assets or stock acquired in the reorganization.[72]

1. Dropdowns to Qualified Group Members

For purposes of the COBE requirement, an acquirer is treated as conducting the businesses, and owning the assets, of its "qualified group".[73] Current regulations define a COBE "qualified group" as including the issuing corporation and any lower-tier subsidiaries that it directly or indirectly controls within the meaning of section 368(c), *i.e.*, ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of each other class of stock.[74] This definition of a qualified group extends the section 368(c) test by attribution, since each 80% controlled corporation to which a qualified group member transfers target or surviving corporation stock or assets will also be a qualified group member as long as the corporation remains an 80% controlled corporation of the issuing corporation.[75]

The use of a qualified group concept permits dropdowns of interests in acquired stock or assets to several different 80% controlled corporations, successive dropdowns, and cross-chain transfers of acquired stock or assets.[76] However, the current COBE rules do not endorse all transfers among affiliates. For example, if part of the target stock were subsequently contributed to each of two 80% controlled subsidiaries of the issuing corporation, neither of which subsequently holds 80% of the transferred corporation's stock (the resulting structure, a "diamond pattern"), the target would no longer be part of the issuing corporation's qualified group after the transfer, because it would not be an 80% controlled corporation with respect to the issuing

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[72] Preamble, COBE Regulations, 1981 Fed. Tax Rep. CCH ¶ 6342, Vol. 10.

[73] Treas. Reg. § 1.368-1(d)(4)(i).

[74] Treas. Reg. § 1.368-1(d)(4)(ii).

[75] Treas. Reg. § 1.368-1(d)(4)(ii).

[76] *See* I.R.C. § 368(a)(2)(C); Prop. Reg. § 1.368-2(k).

corporation after the transfer of its stock.[77] As a result, the target businesses and assets, including the businesses and assets of its 80% controlled subsidiaries, if any, would be excluded from the issuing corporation's qualified group, and thus the COBE requirement would not be satisfied. Similarly, the COBE requirement would not be satisfied with respect to target assets that are dropped through 80% controlled subsidiaries into a corporation whose stock is held in a diamond pattern, because that corporation, which would be conducting the target's business, would not be a member of the issuer's qualified group.[78] By contrast, the current COBE regulations permit target assets, but not target stock, to be transferred to multiple 80% controlled subsidiaries of the issuing corporation, even if no single 80% controlled subsidiary subsequently holds a significant portion of target's historic assets.[79]

The disparate treatment of target stock and asset transfers under the current COBE regulations occurs because the regulations aggregate acquired assets held by qualified group members to determine whether a substantial portion of the target's assets are held or used by the qualified group, but do not aggregate qualified group members' target stock ownership to determine whether the qualified group controls the target. The proposed COBE regulations change this rule, indicating that the government concurs that the resulting limitation on target stock transfers seems unwarranted considering the extent to which a qualified group's ownership of acquired stock could be diluted if, for example, the acquired stock is successively dropped down through several tiers of subsidiaries, each of which is only 80% owned by a qualified group member (and 20% owned by an unrelated party), as permitted by the COBE regulations. By contrast, no target stock leaves the qualified group when the stock is transferred into a diamond pattern. Thus, holding stock in a diamond pattern clearly satisfies the substantive reorganization standards the IRS has adopted, since such stock ownership would constitute "readjustments of continuing interests in the reorganized business in a modified corporate form" and would not "involve the transfer

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77 *See* Rev. Rul. 56-613, 1956-2 C.B. 212 (constructive ownership or aggregation rules do not apply for purposes of the section 368(c) control test).

78 *See* Treas. Reg. § 1.368-1(d)(4)(i) and (ii).

79 Treas. Reg. § 1.368-1(d)(5), Ex. 6.

of the acquired stock or assets to a 'stranger', which would be inconsistent with reorganization treatment."[80]

The proposed COBE regulations add a special rule to conform the treatment of target stock and asset transfers to 80% controlled subsidiaries, which permits the formation of diamond pattern stock ownership after certain reorganizations.[81] The special rule treats the issuing corporation as holding all of the target businesses and assets when qualified group members, *in the aggregate*, control the target.[82] Thus, the COBE requirement would be satisfied if the acquiring corporation transfers target stock to several 80% controlled subsidiaries after a triangular B reorganization, such that the target's stock is held in a diamond pattern, because the qualified group members (*i.e.*, the 80% controlled subsidiaries of the acquiring corporation holding target stock), in the aggregate, would control the target.[83] Notably, however, this result does not obtain because of any change to the definition of a qualified group, and the proposed regulations retain the current rule that the COBE requirement cannot be satisfied with respect to target assets held by a subsidiary owned in a diamond pattern. Neither the current nor proposed regulations treat such assets as owned by the issuer's qualified group because they are not owned by a direct or indirect 80% controlled subsidiary of the issuer.

2. Dropdowns to Partnerships

Another long-debated COBE question is whether contributions of target stock or assets to an affiliated partnership are consistent with COBE. Under current regulations, contributing the stock of a target or surviving corporation to a partnership after a transaction that otherwise qualifies as a tax-free reorganization will likely preclude satisfaction of the COBE requirement, because the target or surviving corporation would no longer be a qualified

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[80] REG-165579-02, *citing* H.R. Rep. No. 83-1337 at A134 (1954).

[81] Prop. Reg. § 1.368-1(d)(4)(i)(B) (rule applies to B reorganizations, forward and reverse triangular mergers, and triangular B, C, and G reorganizations).

[82] Prop. Reg. § 1.368-1(d)(4)(i)(B).

[83] Prop. Reg. § 1.368-1(d)(5), Ex. 7.

group member.[84] By contrast, certain target corporation assets contributed to a partnership after a reorganization may be treated as held by a qualified group for purposes of satisfying the COBE requirement. Treasury regulations provide that a significant target business contributed by an issuing corporation to a partnership, whose business the issuing corporation is treated as conducting, will tend to satisfy the COBE requirement, but is not sufficient to do so alone.[85] An issuing corporation will be treated as conducting the partnership's business if (i) members of the issuing corporation's qualified group, in the aggregate, own a significant interest in the partnership business (a "significant interest"), or (ii) at least one member of the qualified group performs an active and substantial management function as a partner with respect to the partnership business (a "substantial management function").[86]

Although the COBE regulations do not detail when a significant partnership interest and/or a partnership interest that includes a substantial management function will satisfy the COBE requirement, examples in the regulations indicate that, after a dropdown of a significant line of a target's historic business to a partnership, (i) if the qualified group, in the aggregate, performs a substantial management function for the partnership, a qualified group's ownership of a 20% partnership interest, but not a 1% partnership interest, would satisfy the COBE requirement,[87] and (ii) if the qualified group does not perform a substantial management function, the qualified group's ownership of a 33⅓% aggregate partnership interest would satisfy the COBE

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[84] REG-130863-04 (Aug. 18, 2004) (dropdown of target stock to a partnership after an otherwise tax-free reorganization does not satisfy the COBE requirement under either current or proposed regulations).

One fact pattern that may satisfy the COBE requirement involves the acquirer's contribution of stock of a target holding company to a partnership that also acts as a holding company in exchange for a partnership interest that would otherwise be sufficient for COBE purposes. Since the partnership's business that would be attributed up to the acquirer is the same as that of the acquired holding company, the acquirer could be treated as engaged in the target's business through the partnership.

[85] Treas. Reg. § 1.368-1(d)(4)(iii)(C).

[86] Treas. Reg. § 1.368-1(d)(4)(iii)(B).

[87] Treas. Reg. § 1.368-1(d)(5), Ex. 7-8.

requirement.[88] In light of the clear rules set forth in these examples, the reason the regulation provides only that such a transfer to a partnership "tends to" satisfy the COBE requirement, "but is not alone sufficient" is not immediately apparent. One reason Treasury may have included this qualification could be to exclude partnership interests that may satisfy the letter of the examples but do not reflect a proportionate amount of the economic risk and benefit of the target or surviving corporation's assets or business held or conducted by the partnership.[89] Except with respect to these types of interests, most practitioners treat the examples as tantamount to safe harbors.[90]

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[88] Treas. Reg. § 1.368-1(d)(5), Ex. 9-11.

Ownership in tiered partnership structures would be calculated by multiplying each successive tiered partnership ownership interest percentage. For example, if an issuing corporation transferred a target corporation's assets to a 50% owned partnership, and such transferee partnership in turn transferred such assets to a 75% owned second-tier partnership, the issuing corporation would be deemed to have an interest of 37½% (50% multiplied by 75%) in the second partnership for purposes of determining whether the issuing corporation's interest is a significant interest. *See* Treas. Reg. § 1.368-1(d)(5), Ex. 12.

[89] Another concern could be the effective exchange of an interest in target assets for third party assets, when target assets are contributed to a large partnership in exchange for a small interest in the partnership. For example, if all target assets are transferred in exchange for a 10% partnership interest, the qualified group effectively retains a 10% interest in the target assets and acquires a 10% interest in the partnership's other assets. The examples in the COBE regulations appropriately address this problem by requiring the qualified group member to receive (and retain) a significant partnership interest.

[90] *See, e.g., ABA Comments on Proposed Regulations (REG-130863-04) on Transfers of Assets and Stock after a Corporate Reorganization*, 2005 TNT 26-7 (Feb. 9, 2005). The American Bar Association (the "ABA") concurs that examples 8 and 9 represent safe harbors. That is, a 33% partnership interest with no management function, or a 20% partnership interest with a substantial management function, would satisfy the COBE requirement, since neither example suggests any concern about any facts or circumstances other than active management and ownership percentage.

B. -2k Safe Harbors and Other Guidance

1. Current State of the Law

Recent revenue rulings and proposed -2k regulations continue the significant expansion of the scope of permitted post-reorganization transfers that began with the -2k regulations. These transfers were once thought to be governed solely by section 368(a)(2)(C) and the remote continuity doctrine. Section 368(a)(2)(C) once sanctioned only transfers after A, B, C and G reorganizations of stock or assets that were "acquired in the transaction", and *Groman v. Comm'r* and *Helvering v. Bashford*, credited with creating the even more restrictive remote continuity doctrine, provided that continuity of interest was only satisfied if the acquired assets remained in the corporation whose stock was issued in the reorganization.[91] The remote continuity doctrine was eroded by the enactment of A2D and A2E reorganizations, amendments to section 368(a)(2)(C), and several revenue rulings permitting post-reorganization dropdowns.[92] Nonetheless, vestiges of the doctrine lingered until the preamble to the 1998 COBE regulations finally confirmed that the COBE regulations "adequately address" the issues raised in *Groman* and *Bashford*.[93]

The -2k regulations issued in 1998 extended section 368(a)(2)(C) to permit double dropdowns, and to permit transfers of stock or assets after A2E reorganizations. However, they left many questions unanswered. For example, taxpayers still lacked guidance regarding contributions of stock after A2D or triangular C reorganizations. Until the issuance of revenue ruling 2001-24, which blessed a dropdown of the surviving corporation stock after an A2D reorganization, only dropdowns of acquired assets (but not surviving corporation stock) were permitted after an A2D reorganization because the surviving corporation's stock wasn't "acquired in the transaction" as section 368(a)(2)(C) requires.[94] Revenue ruling 2001-24 went beyond

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[91] *Groman v. Comm'r*, 302 U.S. 82 (1937); *Helvering v. Bashford*, 302 U.S. 454 (1938).

[92] *See* Rev. Rul. 64-73, 1964-1 C.B. 142 (sanctioning double dropdown of assets); Rev. Rul. 68-261, 1968-1 C.B. 147 (dropdown of target assets to multiple subsidiaries).

[93] T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

[94] Rev. Rul. 2001-24, 2001-1 C.B. 1290.

section 368(a)(2)(C) and the -2k regulations to sanction a post-A2D reorganization contribution of stock, citing the legislative history to section 368(a)(2)(E) as support for its ruling that A2D and A2E reorganizations should be similarly treated whenever possible, and that, since dropdowns of target corporation stock are permitted after A2E reorganizations, they should also be permitted after A2D reorganizations.[95]

Similarly, although dropdowns after a D reorganization are not addressed in either section 368(a)(2)(C) or the -2k regulations, the IRS approved the acquiring corporation's transfer of the target's assets to the acquiring corporation's controlled subsidiary as part of a non-divisive D reorganization, stating that section 368(a)(2)(C) is permissive and not the exclusive authority with regard to dropdowns.[96] Finally, the -2k regulations also failed to provide comfort that a subsequent asset transfer would not be integrated to disqualify a B reorganization, since such a transfer was not mentioned in -2k or section 368(a)(2)(C). The limitation to stock or assets "acquired in the reorganization" in section 368(a)(2)(C) was once thought to preclude dropdowns of target assets after B reorganizations, since the target's asset are not acquired in a B reorganization. More generally, the -2k regulations do not preclude the integration of transfers to partnerships satisfying the COBE requirement to disqualify a related reorganization. By contrast, Treasury regulation section 1.368-2(f) provides that a transfer of assets to a partnership that satisfies the COBE requirement will not cause a corporation to cease to be a party to an otherwise qualifying reorganization.[97]

Prior to 2001, the above-described lack of guidance in -2k and the stringent statutory requirements for certain acquisitions, *e.g.*, that the target corporation must "hold" substantially all of its historic assets after an A2E reorganization,[98] and that the acquirer

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[95] Rev. Rul. 2001-24, 2001-1 C.B. 1290; S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970); Rev. Rul. 72-576, 1972-2 C.B. 217 (asset dropdown after A2D reorganization permitted as consistent with section 368(a)(2)(C)).

[96] Rev. Rul. 2002-85, 2002-2 C.B. 986.

[97] Treas. Reg. § 1.368-2(f).

[98] This requirement was itself explained in revenue ruling 2001-25, which held that the meaning of "holding" substantially all of a target's assets after an A2E is the same as "acquiring" substantially

must "control" the acquired corporation immediately after a B reorganization, combined to chill acquirers' appetites for post-reorganization transfers. Accordingly, the issuance of revenue rulings 2001-24 and 2002-85, and, more generally, the IRS's statement in the latter ruling that section 368(a)(2)(C) is only a safe harbor for permitted transfers, represented a welcome sea change in the government's patchwork approach to post-reorganization transfers.[99] A Treasury official subsequently reinforced the safe harbor concept when she publicly confirmed that the -2k regulations also constitute a safe harbor.[100] Given the high stakes involved in preserving tax-free treatment for acquisitions, many acquirers and their advisors may not venture significantly beyond the parameters of -2k or an applicable revenue ruling, but the increasing breadth of the current (and proposed) -2k safe harbors and recent rulings will enable even those acquiring groups to integrate target assets and achieve greater synergies more quickly than in the past.

2. Dropdown Rules

The current -2k regulations provide that an A, B, C, or G reorganization will not be disqualified by reason of a transfer or successive transfers of assets or stock acquired in the reorganization to one or more 80% controlled corporations (such transfers, "dropdowns").[101] Similarly, -2k now provides that an A2E reorganization will not be disqualified merely because of a transfer, or successive transfers, of part or all of the surviving corporation's stock, or part or all of the merged corporation's assets, to one or more 80% controlled corporations.[102] The IRS

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all of a target's assets in an A2D reorganization. Rev. Rul. 2001-25, 2001-1 C.B. 1291.

99 *See* Rev. Rul. 2002-85, 2002-2 C.B. 986.

100 *See* comments by Audrey Nacamuli, attorney-advisor in the Treasury Department's Office of Tax Policy, at a D.C. Bar Taxation Section Corporation Tax Committee luncheon held on October 12, 2004 *as summarized in* Ritterpusch, Kurt, *No Firm Plans for Clarifying "Substantially All" for Post Reorganization Transfers, Cain Says*, BNA DAILY TAX REPORT, Oct. 13, 2004, at G-8. *See also* T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

101 *See* Treas. Reg. § 1.368-2(k)(1).

102 Treas. Reg. § 1.368-2(k)(2) (dropdowns to controlled subsidiaries permitted after A2E reorganizations).

has approved the same result for D and A2D reorganizations.[103] However, the -2k regulations would apply step transaction principles to disallow dropdowns of target stock to partnerships; the regulations do not provide any comfort with respect to dropdowns of target assets to partnerships.[104]

It is also important to note that not all dropdowns to corporate affiliates will qualify under the -2k safe harbor. For example, dropdowns to a corporation owned in a diamond pattern would be outside the -2k safe harbor because the transferee corporation would not constitute an 80% controlled corporation. This exclusion is particularly puzzling because the -2k safe harbor permits contributions of target or surviving corporation stock to multiple controlled subsidiaries to *create* a diamond pattern, for example, through a transfer of 50% of the target's stock to each of two issuing corporation 80% controlled corporations. After such transfers, the transferred corporation whose stock is owned in a diamond pattern will cease to constitute an 80% controlled corporation, and subsequent dropdowns to such transferred corporation consequently would not be protected by the -2k safe harbor.[105] Note, however, that the transferred corporation could transfer its assets, or the stock of its subsidiaries, to its own 80% controlled subsidiaries within the -2k safe harbor.[106]

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[103] Rev. Rul. 2001-24, 2001-1 C.B. 1290 (transfers analogous to those allowed following a reverse subsidiary merger should be permitted following a forward subsidiary merger because legislative history indicates that both types of mergers should be treated similarly); Rev. Rul. 2002-85, 2002-2 C.B. 986 (dropdown of assets permitted after non-divisive D reorganization).

[104] *See* Treas. Reg. § 1.368-2(k)(3), Ex. 3 (transfer of target stock to a partnership after a B reorganization, even in exchange for an 80% or greater partnership interest, must be analyzed under the step transaction doctrine and thus the statutory requirement that the acquiring corporation control the target corporation immediately after the B reorganization is not satisfied).

[105] The New York State Bar Association (the "NYSBA") has noted this result in the context of the target corporation as the former member of the qualified group, stating that it is "difficult to rationalize from a policy perspective" and recommending that the regulations be clarified to avoid this result. *See NYSBA Tax Section Suggests Changes to Proposed Regs on Post-Reorganization Transfers*, 2004 TNT 142-16 (Jul. 23, 2004).

[106] *See* Treas. Reg. § 1.368-2(k)(1).

Treasury Regulation section 1.368-2(f) provides that a corporation will remain a party to a reorganization after a transfer described in -2k.[107] Thus, as the IRS has confirmed, the -2k and -2(f) regulations act as a safe harbor, describing transfers that are consistent with continued satisfaction of the relevant statutory requirements for a tax-free reorganization. As discussed above, the COBE requirement must also be satisfied in order for a transaction to "otherwise qualify" as a tax-free reorganization. Caution is warranted when applying these overlapping rules, because not all transfers permitted under the COBE regulations are also permitted under -2k, and, as discussed above, the similar definitions in the COBE and -2k regulations may also provide traps for the unwary. For example, the COBE rules permit the transfer of acquired stock or assets to any 80% controlled subsidiary, whereas the stock and asset transfers permitted by the -2k regulations depend on the type of preceding reorganization. In addition, transfers of target assets to a partnership whose business is conducted by a qualified group member would satisfy COBE, but would not be permitted by the -2k regulations. As these examples indicate, a transfer that satisfies -2k will generally satisfy the COBE requirement as well since the COBE regulations generally have a broader scope than the -2k regulations.[108]

The recently issued proposed -2k regulations[109] would significantly expand the -2k safe harbor to include the transfer, or successive transfers, to qualified group members (*i.e.*, one or more of the issuing corporation's 80% controlled corporations) of target or surviving corporation stock or assets after any type of tax-free reorganization. In addition, the proposed -2k regulations would permit certain transfers of target assets to partnerships whose business is conducted by 80% controlled corporations and certain transfers of target assets and target or surviving corporation stock to shareholders (such transfers, "pushups").[110] As long as the

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[107] Treas. Reg. § 1.368-2(f); Prop. Reg. § 1.368-2(f).

[108] Treas. Reg. § 1.368-1(d)(1).

[109] *See* REG-130863-04 (Aug. 18, 2004). The proposed regulations would apply to transactions occurring after the date such regulations are published in final form. Prop. Reg. § 1.368-2(k)(4).

[110] Prop. Reg. § 1.368-2(k)(1)(ii)(A) and (B), (iii); Treas. Reg. § 1.368-1(d)(4)(iii)(B).

COBE requirement is satisfied, the qualified group will serve as the operative limitation on post-reorganization transfers that will not be recast to preclude tax-free treatment for an original reorganization under the proposed -2k regulations.[111] This result obtains because the -2k safe harbors preclude the application of the step transaction doctrine to dropdowns described therein.[112]

The proposed -2k regulations are much more closely aligned with the COBE rules than the current -2k regulations due to their adoption of the broader COBE qualified group definition. Once the government acknowledged the permissive nature of section 368(a)(2)(C), the -2k rules could be expanded to permit transfers within the COBE qualified group. Consistent with this approach, the proposed -2k regulations would permit dropdowns of target stock or assets without limitation to members of the issuing corporation's qualified group.[113] However, somewhat surprisingly, the proposed -2k regulations do not change the current -2k rule that transfers by a corporation whose stock is held in a diamond pattern are not covered by the -2k safe harbor. This result obtains because the special rule in the proposed COBE regulation that ameliorates certain diamond pattern ownership consequences does not apply for proposed -2k purposes. The cross-referenced COBE definition of a qualified group was not amended; instead, a special rule was

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As the preamble to the proposed -2k regulations notes, the government is considering whether to permit (i) dropdowns of stock to partnerships, and (ii) taxable and/or tax-free distributions to a person that is neither a qualified group member nor a partnership whose business is conducted by a qualified group member. REG-130863-04 (Aug. 18, 2004).

111 Since the proposed -2k regulations adopt the broader COBE qualified group definition, many transactions would satisfy both the proposed -2k and COBE requirements (or not). However, as discussed below, certain differences remain with respect to the treatment of diamond pattern transactions under the proposed -2k and COBE regulations.

112 Treasury Regulation section 1.368-1(a) couples its statement that reorganizations "must be evaluated under relevant provisions of law, including the step transaction" with a *but see* cite to -2k and -2f, indicating that transfers described in -2k will not be integrated with a preceding reorganization to preclude tax-free treatment unless, perhaps, additional transactions not described in -2k occur as part of the same plan.

113 Prop. Reg. § 1.368-2(k)(1)(iii).

added to address diamond patterns, and that rule is not cross-referenced in the proposed -2k regulations.[114] In addition, as a result of adopting the COBE qualified group definition, the proposed -2k regulations no longer permit a target or surviving corporation whose stock is held in a diamond pattern to drop assets or subsidiary stock to its 80% controlled subsidiaries.[115] These transfers are not permitted because a target or surviving corporation held in a diamond pattern would no longer be a member of the qualified group, due to the lack of an 80% link up to the issuing corporation, and only qualified group members can drop down stock or assets under the proposed -2k safe harbor.[116]

It is not clear whether the government intended to preserve the diamond pattern limitations of the current -2k regulations. If so, as the NYSBA and ABA have speculated, one reason for the government's retention of the diamond pattern consequences under current -2k may be the fear of undercutting the section 368(c) control determinations that apply for section 368(a)(2)(C) purposes.[117] I would submit that this concern should be discounted in light of the government's acknowledgement that section 368(a)(2)(C) is simply permissive. The benefits of a single rule should outweigh any concern with moving beyond the permissive boundaries of section 368(a)(2)(C) in this and other areas. The government continues to consider this issue, and has requested comments on whether diamond pattern ownership and/or transfers outside a qualified group should be permitted.[118]

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[114] *See* Prop. Reg. § 1.368-1(d)(4)(i)(B).

[115] These dropdowns are permitted under the current -2k regulations, which only require that the transferring party have section 368(c) control with respect to the transferee, which it would under these facts.

[116] Prop. Reg. § 1.368-2(k)(iii).

[117] *See NYSBA Tax Section Suggests Changes to Proposed Regs on Post-Reorganization Transfers*, 2004 TNT 142-16 (Jul. 23, 2004); *ABA Comments on Transfer of Assets after Putative Reorganizations*, 2004 TNT 109-68 (Jun. 7, 2004).

[118] *See* Ritterpusch, Kurt, *Officials Discuss IRS Regulations on Asset, Stock Transfers Following a Reorganization*, BNA DAILY TAX REPORT, Oct. 5, 2004, at G-8; Ritterpusch, Kurt, *No Firm Plans for Clarifying "Substantially All" for Post Reorganization Transfers, Cain Says*, BNA DAILY TAX REPORT, Oct. 13, 2004, at G-8.

3. Pushup Rules

As discussed below, the proposed -2k regulations would permit for the first time pushups of significant acquired assets and stock after reorganizations.[119] In crafting this pushup rule, the government was faced with several competing concerns. As a threshold matter, revenue ruling 70-107 had been viewed for some time as a bar to pushups after reorganizations. The ruling holds that the assumption of liabilities by both an acquisition subsidiary and its parent precluded C reorganization treatment for assets acquired in exchange for parent stock on the theory that the subsidiary assuming liabilities was also an acquirer.[120] Thus, the initial concern appeared to be that a pushup of liabilities (or assets) immediately after a reorganization would be integrated with the preceding reorganization to cause the party receiving the liabilities or assets to be treated as the acquirer, which would often prevent the transaction from qualifying as a tax-free reorganization. Moreover, the separate status of a pushup was not protected by section 368(a)(2)(C), which applies only to dropdowns. Revenue rulings 67-274 and 72-405, which tested B and A2D reorganizations and subsequent liquidations of the target or surviving corporation, as applicable, as putative C reorganizations, also added weight to the argument that at least a pushup of all acquired assets should be integrated and tested as though the party receiving the assets were the acquirer.[121] The government recognized, however, that whatever unique integration issues might be raised by the liquidation of a target or surviving corporation after a reorganization, it would be analytically difficult to permit asset and stock dropdowns while barring the distribution of any target assets or stock.[122]

The evolution of the government's position on pushups is illustrated by three general counsel memoranda issued between

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[119] Historically, the IRS had permitted distributions of certain assets after tax-free reorganizations. *See, e.g.*, Rev. Rul. 74-35, 1974-1 C.B. 85 (subsequent dividend of 30% of target assets did not affect B reorganization qualification).

[120] Rev. Rul. 70-107, 1970-1 C.B. 78.

[121] Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 72-405, 1972-2 C.B. 217.

[122] *See* Rev. Rul. 74-35, 1974-1 C.B. 85 (distribution of 30% of target assets permitted after a B reorganization).

1974 and 1983. The first of these, G.C.M. 36111, recognized the need to maintain "analytical symmetry" with section 368(a)(2)(C) as a reason not to apply step transaction principles to integrate a reorganization and a subsequent pushup that does not result in a liquidation of the target or surviving corporation. Accordingly, the memorandum recommended that a putative A2D reorganization followed by a distribution of 85% of the acquired assets to the acquirer not be integrated and that the push up of assets therefore not affect satisfaction of the substantially all requirement for the A2D reorganization.[123] By contrast, the second memorandum, G.C.M. 37905, recommended that a triangular C reorganization followed by a distribution to the parent of 90% of the net assets acquired in the reorganization should be integrated, whether or not the distributed assets constituted substantially all of the acquired assets. In effect, the IRS viewed the magnitude of the distribution as sufficient to justify the conclusion that the parent was the substantive acquirer.[124] The third and last memorandum, G.C.M. 39102, concurred with this conclusion in part, recommending the integration of similar transactions, but only if substantially all of the acquired assets are distributed.[125]

In effect, the proposed -2k regulations endorse a variation of the view expressed in G.C.M. 39102 that pushups of less than substantially all of the acquired assets, or less than a controlling interest in target stock, should not be integrated with the previous reorganization. The proposed -2k regulations permit the push up of acquired assets, or, in the case of a putative B or A2E reorganization, assets of the target, to one or more corporations that are members of the issuing corporation's qualified group or to a partnership whose business the qualified group member is treated as conducting, provided that no single transferee receives "substantially all" of the transferred assets.[126] Pushups of less than an 80% controlling interest in target corporation stock are also

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[123] G.C.M. 36111 (Dec. 18, 1974).

[124] G.C.M. 37905 (Mar. 29, 1979).

[125] G.C.M. 39102 (Dec. 21, 1983). G.C.M. 39102 also recommended that the IRS revoke revenue ruling 70-107.

[126] Prop. Reg. § 1.368-2(k)(1)(ii)(A)(1)-(3). The target corporation and the acquiring subsidiary are parties to the reorganization and thus may transfer their assets (including stock they own) in a pushup, subject to the substantially all limitation discussed in the text. *See* Prop. Reg. § 1.368-2(k)(1)(i)(A), (f).

permitted.[127] All pushups must satisfy the following four requirements: (i) the transferee must be a party to the reorganization,[128] (ii) the pushup must be consistent with satisfaction of the COBE requirement,[129] (iii) the transferee must be either a member of the qualified group or a partnership whose business is conducted by a qualified group member,[130] and (iv) no issuing corporation stock may be transferred.[131]

The government considered and rejected the idea of permitting pushups of all or substantially all acquired assets to a single transferee, or, alternatively, permitting pushups that would not trigger an actual or *de facto* liquidation of the target or surviving corporation, apparently due to its general concern that the transferee may constitute the acquirer in the preceding reorganization if substantially all of the acquired assets are transferred to a single party. Since a preexisting acquiring subsidiary could avoid a *de facto* liquidation by retaining historic

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[127] Prop. Reg. § 1.368-2(k)(1)(ii)(A)(4). The proposed regulations define control pursuant to section 368(c) (*i.e.*, 80% of voting power and 80% of shares of each class of nonvoting stock). Prop. Reg. § 1.368-2(k)(2).

[128] Prop. Reg. § 1.368-2(k)(1). In the case of a reorganization in which stock or properties of one corporation are transferred to another corporation, both corporations are parties to the reorganization. A party to a reorganization also includes a corporation resulting from the reorganization. I.R.C. § 368(b). With respect to triangular reorganizations, the proposed regulations expand the term "a party to the organization" to include the corporation controlling the acquiring corporation whose stock is used in the acquisition. Prop. Reg. § 1.368-2(f).

[129] Prop. Reg. § 1.368-2(k)(1)(iv).

[130] Prop. Reg. § 1.368-2(k)(1)(iii). The standard used for determining whether the qualified group conducts the business of a partnership after a pushup or a dropdown is the same as the COBE test (*i.e.*, the partner has a significant interest in, and/or performs a significant management function for, the partnership). *See* Prop. Treas. § 1.368-2(k)(l)(iii); Treas. Reg. § 1.368-1(d)(4)(iii). The proposed -2k regulations cross-reference the COBE regulation and, therefore, the COBE examples would apply (*i.e.*, a one-third partnership interest with no management function, or a 20% partnership interest with a substantial management function satisfies the COBE requirement).

[131] Prop. Reg. § 1.368-2(k)(1)(i)(B).

assets and distributing all the acquired assets to the issuing corporation, the proposed -2k regulations limit pushups to a single transferee to an amount less than substantially all the acquired assets.[132] Although the proposed -2k regulations refer to the C reorganization definition of "substantially all", it is not clear how this standard would be determined.[133] While IRS guidelines for reorganization rulings define substantially all as at least 90% of the fair market value of net assets, and at least 70% of the fair market value of gross assets, these guidelines represent a safe harbor which, if satisfied, presumes satisfaction of the substantially all requirement.[134] By contrast, taxpayers will need to demonstrate in connection with pushups that substantially all of the assets have not been acquired by a transferee, and very little law exists regarding the quantum of assets that would constitute less than substantially all.[135]

If, as is possible, the IRS integrates a reorganization and a subsequent pushup of substantially all acquired assets to the party whose stock was issued in the reorganization, the resulting transaction would likely be tested as a C reorganization, consistent with the IRS's general integration approach to transactions other than upstream mergers.[136] Imposing the exacting C reorganization rules on the integrated transaction would limit the circumstances under which integrating a pushup of all acquired assets would preserve tax-free treatment for the original reorganization.[137]

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[132] *See* REG-130863-04 (Aug. 18, 2004).

[133] REG-130863-04 (Aug. 18, 2004); Prop. Reg. § 1.368-2(k)(l)(ii)(A).

[134] Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722.

[135] *See ABA Comments on Proposed Regulations (REG-130863-04) on Transfers of Assets and Stock after a Corporate Reorganization*, 2005 TNT 26-7 (Feb. 9, 2005).

[136] *See* Rev. Rul. 67-274, 1967-2 C.B. 141 (reverse subsidiary merger followed by an upstream liquidation tested as a C reorganization); *see also* Rev. Rul. 72-405, 1972-2 C.B. 217 (citing revenue ruling 67-274 and holding that a forward subsidiary merger followed by a liquidation may not be considered independently and therefore will be tested as a C, rather than A2D, reorganization).

[137] As discussed in section II.C.2. above, C reorganization treatment may permit the elective recognition of minority target shareholder stock losses.

Given the fact that -2k is a safe harbor, it is not clear whether the government would challenge pushups of all or substantially all acquired assets to a single transferee within the qualified group.[138] As the NYSBA report observed, the government could adopt a broader rule that isolates the original reorganization from all post-reorganization transfers within a qualified group, including transfers of all acquired assets or target stock. While such a rule would require amending other step transaction guidance on reorganizations, I believe it merits the government's consideration.[139] Indeed, the noncommittal language the preamble to the proposed -2k regulations uses to describe the result in revenue ruling 72-405 may indicate that the government is considering such a rule: "it *could be argued that* this transaction should be treated as a direct acquisition of the acquired assets by the issuing corporation" (emphasis added).[140]

On the one hand, revenue ruling 2003-51 indicates that the IRS is willing to separate transactions, such as successive section 351 transactions that occur as part of a single plan in order for the control requirement to be satisfied.[141] On the other hand, the IRS has historically integrated successive transactions that are part of a single plan to produce tax-free A (and C) reorganizations,

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[138] In effect, limiting a pushup to a qualifying group member means that assets or stock will be distributed to the acquirer in most cases. Pushups above the acquirer, and other pushups to transferees who are not qualified group members, including through tax-free spin-offs, raise other important reorganization policy issues, including issues regarding the satisfaction of continuity of interest and COBE that are beyond the scope of this article.

[139] *See NYSBA Tax Section Suggests Changes to Proposed Regs on Post-Reorganization Transfers*, 2004 TNT 142-16 (Jul. 23, 2004); *see, e.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization followed by liquidation of target tested as C reorganization); Rev. Rul. 72-405, 1972-2 C.B. 217 (new subsidiary's acquisition of target assets for parent stock followed by liquidation of subsidiary tested as a C reorganization); Rev. Rul. 2001-46, 2001-2 C.B. 321, Situation 2 (A2E reorganization followed by upstream merger of target tested as an A reorganization); Rev. Rul. 2004-83, 2004-32 I.R.B. 1 (stock acquisition for cash potentially governed by section 304 is properly stepped together with subsequent liquidation to produce D reorganization).

[140] REG-130863-04 (Aug. 18, 2004).

[141] Rev. Rul. 2003-51, 2003-21 I.R.B. 938.

as discussed in section II above. As a result, several old rulings that integrate successive transactions, sometimes to preclude tax-free treatment, would have to be revoked or distinguished if "liquidating" pushups are respected as separate transactions.[142] Accordingly, it may be a bit optimistic to expect the government to expand the pushup rules soon, notwithstanding its continued consideration of the issue.[143] Consistent with the government's broader approach, however, a strong argument can be made to turn off step transaction principles to preserve tax-free treatment for reorganizations followed by pushups of all acquired assets to a single qualified group member. If this approach is not viewed as viable as a result of the government's broader policy of integrating reorganizations, at a minimum, the original reorganization and a liquidating pushup should be treated as a deemed direct merger into the transferee receiving the assets consistent with the recommendations in section II.D. While the latter approach may have more appeal to the government than turning off step transaction for all pushups, distributing assets to one rather than two qualified group members is a somewhat unsatisfying point on which to balance the application of step transaction principles.

C. A Single Rule for Dropdowns and Pushups

COBE was first coordinated with section 368(a)(2)(C) and the remote continuity doctrine in revenue ruling 81-247, which held that dropdowns to directly controlled subsidiaries did not create a COBE problem.[144] Several years later, the preamble to the 1998 COBE regulations confirmed that the COBE regulations "adequately address" the remote continuity issues raised in

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[142] *See*, *e.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization followed by liquidation of target tested as C reorganization); Rev. Rul. 72-405, 1972-2 C.B. 217 (new subsidiary's acquisition of target assets for parent stock followed by liquidation of subsidiary tested as a C reorganization).

[143] *See generally* REG-130863-4 (Aug. 18, 2004) (IRS seeks comments whether to permit transfers after reorganizations to nonqualified group members); Ritterpusch, Kurt, *No Firm Plans for Clarifying "Substantially All" for Post Reorganization Transfers, Cain Says*, BNA DAILY TAX REPORT, Oct. 13, 2004, at G-8 (IRS to continue to consider issues with respect to the proposed -2k regulations).

[144] Rev. Rul. 81-247, 1981-2 C.B. 87, obsoleted by Rev. Rul. 2003-99, 2003-34 I.R.B. 388; *see also* PLR 8432112 (May 11, 1984) (sequential dropdowns held consistent with COBE requirement).

Groman and *Bashford*, putting the final nail in the coffin of the remote continuity doctrine.[145] More recently, the IRS noted the COBE regulations with approval in revenue ruling 2001-24, which sanctioned the contribution of surviving corporation stock after an A2D reorganization, stating that, unlike section 368(a)(2)(C), the COBE regulations do not differentiate between A2D and A2E reorganizations or provide different rules for other transfers of stock or assets within a qualified group depending on whether stock or assets were acquired in a reorganization.

Revenue ruling 2001-24 held that although the contribution of stock did not satisfy section 368(a)(2)(C) or the -2k safe harbor, it was nonetheless consistent with reorganization treatment and would not be recast under the step transaction doctrine because it did not violate the statutory or regulatory policy governing triangular reorganizations. Since reorganization policy is the ultimate governor of permitted post-reorganization transfers, would it not be reasonable to smooth the edges of the COBE and -2k rules to create a single rule for permitted post-reorganization transfers? And would it not be desirable for such a rule to confirm that transfers permitted by the rule would not be subject to recast under the step transaction doctrine?

The NYSBA has proposed the adoption of such a standard.[146] More specifically, the NYSBA has recommended that regulations confirm that a reorganization will not be disqualified as a result of the integration of any transactions involving stock or assets of a party to the reorganization as long as the acquirer's qualified group conducts the target corporation's business within the meaning of the COBE regulations.[147] Notably, this approach

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[145] *See* T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

[146] *NYSBA Tax Section Suggests Changes to Proposed Regs on Post-Reorganization Transfers*, 2004 TNT 142-16 (Jul. 23, 2004).

[147] The NYSBA report recommends expanding the common COBE and -2k definition of a qualified group to include subsidiaries that are controlled within the meaning of either section 368(c) or section 1504 (without regard to the exceptions in section 1504(b)), which would include 80% controlled subsidiaries after they are transferred into a diamond pattern. The ABA report recommends adopting the section 1504 control test instead of the section 368(c) test. *See ABA Comments on Transfer of Assets after Putative Reorganizations*, 2004 TNT 109-68 (Jun. 7, 2004).

would insure that the control tests for certain reorganizations would be determined without integrating subsequent, permitted transfers under step transaction principles. While I believe this principle is consistent with the intent of the COBE and -2k regulations, it could be more clearly stated in the regulations.[148] Accordingly, the COBE and -2k regulations should be clarified and coordinated to prevent a subsequent transfer of acquired assets and stock within the acquirer's qualified group from disqualifying an otherwise valid reorganization. The resulting regulations should also confirm that permitted transfers may be accomplished through either taxable or tax-free transactions.

A strong argument can be made to expand the pushup rules to include pushups of all acquired assets to a single qualified group member. If the government does not believe this approach as consistent with its broader integration approach regarding reorganizations, the original reorganization and a liquidating pushup should be treated as a deemed direct merger into the transferee receiving the assets, consistent with the recommendations in section II.D. regarding integrated reorganizations. While this latter approach may have more appeal for the government, the number of qualified group members to whom assets are pushed up is not a natural fulcrum for the application of step transaction principles.

IV. F REORGANIZATIONS

A. Current Law

F reorganizations, which are described as mere changes in identity, form, or place of organization of one corporation, however effected, are ubiquitous.[149] They often occur as a step in a larger, tax-free transaction, and they have long been granted a unique exemption from the application of the step transaction

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[148] Treasury Regulation section 1.368-1(a) couples its statement that reorganizations "must be evaluated under relevant provisions of law, including the step transaction" with a *but see* cite to -2k and -2f, indicating that transfers described in -2k will not be integrated with a preceding reorganization to preclude tax-free treatment unless, perhaps, additional transactions not described in -2k occur as part of the same plan.

[149] I.R.C. § 368(a)(1)(F).

doctrine.[150] F reorganizations may involve multiple entities as long as only one entity is an operating company (the "single operating company rule").[151] F reorganizations may also involve foreign and domestic entities.[152] F reorganizations involving foreign corporations will often trigger additional tax consequences under sections 367 and 897.[153] For example, a tax-free merger of a foreign subsidiary into its domestic parent, including through a valid F reorganization, would be treated as an inbound asset transfer that would require the domestic parent to include in income the foreign subsidiary's all earnings and profits amount.[154]

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[150] *See*, *e.g.*, Rev. Rul. 96-29, 1996-1 C.B. 50 (acquirer holding company reincorporated in a different state after an operating target merged into an acquirer operating subsidiary in unspecified type of merger; reincorporation held to be a separate and valid F reorganization); Rev. Rul. 2003-48, 2003-19 I.R.B. 863 (conversions of mutual savings banks to stock savings banks qualified as F reorganizations, notwithstanding subsequent change in direct ownership of transferred company); PLR 200510012 (Mar. 15, 2005) (forward triangular merger that followed payment of dividend and initial public offering of the transferred corporation stock qualified as F reorganization).

[151] H.R. Rep. No. 760, 97th Cong., 2d Sess. 541 (1982), 1982-2 C.B. 600, 634-635.

[152] *See*, *e.g.*, Rev. Rul. 88-25, 1988-1 C.B. 116 (conversion of a foreign corporation into a domestic corporation under a state's "domestication" statute is an F reorganization as long as COI and COBE requirements then in effect were satisfied); Rev. Rul. 87-27, 1987-1 C.B. 134 (domestic corporation's transfer of assets and liabilities to newly formed foreign corporation in exchange for foreign corporation's stock that it distributes in complete liquidation constitutes an F reorganization); Prop. Reg. § 1.368-2(m)(5), Ex. 3 (merger of country A subsidiary into country Y target constituted an F reorganization).

[153] Notice 88-50, 1998-1 C.B. 535.

[154] *See* Treas. Reg. § 1.367(b)-3(a), -2(f).

In addition, if a domestic parent and foreign subsidiary are "stapled entities", *i.e.*, more than 50% of the value of the stock of each corporation must be transferred together, the foreign subsidiary is generally deemed converted to a domestic subsidiary in an F reorganization. *See* I.R.C. § 269B; Treas. Reg. § 1.367(b)-2(g); *see also* Prop. Reg. §§ 1.269B-1, 1.367(b)-2(g).

While F reorganizations were historically required to satisfy the continuity of interest ("COI") and continuity of business enterprise (COBE) requirements for reorganizations,[155] recent IRS rulings indicate, at a minimum, a more lenient interpretation of the COI and COBE rules, and a continuing exemption from the step transaction doctrine, to protect F reorganizations.[156] Recent final regulations provide that COI and COBE are no longer required for F reorganizations.[157] As the preamble to the proposed regulations explains, the COI and COBE requirements are not necessary in the case of F reorganizations to protect the policies underlying the reorganization rules. F reorganizations do not present the usual concern that the continuing link between the target assets and the target shareholders would become too tenuous to support reorganization status, because they do not resemble sales and involve only "the slightest change in a corporation".[158]

One ruling in particular foreshadowed the elimination of the COI and COBE requirements and provides valuable guidance on questions that remain under the final regulations. In revenue ruling 96-29, an F reorganization occurred as part of a series of transactions in which a subsequent shift in stock ownership could have precluded satisfaction of COI or COBE.[159] In the first situation, corporation Q reincorporated in a different state by merging into a newly formed subsidiary ("New Q") before selling 60% of its common shares to the public. New Q used the proceeds of the offering to redeem its nonvoting preferred stock, which represented 40% of New Q's aggregate pre-offering value, as part of a plan that included the reincorporation. The COI requirement

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[155] Treas. Reg. § 1.368-1(b), (c), (g), prior to amendment to Treasury Regulation section 1.368-1(b); *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) (F reorganizations are limited to cases where the corporate enterprise continues uninterrupted, except perhaps for a distribution of liquid assets); *Yoc Heating Corp. v. Comm'r*, 61 T.C. 168 (1973) (parent's purchase of 85% of the stock of subsidiary followed by subsidiary's transfer of its assets to parent's newly formed subsidiary is not an F reorganization because the second transfer precluded satisfaction of COI).

[156] *See* Rev. Rul. 96-29, 1996-1 C.B. 50; PLR 199902004 (Oct. 7, 1998).

[157] Treas. Reg. § 1.368-1(b), as amended by T.D. 9182 (Feb. 25, 2005).

[158] REG-106889-04 (Aug. 12, 2004).

[159] Rev. Rul. 96-29, 1996-1 C.B. 50.

was apparently satisfied.[160] In the second situation, W's subsidiary Y acquired Z in a reverse subsidiary merger for W preferred stock. Immediately after the acquisition, W reincorporated in a different state by merging with a newly formed corporation. All W shareholders (including the former Z shareholders) exchanged their stock for stock of the new corporation. W's reincorporation was respected as a separate F reorganization. Similarly, the IRS recently ruled that a target entity's merger into an indirectly owned disregarded entity is an F reorganization, notwithstanding a potential COBE issue due to the target's distribution of significant corporate assets before the F reorganization.[161]

These rulings suggest that a putative F reorganization may be isolated from other related transactions to satisfy the F reorganization requirements without taking into account prior or subsequent transactions, even if those transactions occur as part of a plan. This degree of isolation is unique to F reorganizations, and it stands in stark contrast to the IRS's usual penchant for invoking the step transaction doctrine to integrate a series of steps that are focused towards a particular result.[162] Only the section 338 rules turn off step transaction in a similar manner and, as discussed above, those rules apply in a much more limited context. The historic isolation of F reorganizations from the operation of step transaction principles has been ascribed to their "unique status"

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[160] Revenue ruling 96-29 also raised issues that were subsequently resolved by the subsequent issuance of Treasury regulation section 1.368-1(e)(1)(ii) and 1.368-1(e)(6), Example 9 (a target corporation's redemption of shares with its own funds is consistent with preserving COI). *See* T.D. 8898, 65 Fed. Reg. 52909 (Aug. 31, 2000).

[161] *See*, *e.g.*, PLR 199902004 (Oct. 7, 1998). In the ruling, a REIT doing business through a limited partnership sought to acquire selected assets of a REIT doing business through subsidiary REITs. The target transferred its unwanted assets to a new subsidiary, distributed the subsidiary's common stock to its shareholders as a taxable stock dividend, sold the preferred stock to the acquiring limited partnership for cash and then transferred its remaining assets to a newly formed, indirectly owned, disregarded LLC. The target merged into its new LLC in a putative F reorganization, and an intervening disregarded entity merged into the acquirer. The F reorganization was valid notwithstanding the removal of all unwanted assets from the target group.

[162] *Penrod v. Comm'r*, 88 T.C. 1415, 1428 (1987).

among other reorganizations.[163] Accordingly, a series of steps involving an F reorganization and a second tax-free transaction that would likely be stepped together under general step transaction principles are generally treated as separate for purposes of qualifying a step as an F reorganization.[164] This unique treatment obtains because, unlike other tax-free reorganizations involving two or more operating companies, an F reorganization is generally treated as if there had been no change in the transferred corporation, and thus, as if the resulting corporation is the same entity as the old transferred corporation.[165] This treatment essentially allows the IRS to ignore the F reorganization as a non-transaction. Since nothing has happened, isolating the non-transaction does no injury to the step transaction doctrine.

B. Proposed Regulations

The 2004 proposed regulations regarding F reorganizations provide that an F reorganization must have a business purpose, and must also satisfy four other requirements in order to constitute the requisite mere change in identity, form, or place of reorganization of one corporation (a "mere change").[166] As discussed below, the

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[163] *See* Rev. Rul. 96-29, 1996-1 C.B. 50.

[164] *See*, *e.g.*, Rev. Rul. 69-516, 1969-2 C.B. 51, *revoked by* REG-106889-04 (Aug. 12, 2004) (first step F reorganization of target, followed by a putative C reorganization of target into acquirer; held to be good F and C reorganizations); Rev. Rul. 79-250, 1979-2 C.B.156 (forward merger of target into parent's newly created subsidiary, followed by parent's reincorporation in another state; latter transaction was a valid separate F reorganization), modified and narrowed by revenue ruling 96-29, 1996-1 C.B. 50 (to apply only to F reorganizations); *see also* PLR 199902004 (Oct. 7, 1998) (merger of target corporation into a second tier disregarded entity of target was treated as an F reorganization, notwithstanding an overall plan to remove certain target assets before the F reorganization and to effect a merger after the F reorganization); PLR 200129024 (Jul. 20, 2001) (F reorganization effected simultaneously with sales of 4 of 5 group businesses was isolated and respected).

[165] *See* Rev. Rul. 96-29, 1996-1 C.B. 50.

[166] *See* Prop. Reg. § 1.368-2(m)(5) (all of the examples assume a valid business purpose); Prop. Reg. § 1.368-2(m)(1)(i); *see also* REG-106889-04 (Aug. 12, 2004) (the last two requirements for a mere change in form reflect the statutory requirement that an F reorganization involve only one operating corporation).

proposed regulations also adopt a new approach to the application of step transaction principles to create F reorganizations.

The first requirement of the proposed regulations is that, subject to a nominal stock carveout, all of the resulting corporation's stock must be issued to the transferring corporation, including any stock issued before the putative F reorganization transfer.[167] Thus, a transaction that introduces a new shareholder or involves new capital generally cannot qualify as an F reorganization.[168] Consequently, for example, a new shareholder may not contribute assets to the resulting corporation in exchange for more than a nominal amount of stock (as discussed immediately below) before an F reorganization in which the old "transferring" corporation merges into the new "resulting" corporation.[169] However, the resulting corporation may issue a nominal amount of its stock to facilitate its organization in a jurisdiction that requires two or more shareholders, the ownership of shares by directors, or a transfer of nominal assets to certain preexisting entities.[170]

The second requirement is that the transferring corporation's stock ownership must not change except as a result of a redemption of part (but not all) of the corporation's stock.[171] One example in the proposed regulations applies this partial redemption exception to treat a transaction that included the transferring corporation's complete redemption of a 75% shareholder for cash as an F reorganization.[172] By contrast, another example discusses an asset acquisition involving a target and acquirer incorporated in different states that does not qualify as an F reorganization. The acquirer contributed cash equal to the target's value to a new subsidiary ("Newco"); Target subsequently merged into Newco and target's shareholder exchanged its target stock for Newco's cash in the merger. The latter example

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[167] *See* Prop. Reg. § 1.368-2(m)(1)(i)(A), (ii)(b).

[168] *See* REG-106889-04 (Aug. 12, 2004).

[169] *See* REG-106889-04 (Aug. 12, 2004).

[170] REG-106889-04 (Aug. 12, 2004).

[171] Prop. Reg. § 1.368-2(m)(1)(i)(B); *see also Reef Corp. v. U.S.*, 368 F.2d 125 (5th Cir. 1966) (simultaneous redemption of 98% of corporation's stock did not preclude F reorganization).

[172] Prop. Reg. § 1.368-2(m)(5), Ex. 2.

concludes that the transaction could not qualify as a mere change in form of the target because the target's stock ownership changed completely when the sole target shareholder was redeemed.[173] The results in these two examples can be reconciled on the basis that only part of the transferring corporation's stock was redeemed in the first example, whereas all of the transferring corporation's stock was redeemed in the second example, which exceeds the F reorganization rule permitting redemptions of part of the transferring corporation's stock.[174]

The third requirement provides that the transferring corporation must completely liquidate in the transaction,[175] although it need not legally dissolve and it may retain a nominal amount of assets solely to preserve the corporation's legal existence.[176] These exceptions permit a transferring corporation to preserve its charter, and engage in F reorganizations in jurisdictions where it is customary to preserve preexisting entities for future use.[177] Although the proposed regulations do not describe what would be considered nominal for this purpose, the statement that the "sole" purpose of the exception is to allow preservation of the transferring corporation's legal existence presumably indicates that anything more than the minimal amount necessary to preserve such existence may not be considered nominal. The fourth requirement is that the resulting corporation must be devoid of property and tax attributes[178] immediately before the transfer, except as described below.[179] The resulting corporation may hold or have held (i) a nominal amount of assets,

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[173] Prop. Reg. § 1.368-2(m)(5), Ex. 1.

[174] An alternative rationale to reconcile the examples would look to the different sources of cash. That is, an F reorganization occurred in the first example because the cash was originally held by the transferred entity itself, whereas in the second example, the cash was supplied by the acquirer. *See* Rizzi, Robert A., "*'Mere Transaction': Are 'F' Reorganizations Really Reorganizations?*," 31 J. Corp. Tax'n 6 (Nov/Dec 2004).

[175] Prop. Reg. § 1.368-2(m)(1)(i)(C).

[176] Prop. Reg. § 1.368-2(m)(1)(ii)(A).

[177] REG-106889-04 (Aug. 12, 2004).

[178] Tax attributes include section 381(c) tax attributes, *e.g.*, NOL carryovers, E&P, and capital loss carryovers.

[179] Prop. Reg. § 1.368-2(m)(1)(i)(D).

together with associated tax attributes, to facilitate its organization or preserve its existence as a corporation, and (ii) the proceeds of borrowings undertaken in connection with the transaction, *e.g.*, to accommodate debt refinancings or the leveraged redemption of shareholders.[180]

The proposed regulations permit taxpayers to structure transactions to separate cash distributions made in connection with F reorganizations from the putative F reorganization itself. The section 356(a) boot rules would not apply to limit gain recognition on a distribution to a shareholder by either the transferring or resulting corporation in connection with an F reorganization (including in exchange for its shares) because the distribution must be isolated from the reorganization in a separate step. Typically, the transferring corporation distributes the cash or property immediately before the F reorganization in a separate transaction that is governed by sections 301 and 302.[181] By contrast, a cash distribution that occurs in the same step as a putative F reorganization would disqualify the F reorganization.

More generally, the proposed regulations clearly reaffirm the government's historical approach that the step transaction doctrine will not be applied to prevent F reorganizations. Instead, the proposed regulations adopt a very flexible approach to integration. Moreover, building on revenue ruling 96-29, the proposed regulations provide that an F reorganization will be respected as a separate transaction even if it is also a step in a larger transaction that effects more than a mere change. Even related events that closely precede or follow a transaction, or series of transactions, that constitute a mere change will be isolated and will not affect qualification as an F reorganization.[182] The proposed regulations also explicitly confirm that qualification as an F reorganization will not affect the potentially tax-free treatment of a simultaneous larger transaction.[183]

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[180] Prop. Reg. § 1.368-2(m)(1)(ii)(B); REG-106889-04 (Aug. 12, 2004).

[181] Prop. Reg. § 1.368-2(m)(4); Treas. Reg. § 1.301-1(l); REG-106889-04 (Aug. 12, 2004); *see also* Rev. Rul. 61-156, 1961-2 C.B. 62 (distribution of cash in connection with, but separate from, F reorganization treated as section 301 distribution); PLR 199743001 (Oct. 27, 1997) (same).

[182] Prop. Reg. § 1.368-2(m)(3)(ii); REG-106889-04 (Aug. 12, 2004).

[183] Prop. Reg. § 1.368-2(m)(3)(ii).

For example, the proposed regulations would not apply the step transaction doctrine to produce a merger of two operating companies that would fail to qualify as an F reorganization.[184] Thus, the proposed regulations confirm that a multiple step merger of an operating subsidiary into a holding company parent may satisfy the single operating company rule as long as no single step involves the merger of two operating companies, whereas a direct merger between an operating subsidiary and its operating parent would not.[185] It is not clear what level of operations would cause a corporation to be considered an operating company under the proposed regulations, although a "functioning" corporation has been held to constitute an "operating" corporation; the nature and degree of the corporation's activity was not determinative where the corporation was not newly-formed and had assets and income.[186] The single operating company limitation should not present a practical problem, as the following multiple step transactions may be used to isolate a putative F reorganization involving a subsidiary from the combination of operating affiliates

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[184] *See* Prop. Reg. § 1.368-2(m)(5), Ex. 7 (operating target merged into operating subsidiary; parent then reincorporated by merging into a new subsidiary in another state; reincorporation held a valid and separate F reorganization); *see also* Rev. Rul. 96-29, 1996-1 C.B. 50 (acquirer holding company reincorporated in a different state after an operating target merged into an acquirer operating subsidiary in unspecified type of merger; reincorporation held to be a separate and valid F reorganization).

[185] *See Eastern Color Printing Co. v. Commissioner*, 63 T.C. 27 (1974), *acq.*, 1975-2 C.B. 1 (merger of operating subsidiary with its holding company parent). *Compare Home Constr. Corp. v. U.S.*, 439 F.2d 1165 (5th Cir. 1971) (merger of multiple commonly owned operating subsidiaries engaged in the same line of business held valid F reorganization); *Performance Sys., Inc. v. U.S.*, 382 F. Supp. 525 (MD Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974) (merger of operating subsidiary into operating parent is a valid F reorganization where both are in same or integrated businesses); and *Movie Lab, Inc. v. U.S.*, 494 F.2d 693 (Ct. Cl. 1974) (same); *see generally* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 12.28[4] (7th ed. 2002).

[186] TAM 9211003 (Nov. 25, 1991) (merger of Oldco 1 into Oldco 2 simultaneously with the merger of 21 other corporations into Oldco 2 not an F reorganization because both corporations were operating companies).

under the proposed regulations.[187] In the first step, (i) parent may create a new subsidiary into which the existing subsidiary merges,[188] (ii) parent may contribute the subsidiary's stock to a new subsidiary in exchange for new subsidiary stock and then liquidate the existing subsidiary into the new subsidiary,[189] or (iii) the subsidiary may convert to a partnership and then elect to be treated as a corporation for federal income tax purposes.[190] The resulting entity after any of these first step F reorganizations may subsequently liquidate or merge into the parent in a separate tax-free section 332 liquidation or an A reorganization.[191] These transactions should not be integrated to preclude an F reorganization under either current law or the proposed regulations; the proposed regulations specifically provide that

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[187] *See, e.g.*, Rev. Rul. 72-420, 1972-2 C.B. 473 (overlapping F reorganization and section 1036 exchange); Rev. Rul. 79-289, 1979-2 C.B. 145 (overlapping F and D reorganization not subject to section 357(c)); Rev. Rul. 87-66, 1987-2 C.B. 168 (inbound reincorporation qualified as both F and D reorganization); Rev. Rul. 2003-48, 2003-19 I.R.B. 863 (conversions of mutual savings banks to stock savings banks qualified as F reorganizations, as well as B reorganizations and section 351 transfers).

[188] *See, e.g.*, PLR 199902004 (Oct. 7, 1998); PLR 200129024 (Jul. 20, 2001); Prop. Reg. § 1.368-2(m)(5), Ex. 5.

[189] *See, e.g.*, Rev. Rul. 87-27, 1987-1 C.B. 134 (domestic corporation's transfer of assets and liabilities to new foreign corporation in exchange for foreign corporation's stock distributed in complete liquidation constitutes a valid F reorganization).

[190] *See, e.g.*, Prop. Reg. § 1.368-2(m)(5), Ex. 8 (F reorganization where parent contributed interest in corporate subsidiary S to a newly formed LLC, converting S to a partnership under state law; S elected to be treated as a corporation for tax purposes); FSA 200237017 (Jun. 7, 2002) (same result).

[191] The second transaction could also qualify as an F reorganization even though it involves a section 332 liquidation, but for the fact that it involves two operating companies. For authority before Congress amended section 368(a)(1)(F) to add the single operating company rule, *see Performance Sys., Inc. v. U.S.*, 382 F. Supp. 525 (MD Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974) (section 332 and section 368(a)(1)(F) are not mutually exclusive); Rev. Rul. 75-561, 1975-2 C.B. 129 (section 332 liquidation to which section 334(b)(2) does not apply can also qualify as an F reorganization).

related events before or after a putative F reorganization will not be integrated to preclude qualification as an F reorganization.[192]

Notably, and potentially of significant benefit to taxpayers seeking F reorganization treatment, the preamble to the proposed regulations provides that the reference to "however effected" in the statutory definition of an F reorganization indicates Congress's intent to treat a series of transactions that result in a mere change when stepped together as an F reorganization.[193] To give effect to this intent, the proposed regulations would for the first time affirmatively apply the step transaction doctrine to integrate a series of steps to produce a valid F reorganization. This new rule is illustrated by an example in the regulations in which parent's formation of a new subsidiary and parent's contribution of the stock of a current subsidiary to the new subsidiary, followed by the subsidiary's upstream merger into the new subsidiary, will be integrated to constitute a valid F reorganization.[194] The only limitation on this rule appears to be that F reorganization treatment would be precluded if a redemption of all transferred corporation stock occurs in the same step as a putative F reorganization.[195]

Like current law, the proposed regulations also place a great deal of emphasis on form, and in particular, on isolating integrated steps that constitute an F reorganization from other transactions, because ignoring an F reorganization depends on separating it from any other action that must be given tax effect, such as the payment of a dividend. This combination integration-isolation approach in the proposed regulations raises several questions, including the types of other actions that are (or are not)

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[192] Prop. Reg. § 1.368-2(m)(3)(ii); *see also*, *e.g.*, Rev. Rul. 69-516, 1969-2 C.B. 51, *revoked by* REG-106889-04 (Aug. 12, 2004) (separate F reorganization of target respected when followed by C reorganization in which target's assets were transferred to acquirer); Rev. Rul. 79-250, 1979-2 C.B. 156 (forward merger of target into new acquirer subsidiary before parent's reincorporation into another state did not affect F reorganization); Rev. Rul. 96-29, 1996-1 C.B. 50 (F reorganization when acquirer holding company reincorporated in new state after merger of operating target into acquirer operating subsidiary).

[193] REG-106889-04 (Aug. 12, 2004); Prop. Reg. § 1.368-2(m)(3)(i).

[194] Prop. Reg. § 1.368-2(m)(5), Ex. 5.

[195] *See* Prop. Reg. § 1.368-2(m)(5), Ex. 1.

compatible with F reorganization treatment, whether, and if so when, the order of related steps impacts qualification as an F reorganization, and when steps may constitute both an F reorganization and another type of reorganization. Moreover, additional complexity will result whenever one or more simultaneous or sequential actions that are part of a plan qualify as part of two (or more) transactions that each constitutes F reorganizations under the proposed regulations. Presumably only one mere change in form should occur in such cases, but it is not clear whether or how taxpayers can designate the transaction(s) treated as an F reorganization.

As one example, an upstream merger of a subsidiary into its parent followed by a contribution of all, or even some, of the subsidiary's assets to a new subsidiary may qualify as both an A and F reorganization in the absence of absolute shareholder and asset identity F reorganization requirements. However, this result may not obtain if a new shareholder contributes significant capital to the new subsidiary before the reincorporation.[196] It is clear that the ability to create F reorganizations by integrating multiple steps will increase the number of F reorganizations that also qualify for tax-free treatment under one or more other reorganization provisions. In view of the important issues raised in overlap cases, including whether the transferring corporation's taxable year ends and whether its net operating losses can be carried back to prior years, it is important for the government to confirm the validity of historical guidance regarding overlapping reorganizations and explicitly address the treatment of reorganization overlap in final regulations.

The ability to integrate steps to produce an F reorganization may appear to be at odds with the "nothing" theory underlying the rule that separate, related transactional steps will not be integrated if a single step in the series, considered separately, would constitute a valid F reorganization. Nonetheless, as long as a putative F reorganization occurs as a clearly separate step or steps

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[196] *See* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger followed by contribution of target's assets to new subsidiary qualified as A reorganization); Rev. Rul. 66-284, 1966-2 C.B. 115, as amplified by Rev. Rul. 78-441, 1978-2 C.B. 152; Rev. Rul. 2003-99, 2003-34 I.R.B. 388, *revoking* Rev. Rul. 75-561, 1975-2 C.B. 129 (requiring complete identity of assets and shareholder interests for F reorganization).

in a series of related steps, its separate nothingness will be protected under the proposed regulations. This flexible approach to integrating and isolating transactions to produce F reorganizations illustrates both the IRS's recent use of step transaction principles to produce tax-free reorganizations and its isolation of reorganizations from related transactions to protect their tax-free status. The broad scope that Congress accorded F reorganizations makes the use of both of these approaches necessary and appropriate.

V. CONCLUSION

Having just emerged from several weeks in the step transaction labyrinth, I am tempted to conclude with the often quoted observation that the step transaction doctrine applies except when it does not. Still, some common themes have emerged in my odyssey. Step transaction principles are being more widely applied in the case of double mergers and F reorganizations to produce tax-free reorganizations. In particular, the rules regarding F reorganizations also reflect a broad and flexible approach to integration and isolation, in each case, to the benefit of a taxpayer seeking tax-free treatment for a series of transactions. Recent developments in these areas indicate that the government is adopting a policy-based approach to the reorganization rules that I would hope will be refined and applied consistently across all types of sequential mergers through the adoption of a single rule testing all integrated mergers and liquidations as deemed direct mergers into the company ultimately holding the acquired assets.

In apparent contrast, the overlapping COBE and -2k rules governing post-reorganization transfers turn off step transaction principles with respect to a broad range of permitted dropdowns and, for the first time, pushups of significant assets, in order to protect tax-free reorganization status. The rules stop short of turning off the step transaction doctrine for all post-reorganization transfers, however, the way the section 338 regulations separate all transactions from a preceding qualified stock purchase. The overlapping nature of the COBE and -2k rules is a trap for the unwary that the IRS can and should eliminate, either by better integrating the rules, or, ideally, by expressly adopting a single set of rules that address the COBE requirements and also turn off step transaction principles to protect the tax-free status of the original reorganization.

One final observation is that permitted dropdowns and pushups and the type of sequential transactions that are integrated under revenue rulings 2001-26 and 2001-46 fit together like puzzle pieces. That is, under the proposed COBE and -2k rules, step transaction principles are turned off after a reorganization, permitting dropdowns and pushups, except in circumstances that would typically produce a *de facto* or actual liquidation. In those cases the reorganization and subsequent liquidation would generally be integrated and tested as a C reorganization, or, hopefully, as a deemed direct merger. While this relationship may explain the government's hesitancy to isolate post-reorganization transfers of all or substantially all acquired assets, I would nonetheless submit that, in order to facilitate tax-free treatment for transactions that are consistent with reorganization policy, the government should consider either expanding the -2k rules to isolate reorganizations from all subsequent pushups, or, at a minimum, testing all integrated transactions as deemed direct mergers.

MULTIPLE STEP ACQUISITIONS