

**GLOBAL TAX-FREE DEALS:
MERGERS, ACQUISITIONS
AND SPINS AT HOME
AND ABROAD[©]**

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GLOBAL TAX-FREE DEALS: MERGERS, ACQUISITIONS AND SPINS AT HOME AND ABROAD*

The first four sections of this article discuss the tax consequences of domestic and cross-border tax-free acquisitions and spinoffs. The balance of the article applies these rules to the types of intra-group transactions that multinational groups typically employ before and after acquisitions and dispositions.

I. TAX-FREE ACQUISITIONS UNDER SECTION 368

A. General Requirements

Acquisitive reorganizations include mergers, consolidations, acquisitions by one corporation of the stock or assets of another corporation, and changes in form or place of organization. As a general matter, reorganizations described in section 368¹ have the following tax consequences: (i) the target corporation generally recognizes no gain or loss on any transfer of its property in exchange for stock or securities of another corporation that is “a party to the reorganization under section 361”; (ii) the target shareholders and creditors may exchange their stock and securities for such new stock and securities without recognizing gain or loss under section 354 (although holders would recognize gain, but not loss, equal to the lesser of the amount of “boot” received, and the holder’s gain realized, in the reorganization); and (iii) if a target corporation’s assets are acquired in a reorganization, its tax attributes carry over to the acquiring corporation under section 381.²

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¹ All references to “sections” are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), and all references to “regulations” or “Treasury Regulations” are to regulations promulgated thereunder.

² Under current law, the allocation of earnings and profits (sometimes referred to herein as “E&P”) under requirement (iii) above is ambiguous. See, e.g., *Treasury Addresses Earnings, Profits*

To qualify for tax-free treatment under section 368, all transactions other than 368(a)(1)(E) reorganizations (“E reorganization”) and 368(a)(1)(F) reorganizations (“F reorganization”)³ must satisfy the judicial requirements of a valid business purpose, continuity of interest (“COI”), continuity of business enterprise (“COBE”) and a plan of reorganization, and also must satisfy the requisite statutory requirements, which differ

Transfers for Corporate Reorganizations, Daily Tax Rep. (BNA), at G-6 (Nov. 18, 2011) (acknowledging conflicts between sections 381 and 312 and noting various proposals, such as allocating earnings and profits in accordance with tax basis in a reorganization); Michael L. Schler, Eric Solomon, Karen Gilbreath Sowell, Jonathan J. Katz & Gary Scanlon, *Updating the Tax-Free Reorganization Rules: Attributes, Overlaps and More*, Taxes—the Tax Magazine (Mar. 2012), 87 (examines current law and sets forth new proposals regarding the location of attributes resulting from asset transfers after reorganizations); Amy S. Elliott, ‘*Substantially All*’ Unlikely to Replace ‘*All*’ in Reorg Rules, 2011 TNT 220-7 (Nov. 15, 2011) (noting ambiguity in section 381 and 312 regulations as to whether earnings and profits can be allocated between corporations when only a portion of a corporation’s assets are transferred following a reorganization).

The Internal Revenue Service (“IRS”) recently released proposed regulations providing that no portion of the transferor’s E&P is allocated to the transferee following a tax-free property transfer, unless the transfer is described in section 381(a). 77 Fed. Reg. 22515 (Apr. 16, 2012). See generally Amy S. Elliot, *Treasury Proposes to Clarify that E&P Can’t Be Allocated Between Parties to Asset Reorg*, 2012 TNT 73-5 (Apr. 16, 2012); *Proposed Rules on Divvying of Earnings, Profits Aim to Clarify Antiquated Provision*, Daily Tax Rep. (BNA), at G-4 (Apr. 16, 2012); Mark Boyer, David Friedel, Julie Allen & Elizabeth Wivagg, *Practitioners Look for Further Guidance on E&P Allocation*, 2012 TNT 78-16 (Apr. 23, 2012). However, these new E&P rules may be elective. See Amy S. Elliot, *Electivity of Proposed Asset Reorg E&P Rule Is Inevitable*, *Alexander Says*, 2012 TNT 77-1 (Apr. 20, 2012). The proposed regulations also clarify that, where parties engage in a section 381(a) transaction, only the “acquiring corporation” (defined in Treasury Regulation section 1.381(a)-1(b)(2)) succeeds to the transferor corporation’s E&P. 77 Fed. Reg. 22515 (Apr. 16, 2012).

³ Recent final regulations exempt E and F reorganizations from both the COI and COBE requirements, stating that the requirements are not necessary to protect a reorganization policy in the case of E or F reorganizations. See T.D. 9182, 2005-1 C.B. 713; Treas. Reg. § 1.368-1(b).

for each specific form of reorganization.⁴ The Code also limits the consideration that may be used in certain types of reorganizations.⁵

The business purpose requirement is designed to ensure that the parties to the reorganization engage in the transaction for a legitimate business purpose, rather than to avoid tax.⁶ Either a

⁴ Additional judicial doctrines such as the “substance over form”, “economic substance” and “step transaction” doctrines may also apply, depending on the facts and circumstances of a particular transaction. For the codification of the economic substance doctrine, which incorporates its judicial legacy, see section 7701(o). For excellent discussions of these issues, see Lewis R. Steinberg, *Substance and Directionality in Subchapter C*, 52 Tax Law. 457 (Spring, 1999); Robert Willens, *Form and Substance in Subchapter C – Exposing the Myth*, 84 Tax Notes 739 (Aug. 2, 1999) and *Transactions: Form, Substance, and Understanding the Limits*, New York State Bar Association Panel by William D. Alexander, Kimberly Blanchard, Michael A. DiFronzo, Gordon E. Warnke and Karen Gilbreath-Sowell on January 26, 2010; *New IRS Directive Offers Some Guidance but Leaves in Question Cross-Entity Mergers’ Treatment Under Codified Economic Substance Doctrine*, Daily Tax Rep. (BNA), at J-1 (Aug. 11, 2011).

⁵ For example, no boot is permitted in B reorganizations and certain C reorganizations in which liabilities are assumed.

⁶ See, e.g., *Gregory v. Helvering*, 293 U.S. 465 (1935) (reorganization that lacked business purpose was re-characterized as taxable stock transfer). Minimization of state and local taxes is, however, an acceptable business purpose. See Rev. Rul. 76-187, 1976-1 C.B. 97. Additional acceptable business purposes should include, among others, reducing administrative expenses; broadening customer base; expanding into new lines of business; transfers of voting power; rewarding key employees with equity interests; squeezing out minority target shareholders; and enabling shareholders of several related corporations to consolidate their interests through combinations of such affiliated corporations. See also P.L.R. 2011-05-019 (Feb. 4, 2011) (one corporate business purpose of A reorganization was to enable acquirer to establish a voting trust); Jasper L. Cummings, *Reorganization Business Purpose*, 2012 TNT 166-7 (August 7, 2012) (arguing that acquiring a business that satisfies the COBE requirement, by itself, should also result in the satisfaction of the business purpose requirement); Amy S. Elliot, *Some Upstream Reorgs Necessarily Satisfy Business Purpose*, 2013 TNT 26-2 (Feb. 7, 2013) (Bill Alexander suggesting an upstream

corporate or shareholder business purpose will suffice for this purpose, and the business purpose requirement for a reorganization is much less rigorous than the corresponding requirement for a tax-free spinoff.⁷ However, the IRS will seek to tax transactions that satisfy the technical requirements of a reorganization if the business purpose for the transaction is to avoid tax on what, in substance, amounts to a sale.⁸

The COI doctrine once required that target shareholders indirectly retain their interest in the target's assets by both receiving and retaining ownership of acquirer stock for some period of time after the transaction. Although IRS ruling guidelines have historically adopted a 50% threshold for such continuing target shareholder ownership of acquirer stock, practitioners generally advise that 40% continuity is adequate for purposes of section 368⁹ and the IRS now seems to have adopted

reorganization satisfies the business purpose requirement because, in part, the parent remains fully invested in essentially the same assets).

⁷ See, e.g., *Easson v. Commissioner*, 294 F.2d 653 (9th Cir. 1961).

⁸ See CC-2002-003 (Oct. 18, 2001) (transaction was equivalent to a sale where target shareholders received acquirer stock representing an indirect interest in cash equivalent to target's fair market value and appreciation in the value of investments made with such cash, but no significant continuing interest in the business of acquirer or target).

⁹ For ruling purposes, the IRS requires that target shareholders receive at least 50% of the total acquisition consideration in the form of acquirer (or acquirer parent) stock. See Rev. Proc. 77-37, 1977-2 C.B. 568, § 302. However, courts have upheld reorganization treatment where a smaller percentage of stock was used as consideration. See, e.g., *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (38% preferred stock; 62% cash); *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936) (25% stock; 75% cash).

As discussed in more detail in Section I.B.2.a. below, COI is generally determined based on the fair market values of stock consideration and boot at the time of closing. Temporary regulations ameliorate the potential problem that a sufficient change in their relative fair market values between signing and closing could cause the COI requirement to be violated by providing that, under certain circumstances, acquisition consideration is valued for COI purposes when a deal is signed. See T.D. 9316, 2007-1 C.B. 962; Temp. Reg. § 1.368-1T(e)(2)(i).

40% as the COI threshold as well.¹⁰ Other COI regulations, which are discussed in Section I.B. below, have significantly altered the contours of the COI requirement, including, in particular, largely eliminating the requirement that acquirer stock be retained.

The continuity of business enterprise doctrine, which historically required that the acquirer itself continue a significant business of the target, has also been expanded to permit attribution of the activities of certain group members, including partnerships, to an acquirer for purposes of satisfying the COBE requirement.

The section 368 regulations also require a “plan of reorganization.” It is advisable, although not strictly required,¹¹ to prepare a written plan that includes a general description of the reorganization and the parties thereto, the specific transaction steps, the acquisition consideration and the business purpose for the transaction.¹²

B. Continuity of Business Enterprise and Continuity of Interest

All reorganizations other than E or F reorganizations must satisfy COBE and COI.¹³ Five sets of COBE and COI regulations issued in the past decade have dramatically altered the contours of the COI and COBE requirements for corporate reorganizations.¹⁴

¹⁰ See Temp. Reg. § 1.368-1T(e)(2)(v), Exs. 1 & 5.

¹¹ See *Transport Prods. Corp. v. Commissioner*, 25 T.C. 853, *aff'd*, 239 F.2d 859 (6th Cir. 1956); *C.T. Invs. Co. v. Commissioner*, 88 F.2d 582 (8th Cir. 1937).

¹² See Treas. Reg. § 1.368-1(c).

¹³ See T.D. 9182, 2005-1 C.B. 713; Treas. Reg. § 1.368-(b).

¹⁴ T.D. 9361, 2007-2 C.B. 1026; T.D. 8760, 1998-1 C.B. 803; T.D. 8761, 1998-1 C.B. 812. See generally George R. Goodman, *Postacquisition Restructuring and Beyond*, 120 Tax Notes 577 (Aug. 11, 2008); Robert Willens, *New IRS Regulations Mark Demise of “Remote Continuity”*, Daily Tax Rep. (BNA), at J-1 (Nov. 20, 2007); Mark Silverman & Andrew Weinstein, *The New Continuity of Interest and Continuity of Business Enterprise Regulations*, 25 J. Corp. Tax’n 219, 239 (1998); Robert Willens, *New Continuity Regs. Increase Flexibility in Planning and Implementing Tax-Free Reorganizations*, 88 J. Tax’n 133 (Mar. 1998). Cf. ABA, *Tax*

The IRS ruling guidelines set forth in Revenue Procedures 77-37 and 86-42 for blessing tax-free reorganizations will have to be modified in several respects, including to conform the guidelines to the current COI and COBE regulations.¹⁵ The American Bar Association (“ABA”) has submitted a helpful report suggesting changes to Revenue Procedures 77-37 and 86-42 to reflect subsequent amendments to reorganization law, including the enactment of section 362(e) and modifications to the COI and COBE rules and section 357(c) and (d).¹⁶

1. Continuity of Business Enterprise

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).¹⁷ The “issuing corporation” refers to the acquiring corporation, or, in a triangular reorganization, the corporation that controls the acquiring subsidiary.¹⁸ The regulations require an analysis of all the facts and circumstances in light of COBE’s policy goal, which is to limit reorganizations to transactions that are mere readjustments of continuing property interests in modified form and do not “involve the transfer of the acquired stock or assets to a

Section Proposal for Revision of Revenue Procedure 86-42, reprinted in Daily Tax Rep. (BNA) (Apr. 11, 2007).

¹⁵ The New York State Bar Association tax section (the “NYSBA”) also submitted an excellent report in 1998 suggesting changes to the ruling guidelines. *See* NYSBA, *Report on Conforming Rev. Proc. 77-37 and Rev. Proc. 86-42 to the New Continuity Regulations*, reprinted in *Highlights and Documents*, July 17, 1998, at 556. As indicated above, however, the NYSBA’s 1998 report does not take into account any of the changes in reorganization law since 1998, including additional COI and COBE amendments. *See, e.g.*, T.D. 9225, 2005-2 C.B. 716.

¹⁶ *See* ABA, *Tax Section Proposal for Revision of Revenue Procedure 86-42*, reprinted in *Daily Tax Rep. (BNA) (Apr. 11, 2007)*.

¹⁷ Treas. Reg. § 1.368-1(d)(1).

¹⁸ Treas. Reg. § 1.368-1(b).

‘stranger’.”¹⁹ More generally, COBE policy requires a link between the target corporation shareholders and the assets or stock acquired in the reorganization.²⁰

The current Treasury Regulations treat an acquirer as conducting the business, and owning the assets, of its “qualified group,”²¹ which includes the issuing corporation, one or more corporations with respect to which the issuing corporation directly owns stock representing section 368(c) control,²² and any other corporations in which group members’ aggregate ownership constitutes section 368(c) control directly or through certain partnerships, as described below.²³ The government has finally concluded in the current regulations that aggregation adequately preserves the link between the former target shareholders and the target’s business assets while further facilitating the post-acquisition relocation of assets and stock as necessary within the qualified group.²⁴ The 2007 COBE regulations first expanded the qualified group definition by permitting group members to aggregate their stock ownership in a lower-tier subsidiary to

¹⁹ See 69 Fed. Reg. 51026 (Aug. 17, 2004) (citing H.R. Rep. No. 83-1337 at A134 (1954)); Treas. Reg. § 1.368-1(d)(1).

²⁰ Preamble, COBE Regulations, 1981 Fed. Tax Rep. CCH ¶ 6342, Vol. 10.

²¹ Treas. Reg. § 1.368-1(d)(4)(i).

²² Section 368(c) control requires ownership of at least 80% of the relevant corporation’s total combined voting power and 80% of the total number of shares of each other class of stock. See Rev. Rul. 59-259, 1959-2 C.B. 115.

²³ Treas. Reg. § 1.368-1(d)(4)(ii). See generally George R. Goodman, *Postacquisition Restructuring and Beyond*, 120 Tax Notes 577 (Aug. 11, 2008); *IRS Expands Definition of “Qualified Group” for Transfers But Not as Practitioners Asked*, Daily Tax Rep. (BNA), at G-3 (Dec. 19, 2007); Robert Willens, *New IRS Regulations Mark Demise of “Remote Continuity”*, Daily Tax Rep. (BNA), at J-1 (Nov. 20, 2007). Some commentators argued that the qualified group definition should not be restricted by the section 368(c) control standard but rather should be expanded to parallel the affiliated group definition in section 1504(a). The government rejected this argument, primarily because the section 368(c) standard is a “major structural component underlying the framework of the reorganization provisions.” T.D. 9361, 2007-2 C.B. 1026.

²⁴ See T.D. 9361, 2007-2 C.B. 1026.

determine whether the subsidiary is itself a member of the qualified group,²⁵ and the current regulations expand the definition further to permit compliance with COBE through the attribution of target stock or assets contributed into and held through a “diamond pattern”.²⁶

In testing target asset contributions to partnerships, the regulations treat an issuing corporation as conducting a 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”).²⁷ An issuing corporation’s contribution of a significant target business to a partnership, which business the issuing corporation is treated as conducting, will tend to satisfy the COBE requirement, but is not alone sufficient to do so.²⁸

Although the 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, the examples indicate that, following the contribution 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, and (ii) if the qualified group does not perform a substantial management function, the qualified group’s ownership of a 33⅓% aggregate

²⁵ Treas. Reg. § 1.368-1(d)(4)(ii).

²⁶ A “diamond pattern” is created when target stock is contributed to multiple 80% controlled subsidiaries which, in turn, contribute their target stock to a corporation in which no single transferor holds section 368(c) control.

²⁷ Treas. Reg. § 1.368-1(d)(4)(iii)(B). *See generally* Robert Willens, *A.G. Edwards/Wachovia: No Remote COI Problem*, 116 Tax Notes 395 (July 20, 2007) (A.G. Edwards’ merger into Wachovia subsidiary in 368(a)(2)(D) (“A2D”) reorganization and dropdown of its assets to Wachovia partnership should satisfy COBE).

²⁸ Treas. Reg. § 1.368-1(d)(4)(iii)(C).

partnership interest would satisfy the COBE requirement.²⁹ 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. Except with respect to these types of interests, most practitioners treat the examples as tantamount to safe harbors.³⁰

In a significant change from prior law, the 2007 COBE regulations also attribute target stock owned by a partnership to the qualified group if the group’s members own partnership interests meeting requirements equivalent to section 368(c) control (a “section 368(c) controlled partnership”).³¹ The government

²⁹ See Treas. Reg. § 1.368-1(d)(5), Exs. 8-10.

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. 13.

³⁰ 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) (concurring that 33% partnership interest with no management function or 20% partnership interest with a substantial management function should be a safe harbor, since the relevant examples do not suggest any concern about any facts or circumstances other than active management and ownership percentage).

³¹ See Treas. Reg. § 1.368-1(d)(4)(iii)(D). The prior COBE rules did not permit post-reorganization contributions of target stock to partnerships. See Former Treas. Reg. § 1.368-2(k), Ex. 3. The government concluded, as it did with diamond structures, that transfers to section 368(c) controlled partnerships adequately

described the purpose of importing this section 368(c) control standard as treating “partnerships in a manner similar to [corporate] members of the COBE qualified group.”³² The definition of a section 368(c) controlled partnership is not clear, as the regulation examples indicate only that a “straight up” 80% partnership interest is equivalent to section 368(c) control, while the same 50% interest is not.³³

While the introduction of the section 368(c) controlled partnership concept represents welcome guidance, the application of section 368(c) to tax partnerships is difficult, because, as the NYSBA noted, a partnership may employ varying rights such as capital interests and profits interests, “catch-ups,” clawbacks, preferred returns, and guaranteed payments, all of which may vary significantly over time, while section 368(c) contemplates a mechanical determination of voting and value ownership.³⁴ Unlike corporate stock, which permits a more precise application of section 368(c) based on the stock’s “value” and “voting power,” the economic entitlements, management and control rights in the partnership context are largely left to the underlying partnership agreement, which presents interpretive difficulties.

In particular, the determination of voting power is often unclear in the partnership context because section 368(c) voting power generally refers to the right to vote for directors, while a partnership may not have a board of directors and may be managed in accordance with the partnership agreement. One possible approach raised by the NYSBA would be to treat a qualified group member that is the general partner of a limited partnership but that owns no economic interest as possessing the equivalent of voting control of the partnership, because a general partner carries out

preserve the link between the former target shareholders and the target’s assets. *See* T.D. 9361, 2007-2 C.B. 1026.

³² T.D. 9361, 2007-2 C.B. 1026.

³³ *See* Treas. Reg. § 1.368-1(d)(5), Exs. 14-15.

³⁴ *See* NYSBA, *Report on Final Regulations Regarding the Effect of Subsequent Transfers of Assets or Stock on the Continuing Qualifications of Reorganizations Under 368*, reprinted in 2008 TNT 68-23 (Apr. 8, 2008) (hereinafter “NYSBA 2008 -2k Report, reprinted in 2008 TNT 68-23 (Apr. 8, 2008)”).

management functions like a corporate director.³⁵ This approach, however, may be questionable because a general partner owes a fiduciary duty to the limited partners and may not manage the partnership for its own interests, thereby indicating that the general partner does not have at least 80 percent control of the voting stock. If that is the case, even if a general partner is treated as owning 100 percent of the partnership's nonvoting interests, section 368(c) still might not be satisfied.

Alternatively, a contribution of stock to a partnership could be analyzed by evaluating whether (i) in an immediate deemed (in-kind) liquidation of the partnership, qualified group members would receive stock in the corporation representing at least 80 percent of the corporation's value, taking into account the qualified group's economic interest in partnership assets, and (ii) as a functional matter, qualified group members possess, through their partnership interests, at least 80 percent of the corporation's voting power (or a person owing a fiduciary duty to the qualified group members holds that power and votes it on their behalf). This approach is generally consistent with the look-through nature of the section 368(c) partnership standard and the principles of Subchapter K. In particular, the use of a deemed liquidation analysis to determine the partners' economic arrangement is consistent with the approach in section 704(b) for determining whether allocations are in accordance with the partners' interests in the partnership.³⁶

Another option would be to apply the voting test by evaluating whether the qualified group members would have sufficient voting power after a deemed immediate liquidation.

³⁵ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008).

³⁶ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008). This approach does not require an analysis of the nature of the partnership interests, which can vary greatly over time. If the partnership agreement is silent as to the allocation of identified assets (or if the agreement provides another party, such as the general partner, with the power to determine the allocation), the deemed liquidation standard could be applied by presuming that each partner would receive, upon liquidation, a percentage of each asset that is proportionate to such partner's respective liquidation rights under the agreement, which is consistent with the partners' economic rights in the partnership assets. See NYSBA 2008 -2k Report.

However, this approach may not accord sufficient weight to the partners' existing voting rights through the partnership.³⁷

Finally, the government could evaluate the contribution of stock to partnerships using the same test used for asset contributions, by focusing on the qualified group's economic interest in the partnership as well as the extent of its participation in partnership management. This approach would create a uniform standard for application to all post-reorganization partnership contributions, and provide a clear rule for taxpayers. However, similar treatment would raise other issues, as asset transactions are distinct from stock transactions, and are so treated under many existing reorganization rules.³⁸

In sum, any approach will have certain advantages and disadvantages and will necessarily require a balancing of competing interests. Once the government selects and issues guidance regarding the appropriate standard, it should include numerous examples applying the standard to contemporary commercial partnerships in order to provide taxpayers with certainty.

2. Continuity of Interest

Before promulgation of the current COI regulations, the "continuity of shareholder interest" doctrine, as it was then known, required that historic target shareholders as a group (i) exchange 40% of their target stock for acquirer stock (or, in certain cases, acquirer parent stock) in the reorganization,³⁹ and (ii) either

³⁷ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008).

³⁸ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008).

³⁹ See *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1936). The IRS's ruling guidelines require that at least 50% of historic target shareholders continue their equity investment in the target through the acquisition and retention of acquirer (or acquirer parent) stock in a reorganization. However, most practitioners, including the author, believe that the relevant case law supports a 40% continuing interest, and final regulations now indicate that the IRS concurs with this conclusion. See, e.g., *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); Temp. Reg. § 1.368-1T(e)(2)(v), Ex. 1; P.L.R. 2006-10-007 (Dec. 1, 2005).

continue to hold the requisite acquirer stock following the reorganization, or demonstrate that a subsequent disposition of acquirer stock was not part of the same plan as the reorganization. The current COI regulations largely eliminate the requirement that stock received in a reorganization must be held for any period of time thereafter.

McDonald's was the high watermark for the IRS regarding continuity of shareholder interest. In that case, the court of appeals held that target shareholders' sales of acquirer stock in close proximity to a merger were part of the reorganization plan, and contravened the COI requirement.⁴⁰ By contrast, the Tax Court subsequently read the COI requirement significantly more narrowly in *J.E. Seagram*,⁴¹ holding that sales by public shareholders *prior* to a reorganization to parties unrelated to either the acquirer or the target were not part of a plan of reorganization, and so were to be disregarded in determining whether the acquisition satisfied the COI requirement.

Against this backdrop, the IRS issued final COI regulations regarding post-reorganization transactions, and temporary and proposed regulations regarding pre-reorganization transactions in January of 1998. The IRS gives up the *McDonald's* ghost in the preamble to the final COI regulations, explaining that the law in cases such as *McDonald's* fails to support the principles underlying the reorganization provisions, and moreover, the need to divine shareholder intent and acquirer participation in contemporaneous sales of target or acquirer stock makes the *McDonald's* test difficult to administer.⁴²

Under the regulations, prearranged dispositions of acquirer⁴³ stock by target shareholders no longer affect COI, and,

⁴⁰ See *McDonald's Restaurant of Ill. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); see also Rev. Rul. 66-23, 1966-1 C.B. 67 (rendered obsolete by preamble to 1998 COI regulations).

⁴¹ *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

⁴² See T.D. 8760, 1998-1 C.B. 803.

⁴³ As a technical matter, the COI regulations refer to the "issuing corporation," which includes the acquirer, the surviving corporation in a reverse merger, and the acquirer parent in a triangular reorganization. See Treas. Reg. § 1.358-6(b)(2). For simplicity, the issuing corporation will be referred to herein as the acquirer.

indeed, a transaction may qualify as a reorganization even if none of the historic target shareholders participate in the reorganization.⁴⁴ Instead, COI now depends on whether the type and amount of consideration furnished by the issuing corporation to the target's shareholders constitutes a sufficient continuing ownership interest in the new enterprise. Accordingly, the COI regulations require that a "substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization."⁴⁵ The COI regulations focus on consideration provided by the acquirer (and related parties) in connection with a reorganization, and thus disregard dispositions of acquirer stock received in the reorganization to persons unrelated to the acquirer.⁴⁶

Although the regulations do not define a "substantial part of the value," temporary regulations regarding the value of acquirer stock for measuring COI now confirm that a 40% continuing equity interest received by target shareholders satisfies COI.⁴⁷ While the IRS has not amended its ruling guideline requiring a 50% continuing equity interest, the regulations demonstrate the IRS's acceptance of the 40% practitioner-favored threshold as its COI benchmark.

More specifically, the COI regulations provide that a proprietary interest in target stock is preserved in three cases. First, a target stock interest is preserved to the extent target stock is exchanged for acquirer stock.⁴⁸ Since the requisite proprietary

⁴⁴ See Treas. Reg. § 1.368-1(e)(7), Ex. 1. See also Robert Willens, *Historic Shareholder Continuity of Interest*, 121 Tax Notes 1431 (Dec. 22, 2008) (no postmerger continuity requirement after *J.E. Seagram*).

⁴⁵ See Treas. Reg. § 1.368-1(e)(1); see generally Robert Willens, *Corporate Reorganizations: Meaning of 'Substantial' Portion Difficult to Pin Down*, 28 Tax Mgmt. Weekly Rep. 939 (July 27, 2009).

⁴⁶ See Treas. Reg. § 1.368-1(e)(1)(i).

⁴⁷ See Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1; P.L.R. 2006-10-007 (Dec. 1, 2005).

⁴⁸ See Treas. Reg. § 1.368-1(e)(1)(i). By contrast, a proprietary interest in target stock is not preserved if, in connection with a reorganization, such proprietary interest is acquired by acquirer for consideration other than stock of acquirer (or its parent). Recently,

interest is determined on an aggregate basis, no particular shareholder is required to receive any minimum amount of issuer stock in a reorganization. Second, target proprietary interests are preserved if an acquirer exchanges its target stock for a direct interest in the target assets.⁴⁹ For example, COI would be satisfied in an upstream merger of a target into its 50% shareholder in which the minority shareholders are cashed out. Finally, a proprietary interest in the target is preserved if it “otherwise continues” as a proprietary interest in the target.⁵⁰ This result obtains when target stock remains outstanding after a reorganization.

By contrast, a proprietary interest is not preserved in a putative reorganization to the extent that (i) an acquirer acquires either target stock or acquirer stock held by target shareholders in connection with the acquisition, other than for issuing corporation stock;⁵¹ (ii) an acquirer redeems acquirer stock that was issued to target shareholders in the acquisition in exchange for cash or other boot;⁵² or (iii) a corporation related to the acquirer acquires either target stock, or acquirer stock received by target shareholders, other than for equity in the acquirer, in connection with a putative reorganization. In determining whether proprietary interests in a target are preserved, acquisitions of either acquirer stock or target stock by persons acting on behalf of any of the target, the acquirer, or a corporation that is a related party with respect to either the

the IRS ruled, however, that warrants of the acquirer are treated as proprietary interests of the acquirer and thus “stock” for purposes of the COI requirement. *See* P.L.R. 2010-32-009 (Aug. 13, 2010) (exchange of claims held by senior claim holders and by creditors with claims that are equal and junior to that of the senior claim holders for at least 40% of the fair market value of the total consideration, which consists of new common stock and warrants in a G reorganization, satisfies the COI requirement); Robert Willens, *A Surprising Continuity-Of-Interest Ruling*, CFO.com (Sept. 7, 2010), available at <http://www.cfo.com/printable/article.cfm/14522844> (discussing Private Letter Ruling 2010-32-009 and the opening to use warrants to satisfy the COI test).

⁴⁹ *See* Treas. Reg. § 1.368-1(e)(1)(i); G.C.M. 39404, (Sept. 19, 1985) (COI satisfied upon subsidiary’s upstream merger into 70% old and cold parent in A reorganization).

⁵⁰ *See* Treas. Reg. § 1.368-1(e)(1)(i).

⁵¹ *See* Treas. Reg. § 1.368-1(e)(1)(i).

⁵² *See* Treas. Reg. § 1.368-1(e)(1)(i).

target or acquirer, will be treated as made by the target or acquirer, as the case may be.⁵³ Thus, for example, if a holder sells acquirer stock to an unrelated party after a reorganization, and such stock is then redeemed by the acquirer, the holder's stock would be treated as redeemed by the acquirer and so would not be treated as a continuing interest for COI purposes.⁵⁴ Notably, the examples in the regulations illustrating this rule do not discuss whether a specific agency relationship must exist between the parties. Except as described above, all post-reorganization sales and dispositions are disregarded.

The COI regulations define a "related person" quite narrowly. A related person does not include any individuals. Moreover, two corporations are related only if they are either members of the same affiliated group or under common control. Two corporations are considered to be commonly controlled under the regulations if a purchase of one corporation's stock by the other would invoke section 304(a)(2),⁵⁵ which is the case when one corporation is at least 50% owned (by vote or value) by the other. Note that whether section 304(a)(2) also applies when at least 50% of the stock of each of two corporations is owned by a third corporation (each of the two corporations, a "50% affiliate"), depends on whether one believes that section 304(a)(2) applies, in addition to section 304(a)(1), to a deemed parent-subsidary relationship created solely by operation of the constructive ownership rules.⁵⁶ A corporation other than the target corporation or a 50% affiliate of the target is treated as related to the acquirer only if (i) the requisite overlapping ownership exists immediately

⁵³ See Treas. Reg. § 1.368-1(e)(7), Exs. 4-6.

⁵⁴ See Treas. Reg. § 1.368-1(e)(7), Ex. 5; *see also* Rev. Rul. 68-388, 1968-2 C.B. 122 (similar result).

⁵⁵ See Treas. Reg. § 1.368-1(e)(4). This narrow definition eliminates the COI problem in *Superior Coach of Florida*, 80 T.C. 895 (1983) (COI not satisfied where corporation's sole individual shareholder purchased target stock in advance of, but as part of the same plan as, the target's merger into the issuing corporation). The IRS will no longer apply the holding in *Superior Coach*. See T.D. 8760, 1998-1 C.B. 803.

⁵⁶ See Treas. Reg. § 1.368-1(e)(4); *see also* I.R.C. § 304(a)(1). *But see Broadview Lumber Co. v. U.S.*, 561 F.2d 698,709 (7th Cir. 1977) (section 304(a)(2) should apply only when parent directly controls subsidiary without resort to constructive ownership rules).

before or immediately after the acquisition of stock⁵⁷ or (ii) the relationship is created in connection with a putative reorganization.⁵⁸

The regulations contain an exception to the above-described related party rule pursuant to which an acquisition of stock by a corporation related to the acquirer will nonetheless preserve a proprietary interest in the target if the owners of the target stock before the reorganization continue to own issuing corporation stock, either directly or indirectly. This rule permits related party mergers to satisfy the COI requirement. Although the regulations do not so state, this exception may also preserve COI in the context of certain back-to-back reorganizations.

COI is not affected if target shareholders sell their acquirer stock immediately in the public markets,⁵⁹ and the acquirer may even facilitate placement of the shares or arrange a secondary offering of shares, as long as neither the acquirer nor a party related to the acquirer purchases such shares.⁶⁰ As a result, a transaction may qualify as a reorganization notwithstanding the fact that all stock received by target shareholders is immediately sold pursuant to a preexisting binding agreement, as long as the stock is not purchased by the acquirer, a corporation related to the acquirer, or an agent of the acquirer.⁶¹ It is not clear how soon after a reorganization an acquirer or related party can repurchase its stock without affecting COI, although government officials have confirmed that prearranged redemptions of acquirer stock effected more than five years after a reorganization will not be

⁵⁷ See Treas. Reg. § 1.368-1(e)(4)(ii)(A).

⁵⁸ See Treas. Reg. § 1.368-1(e)(4)(ii)(B).

⁵⁹ See Treas. Reg. §§ 1.368-1(e)(1)(i), -1(e)(8), Ex. 1.

⁶⁰ See Treas. Reg. § 1.368-1(e)(7), Ex. 3; *see also* Rev. Rul. 99-58, 1999-2 C.B. 701 (acquisition otherwise qualifying as reorganization will not violate COI merely because acquirer subsequently repurchases its stock on open market from target shareholders, unless the repurchase resulted from a prior understanding between the parties).

⁶¹ See Treas. Reg. § 1.368-1(e)(7), Ex. 1.

considered to occur “in connection with” the reorganization, and so do not affect continuity.⁶²

In short, the COI regulations provide that target stock interests are preserved if the acquirer furnishes its (or its parent’s) stock as consideration for the target stock in a reorganization, unless the acquirer subsequently reacquires such stock, either directly, or through a related party, agent or other intermediary, in connection with the reorganization. It will therefore be important to obtain representations in connection with reorganizations that neither the acquirer, nor any corporation that is a related party with respect to the acquirer, has any intention to directly or indirectly reacquire its stock, or to cause such stock to be reacquired, under any of the above-described circumstances. Representations should also be obtained that, to the best knowledge of each of the target, acquirer, and, where relevant, acquirer’s parent, no corporation (including, in particular, no target corporate shareholder or affiliate) will become a related party with respect to the issuing corporation in connection with the reorganization. This representation takes on particular importance in the case of a small acquirer and large target, because in such cases a large target shareholder could easily become a related party to the acquirer by reason of the reorganization.

Whether an event occurs “in connection with” a reorganization depends on the facts and circumstances of a given transaction. Examples in the regulations generally presume that an issuing corporation’s redemption of its stock issued in a potential reorganization occurs “in connection with” such transaction.⁶³ However, an exception to this rule is provided for redemptions of small amounts of issuing corporation stock pursuant to an ongoing stock repurchase program where the stock is widely held and publicly traded.⁶⁴ It is not clear whether stock repurchase programs permitted in connection with tax-free section 355 distributions, and perhaps other repurchase programs, will qualify for the exception, or will instead be treated as issuer redemptions in connection with reorganizations that are not consistent with

⁶² See *Officials Try to Clarify Continuity of Interest Regs.*, 98 TNT 67-1 (Apr. 8, 1998); see also Rev. Rul. 78-142, 1978-1 C.B. 111.

⁶³ See Treas. Reg. § 1.368-1(e)(7).

⁶⁴ See Treas. Reg. § 1.368-1(e)(7), Ex. 8.

continuing proprietary interests.⁶⁵ The IRS and Treasury are also considering the consequences of modifying a stock repurchase program in connection with a reorganization.⁶⁶

COI is not preserved if and to the extent consideration received prior to a potential reorganization in redemption of, or with respect to, target stock is treated as “other property or money” under section 356.⁶⁷ Whether a pre-reorganization distribution or redemption would be so treated appears to depend on whether the target or acquirer was the source of funds used to make the payment (a “tracing approach”).⁶⁸ It is not entirely clear, however, whether the IRS intended to adopt this type of tracing approach for

⁶⁵ See Rev. Proc. 96-30, § 4.05(1)(b), 1996-1 C.B. 696. See also *Corporate Reorganizations: NYSBA Tax Section Seeks Guidance on Stock Buybacks in Reorganizations*, Daily Tax Rep. (BNA), at G-3 (Aug. 20, 2008); NYSBA, *Formal Guidance for Stock Buybacks and ‘North South’ Transactions*, reprinted in 2008 TNT 161-14 (Aug. 19, 2008) (requesting that IRS issue formal guidance regarding stock buybacks following section 368(a) reorganization or section 355 distribution).

⁶⁶ See Highlights and Documents, Apr. 8, 1998, at 274; Daily Tax Rep. (BNA), at G-7 (Mar. 9, 1999).

⁶⁷ See Treas. Reg. § 1.368-1(e)(1)(ii). Under section 356, if stock or other securities are received, gain will be recognized only to the extent the principal amount of the securities received exceeds the principal amount of securities surrendered. I.R.C. § 356(d). Further, nonqualified preferred stock will also constitute “other property” unless it is received in exchange for, or in a distribution with respect to, other nonqualified preferred stock. I.R.C. § 356(e); Treas. Reg. § 1.356-6. Note, however, that warrants and options are now generally treated as zero principal amount securities rather than “other property” for purposes of section 356. Treas. Reg. § 1.354-1(e).

⁶⁸ See, e.g., *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970) (pre-acquisition dividend of notes repaid with money lent by acquirer recast as part of purchase price); but see Robert Willens, *When Will Preliminary Distributions Impact Continuity of Interest?*, Daily Tax Rep. (BNA) at J-1 (Apr. 6, 2010) (suggesting that the tracing approach is not decisive, but that the controlling factor could well be whether the distribution and ensuing merger are mutually interdependent steps in a single, integrated transaction).

COI purposes with respect to all reorganizations,⁶⁹ although it has clearly been adopted for redemptions before B reorganizations, permitting target shareholders to be redeemed before a reorganization with cash provided by the target corporation.⁷⁰ Two public mergers utilized pre-acquisition dividends to take advantage of the (then 15%) reduced maximum tax rate available to shareholders with respect to dividends compared to the (then 35%) tax rate applicable to short-term capital gain that some shareholders might recognize on the receipt of boot in the reorganization.⁷¹

⁶⁹ See generally NYSBA, *Report on Distributions in Connection with Acquisitions*, reprinted in 2008 TNT 120-25 (June 20, 2008); Mark J. Silverman & Andrew J. Weinstein, *The New Pre-Reorganization Continuity of Interest Regulations*, The Law School at the University of Southern California, 53rd Annual Institute on Federal Taxation, Jan. 2001 (discussing source of funds analysis in the context of COI regulations); see also Jennifer B. Giannattasio, Eric W. Scott & Eric J. Savoy, *New Continuity of Interest Regulations*, Tax Notes, Feb. 5, 2001, 805 (concluding that a pure tracing approach was not adopted); Brett T. Enzor, *2000 Continuity Regulations Appear to Require Section 356 Standard*, 2001 TNT 96-54 (Feb. 2001) (expressing doubt as to whether a pure tracing approach was adopted).

⁷⁰ See Treas. Reg. § 1.368-1(e)(7), Ex. 9; see also Rev. Rul. 68-285, 1968-1 C.B. 147. Note that such payments will affect whether substantially all of a target's historic assets are transferred or acquired in a merger. In light of this tracing approach for pre-reorganization redemptions, tax practitioners should condition the delivery of a favorable tax opinion in a B or C reorganization on a representation from the acquiring corporation that it has no plan or intention to distribute cash or any consideration that would constitute money or other property to target shareholders prior to the merger in redemption of, or as a distribution with respect to, target stock.

⁷¹ See Robert S. Bernstein, *The MCI-Verizon and AT&T-SBC Transactions*, 27 J. Corp. Tax'n 50 (May/June 2005) (discussing MCI-Verizon A reorganization structure and AT&T-SBC A2E reorganization structure). Presumably, a target must have sufficient resources to fund the dividend with its own cash or credit to avoid a recast of the dividend as boot. See, e.g., *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970); P.L.R. 2007-52-014 (Dec. 28, 2007) (dividend declared and paid after the merger treated as a dividend rather than merger consideration); P.L.R. 2006-10-007 (Mar. 10, 2006) (pre-merger dividend paid by one of the two combining entities treated as a dividend rather than merger consideration). See generally Robert Willens, *Caremark's Special*

There is also some indication that a similar tracing approach should generally apply to all reorganizations, and at least one private ruling issued before the final COI regulations suggests that a general tracing approach is appropriate.⁷² It is unclear why the IRS would distinguish between B reorganizations and other types of reorganizations when the COI requirement generally applies uniformly to all reorganizations.⁷³ On the other hand, some older authorities (which may conflict with the final COI regulations) suggest that a tracing approach is not appropriate in all circumstances.⁷⁴ Most notably, Revenue Ruling 71-364 held that excess cash distributed by the target corporation to its shareholders more than 12 months after, but as part of, a section 368(a)(1)(C) reorganization (“C reorganization”) constituted taxable boot.⁷⁵ This ruling may not apply to a target’s liquidating asset distributions less than 12 months after a reorganization, and should perhaps be limited to its actual holding with respect to section 381, reducing its C reorganization requirements to dicta. Nonetheless, the ruling’s continued existence may cause cautious taxpayers to question whether the IRS may attempt to characterize even a pre-

Dividend, 115 Tax Notes 665 (May 14, 2007) (arguing that distribution declared before, but paid after, an acquisition should be respected as a dividend and not treated as merger consideration).

⁷² See P.L.R. 94-06-021 (Nov. 15, 1993) (assuming prior redemption did not disqualify A2D reorganization). See generally Treas. Reg. § 1.368-1(e)(7), Ex. 9 (focusing on source of funds for redemption).

⁷³ See, e.g., Rev. Rul. 82-34, 1982-1 C.B. 759. See also Robert Willens, *Evidence Suggests IRS Did Intend to Adopt Tracing Approach in COI Regs*, 90 Tax Notes 961 (2001) (COI regulations did not intend a tracing approach; insertion of “in connection with” standard would merely replicate the approach of the previous regulations).

⁷⁴ See *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955) (distribution of cash by corporation whose assets were acquired in a transaction intended to qualify as a tax-free reorganization was boot when the distribution was part of, and in pursuance of, reorganization); *Sheldon v. Commissioner*, 6 T.C. 510 (1946) (prior distribution of cash to equalize two companies’ assets was integral to reorganization and was therefore boot).

⁷⁵ Rev. Rul. 71-364, 1971-2 C.B. 182.

reorganization redemption or distribution (other than ordinary course dividends) as boot in the reorganization.⁷⁶

a. Measurement of Stock Consideration

Satisfaction of the COI requirement is generally determined by using the fair market value of consideration issued to target shareholders on the closing date of an acquisition. Because an acquirer's stock may fluctuate between the signing and closing dates, a putative reorganization that includes stock and boot may be subject to significant uncertainty regarding satisfaction of the COI requirement. Taxpayers are often forced to address this uncertainty through complicated consideration adjustments designed to qualify the transaction as a tax-free reorganization, or by restructuring the transaction to complete it in a more tax-efficient manner if the tax opinions cannot be delivered.⁷⁷

Fortunately, in 2005, the government issued final regulations permitting taxpayers to measure COI under certain circumstances using the value of the acquirer's stock on the last business day before an acquisition agreement is signed (the "Signing Date Rule").⁷⁸ The IRS revised these rules in proposed

⁷⁶ Robert Willens, *Evidence Suggests IRS Did Intend to Adopt Tracing Approach in COI Regs*, 90 Tax Notes 961 (2001); Mark J. Silverman & Andrew J. Weinstein, *The New Pre-Reorganization Continuity of Interest Regulations*, The Law School at the University of Southern California, 53rd Annual Institute on Federal Taxation, Jan. 2001. The legislative history regarding C reorganizations suggests, but does not state conclusively, that liquidating distributions of retained target corporation assets pursuant to the plan of reorganization are permitted within 12 months after a C reorganization. See Tax Reform Act of 1984, P.L. 98-369, 98 Stat. 494 (1984). For a discussion of pre-merger dividends and COI, see Robert Willens, *Postmerger Dividends are Not Boot*, 118 Tax Notes 841 (Feb. 18, 2008).

⁷⁷ Taxpayers would generally elect to effect a taxable acquisition as a reverse subsidiary merger, rather than a forward merger treated as an asset acquisition, so that corporate level tax is not imposed on the acquisition.

⁷⁸ See T.D. 9225, 2005-2 C.B. 716; Former Treas. Reg. § 1.368-1(e). This measurement date permits corporations to determine that a putative reorganization satisfies the COI test with a degree of certainty that would not be available if the signing date or closing

and temporary regulations in 2007,⁷⁹ and released final regulations on December 19, 2011.⁸⁰

In order to rely on the Signing Date Rule, the parties must have entered into a binding contract that provides for fixed consideration.⁸¹ A contract is “binding” if it is legally enforceable against the signatories.⁸² “Fixed consideration” is the number of issuing corporation shares and the amount of money and other

date were used. For example, in The McClatchy Company’s acquisition of Knight-Ridder Inc., the COI measurement was just above 40% based on the acquirer’s stock price on the day preceding the signing date and would have fallen below 40% if the signing date value were used. See Robert Willens, *New Continuity of Interest Rules Will Result in ‘A’ Reorganization for McClatchy-Knight Ridder Merger*, Daily Tax Rep. (BNA), at J-1 (Apr. 11, 2006). In response to concerns raised by the NYSBA and others about the precise meaning of “the end of the last business day” as used in the 2004 proposed COI regulations, the IRS removed the phrase and requires only that the consideration be measured on the day preceding the signing of a binding contract. See T.D. 9225, 2005-2 C.B. 716; Former Treas. Reg. § 1.368-1(e)(2).

⁷⁹ See T.D. 9316, 2007-1 C.B. 962 (Mar. 20, 2007); Temp. Reg. § 1.368-1T(e)(2); Prop. Reg. § 1.368-1(e)(2); see generally Robert Willens, *Continuity of Interest and the Signing Date Rule*, 121 Tax Notes 1071 (Dec. 1, 2008); Andrew M. Eisenberg & Scott M. Levine, *Regulations Narrow Continuity of Interest Signing Date Rule*, 115 Tax Notes 455 (Apr. 30, 2007); Robert Willens, *When Is Continuity of Interest Assessed*, 115 Tax Notes 259 (Apr. 16, 2007). Taxpayers were permitted to elect to rely on Former Treasury Regulation section 1.368-1(e)(2) for transactions subject to a binding contract entered into between September 16, 2005 and March 21, 2007. See Temp. Reg. § 1.368-1T(e)(8)(ii).

⁸⁰ T.D. 9565, 76 Fed. Reg. 78,540 (Dec. 19, 2011) (Treas. Reg. § 1.368-1(e)(2)(i)-(v)).

⁸¹ See Treas. Reg. § 1.368-1(e)(2)(ii). While the 2004 proposed regulations did not apply to transactions involving non-cash boot, the NYSBA noted that the proposed regulations already addressed certain consideration that was difficult to value, such as nonpublicly traded stock, and recommended expansion of the regulations to cover any boot or, at a minimum, debt instruments and other securities (which may trade publicly). See NYSBA, *Report on Proposed Regulations Regarding Continuity of Interest and Pre-Closing Stock Value Fluctuation*, reprinted in 2004 TNT 233-12 (Nov. 29, 2004).

⁸² Treas. Reg. § 1.368-1(e)(2)(ii).

property to be exchanged for all the target shares or each target share, as the case may be.⁸³ Contingent adjustments are generally acceptable if the consideration would otherwise satisfy the “fixed consideration” requirement, provided the target corporation shareholders are nonetheless subject to the economic benefits and burdens of ownership of the issuing corporation’s stock at the time the contract becomes binding.⁸⁴ The final regulations specify that, if the contract does not provide for fixed consideration, the Signing Date Rule does not apply.⁸⁵

If the parties amend a binding contract after the signing date but before the closing date, the modified contract replaces the original contract and continuity is measured as of the amendment date.⁸⁶ A comparable rule applies to modifications to tender offers.⁸⁷

In a cash-election merger, consideration is fixed if the number of issuing corporation shares to be provided is based on the issuing corporation stock’s value on the last business day before the first date there is a binding contract.⁸⁸ The presence of a condition to completion of the transaction that is outside of the parties’ control, such as a shareholder vote, will not prevent an

⁸³ Treas. Reg. § 1.368-1(e)(2)(iii)(A). The final regulations clarify that a shareholder’s election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination thereof) in exchange for the shareholder’s interest in the target corporation will not prevent a contract from providing for fixed consideration if such requirement is otherwise met. Treas. Reg. § 1.368-1(e)(2)(iii).

⁸⁴ Treas. Reg. § 1.368-1(e)(2)(iii)(C). *See ABA Tax Section Seeks Changes to Rules on Continuity of Interest in Reorganizations*, Daily Tax Rep. (BNA), at G-2 (Mar. 2, 2010) (requesting that IRS expand the scope of the Signing Date Rule to cover certain contracts that provide for contingent adjustments).

⁸⁵ T.D. 9316, 2007-1 C.B. 962; Treas. Reg. § 1.368-1T(e)(2)(i). Events outside the parties’ control, and insubstantial terms that have yet to be negotiated, do not prevent an agreement from constituting a “binding contract.” Temp. Reg. § 1.368-1T(e)(2)(ii).

⁸⁶ *See* Treas. Reg. § 1.368-1(e)(2)(ii)(B).

⁸⁷ *See* Treas. Reg. § 1.368-1(e)(2)(ii)(C).

⁸⁸ Treas. Reg. § 1.368-1(e)(2)(iii)(A).

agreement from constituting a binding contract.⁸⁹ Placing acquirer stock into escrow to secure customary pre-closing covenants and representations and warranties will not prevent consideration from being fixed, although any escrowed stock that is forfeited will not count toward satisfying COI.⁹⁰ Certain other customary provisions such as (i) an anti-dilution clause, (ii) the exercise of dissenters' rights, and (iii) the issuance of cash in lieu of fractional shares, also will not prevent consideration from being fixed.⁹¹ *De minimis* changes to the consideration or changes that do not cause the percentage of stock relative to cash to decrease also should not prevent the merger consideration from being treated as fixed. This would permit the target to (i) issue shares between the signing and closing dates to its employee stock option holders, (ii) repurchase or redeem its shares or (iii) make an extraordinary distribution out

⁸⁹ Treas. Reg. § 1.368-1(e)(2)(ii).

⁹⁰ See Treas. Reg. § 1.368-1(e)(2)(iii)(D), (v), Ex. 1. The regulations do not address how an escrow used for other purposes, such as funding a potential earnout, will affect COI, and the IRS has not yet determined how the regulations will be coordinated with Revenue Procedure 84-42, which provides certain requirements for parties using escrow and contingent stock arrangements in section 368 reorganizations. See T.D. 9316, 2007-1 C.B. 962; Rev. Proc. 84-42, 1984-1 C.B. 521.

In order to escrow stock without adverse COI consequences, Revenue Procedure 84-42 requires that (i) a valid business reason exist for the escrow (such as the difficulty in valuing one or both of the parties), (ii) the stock subject to the escrow is issued and outstanding on the balance sheet of the acquirer and under applicable state law, (iii) any dividends are distributed currently to the target shareholders, (iv) any voting rights are exercisable by the shareholders or their authorized agent, (v) no shares are subject to return because of death, failure to continue employment or similar restrictions, (vi) all such stock is released within 5 years after the closing date, (vii) at least 50% of the maximum number of shares is not subject to the arrangement, (viii) the return of stock cannot be triggered by an event that is within the control of the shareholders, (ix) the return of stock cannot be triggered by the result of an IRS audit of the shareholders or the corporation with respect to (a) the reorganization in which the escrowed stock is issued, or (b) an escrowed stock reorganization involving related persons, and (x) the mechanism for calculating the number of shares of stock to be returned is objective and readily ascertainable.

⁹¹ See Treas. Reg. § 1.368-1(e)(2)(iii)(E), (F), (G).

of excess target cash, each of which could affect the aggregate consideration provided to target shareholders.⁹²

The regulations represent a significant step forward for the COI rules by removing unnecessary limitations on parties' ability to effect business combinations and by acknowledging that, as a practical matter, the economic fortunes of the target shareholders are linked to those of the acquirer as of the signing date.⁹³ However, the regulations are extremely limited in scope, and senior IRS officials have even acknowledged the regulations' limitations.⁹⁴ For example, the regulations do not permit any additional cash to be issued, even if it was issued with additional stock in the same proportion as the original contract or even in a manner that increases the proportion of stock to cash.⁹⁵

Although the regulations clarify when the parties to a reorganization need to value the acquirer's stock to measure COI, they provide no guidance as to how to calculate the value of such stock or other reorganization proceeds. The parties to a reorganization may face a valuation concern, particularly, when they have to decide whether discounts on acquirer stock should be reduced to reflect any restrictions on transfer of such stock for some specified period of time, *e.g.*, when the target shareholders enter into a lock-up agreement. Risk averse taxpayers may wish to

⁹² See NYSBA, *Report on Proposed Regulations Regarding Continuity of Interest and Pre-Closing Stock Value Fluctuation*, reprinted in 2004 TNT 233-12 (Nov. 29, 2004).

⁹³ See T.D. 9225, 2005-2 C.B. 716.

⁹⁴ See *IRS Officials Discuss Recent Corporate Guidance*, 108 Tax Notes 1516 (2005) (IRS Associate Chief Counsel (Corporate) Bill Alexander stating "[d]on't fool yourselves that the rules accomplish more than they do"). Many of the limitations and uncertainties raised by the prior proposed regulations remained after the regulations were finalized. See generally NYSBA, *Report on Proposed Regulations Regarding Continuity of Interest and Pre-Closing Stock Value Fluctuation*, reprinted in 2004 TNT 233-12 (Nov. 29, 2004); see also Robert Rizzi, *Contingent Boot*, 35 Corp. Tax'n 11 (May/June 2008); Deborah L. Paul, *IRS to Ease Continuity Requirements for Part-Cash/Part-Stock Deals*, The M&A Lawyer, Vol. 8 No. 5, Oct. 2004.

⁹⁵ See Treas. Reg. § 1.368-1(e)(2)(iii)(A).

utilize a discounted value for such acquirer stock in the absence of further guidance.⁹⁶

Simultaneously with the release of the final regulations, Treasury also released proposed regulations that provide three alternative methods of determining COI in circumstances where target company shareholders receive varying consideration but remain subject to the economic fluctuations of the consideration received in the exchange, as if they actually owned such consideration.⁹⁷ For example, a “collar” generally provides target shareholders with a fixed value of acquirer stock if the acquirer’s stock trades within a certain price range prior to the closing date.⁹⁸ A typical collar provides additional acquirer shares if the acquirer’s stock trades below the defined range and fewer acquirer shares if the acquirer’s stock trades above the defined range.

The first method of determining COI, the “Floor Price Rule,” applies where a particular item of consideration, *e.g.*, cash, increases as the value of the acquirer’s stock decreases (though the amount of consideration does not vary below the stock price agreed upon by the parties, the “Floor Price”) between the “pre-

⁹⁶ See Andrew Kreisberg, *The Effect of Transfer Restrictions On Continuity of Interest*, 128 Tax Notes 515 (Aug. 2, 2010).

⁹⁷ T.D. 9565, 76 Fed. Reg. 78,592 (Dec. 19, 2011). See generally Kevin M. Keyes, *New ‘Signing Date’ COI Regs.: Treatment of Contingent Consideration Remains Unclear*, 116 J. Tax’n 142 (Mar. 2012) (the proposed COI regulations only provide guidance where the amount of consideration varies before the closing date, but not where the consideration varies after the closing date, such as where contingent stock rights are present; therefore, it is unclear, for example, when to test for COI if a contingent stock right is present or what value to assign to the relevant stock).

⁹⁸ While the proposed regulations do not provide an example for collars, they do address transactions with both a floor and ceiling price for the value of the acquirer’s stock, and indicate that taxpayers should use the rule that is applicable on the closing date. Prop. Reg. § 1.368-1(e)(2)(vii), Ex. 1. See generally Robert Rizzi, *Continuity of Interest and Contingency of Deal-Making*, Corporate Taxation (May / June 2012) (proposed regulations represent a welcome development and a reasonable accommodation to the complex pricing mechanisms found in many corporate transactions).

signing date”⁹⁹ and the “closing date.”¹⁰⁰ Under the Floor Price Rule, if, at the closing date, the value of the acquirer’s stock has fallen below the Floor Price, the stock is nevertheless valued at the Floor Price for purposes of determining COI. The parties then determine COI based upon the value of the Floor Price. Conversely, if the price of the acquirer’s stock is between the Floor Price and the pre-signing date price, the parties measure COI on the date the transaction closes (the “Closing Date Rule”).

The second alternative, the “Ceiling Price Rule,” applies where a particular item of consideration decreases as the value of the acquirer’s stock increases, though the amount of consideration does not vary above the ceiling price of the stock set by the parties (the “Ceiling Price”) between the pre-signing date and the closing date. If the value of the acquirer’s stock is higher than the Ceiling Price on the closing date, the value of the Ceiling Price is used to determine whether the relevant acquisition satisfies COI.¹⁰¹ If, instead, the price of the acquirer’s stock is between the pre-signing date price and the Ceiling Price, the parties measure COI under the Closing Date Rule.¹⁰²

The final alternative, the “Average Price Rule,” applies when the relevant consideration includes an amount of acquirer stock, money or other property that is based upon the average price

⁹⁹ The pre-signing date is the last business day before the first date that the contract is considered binding. Treas. Reg. § 1.368-1(e)(2)(i).

¹⁰⁰ Prop. Reg. § 1.368-1(e)(2)(vi)(A). The closing date is the date on which the exchange of consideration takes place. Prop. Reg. § 1.368-1(e)(2)(vi)(D).

¹⁰¹ Prop. Reg. § 1.368-1(e)(2)(vi)(B).

¹⁰² The Ceiling Price Rule appears to have no function in assuring COI’s satisfaction; if a transaction would satisfy COI at the Ceiling Price, it would continue to satisfy COI if the price of the acquirer’s stock rose above the Ceiling Price because the target shareholders would simply receive stock with even greater value, thereby preserving the COI that was already preserved at the Ceiling Price. The NYSBA has suggested that the IRS clarify whether the Ceiling Price Rule is instead intended to protect the taxable status of transactions that are not intended to qualify as tax-free reorganizations. *See* NYSBA, *Proposed Continuity of Interest Regulations Report*, reprinted in 2012 TNT 99-12 (May 18, 2012).

of the acquirer's stock during the time period between the signing date and the closing date.¹⁰³

While the proposed regulations would provide helpful clarifications, they would also create new uncertainties. For example, the proposed regulations fail to define the term “item of consideration”, which describes the consideration that might vary when the acquirer's stock price rises or falls between the signing date and the closing date. Accordingly, it appears that either stock consideration or cash consideration, not merely the latter, can vary in accordance with a floor, ceiling or collar. The proposed regulations also do not indicate whether an “item of consideration” includes items other than cash or stock, and therefore whether the Floor Price Rule or Ceiling Price Rule would apply where target shareholders receive non-cash consideration. Additionally, the proposed regulations do not address whether the term “item of consideration” would preclude the new rules from applying where there are multiple items of consideration that vary in accordance with the price of the acquirer's stock.¹⁰⁴

The NYSBA Proposed COI Regulations Report also suggests that the final regulations limit the Floor Price Rule and the Ceiling Price Rule to typical “market” collars where the pre-signing date value of the acquirer's stock is approximately midway between the floor price and the ceiling price. This limitation would ensure that the Signing Date Rule only applies to price protection mechanisms that subject target shareholders to

¹⁰³ Prop. Reg. § 1.368-1(e)(2)(vi)(C).

Although the text of the regulations appears to indicate that the Average Price Rule is elective, Bill Alexander, IRS Associate Chief Counsel (Corporate), recently clarified that the Average Price Rule was not likely meant to be elective. See Amy S. Elliot, “*Value Average Mechanism in Proposed COI Regulations Is Not Elective*,” *Alexander Says*, 2012 TNT 21-3 (Feb. 1, 2012). See also *ABA Comments Concerning Measurement of Continuity of Interest in Reorganizations*, 2012 TNT 124-16 (June 26, 2012) (recommending that the average price rule should be available even if the average price does not otherwise determine all elements of consideration exchanged for the target stock).

¹⁰⁴ See NYSBA, *Proposed Continuity of Interest Regulations Report*, reprinted in 2012 TNT 99-12 (May 18, 2012).

meaningful economic exposure, *i.e.* fluctuations in the price of the acquirer's stock between the signing date and the closing date.¹⁰⁵

b. Effect of Acquirer Stock Repurchases

The preamble to the 1998 COI regulations also indicates that certain open market stock repurchases by the acquiring company will not violate the COI requirement. The final regulations removed an example contained in the proposed regulations in which the acquiring corporation repurchasing a small percentage of its stock after a reorganization as part of a preexisting stock repurchase program will not run afoul of the COI regulations. The preamble explains that this example was removed because it suggested a more restrictive approach to COI than was intended by the Treasury department and directs¹⁰⁶ taxpayers to Revenue Ruling 99-58.¹⁰⁷

Revenue Ruling 99-58 blesses an increase in a publicly traded corporation's existing stock repurchase plan following its acquisition of a target corporation in a tax-free reorganization to prevent the acquisition from having a dilutive effect. In the ruling, the repurchase program was increased to permit open market repurchases of the amount of shares issued to target shareholders. The repurchases were effected through a broker at the prevailing market price without the acquirer's knowledge of any selling shareholder's identity. Although the increase in the repurchase program was announced prior to the merger, the increase was not negotiated with the target or its shareholders, and there was no understanding that the target shareholders' ownership would be transitory. On these facts, the repurchases did not affect satisfaction of the COI requirement because there was no agreement between the acquirer and the target shareholders that the target shareholders' stock ownership would be transitory. Accordingly, since the mechanics of the repurchase program did not favor the target shareholders, any repurchase of target shareholder stock would be coincidental.¹⁰⁸

¹⁰⁵ See NYSBA, *Proposed Continuity of Interest Regulations Report*, reprinted in 2012 TNT 99-12 (May 18, 2012).

¹⁰⁶ See T.D. 8898, 2000-2 C.B. 271.

¹⁰⁷ Rev. Rul. 99-58, 1999-2 C.B. 701.

¹⁰⁸ See Rev. Rul. 99-58, 1999-2 C.B. 701. See also Robert Willens, *CVS/Caremark Repurchase Should Not Affect Merger*, 115 Tax

The IRS has also issued private rulings in the section 355 context permitting a controlled corporation to enter into variable share forward contracts, a series of puts and calls, and unidentified derivative transactions with an unrelated investment bank in connection with share repurchases outside the section 355 safe harbor guidelines set forth in Revenue Procedure 96-30.¹⁰⁹ These rulings may provide comfort to acquiring corporations seeking to enter into such arrangements in connection with open market repurchases (which may therefore not satisfy the safe harbor for section 368 reorganizations). It is important to note, however, that,

Notes 1195 (June 18, 2007) (arguing that CVS's post-merger self-tender offer should satisfy Revenue Ruling 99-58).

¹⁰⁹ See P.L.R. 2001-30-003 (Apr. 30, 2001) (forward contracts); P.L.R. 2001-25-011 (June 25, 2001) (puts and calls), P.L.R. 2001-46-019 (Nov. 19, 2001) (derivative transactions). Under a typical forward contract between the controlled corporation and an unrelated bank, the controlled corporation would contract to purchase its shares from the bank at a fixed price on a specified future date. The controlled corporation could settle the forward contract at maturity by purchasing the shares from the bank at the agreed price, or paying the difference between the agreed price and the market value if the market value of the shares had fallen in relation to the agreed price. If the market value of the controlled shares rose in relation to the agreed price, the bank would owe the controlled corporation the difference and could settle in cash or in shares of controlled corporation stock. As a result, the controlled corporation might reacquire shares that the bank purchased on the open market to satisfy its obligations to the controlled corporation under the forward contract.

In the forward contract ruling, the IRS relied on taxpayer representations that (i) there was a valid business purpose for the stock purchases, (ii) the stock was widely held, (iii) the stock purchases would be made in the open market or, in certain cases, from one or more investment banks in connection with its derivative transactions with such banks, (iv) there was no plan or intent to reacquire more than 20% of its stock, and (v) the controlled corporation would not know the identity of the seller of its stock with respect to any derivatives transaction. In connection with the ruling in which puts and calls were identified, the taxpayer represented that (i) the banks, acting on behalf of the distributing and controlled corporations, will be unrelated third parties, and (ii) in no instance will either the distributing or controlled corporation be able to identify any person from whom stock is obtained as a result of these derivative transactions.

because the rulings were issued in the context of section 355 there can be no assurance that the IRS will not challenge such structures following a tax-free reorganization.

C. Post-Reorganization Transfers

The tax treatment of post-reorganization dropdowns and pushups is an important consideration for multiple step acquisitions and post-reorganization restructurings. At one time, statutory rules and case law effectively limited post-reorganization transfers, and step transaction case law were rarely invoked to police the reorganization definitions.¹¹⁰ 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 all highlight the importance of step transaction considerations with respect to post-reorganization transfers.¹¹¹

Post-reorganization transfers implicate three different reorganization requirements. First, the transfers must be consistent with the COBE requirement addressed above in Section I.B.1.¹¹² 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. The government issued final regulations under Treasury Regulation sections 1.368-2(f) ("-2f") and 1.368-2(k) ("-2k") in October, 2007, and amended -2k regulations in May, 2008 (collectively, the "Final -2k Regulations"), which describe permitted post-reorganization stock and asset transfers and provide, in part, that a taxpayer remains a

¹¹⁰ See, e.g., Rev. Rul. 72-405, 1972-2 C.B. 217 (section 368(a)(2)(D) reorganization (an "A2D reorganization") followed by acquiring corporation's immediate liquidation is tested as a C reorganization); Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization followed by immediate liquidation of target is tested as a C reorganization).

¹¹¹ 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 A2D reorganizations).

¹¹² See Treas. Reg. § 1.368-1(d).

party to a reorganization after a transfer described in -2k.¹¹³ Third, the putative tax-free reorganization must “be evaluated under relevant provisions of law, including the step transaction doctrine.”¹¹⁴

1. Summary of Prior Law

Section 368(a)(2)(C) once sanctioned only transfers after A, B, C and G reorganizations of stock or assets “acquired in the transaction”, and *Groman v. Commissioner* and *Helvering v. Bashford*, credited with creating the even more restrictive remote continuity doctrine, held that COI required that the acquired assets remain in the corporation whose stock was issued in the reorganization.¹¹⁵ Congress eroded this remote continuity doctrine by enacting A2D and section 368(a)(2)(E) (“A2E”) and amending section 368(a)(2)(C), and several subsequently issued Revenue Rulings permitting other post-reorganization dropdowns.¹¹⁶ Nonetheless, vestiges of the doctrine lingered until 1998, when the preamble to the COBE regulations issued that year finally confirmed that those regulations “adequately address” the issues raised in *Groman* and *Bashford*.¹¹⁷

¹¹³ See T.D. 9396, 2008-1 C.B. 1026; T.D. 9361, 2007-2 C.B. 1026 (collectively, the “-2k Preamble”). The belief that transactions satisfying COBE and -2k should not be stepped together with subsequent pushups or dropdowns has prompted questions as to whether, in fact, a single standard should be adopted to govern post-reorganization transfers. See, e.g., NYSBA, *Report on Transfers of Assets or Stock Following a Corporate Reorganization*, reprinted in 2004 TNT 142-16 (July 23, 2004) (COBE rules and step transaction guidance should be aligned for purposes of determining whether post-reorganization restructurings affect qualification under section 368). The closer coordination of the Final -2k Regulations and the 2007 COBE Regulations represents an important step toward this goal.

¹¹⁴ Treas. Reg. § 1.368-1(a).

¹¹⁵ *Helvering v. Bashford*, 302 U.S. 454 (1938); *Groman v. Commissioner*, 302 U.S. 82 (1937).

¹¹⁶ See Rev. Rul. 64-73, 1964-1 C.B. 142 (double dropdown of assets); Rev. Rul. 68-261, 1968-1 C.B. 147 (dropdown of target assets to multiple subsidiaries).

¹¹⁷ T.D. 8760, 1998-1 C.B. 803.

The -2k regulations issued in 1998 (the “1998 -2k Regulations”) extended the scope of section 368(a)(2)(C) by providing that an A, B, C, or G reorganization would 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”).¹¹⁸ Similarly, the 1998 regulations did not disqualify an A2E reorganization 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.¹¹⁹

However, the 1998 -2k Regulations left many questions unanswered. Significantly, dropdowns to a corporation owned in a diamond pattern¹²⁰ were not included in the -2k safe harbor, because the transferee corporation did not constitute an 80% controlled corporation,¹²¹ and contributions of stock after A2D or triangular C reorganizations were not included in the safe harbor. The regulations also failed to provide comfort that a subsequent asset transfer would not be integrated to disqualify a B reorganization, apparently because the limitation in section 368(a)(2)(C) to stock or assets “acquired in the reorganization” was once thought to preclude dropdowns of target assets after target stock was acquired in a B reorganization. More generally, the 1998 -2k Regulations did not provide comfort that transfers to partnerships that would satisfy COBE would not be integrated with a related acquisition to render it taxable.

In 2001, the IRS addressed some of the concerns regarding the limited scope of section 368(a)(2)(C) and the 1998 -2k

¹¹⁸ See Former Treas. Reg. § 1.368-2(k)(1).

¹¹⁹ Former Treas. Reg. § 1.368-2(k)(2) (dropdowns to controlled subsidiaries permitted after A2E reorganizations).

¹²⁰ A “diamond pattern” is created when target stock is contributed to multiple 80% controlled subsidiaries which, in turn, contribute their target stock to a corporation in which no single transferor holds section 368(c) control.

¹²¹ See NYSBA, *Post-Reorganization Transfer Report*, reprinted in 2004 TNT 142-16 (July 23, 2004) (diamond pattern issue is “difficult to rationalize from a policy perspective”; recommending regulatory amendment to avoid this result).

Regulations by issuing Revenue Ruling 2001-24,¹²² which sanctioned a post-A2D reorganization contribution of stock. The IRS cited the legislative history to section 368(a)(2)(E) as support for treating A2D and A2E reorganizations similarly whenever possible, and explained that, since A2E reorganizations permit dropdowns of target corporation stock, dropdowns should also be permitted after A2D reorganizations.¹²³ Similarly, although neither section 368(a)(2)(C) nor the 1998 -2k Regulations permitted dropdowns after a D reorganization, the IRS approved an 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.¹²⁴ The issuance of Revenue Rulings 2001-24 and 2002-85, the IRS's statement in the latter ruling that section 368(a)(2)(C) is only a safe harbor for permitted transfers, and a Treasury official's confirmation that the 1998 -2k Regulations constituted a safe harbor,¹²⁵ represented a welcome sea change in the government's patchwork approach to post-reorganization transfers.¹²⁶

In 2004, the government issued proposed -2k regulations (the "Proposed -2k Regulations") which evidenced a similarly expansive interpretation of section 368(a)(2)(C). The Proposed -2k Regulations provided that a reorganization would not be disqualified as a result of a transfer, or successive transfers, to one or more of the issuing corporation's 80% controlled corporations of target or surviving corporation stock or assets after any type of

¹²² 2001-1 C.B. 1290.

¹²³ 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)).

¹²⁴ Rev. Rul. 2002-85, 2002-2 C.B. 986.

¹²⁵ *No Firm Plans for Clarifying "Substantially All" for Post Reorganization Transfers, Cain Says*, Daily Tax Rep. (BNA), at G-8 (Oct. 13, 2004) (comments by Audrey Nacamuli, then an 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). See also T.D. 8760, 1998-1 C.B. 803.

¹²⁶ See Rev. Rul. 2002-85, 2002-2 C.B. 986.

tax-free reorganization.¹²⁷ The proposed regulations also permitted certain transfers of target assets to partnerships whose business continued to be conducted by 80% controlled corporations.¹²⁸

Significantly, the Proposed -2k Regulations also permitted certain post-reorganization transfers to shareholders for the first time (such transfers, “pushups”).¹²⁹ More specifically, the Proposed -2k Regulations permitted the pushup of acquired assets, or, in the case of a putative B or A2E reorganization, target assets, to one or more corporate members of the issuing corporation’s qualified group, or, to a partnership, if a qualified group member was treated as conducting its business, provided that no single

¹²⁷ See Former Prop. Reg. § 1.368-2(k)(1). Despite their expansiveness, the Proposed -2k Regulations did not include within the -2k safe harbor transfers to corporations whose stock was held in the diamond pattern. See NYSBA Post-Reorganization Transfer Report; *ABA Comments on Transfer of Assets after Putative Reorganizations*, 2004 TNT 109-68 (June 7, 2004).

¹²⁸ Former Prop. Reg. § 1.368-2(k)(1)(ii)(B), (iii); Treas. Reg. § 1.368-1(d)(4)(iii)(B).

¹²⁹ Three general counsel memoranda illustrate the early evolution of the government’s position on pushups. The first, 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 pushup of assets therefore not affect satisfaction of the substantially all requirement for the A2D reorganization. G.C.M. 36111 (Dec. 18, 1974). 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 target’s 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 treat the parent as the substantive acquirer. G.C.M. 37905 (Mar. 29, 1979). The 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. G.C.M. 39102 (Dec. 21, 1983).

transferee received “substantially all” of the transferred assets.¹³⁰ The proposed regulations also allowed pushups of less than an 80% controlling interest in target corporation stock.¹³¹

2. Final -2k Regulations

The Final -2k Regulations expand and modify the Proposed -2k Regulations and, as the government states in the Preamble to the regulations, “continue the trend of broadening the rules regarding transfers of assets or stock following an otherwise tax-free reorganization where the transaction adequately preserves the link between the former [target] shareholders and the [target] business assets.”¹³² The final regulations generally provide that an otherwise qualifying reorganization will not be disqualified or recharacterized as a result of one or more subsequent transfers, including successive transfers, of stock or assets, provided that (i) the acquisition satisfies the COBE requirement after the transfers (discussed above), and (ii) each transfer qualifies under the “distribution” or “transfers other than distributions” (“other transfers”) safe harbor.¹³³

¹³⁰ Former Prop. Reg. § 1.368-2(k)(1)(ii)(A)(1)-(3).

¹³¹ Former Prop. Reg. § 1.368-2(k)(1)(ii)(A)(4).

¹³² -2k Preamble, 2007-2 C.B. 1026. *See generally* Questions Remain on Application of COBE in Asset and Stock Transfers, Panelists Say, Daily Tax Rep. (BNA), at G-7 (Apr. 11, 2008); Robert Willens, *IRS Endorses Most Types of Postreorganization Transfers*, 2008 TNT 122-30 (June 24, 2008); Thomas R. May, *IRS and Treasury Issue Final Remote Continuity Regulations*, 118 Tax Notes 719 (Feb. 11, 2008); Robert Willens, *New IRS Regulations Mark Demise of “Remote Continuity”*, Daily Tax Rep. (BNA), at J-1 (Nov. 20, 2007); D. Kevin Dolan, Patrick Jackman, Ronald Dabrowski & Philip Tretiak, *Recent U.S. International M&A Regulations*, 19 J. Int’l Tax’n 38 (July 2008).

¹³³ *See* Treas. Reg. § 1.368-2(k)(1). *See generally* NYSBA, *Report on Selected Issues in Triangular Reorganizations*, reprinted in 2008 TNT 185-18 (Sept. 23, 2008) (recommending that Congress amend section 368 to allow use of stock of grandparent or higher-tier entity as consideration in triangular reorganization). *See also* IRS says COBE work was examined in 2007 guidance on liquidations, reincorporations, Daily Tax Rep. (BNA), at G-4 (Nov. 10, 2010) (the government took into account its work on COBE when it made a

The definition of COBE is an important governor of the Final -2k Regulations, as COBE must be satisfied after any -2k transfer. In a significant expansion of prior law, the 2007 COBE regulations attribute to the qualified group target stock held by a section 368(c) controlled partnership, which is generally a partnership for which group members own interests equivalent to section 368(c) control.¹³⁴ As described in detail above, the NYSBA Tax Section has asked the government to clarify the application of section 368(c) principles to partnership interests given the complex nature of many commercial partnership arrangements.¹³⁵

The so-called distribution safe harbor in the Final -2k Regulations permits distributions of stock and assets of the acquiring, target or surviving corporation (the “relevant entity”), provided that (i) the acquisition satisfies the COBE requirement after the distribution, (ii) the aggregate distributions do not result in the relevant entity’s liquidation for U.S. tax purposes (disregarding any assets held by the acquiring corporation or merger subsidiary prior to the transaction), and (iii) not all target stock acquired in the transaction is distributed (aggregating all distributions) and the target remains a member of the acquirer’s qualified group after the distribution.

The Final -2k Regulations treat indirect asset distributions in the same manner as direct distributions. An indirect distribution generally occurs when an acquiring corporation transfers a portion of the target’s assets to a corporation or partnership in exchange

significant change in its guidance relating to liquidation-reincorporation in the form of the Final -2k Regulations).

¹³⁴ See Treas. Reg. § 1.368-1(d)(4)(iii)(D). The government explained that the purpose of this 368(c) equivalent control standard is to treat “partnerships in a manner similar to members of the COBE qualified group.” T.D. 9361, 2007-2 C.B. 1026. The examples indicate only that a “straight up” 80% partnership interest is equivalent to section 368(c) control, while a 50% interest is not. See Treas. Reg. § 1.368-1(d)(5), Exs. 14-15.

¹³⁵ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008). For a detailed discussion of the uncertainty regarding the application of the section 368(c) controlled partnership standard, see Section I.B.1 above.

for an interest in the transferee entity and then distributes that interest to a shareholder.¹³⁶

The other transfers safe harbor allows transfers of the relevant entity's stock or assets, provided that (i) the acquisition satisfies the COBE requirement after the transfer, (ii) no transfer constitutes a "distribution", and (iii) the relevant entity continues to exist for U.S. tax purposes after the aggregate transfers and remains a member of the qualified group.¹³⁷

In applying COI, the Treasury Regulations disregard acquirer stock issued in a putative reorganization to the extent the acquirer or a related person redeems (or acquires) the stock in connection with the transaction in exchange for cash or other boot.¹³⁸ More specifically, pursuant to a May 2008 amendment, the Final -2k Regulations exclude transfers to the former target corporation shareholders (other than the acquiring corporation) or the surviving corporation (collectively, "Former Shareholders") that are in substance a redemption of their target or surviving corporation stock.¹³⁹ The -2k Preamble explains that these transfers would call into question whether the underlying acquisition satisfies the COI test and, if applicable, certain statutory limitations on permissible consideration, such as the "solely for voting stock" requirement.¹⁴⁰ The safe harbor also excludes Former Shareholders' transfers of consideration initially received in the potential reorganization to the issuing corporation or a related person.¹⁴¹ By contrast, the -2k safe harbor will apply to transfers to Former Shareholders that do not represent

¹³⁶ See -2k Preamble, 2007-2 C.B. 1026; Treas. Reg. § 1.368-2(k)(1)(i)(A), (2), Ex. 3.

¹³⁷ See Treas. Reg. § 1.368-2(k)(1)(ii).

¹³⁸ See Treas. Reg. § 1.368-1(e)(i).

¹³⁹ Treas. Reg. § 1.368-2(k)(1). See generally *IRS Denies Safe Harbor to Some Transfers in Section 368(a) Tax-Free Restructurings*, Daily Tax Rep. (BNA), at G-1 (May 9, 2008). Although excluding a transfer to a shareholder that is also the acquiring corporation, the regulations continue to provide safe harbor protection to certain upstream reorganizations that are followed by a transfer of acquired assets. See, e.g., Rev. Rul. 69-617, 1969-2 CB 57.

¹⁴⁰ See -2k Preamble, 2008-1 C.B. 1026.

¹⁴¹ See Treas. Reg. § 1.368-2(k)(1).

consideration for their target or surviving corporation stock, including certain *pro rata* distributions made by an acquiring corporation following a reorganization.

The -2k Preamble explains that the government's principal concern in adopting the distribution safe harbor was to properly address whether and when an acquisition followed by a significant post-acquisition distribution should be characterized as a direct acquisition by the distributee.¹⁴² The government believes that the "liquidation" standard adequately polices this issue by preserving the analysis in Revenue Rulings 67-274, 72-405 and 2004-83, and thus remains faithful to the Congressional determination that a target corporation must liquidate in an asset reorganization,¹⁴³ by limiting non-integration under -2k to only non-liquidating distributions. It is not entirely clear, and the NYSBA has asked the government to clarify, whether the liquidation standard in the distribution safe harbor contemplates the application of the "de facto liquidation" authorities, which generally deem a corporation to have liquidated only if it retains no assets, conducts no activities and remains merely as a corporate shell.¹⁴⁴

As the government states, adoption of the liquidation standard addresses the concern that the parameters of the substantially all standard of the proposed regulations, at least under the case law, were less certain¹⁴⁵ and more consistently applies the principles of section 368(a)(2)(C), which permits transfers of all of the acquired assets or stock, to post-acquisition distributions.¹⁴⁶

The Final -2k Regulations also provide that a permissible transfer will not cause an otherwise qualifying reorganization to be

¹⁴² See -2k Preamble, 2007-2 C.B. 1026.

¹⁴³ See -2k Preamble, 2007-2 C.B. 1026.

¹⁴⁴ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008); *see, e.g., Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977); *Wier Long Leaf Lumber Co. v. Commissioner*, 173 F.2d 549 (5th Cir. 1949); *Kamin Chevrolet Co. v. Commissioner*, 3 T.C. 1076 (1944).

¹⁴⁵ See -2k Preamble, 2007-2 C.B. 1026.

¹⁴⁶ See -2k Preamble, 2007-2 C.B. 1026.

disqualified or recharacterized.¹⁴⁷ It is not entirely clear, and the NYSBA has asked the government to clarify, whether the new words “or recharacterized” are intended to “turn off” the step transaction doctrine once the applicable reorganization requirements are satisfied, even if the integration of subsequent steps, with the initial steps, would also yield a second type of reorganization (a so-called “first to the finish line” approach to the application of the step transaction doctrine under section 368).¹⁴⁸ For example, the NYSBA noted that a taxpayer may effect a reincorporation of a subsidiary’s assets in a new entity through an upstream merger followed by a transfer of all of the assets to a new corporation, and asked for clarification as to whether the reincorporation should be treated as an F reorganization or a section 368(a)(1)(A) reorganization (“A reorganization”) merger followed by a permissible section 368(a)(2)(C) transfer.¹⁴⁹

¹⁴⁷ See Treas. Reg. § 1.368-2(k)(1); see also Deanna Walton Harris, *Reg 1.368-2(k) – Things That Make You Go Hmmm*, 37 Corp. Tax. 4, at 32 (July/Aug. 2010) (concluding that the Final -2k Regulations grant enormous electivity to well-informed taxpayers, and contain many traps for the unwary).

¹⁴⁸ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008).

¹⁴⁹ See NYSBA 2008 -2k Report, *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008). See also P.L.R. 2011-27-004 (Sept. 8, 2011) (a subsidiary’s conversion to a disregarded entity before reincorporating as a corporation treated as an upstream C reorganization, in which subsidiary was deemed to transfer substantially all of its assets to its parent in exchange for parent voting stock which it immediately distributed to its parent in complete liquidation of the subsidiary). For commentary regarding the impact of Private Letter Ruling 2011-27-004 on the liquidation-reincorporation doctrine, see Robert Willens, *Liquidation/Reincorporation Treated as a C Reorganization*, 132 Tax Notes 1299 (Sept. 19, 2011); *Letter Ruling Suggests the End of the Liquidation-Reincorporation Doctrine*, 133 Tax Notes 661 (Nov. 7, 2011); Jasper L. Cummings, Jr., *The Demise of the Liquidation-Reincorporation Doctrine*, 2012 TNT 219-11 (November 12, 2012) (in the letter ruling, taxpayer was not required to provide a representation that it would not sell the stock of the newly reincorporated entity after the transaction). See also P.L.R. 2012-36-014 (June 6, 2012) (section 332 liquidation respected even though assets were ultimately reincorporated and distributed in a section 355 distribution); Christopher Brown, *Spinoff Treatment Sees New Development in Liquidation Law, IRS Official Says*, 217 Daily Tax Rep. (BNA), at G-2 (Nov. 9, 2012) (Bill Alexander suggesting

D. Asset Combination Reorganizations

1. A Reorganizations

In an A reorganization, the target merges with and into the acquirer in a merger that qualifies under the statute necessary to effect the merger.¹⁵⁰ As the surviving corporation, the acquirer absorbs all the assets and assumes all the liabilities of the target. Shareholders of the target become shareholders of the acquirer by operation of law. In the merger, target shareholders exchange their target stock for acquirer stock and up to 60% “boot.” Boot includes cash, other nonstock property, “excess principal amount” securities, and, for purposes of determining shareholder gain or loss recognition, nonqualified preferred stock exchanged for property other than nonqualified preferred stock.¹⁵¹ Target

that, while a liquidation under section 332 may be disallowed when more than 50 percent of the liquidated corporation’s assets are reincorporated, a liquidation under section 332 may be permitted, notwithstanding a reincorporation of more than 50 percent of the assets, when assets of the liquidated company are spun off by the parent in a related section 355 transaction); P.L.R. 2012-32-033 (August 10, 2012) (upstream A reorganization respected notwithstanding reincorporation of some assets). For general commentary on the liquidation-reincorporation doctrine, *see* Jasper L. Cummings, Jr., *Mergers, Reincorporations, and Groman*, 2010 TNT 162-5 (Aug. 23, 2010) (discussing, among other things, the possible tax consequences of a downstream asset transfer followed by an upstream merger); Jasper L. Cummings, Jr., *The Current State of Liquidation-Reincorporation*, PLI Corporate Tax Practice Series 2012, Chapter 159A (2012) (describing the historical development of the liquidation-reincorporation doctrine up to its current rendition); Amy S. Elliot, *Practitioners Hash Out Nuances of IRS Spinoff Rulings Positions*, 2012 TNT 198-5 (Oct. 12, 2012) (suggesting that the relaxation of the liquidation-reincorporation doctrine may be useful in pre-spinoff restructuring to separate wanted from unwanted assets).

¹⁵⁰ See I.R.C. § 368(a)(1)(A). A transaction in which the target company does not go out of existence or is merged into two or more acquirers will not qualify as an A reorganization. *See* Rev. Rul. 2000-5, 2000-1 C.B. 436.

¹⁵¹ See I.R.C. § 356(a)(1), (d), (e); *see also* P.L.R. 2009-30-025 (July 24, 2009) (target’s right to claw back tax savings resulting from acquirer’s use of target’s NOLs and unrealized deductions following a downstream A reorganization was treated as boot that did not have

shareholders recognize gain with respect to boot received in the merger, up to the amount of gain a holder realizes upon the merger.¹⁵²

Because prior regulations required that an A reorganization must have been consummated by a merger qualifying under state law, a merger or consolidation of a foreign corporation and a domestic corporation (or two foreign corporations) was not previously able to qualify with certainty as an A reorganization. In January 2006, the IRS issued final regulations that removed the A reorganization requirement that a merger be effected under domestic law, and now permit A reorganizations involving foreign corporations.¹⁵³ The regulations represent a rational expansion of

to be recognized until the right matured). *See generally* Robert Willens, *An Unusual Way to Monetize a Corporation's Tax Attributes*, 37 Ins. Tax Rev. 551 (2009). *See* Section I.H. below for a detailed discussion concerning nonqualified preferred stock.

¹⁵² *See* I.R.C. § 356(a)(1), (c).

¹⁵³ *See* T.D. 9242, 2006-1 C.B. 422; Treas. Reg. §§ 1.368-2(b)(1)(ii), -2(b)(1)(iii), Ex. 13. Taxpayers considering an A reorganization involving foreign entities should consider the potential application of sections 367 and 7874 discussed in Section IV, below. In addition, the IRS intends to amend the Foreign Interest in Real Property Tax Act regulations under sections 897(d) and (e) to include certain A reorganizations involving “U.S. real property interests”. *See* Notice 2006-46, 2006-1 C.B. 1044. *See also* P.L.R. 2007-33-002 (Aug. 10, 2007) (transaction involving foreign entities was treated as a section 351 transaction followed by an upstream merger that qualified as an A reorganization); *IRS Explains Reasoning Behind ‘A’ Reorg Merger Ruling*, 2009 TNT 186-6 (Sept. 29, 2009) (comparing Private Letter Ruling 2007-33-002 with Revenue Ruling 58-93, 1958-1 C.B. 188, where a similar transaction was treated as a deemed upstream merger followed by a section 368(a)(2)(C) drop of assets into a subsidiary); *Alexander Defends Continued Application of Upstream Reorg Revenue Ruling*, 2011 TNT 83-1 (Apr. 29, 2011) (implying that the IRS had indeed followed the holding of Revenue Ruling 58-93 in Private Letter Ruling 2007-33-002); *IRS will follow 50-Year-Old Revenue Ruling in Reorg Letter Rulings, Official Says*, 2011 TNT 16-2 (Jan. 25, 2011) (Eric Solomon noting that, if the transaction in Private Letter Ruling 2007-33-002 could instead be treated as a downstream D reorganization, it could make a difference regarding attribute location, computation of stock basis, and the possibility of gain recognition); Richard W. Bailine, *Ruminations on the Modern Merger*, 34 J. Corp. Tax’n 22 (Nov./Dec. 2007); Robert

permissible A reorganizations, recognizing that foreign jurisdictions' merger statutes are often similar to U.S. statutes.¹⁵⁴ Under the regulations, a statutory merger or consolidation is a transaction effected "pursuant to the statute or statutes necessary to effect the merger or consolidation" in which (i) all of the assets and liabilities of the target and its disregarded single member entities ("DEs" or "Disregarded Entities"), if any, become the assets and liabilities of the acquirer and its disregarded DEs, if any, and (ii) the target ceases its separate legal existence.¹⁵⁵ The regulations permit mergers of a target into either the acquirer or a disregarded entity wholly owned by the acquirer.¹⁵⁶ Taxpayers with a binding agreement to consummate a cross border merger in place prior to the issuance of the final regulations, but whose merger was not complete prior to the issuance of the regulations may elect to rely on the new regulations to treat their merger as an A reorganization.¹⁵⁷

The regulations do not treat the acquisition of target and subsequent conversion to a DE as an A reorganization, apparently because the target continues to exist as a "judicial entity" and has not terminated its separate legal existence.¹⁵⁸ The regulations also clarify that an acquisition and liquidation of a target will not qualify as an A reorganization, because the target's assets are not acquired in a merger.¹⁵⁹ By contrast, a merger by way of

Willens, *'Upstream' Merger of Recently Purchased Subsidiary Can Constitute Reorganization*, 177 Daily Tax Rep. (BNA), at J-1 (Sept. 13, 2007).

¹⁵⁴ See T.D. 9242, 2006-1 C.B. 422.

¹⁵⁵ See Treas. Reg. § 1.368-2(b)(1)(ii). See also *ABA Tax Section Examines Regs on Statutory Merger or Consolidation*, 115 Tax Notes 1135 (June 18, 2007) (recommending that stock acquisition followed by state law conversion of target into disregarded entity should qualify as A reorganization).

¹⁵⁶ See Treas. Reg. § 1.368-2(b)(ii), (iii) Ex. 2.

¹⁵⁷ See T.D. 9259, 2006-1 C.B. 874; Treas. Reg. § 1.368-2(b)(1)(v).

¹⁵⁸ See Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 9. See also *ABA Tax Section Examines Regs on Statutory Merger or Consolidation*, 115 Tax Notes 1135 (June 18, 2007) (recommending that stock acquisition followed by check-the-box election to treat target as disregarded entity should not qualify as A reorganization).

¹⁵⁹ See Treas. Reg. § 1.368-2(b)(i)(iii), Ex. 10.

consolidation or amalgamation may qualify as an A reorganization.¹⁶⁰ Although such a consolidation or amalgamation results in the continued existence of both corporations within the consolidated corporation, the target nonetheless terminates its separate legal existence.¹⁶¹ The author would submit that these are distinctions without a difference that should be eliminated. In connection with the final A reorganization regulations, the government announced that it is still considering whether a stock acquisition followed by a conversion or change in the entity classification of the acquired corporation to a DE should be permitted to qualify as an A reorganization. In addition, the government has asked for comments regarding what implications, if any, permitting these two-step transactions to qualify as a statutory merger or consolidation would have on Revenue Ruling 67-274 and Revenue Ruling 72-405.¹⁶²

Temporary regulations issued in 2003 permitting certain mergers involving DEs to qualify as A reorganizations were finalized as part of the 2006 revisions to the A reorganization regulations.¹⁶³ The final regulations provide that, in order to qualify as a tax-free A reorganization, all of the assets (other than those distributed in the transaction) and liabilities (other than those satisfied or discharged in the transaction) of a target corporation

¹⁶⁰ See Treas. Reg. § 1.368-2(b)(iii), Ex. 12, 14.

¹⁶¹ See T.D. 9242, 2006-1 C.B. 422. Notably, the IRS is considering whether a consolidation or amalgamation of two operating companies can be viewed as a mere change in form with respect to one corporation that would qualify as an F reorganization, and an A reorganization with respect to the other corporation. See T.D. 9242, 2006-1 C.B. 422.

¹⁶² T.D. 9242, 2006-1 C.B. 422; see American Bar Association, *Comments on Final Regulations Defining the Term "Statutory Merger or Consolidation"*, reprinted in 2007 TNT 113-21 (June 12, 2007) (stock purchase and related conversion should constitute an integrated A reorganization under current law; stock purchase and related check-the-box liquidation should not); NYSBA, *Section 368(a)(1)(A) Regulations Defining a "Statutory Merger or Consolidation"*, reprinted in 2006 TNT 200-17 (Oct. 17, 2006) (neither target's second step conversion nor its check-the-box liquidation should be integrated with related purchase of target stock and tested as A reorganization under current law; both transactions lack necessary predicate of state law merger).

¹⁶³ See T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b).

and its DEs must be transferred to one or more DEs of the acquirer, and the target corporation must cease its separate legal existence for all purposes.¹⁶⁴ The purpose of this asset transfer requirement is to preclude essentially divisive reorganizations from qualifying as A reorganizations.¹⁶⁵ As the preamble to the 2003 temporary regulations confirmed, however, this requirement does not import a “substantially all” requirement to A reorganizations involving DEs.¹⁶⁶ The regulations also (i) require that a DE participating in an A reorganization be owned by a corporate entity, and (ii) prohibit target shareholders from receiving interests in the DE.¹⁶⁷ Because the regulations now permit foreign entities to participate in A reorganizations, the requirement that all parties to the reorganization be U.S. entities was eliminated.¹⁶⁸

The regulations remove the formalistic requirement that a merger be “effected pursuant to the corporation laws” of the United States, a state or the District of Columbia, which precluded A reorganizations involving DEs under the prior regulations, in favor of a results-based approach that determines whether the target’s assets and liabilities become assets and liabilities of the acquirer.¹⁶⁹ The IRS has noted that abandoning the formal requirement of a merger taking place under “corporation laws” is consistent with its long-standing position that a transaction may qualify as an A reorganization even if the transaction is undertaken pursuant to laws other than the corporation law of the relevant jurisdiction.¹⁷⁰

¹⁶⁴ See Treas. Reg. § 1.368-2(1)(ii).

¹⁶⁵ See Rev. Rul. 2000-5, 2000-1 C.B. 436 (state law mergers that were essentially divisive reorganizations, not section 368(a)(1)(A) mergers, must satisfy section 355 requirements to receive tax-free treatment).

¹⁶⁶ See T.D. 9038, 2003-1 C.B. 524.

¹⁶⁷ See Treas. Reg. § 1.368-2(b)(1)(iv), Exs. 5-7.

¹⁶⁸ See T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b)(1).

¹⁶⁹ See T.D. 9038, 2003-1 C.B. 524.

¹⁷⁰ See T.D. 9038, 2003-1 C.B. 524; Treas. Reg. § 1.368-2(b); Rev. Rul. 84-104, 1984-2 C.B. 94 (treating a consolidation pursuant to the National Banking Act, 12 U.S.C. 215, as a merger for federal income tax purposes).

Thus, a merger of a target corporation into a DE will qualify as an A reorganization, provided the merger satisfies the other A reorganization requirements.¹⁷¹ Further, a forward triangular merger of a target corporation into a DE in exchange for stock of the corporate parent two levels up a corporate chain may qualify as an A reorganization, provided the merger satisfies the other requirements for an A2D reorganization.¹⁷² These outcomes are logical and consistent with the underlying principles of section 368(a)(1)(A), since the acquirer would be treated as holding the target's assets directly for all other federal tax purposes.

The preamble to the temporary regulations finalized in 2006 confirmed that an immediate merger, or presumably, liquidation of the acquiring DE into its corporate parent would not affect the outcome of the merger of the target corporation into the DE, because neither transaction would alter the tax ownership of the target assets, and notes that an additional example was not necessary to illustrate this result.¹⁷³ Accordingly, a transitory DE that is immediately merged into its corporate owner may be used to effect a tax-free reorganization.¹⁷⁴ By contrast, a merger of a DE into an acquiring corporation will not qualify as an A

¹⁷¹ See Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 2. See, e.g., P.L.R. 2011-05-019 (Feb. 4, 2011) (target merger into an DE owned by acquirer treated as if target merged directly into acquirer).

¹⁷² See Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 4.

¹⁷³ See T.D. 9038, 2003-1 C.B. 524. The preamble to the 2003 temporary DE merger regulations described one commentator's suggestion that the recast in Revenue Ruling 72-405 of an A2D merger followed by a liquidation of the surviving subsidiary as a C reorganization should not disqualify an otherwise tax-free A reorganization of a target corporation into a DE when the DE immediately thereafter merges into its corporate parent. The preamble generally agreed with this conclusion and states that the merger of a target corporation into a DE followed by the merger of the DE into its corporate parent "does not implicate the principles of Revenue Ruling 72-405." The preamble did not explicitly confirm, however, that an A-DE merger followed by a liquidation (rather than merger) of the DE will be treated as an A, rather than a C, reorganization.

¹⁷⁴ See T.D. 9038, 2003-1 C.B. 524. Such a result would also be consistent with the treatment of two-step corporate reorganizations. See, e.g., Rev. Rul. 2001-46, 2001-2 C.B. 321.

reorganization unless the DE parent corporation also merges into the same corporation. Without both mergers, some or all of the DE parent corporation's assets may not be transferred to the acquirer, producing a divisive reorganization.¹⁷⁵

The acquirer in an A reorganization generally may distribute acquired assets and/or contribute them to subsidiaries, provided that the aggregate transfers do not cause the acquirer to be treated as having liquidated for tax purposes (disregarding assets held by the acquirer prior to the reorganization) and the acquisition satisfies COBE.¹⁷⁶ An A reorganization may also potentially qualify as a C or D reorganization.

The acquirer carries over the target's basis in its assets and the target's other pre-merger tax attributes after the transaction, subject to the limitations contained in section 362(e).¹⁷⁷ The target shareholders take a substituted basis in the acquirer stock they receive, *i.e.*, their basis in the target stock before the transaction, increased by any gain recognized and reduced by the amount of cash and the fair market value of any other boot received.¹⁷⁸ The target corporation in the merger recognizes no gain.¹⁷⁹

If a transaction fails to qualify as an A or other type of tax-free reorganization, the acquirer is treated as having purchased the target's assets and the target is treated as distributing the merger consideration to its shareholders in liquidation.¹⁸⁰ Accordingly, the entire transaction is generally taxable to both the target and its shareholders. However, a shareholder that owns 80% or more of the target stock may separately qualify for tax-free treatment under section 332, which generally governs the tax treatment of such a shareholder in an upstream merger, *i.e.*, a merger of a subsidiary

¹⁷⁵ See Treas. Reg. § 1.368-2(b)(1)(iii), (b)(iv), Exs. 1 & 6.

¹⁷⁶ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

¹⁷⁷ See I.R.C. §§ 362(b) and (e), 381.

¹⁷⁸ See I.R.C. § 358(a).

¹⁷⁹ See I.R.C. § 361(a).

¹⁸⁰ See Rev. Rul. 69-6, 1969-1 C.B. 104.

into its parent.¹⁸¹ If an upstream merger is followed by a dropdown of the acquired assets, the transaction will not be treated as such a liquidation.¹⁸²

The primary appeal of A reorganizations is their flexibility. A reorganizations have no voting stock requirement, no “solely for stock” requirement, and no requirement that “substantially all” the assets of a target be acquired in the merger. Moreover, 60% of the merger consideration may be boot. These benefits must be weighed, however, against the disadvantages of A reorganizations, including the fact that the acquirer in an A reorganization directly assumes all liabilities of the target, known and unknown, fixed and contingent. Another significant disadvantage is that most state merger laws require that the acquirer stockholders, as well as the target stockholders, approve such a merger. Note, however, that a merger into a DE of the acquirer could, in most cases, avoid an acquirer shareholder vote.

Target corporations also may not wish to be viewed as being subsumed into acquirers in A reorganizations. A reorganizations are most typically used in connection with mergers of equals, mergers into limited liability companies (“LLCs”)

¹⁸¹ I.R.C. § 332(b); Treas. Reg. § 1.332-2(d); *Kansas Sand & Concrete, Inc. v. Commissioner*, 462 F.2d 805 (10th Cir. 1972). *But see* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of more than 80%-owned subsidiary treated as A reorganization to all parties). Also, tax-free treatment is available under section 368(a)(1)(A) even if the target company was a stockholder in the acquiring corporation prior to the transaction (“downstream” acquisition). *See* I.R.S. Information Letter (INFO 2000-0001) (Mar. 31, 2000) (citing Revenue Ruling 70-223 to reinforce the ruling’s applicability to such downstream mergers).

¹⁸² *See* P.L.R. 2002-50-024 (Dec. 12, 2002) (treating three upstream mergers followed by dropdowns as A reorganizations, and an upstream merger without a dropdown as a section 332 liquidation); Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger followed by dropdown treated as an A reorganization). It is clear that dropping down a *de minimis* amount of assets should not disqualify a section 332 liquidation. *See* David W. Feeney, *Tasco and its Progeny: Still Hanging Around Subchapter C?* (Sept. 22, 2003) (unpublished Tax Club manuscript, on file with author).

wholly owned by an acquirer,¹⁸³ and, along with A2Ds, to effect cash election mergers.¹⁸⁴

2. C Reorganizations

The acquirer in a C reorganization must acquire substantially all¹⁸⁵ of the target's assets in exchange solely for voting stock of the acquirer, or, in a "triangular C" reorganization, solely for voting stock of the acquirer's parent. In order for stock of the acquirer's parent to be used, the parent must be in control of the acquirer within the meaning of section 368(c). There is some uncertainty as to when "control" within the meaning of section 368(c) is measured for this purpose. The IRS has historically required a representation that the parent was in control of the acquirer before the merger.¹⁸⁶ However, a Revenue Ruling predating the IRS private ruling guidelines and a private letter ruling suggest that the test is properly applied immediately after the acquisition.¹⁸⁷

Under certain circumstances, a combination of such voting stock and a limited amount of boot (up to 20% of the total merger

¹⁸³ See discussion *infra* at Section I.N.

¹⁸⁴ See discussion *infra* at Section I.D.5.

¹⁸⁵ See Section I.F. for a detailed discussion of the substantially all requirement.

¹⁸⁶ See Rev. Proc. 86-42, 1986-2 C.B. 722.

¹⁸⁷ See Rev. Rul. 73-16, 1973-1 C.B. 186 (three unrelated corporations effect back-to-back B reorganizations in which corporation 1 acquires all of the stock of corporation 2, and corporation 3 acquires all the stock of corporation 1; treated as a single triangular B reorganization in which corporation 1 acquired the stock of corporation 2 solely in exchange for corporation 3 voting stock); P.L.R. 2004-39-003 (Sept. 24, 2004) (target merges downstream into a subsidiary in which it holds more than 20% of the stock and the acquirer holds the remaining interest; treated as A2D reorganization). Private Letter Ruling 2004-39-003 is particularly notable because the parties represented that, "[i]n connection with the Proposed Transaction, Parent will be in control of Sub within the meaning of section 368(c) of the Internal Revenue Code". See P.L.R. 2004-39-003 (Sept. 24, 2004) (emphasis added).

consideration) may also be used.¹⁸⁸ As part of the plan of reorganization, the target must generally make a liquidating distribution of the acquirer voting stock (and all its other remaining assets) to its shareholders (and creditors).¹⁸⁹

It should be noted that the assumption of target liabilities, such as liabilities associated with stock options, by the acquirer parent would constitute boot when acquirer stock is used as the merger consideration.¹⁹⁰ By contrast, both the parent and acquiring subsidiary can assume liabilities in an A, A2D or A2E reorganization.¹⁹¹ However, because a C reorganization is an asset acquisition, the acquirer will not automatically assume any target liabilities by operation of law, nor is there a requirement that the acquirer make such an assumption. Thus, practitioners should consider explicitly providing that acquirer parent assumes no liabilities in the merger. Consistent with the treatment of stock rights as zero principal amount securities, the author believes the assumption by the acquirer parent of liabilities associated with target employee stock options should properly be disregarded in determining whether a transaction qualifies as a C reorganization.¹⁹²

¹⁸⁸ See I.R.C. § 368(a)(2)(B). When Congress enacted the C reorganization statute in 1934, C reorganizations were viewed as “practical mergers” as it was then thought that state law mergers typically required the use of stock as the sole consideration. See H.R. Rep. No. 73-704 (1939), 1939-1 C.B. 254, 564; S. Rep. No. 73-558 (1939), 1939-1 C.B. 586, 598.

¹⁸⁹ See I.R.C. § 368(a)(2)(G). Revenue Procedure 89-50, 1989-2 C.B. 631, contains limited qualifications to the liquidation requirement for the retention of minimal assets when the target corporate shell will be sold to an unrelated buyer (or dissolved) within 12 months of the reorganization. Taxpayers are also generally permitted to retain cash in the target, subject to satisfaction of the substantially all test, to pay liabilities and may take up to one year to effect the liquidation. See Rev. Rul. 71-364, 1971-2 C.B. 182.

¹⁹⁰ See Rev. Rul. 70-224, 1970-1 C.B. 79; Rev. Rul. 70-107, 1970-1 C.B. 78. See generally Robert Willens, *Liabilities in C Reorganizations*, 117 Tax Notes 817 (Nov. 19, 2007).

¹⁹¹ See Rev. Rul. 73-527, 1973-1 C.B. 189; Treas. Reg. §§ 1.368-2(b)(2), -2(b)(2)(j)(5).

¹⁹² See *Attorneys Urge Treasury to Issue Guidance on Treatment of Warrants*, Highlights and Documents, at 1971 (Aug. 28, 1998).

The assumption of liabilities by the acquirer is disregarded in determining whether the acquisition is solely for voting stock unless the merger consideration includes boot, in which case any liabilities assumed also constitute boot.¹⁹³ The operation of this rule will preclude satisfaction of the 20% boot limitation in putative C reorganizations with boot whenever the ratio of target liabilities assumed to equity consideration issued is greater than 1:4, which is often the case. The acquirer in a C reorganization generally may distribute acquired assets and/or contribute them to subsidiaries, provided that the aggregate transfers do not cause the acquirer to be treated as having liquidated for tax purposes (disregarding assets held by the acquirer prior to the reorganization) and the acquisition satisfies COBE.¹⁹⁴

A triangular C reorganization can also be effected through the use of an acquirer subsidiary as the acquisition vehicle and acquirer stock as the merger consideration. The tax consequences to the target and its shareholders are the same as those resulting from a straight C reorganization. Voting stock of either the acquirer (in a straight C) or its parent (in a triangular C) may be used, but not a combination of both.¹⁹⁵ Only the acquirer subsidiary may assume target liabilities in a triangular C.¹⁹⁶

The acquiring corporation carries over the target's basis in the transferred assets, increased to reflect any gain recognized on the transfer.¹⁹⁷ The target does not recognize gain or loss in connection with its required distribution to shareholders and creditors of acquirer stock, stock rights, or debt obligations (including nonsecurities), but does recognize gain (but not loss) upon the distribution of any other property ("nonqualified property") to its shareholders.¹⁹⁸ The target shareholders recognize no gain or loss on the required target liquidation, except with

¹⁹³ See I.R.C. § 368(a)(2)(B).

¹⁹⁴ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

¹⁹⁵ See Treas. Reg. § 1.368-2(b)(2).

¹⁹⁶ Rev. Rul. 70-224, 1970-1 C.B. 79; Rev. Rul. 70-107, 1970-1 C.B. 78. See generally Robert Willens, *C Reorganizations and the Integrated Transaction Doctrine*, 115 Tax Notes 175 (Apr. 9, 2007).

¹⁹⁷ See I.R.C. § 358(a).

¹⁹⁸ See I.R.C. § 361(c)(1), (c)(2)(A).

regard to boot received in the reorganization.¹⁹⁹ The target shareholders' basis in the acquirer stock equals their basis in the target stock, increased by gain recognized and reduced by the amount of boot received.²⁰⁰ The acquirer takes a carryover basis in the target assets, subject to the limitations in section 362(e).²⁰¹

The "solely for voting stock" rule in the context of C (but not B) reorganizations has been liberalized to permit the use of a C reorganization to acquire the assets of an acquirer's own subsidiary.²⁰² Historically, the stock of an acquirer's own subsidiary was considered boot, and so an acquisitive reorganization could not qualify as a C reorganization under the "boot relaxation rule" of section 368(a)(2)(B) if the liabilities of the subsidiary exceeded 20% of the fair market value of the subsidiary's assets, a common occurrence for operating companies.²⁰³ However, regulations issued in 1999 no longer treat

¹⁹⁹ See I.R.C. §§ 354, 356.

²⁰⁰ See I.R.C. § 358(a).

²⁰¹ See I.R.C. § 362(b) and (e).

²⁰² See P.L.R. 2009-52-032 (Dec. 24, 2009) (confirming that the liquidation of a wholly owned subsidiary into its parent can qualify as an upstream C reorganization, with the "solely for stock" rule satisfied by a deemed issuance of the acquirer's voting stock to the target). See generally Robert Willens, *Upstream Transfer Ruled a C Reorganization*, 2010 TNT 32-7 (Feb. 1, 2010).

²⁰³ See *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir.), cert. denied, 361 U.S. 835 (1959). In *Bausch & Lomb*, the parent merged its 79%-owned subsidiary upstream, exchanging parent stock for the subsidiary's assets. The subsidiary then liquidated, distributing all of the parent stock received to the subsidiary's shareholders and causing the minority subsidiary shareholders to become minority parent shareholders. The court held that the transaction constituted a taxable liquidation rather than a tax-free C reorganization, because the assets were exchanged not solely for acquirer voting stock, as required by section 368(a)(1)(C), but (at least in part) for subsidiary stock previously owned by the parent. See *Bausch & Lomb*, 267 F.2d 75, 78 (2d Cir.), cert. denied, 361 U.S. 835 (1959). The government now agrees that this conclusion is unreasonable, since a subsidiary acquisition simply permits the parent to own assets directly that the parent previously owned indirectly. See Treas. Reg. § 1.368-1(d)(4)(i) (parent is treated as holding all assets of all of the members of parent's qualified group).

pre-owned stock as boot.²⁰⁴ Thus, if no other boot is exchanged in the reorganization, the acquisition of even a highly leveraged subsidiary can qualify as a C reorganization.²⁰⁵ In addition, recent COI regulations clarify that a parent's historic stake in its subsidiary counts toward satisfying the COI requirement.²⁰⁶ The IRS has also approved a downstream C reorganization in which a parent transferred substantially all of its assets to its subsidiary, distributed the subsidiary's stock to its shareholders and dissolved.²⁰⁷

A transaction that fails to qualify as a C reorganization, and otherwise fails to qualify for tax-free treatment, is treated as a purchase by the acquirer of the target assets acquired in the merger. The target is treated as subsequently liquidating, generally rendering the entire transaction taxable to the target and its shareholders.²⁰⁸ However, a shareholder that owns 80% or more of the target stock may separately qualify for tax-free treatment under section 332, which generally governs the tax treatment of such a shareholder in an upstream merger.

A failed C reorganization may satisfy the requirements for another type of tax-free reorganization, such as an A (in the rare case of a "merging" C) or a D reorganization.²⁰⁹ For example, a transaction involving commonly controlled corporations may qualify as both a C and D reorganization if the surviving corporation subsequently distributes acquirer stock (together with its remaining assets) pursuant to a plan of reorganization under sections 354, 355 or 356. Such a transaction is treated as a

²⁰⁴ See Treas. Reg. § 1.368-2(d)(4)(i).

²⁰⁵ See Treas. Reg. § 1.368-2(d)(4). Note that the regulations apply only to C, and not to B, reorganizations. See Rev. Rul. 69-294, 1969-1 C.B. 110; T.D. 8885, 2000-1 C.B. 1260.

²⁰⁶ See Treas. Reg. § 1.368-1(c)(1).

²⁰⁷ See P.L.R. 2007-47-006 (Nov. 23, 2007); P.L.R. 2007-09-037 (Mar. 2, 2007); P.L.R. 2005-15-012 (Apr. 15, 2005).

²⁰⁸ I.R.C. § 331.

²⁰⁹ Combinations of transactions may qualify as one or more types of tax-free reorganizations. There have been recent efforts to rationalize (or at least provide more certainty to) such overlap situations. See, e.g., NYSBA, *Characterizing Overlap Transactions in Subchapter C*, reprinted in 2011 TNT 5-13 (Jan. 6, 2011).

D reorganization.²¹⁰ A “merging” C reorganization may also qualify as an A reorganization, in which case it would constitute an A reorganization. The C reorganization rules may also be imposed on a stock-for-stock exchange in which the acquired subsidiary is liquidated pursuant to a plan that includes the reorganization.²¹¹ In addition, the IRS has recharacterized a section 351 transfer of subsidiary stock followed by a D reorganization and a subsequent liquidation of the transferred subsidiary as a triangular C reorganization.²¹² Finally, a C reorganization may also qualify as a section 351 exchange.²¹³

A reorganizations are generally viewed as a better alternative than Cs, since A reorganizations have neither a solely for voting stock requirement nor a substantially all requirement.²¹⁴ Similarly, A2D reorganizations generally yield the same favorable tax consequences as triangular Cs, while permitting up to 60% boot. The practical utility of C reorganizations is presently limited to direct reorganizations involving non-corporate entities.²¹⁵ Final regulations permit reorganizations involving foreign corporations to qualify as A reorganizations, a change that has further limited

²¹⁰ See I.R.C. § 368(a)(2)(A).

²¹¹ See *Commissioner v. Dana*, 103 F.2d 359 (3d Cir. 1939); Rev. Rul. 67-274, 1967-2 C.B. 141 (B reorganization followed by liquidation tested as C reorganization); cf. Rev. Rul. 74-35, 1974-1 C.B. 85 (distribution of unwanted assets subsequent to B reorganization treated as dividend that did not destroy B status).

²¹² See Rev. Rul. 68-357, 1968-2 C.B. 144 (both section 351 and section 368(a)(1)(C) applied when three corporations and a sole proprietorship transferred their assets to a newly formed, commonly owned corporation pursuant to a plan of reorganization that included liquidation of corporate transferors). Qualification as a section 351 exchange will not result in the potential application of section 357(c). See Rev. Rul. 2007-8, 2007-1 C.B. 469.

²¹³ See Rev. Rul. 78-130, 1978-1 C.B. 114.

²¹⁴ However, like A reorganizations, C reorganizations can also be accomplished even though the target was a stockholder of the acquirer prior to the acquisition. See I.R.S. Information Letter (INFO 2000-0001) (Mar. 31, 2000) (citing Revenue Ruling 70-223 to reinforce the ruling’s applicability to such downstream mergers).

²¹⁵ P.L.R. 1999-23-048 (Mar. 10, 1999) (merger of two regulated investment companies qualifies as C reorganization).

the utility of C reorganizations.²¹⁶ However, because C reorganizations are the only form of tax-free reorganization that permits an acquirer to leave liabilities behind, one commentator has suggested that they may see a rise in popularity in risk-averse environments.²¹⁷ Note that intra-group C reorganizations may also qualify, and, if so, would be tested, as D reorganizations.²¹⁸ Inadvertent Cs, such as B reorganizations followed by liquidations, are also common traps for the unwary.²¹⁹

3. Forward Subsidiary Mergers²²⁰

In a forward subsidiary merger – a so-called A2D reorganization – the target corporation merges with and into an acquirer subsidiary in a transaction that would have qualified as an A reorganization if the target had instead merged into the parent.²²¹

²¹⁶ T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b)(1)(i).

²¹⁷ See Robert Willens, *Efforts to Avoid Acquisition of Target's Liabilities Could Signal Renaissance for 'C' Reorganizations*, Daily Tax Rep. (BNA), at J-1 (Aug. 12, 2002).

²¹⁸ I.R.C. § 368(a)(2)(A).

²¹⁹ See Rev. Rul. 67-274, 1967-2 C.B. 141.

²²⁰ Prior to statutory changes in 1968, the Supreme Court denied tax-free treatment to triangular mergers, holding in *Groman v. Commissioner*, 302 U.S. 82 (1937), that parent stock received in a putative reorganization constituted taxable boot to the target shareholders because the parent was not a “party to the reorganization,” and holding in the related case of *Helvering v. Bashford*, 302 U.S. 454 (1938), that the dropdown of acquired properties to a subsidiary as part of a single plan caused an acquisition to fail as a section 368 reorganization. Taken together, these cases gave rise to the “remote continuity” doctrine. Congress subsequently amended sections 368(a) and 368(b) to permit the use of parent stock in A reorganizations, and to permit dropdowns of acquired assets or stock after A, B and C reorganizations. See also Treas. Reg. § 1.368-2(k) (providing acquiring corporation with broad flexibility to contribute or distribute stock or assets after section 368(a) reorganization).

²²¹ See Treas. Reg. § 1.368-2(b)(2); see also P.L.R. 2007-52-019 (Sept. 28, 2007) (disregarding circular cash flow to parent corporation and its transitory ownership of foreign subsidiary stock in connection with a global restructuring involving A2D reorganization); P.L.R. 2007-40-005 (July 3, 2007) (publicly held parent corporation

This provision means that the general A reorganization requirements, such as business purpose, COI and COBE, must be met in addition to the special requirements set forth in section 368(a)(2)(D).²²² A recent private ruling indicates the IRS will also permit downstream A2D mergers.²²³

As discussed above, regulations now permit A reorganizations to be accomplished with foreign parties, including A reorganizations into disregarded DEs, which would eliminate one of the primary uses for A2D reorganizations under current law.²²⁴ An A2D merger could also be accomplished by merging a target corporation into a DE owned by an acquirer subsidiary.²²⁵ The acquirer subsidiary must acquire substantially all of the target's properties in an A2D merger.²²⁶ The target shareholders receive acquirer parent stock and may also receive boot in the merger in exchange for their target shares, subject only to continuity of interest limitations.²²⁷ As in an A reorganization, the acquiring corporation (in an A2D, the surviving subsidiary) acquires all the target's assets and liabilities held immediately before the merger. However, the acquirer parent may also directly

acquired target in A2D reorganization). *See generally* Robert Willens, *Transocean Will Pay a Dividend in Connection with the Purchase of Global Santa Fe*, Daily Deal (July 27, 2007) (A2D reorganization involving foreign entities). *See also* Michael L. Schultz, *Are Tax-Free Mergers With 'Grandparent' Stock Now Possible?*, 128 Tax Notes 1249, (Sept. 20, 2010) (arguing that tax-free mergers with 'grandparent' stock should be possible since the remote continuity doctrine has been subsumed within COBE).

²²² *See* Treas. Reg. § 1.368-2(b)(2); *see also* Rev. Rul. 74-297, 1974-1 C.B. 84.

²²³ *See* P.L.R. 2004-39-003 (Sept. 28, 2004) (downstream A2D to facilitate formation of a holding company structure).

²²⁴ *See* T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b)(1)(i).

²²⁵ *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 3.

²²⁶ I.R.C. § 368(a)(2)(D).

²²⁷ No stock of the subsidiary may be used in the transaction. *See* I.R.C. § 368(a)(2)(D)(i).

assume a portion of the target's liabilities without threatening the transaction's tax-free characterization.²²⁸

In addition, in connection with the release of the new regulations, the government announced that a triangular consolidation or amalgamation should be tested as an A2D merger of each of the consolidating or amalgamating corporations into a wholly owned subsidiary of the parent corporation. Although recognizing that the parent corporation does not control the acquiring corporation immediately before triangular consolidations and amalgamations, the government nonetheless concluded, as an example in the regulations now confirms, that an A2D merger does not require the parent corporation to control the acquiring corporation immediately prior to the acquisition. Rather, the parent's control of the acquiring corporation immediately after the transaction is sufficient to satisfy the A2D rules.²²⁹

A forward subsidiary merger that does not qualify as an A2D transaction may qualify as a straight A reorganization if the acquiring subsidiary's stock represents at least 40% of the total merger consideration.²³⁰ An A2D reorganization that is immediately followed by a liquidation of the surviving corporation will be tested as a C reorganization.²³¹

The acquiring corporation in an A2D reorganization generally may distribute acquired assets and/or contribute them to subsidiaries and the acquiring corporation's stock may also be contributed to subsidiaries, provided that the aggregate asset transfers do not cause the acquirer to be treated as having liquidated for tax purposes (disregarding assets held by the

²²⁸ See Rev. Rul. 73-257, 1973-1 C.B. 189. See also Treas. Reg. § 1.368-2(b)(2) (parent is a "party to the exchange" for section 357(a) purposes).

²²⁹ See T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 14.

²³⁰ In this straight A reorganization, the parent stock would constitute taxable boot.

²³¹ See Rev. Rul. 72-405, 1972-2 C.B. 217; P.L.R. 94-44-046 (Aug. 8, 1994). By contrast, a reverse triangular merger (an A2E) followed by the target corporation's upstream merger into the parent corporation is tested as an A reorganization. See Rev. Rul. 2001-46, 2001-2 C.B. 321; P.L.R. 91-09-055 (Dec. 5, 1990).

acquirer prior to the reorganization), the acquirer remains a member of its parent's qualified group, and the acquisition satisfies COBE.²³²

The acquirer in an A reorganization carries over the target's basis in its assets and its other tax attributes after the transaction.²³³ The target corporation recognizes no gain in the merger.²³⁴ The acquirer's basis in the surviving subsidiary is increased by the acquisition of the target's assets. The target shareholders take a substituted basis for the acquirer stock received, *i.e.*, the same basis at which they held the target stock before the transaction, increased to reflect any gain recognized and reduced by the amount of boot received.²³⁵ If the transaction fails to qualify as an A2D or other type of tax-free reorganization, the subsidiary is treated as having purchased the target's assets.²³⁶ The target is treated as having liquidated, and the entire transaction is generally taxable to the target and its shareholders.²³⁷ However, a shareholder that owns 80% or more of a target's stock may separately qualify for tax-free treatment under section 332, which generally governs the tax treatment of such a shareholder in an upstream merger.²³⁸

Although A2D reorganizations are similar to As (and in certain aspects, to triangular Cs), A2Ds are both more restrictive and more flexible in certain respects. The principal restriction on A2Ds is that substantially all of the target's assets (including target subsidiaries) must be acquired in the merger. When this requirement can be satisfied, A2Ds may be the preferred form for

²³² See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

²³³ See I.R.C. § 362(b).

²³⁴ See I.R.C. §§ 1032, 361(a).

²³⁵ See I.R.C. § 358(a).

²³⁶ I.R.C. §§ 311, 331; *see, e.g.*, Rev. Rul. 69-6, 1961-1 C.B. 104 (transaction that failed to qualify as a C reorganization or an A reorganization constituted a taxable asset sale).

²³⁷ I.R.C. §§ 311, 331, 332(b); Treas. Reg. § 1.332-2(d); *Kansas Sand & Concrete, Inc. v. Commissioner*, 462 F.2d 805 (10th Cir. 1972). *But see* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of more than 80%-owned subsidiary treated as A reorganization with respect to all parties).

²³⁸ See Rev. Rul. 69-617, 1969-2 C.B. 57.

asset mergers, since the other requirements for qualification as an A2D are the same as those for an A reorganization. In addition, in an A2D, generally only the acquirer's parent corporation, and not the parent's shareholders, must approve the merger if the parent issues less than 20% of its outstanding stock in the merger. Moreover, since assets are generally transferred directly to the acquisition subsidiary in an A2D, the acquirer parent need not assume directly any of the target's liabilities. Finally, the amount of boot that may be used in an A2D is limited only by the continuity of interest requirements. The risk of a failed A2D is the same as the risk for all other asset-based reorganizations: two levels of tax.

4. Acquisitive D Reorganizations

An acquisitive D reorganization requires a transfer by a target corporation of substantially all of its assets to a corporation that is controlled immediately after the transfer by the transferor or its shareholders.²³⁹ In contrast to the other reorganizations in which a direct 80% interest is required for control under the section 368(c) test, control is defined for D reorganizations as direct or indirect ownership of at least 50% of the acquirer's stock, in terms of either voting power or value, and includes ownership through attribution under the rules of section 318.²⁴⁰ Generally, when assets are transferred across a corporate chain, *e.g.*, between brother-sister corporations, acquirer stock held by the transferor's 50% or greater shareholder is attributed in full to the transferor if at

²³⁹ See I.R.C. §§ 368(a)(1)(D), 354(b)(1)(A); *see also* P.L.R. 2012-15-005 (Apr. 16, 2012) (treating two multi-step transactions involving contributions followed by distributions in a controlled group, which transactions resulted in the spinoff of a domestic corporation to a foreign parent, as D reorganizations); P.L.R. 2007-06-007 (Feb. 9, 2007) (treating multi-step transaction as D reorganization); P.L.R. 2006-45-006 (Nov. 10, 2006) (recasting as D reorganization a multi-step transaction that involved transfer of unwanted bank charter); P.L.R. 2010-15-002 (Apr. 16, 2010) (contributions of stock of one subsidiary to another followed by an upstream merger, and a contribution followed by an election by the contributed subsidiary to be treated as a disregarded entity, each treated as D reorganization). *See generally* Richard W. Bailine, *The D Reorganization: Resolving Control Immediately After?*, 34 J. Corp. Tax'n 21 (May/June 2007).

²⁴⁰ See I.R.C. § 368(a)(1)(D), (a)(2)(H)(i).

least 5% of the acquirer's stock is distributed to the transferor.²⁴¹ The IRS has also confirmed in private rulings that persons whose stock is attributable to one another under section 318 will be treated as the same person for this purpose.²⁴² These rulings are particularly significant in the intragroup reorganization context where the relaxed control requirement permits both remote and first tier subsidiaries to engage in cross chain D reorganizations.²⁴³ There is also no limitation on the use of boot in acquisitive D reorganizations, and the IRS has blessed all cash D reorganizations in which the transferor and transferee had identical ownership and the transferee corporation exchanged cash equal to the fair market value of the transferor's assets (leaving no economic "room" for a deemed stock issuance).²⁴⁴

The transferor in a D reorganization must distribute the stock and securities of the acquirer as part of the plan of reorganization and then liquidate (the "Distribution Test").²⁴⁵ In

²⁴¹ I.R.C. § 318(a)(3)(C).

²⁴² See, e.g., P.L.R. 91-11-055 (Dec. 19, 1990); P.L.R. 93-45-040 (Aug. 15, 1993).

²⁴³ See I.R.C. § 368(a)(1)(D), (a)(2)(H)(i). By contrast to the direct ownership generally required for reorganizations under section 368(c), the D reorganization control test measures indirect ownership, determined by reference to the section 318 attribution rules.

²⁴⁴ See Rev. Rul. 2004-83, 2004-2 C.B. 157; Rev. Rul. 70-240, 1970-1 C.B. 81; *Armour v. Commissioner*, 43 T.C. 295 (1964). In *Armour*, the consideration paid to the transferor was equal to the fair market value of the assets obtained in the transfer. The Tax Court held that D reorganization treatment does not depend on an economic deemed issuance of stock, but on the target shareholders retaining their interest in the same business in a new corporate shell. See also *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540 (1965) (relying on *Armour* to reach the same conclusion); *Wilson v. Commissioner*, 46 T.C. 334 (1966). See generally Joseph Toce, *Boot Dividends and the All-Cash D Reorganization*, 133 Tax Notes 173 (Oct. 10, 2011) (discussing implications of the push for greater conformity between acquisitive D reorganizations and section 304(a)(1) stock sales).

²⁴⁵ See I.R.C. § 354(b); P.L.R. 2007-09-018 (Mar. 2, 2007) (foreign corporation's bankruptcy restructuring treated as D reorganization); see also *Reorganization of Foreign Entity Involving Debt-for-Stock Exchange Was D Reorganization*, 107 J. Tax'n 55 (July 2007).

December, 2009, the government issued final regulations clarifying the Distribution Test.²⁴⁶ Consistent with this historical

²⁴⁶ T.D. 9475, 2010-1 C.B. 304. *See generally IRS Rules Retain Nominal Share Approach for All Cash D Reorganizations in Groups*, Daily Tax Rep. (BNA), at G-7 (Dec. 18, 2009); NYSBA, *Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive 'D' Reorganizations*, reprinted in 2009 TNT 185-74 (Sept. 25, 2009).

The regulations confirm the application of the nominal share construct to the consolidated group context, despite widespread criticism from commentators. *See* T.D. 9475, 2010-1 C.B. 304 (justifying application of nominal share construct to consolidated groups as a means of preserving the location of gain or loss within the group); Treas. Reg. § 1.1502-13(f)(7)(i), Ex. 4, which applies to transactions occurring after December 17, 2009. *See generally* NYSBA, *Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive 'D' Reorganizations*, reprinted in 2009 TNT 185-74 (Sept. 25, 2009) (discussing problems arising from application of nominal share construct in consolidated group context); *Officials Address Nominal Share Outside All-Cash D Regs*, 126 Tax Notes 612 (Feb. 1, 2010) (same); *Unwelcome Result of All-Cash D Regs in Consolidation Can Be Avoided*, 2010 TNT 3-2 (Jan. 6, 2010) (same); Benjamin M. Willis & Pat Grube, *The Final Cash D Regulations: Implementing A Deemed Reality*, 37 Corp. Tax. 3, at 3 (May/June 2010) (identifying the following uncertain tax consequences of all cash D reorganizations: (i) the determination and designation of the basis of the issuing corporation's share of stock to which the nominal share's basis, if any, will attach, pursuant to the movement of the nominal share through chains of ownership to reflect actual ownership, (ii) a possible deconsolidation due to the movement of the deemed issued shares when fair market value nonstock consideration is not provided, and (iii) the qualification of a triple drop and liquidation as a D reorganization when stock consideration is issued); Jerred G. Blanchard, *The Interaction of the All-Boot D Regulations with Rev. Rul. 78-130*, 2010 TNT 129-3 (July 7, 2010) (arguing that the IRS should provide support that the form of a triple drop and liquidation (*i.e.*, parent's cascading contribution of target stock through three layers of subsidiaries followed by the liquidation of target) should be respected as such and not recast as an acquisitive all-boot D reorganization in which target transfers assets cross-chain to third tier subsidiary in exchange for stock of the first tier subsidiary, and then distributes first tier subsidiary stock to parent in liquidation of target); NYSBA, *Report on Certain International Issues Relating to All-Cash Acquisitive D Reorganizations* (Dec. 29, 2010) (providing recommendations on the

practice, the regulations deem the Distribution Test to be satisfied without an actual stock issuance where the same persons own, directly or indirectly, all of the transferor's and transferee's stock in identical proportions (or where there is only a *de minimis* variation in share ownership).²⁴⁷ In cases where the fair market value of the transferor's assets exceeds the value of the

manner in which (i) any section 1248 amount attributable to the stock of target should be preserved; (ii) earnings and profits should be taken into account for purposes of section 902 when gain is recognized as a dividend under section 356(a)(2) and (iii) any shareholder should be able to access previously taxed earnings and profits of target and acquiring under section 959); Benjamin M. Willis, Pat Grube & Henry H. Miyares, *Bottoms Up: Tiered D Reorganizations*, 2011 TNT 114-7 (June 13, 2011) (advocating that the drop by parent of the stock of S1 (which wholly owns its own subsidiary, S2) to a third subsidiary, followed by a check-the-box election of S1 and S2, should be treated under a "bottoms-up" approach to avoid duplication of gain if boot is issued).

When it initially introduced the regulations as temporary regulations in 2006, the government acknowledged that neither the IRS nor courts have required an actual issuance of stock that would constitute a mere formality, *i.e.*, a "meaningless gesture. See T.D. 9303, 2007-1 C.B. 379, as amended by Announcement 2007-48, 2007-1 C.B. 1274. See generally ABA Members Comment on Treatment of Stock in Acquisitive Reorganizations, 2008 TNT 212-24 (Oct. 29, 2008); ABA Members Comment on Temporary and Proposed Regs on Acquisitive Reorganizations, 2008 TNT 75-22 (Apr. 16, 2008); Robert Willens, *The D Reorg Went a Bit Too Far*, 114 Tax Notes 1261 (Mar. 26, 2007); Robert Willens, *IRS Clarifies Contours of D Reorganizations*, 114 Tax Notes 227 (Jan. 15, 2007); D. Kevin Dolan, Patrick Jackman, Ronald Dabrowski & Philip Tretiak, *Recent U.S. International M&A Regulations*, 19 J. Int'l Tax'n 38 (July 2008).

²⁴⁷ Treas. Reg. § 1.368-2(l)(2)(i), (iii). The regulations contain an example treating a 1% deviation in the ownership of the transferor and transferee corporations as *de minimis*. See Treas. Reg. § 1.368-2(l)(3), Ex. 4; see also *IRS Official Responds to All-Cash D Transaction Questions*, 126 Tax Notes 601 (Feb. 1, 2010) (noting an IRS official's comment that the IRS would consider issuing private rulings on what constitutes a *de minimis* variation in ownership). In applying the identity of ownership test, the regulations (i) treat an individual and all of his or her family members that have a relationship described in section 318(a)(1) as one individual, and (ii) disregard section 1504(a)(4) preferred stock. See Treas. Reg. § 1.368-2(l)(2)(ii), (iii).

consideration that the transferor receives, the transferee is deemed to issue stock with a value equal to this excess. In cases where the fair market value of the transferor's assets is equal to the value of the consideration that the transferor receives, the transferee is deemed to issue a nominal share of its stock in addition to the actual consideration.²⁴⁸ In either situation, the share that the transferee is deemed to have issued is then deemed distributed by the transferor to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the transferor's and transferee's actual ownership.²⁴⁹ A shareholder or security holder who is deemed to receive a nominal share may designate the share of transferee stock to which the basis of the nominal share will attach, provided that the shareholder or security holder

²⁴⁸ See T.D. 9475, 2010-1 C.B. 304; Treas. Reg. § 1.368-2(l)(2)(i); NYSBA, *Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive 'D' Reorganizations*, reprinted in 2009 TNT 185-74 (Sept. 25, 2009) (urging the IRS not to "unduly elevate the importance of valuation"). See also CCA 201032035 (Aug. 13, 2010) (IRS Office of Chief Counsel advises that the transferee stock and cash received must be allocated proportionally among all the assets that transferee was deemed to have acquired, rejecting characterization of a transfer of assets without positive value as a D reorganization).

²⁴⁹ See Treas. Reg. § 1.368-2(l)(2)(i). These rules do not apply to a transaction otherwise qualifying as an A2D reorganization, a triangular C reorganization or a triangular G reorganization. See Treas. Reg. § 1.368-2(l)(2)(iv). Without this carveout, an intragroup A2D reorganization, triangular C reorganization or triangular G reorganization could also be viewed as a transaction described in section 368(a)(1)(D). Since each of these reorganizations precludes the issuance of acquiring corporation stock, see I.R.C. § 368(a)(2)(D) and Treas. Reg. § 1.368-2(d)(1), the deemed issuance of a nominal share of acquirer stock in satisfaction of the Distribution Test would have prevented these transactions from qualifying as the applicable form of triangular reorganization, causing the transferor to recognize potentially substantial amounts of gain. The parent stock would also have been treated as boot in a D reorganization. See, e.g., Robert Willens, *The D Reorg Expansion Went a Bit Too Far*, 114 Tax Notes 1261 (Mar. 26, 2007); Announcement 2007-48, 2007-1 C.B. 1274 (amending the prior temporary regulations). In addition, even if no acquiring corporation stock were deemed issued, an overlap between a C reorganization and a D reorganization would have resulted in a D reorganization absent Treas. Reg. § 1.368-2(l)(2)(iv). See Section 368(a)(2)(A) and T.D. 9313 2007-13 I.R.B. 805.

actually owns shares of transferee stock,²⁵⁰ thereby preserving the basis in the transferor's stock or securities that are surrendered in the reorganization.²⁵¹

The government described the regulations as a “reasonable interpretation” of sections 354 and 368 given the history of those Code sections and their prior interpretation by the IRS and the courts,²⁵² and has also confirmed that it continues its “broad study” of issues relating to acquisitive D reorganizations.²⁵³

²⁵⁰ Temp. Reg. § 1.358-2T; *see also* T.D. 9558, 2011-51 I.R.B. 859; Amy S. Elliott, *Treasury Issues Regs Targeting Misinterpretation of All-Cash D Rules*, 2011 TNT 224-1 (Nov. 21, 2011) (final all cash D reorganization regulations prevent parties that do not own issuing corporation stock from allocating the adjusted basis of nominal shares to issuing corporation stock owned by another entity); *IRS Issues Rules on the Allocation of Basis in 'All Cash D' Reorganization Transactions*, Daily Tax Rep. (BNA), at G-6 (Dec. 21, 2011) (final regulations provide that a shareholder deemed to receive a nominal share is permitted to allocate the basis of the nominal share to transferee stock only if it owns the transferee stock itself). If shareholders of the transferor corporation are also transferee corporation shareholders, this requirement that the shareholder actually own shares of the transferee should not raise any issues. However, if the shareholders do not overlap, transferor corporation shareholders would not own any shares to which such shareholders could allocate the basis in the nominal share, and thus would potentially lose that basis in the deemed transfer. *See, e.g.*, Lewis J. Greenwald & Christopher M. Flanagan, *New Regs Confirm That Basis Is Lost In Some Cash D Reorgs*, 65 Tax Notes Int'l 1021 (Feb. 20, 2012).

²⁵¹ *See* T.D. 9475, 2010-1 C.B. 304; Treas. Reg. § 1.358-2(a)(2)(iii).

²⁵² *See* T.D. 9475, 2010-1 C.B. 304; T.D. 9303, 2007-1 C.B. 379, *as amended by* Announcement 2007-48, 2007-1 C.B. 1274. The preamble to the temporary regulations also explained that the temporary regulations did not apply the proposed “no net value” regulations (which are discussed below), and the final regulations are silent on the issue of whether D reorganizations may be subjected to a solvency requirement in the future. *See* T.D. 9475, 2010-1 C.B. 304; T.D. 9303, 2007-1 C.B. 379, *as amended by* Announcement 2007-48, 2007-1 C.B. 1274.

²⁵³ T.D. 9475, 2010-1 C.B. 304. Among the issues that the IRS will consider as part of its broad study are (i) the extent to which the COI test should apply to a D reorganization and (ii) the continuing vitality of various liquidation-reincorporation authorities. T.D. 9475, 2010-1

The courts have applied the “substantially all the assets” requirement for D reorganizations in a more relaxed fashion than the similar requirement for Cs, A2Ds and A2Es.²⁵⁴ The IRS has confirmed, first by Revenue Ruling and now in the Final -2k Regulations, that dropdowns are permitted immediately after D reorganizations.²⁵⁵ Under a literal reading of section 368(a)(2)(C), dropdowns of target assets after D reorganizations may have been permitted only where a D reorganization also qualifies as a C reorganization.²⁵⁶ The IRS reasoned in Revenue Ruling 2002-85 that section 368(a)(2)(C) was permissive and indicated that its failure to reference D reorganizations was a mere oversight.²⁵⁷ The acquirer in a D reorganization generally may distribute acquired assets and/or contribute them to subsidiaries, provided that the aggregate transfers do not cause the acquirer to be treated as having liquidated for tax purposes (disregarding assets held by

C.B. 304; *see also* T.D. 9303, 2007-1 C.B. 379 (requesting comments on these issues). In addition, the preamble to the final regulations requests comments on various specified applications of the regulations to reorganizations involving foreign corporations or shareholders. T.D. 9475, 2010-1 C.B. 304.

²⁵⁴ *See, e.g., Armour v. Commissioner*, 43 T.C. 295 (1965) (transfer of 51% of the target assets sufficient); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970) (20% of the target assets sufficient because represented all operating assets); P.L.R. 2004-10-009 (Nov. 26, 2003) (transfer of “approximately half” of parent’s property, including cash, in connection with a D reorganization/section 355 split-off); P.L.R. 2004-05-006 (Oct. 28, 2003) (transfer of assets comprising one of parent’s multiple businesses in connection with a D reorganization/section 355 split-off); P.L.R. 2004-05-011 (Oct. 15, 2003) (transfer of two businesses, including LLC membership interests and certain liabilities, in connection with a D reorganization/section 355 split-off).

²⁵⁵ *See* Treas. Reg. § 1.368-2(k); Rev. Rul. 2002-85, 2002-2 C.B. 986; Robert Willens, *IRS Revenue Ruling Administratively Expands Definition of ‘D’ Reorganizations*, Daily Tax Rep. (BNA), at J-1 (Jan. 8, 2003).

²⁵⁶ *See* Robert Willens, *Top Ten Tax Surprises When You Receive Just Stock in an Acquisition*, 82 Tax Notes 369 (Jan. 18, 1999).

²⁵⁷ *See* Rev. Rul. 2002-85, 2002-2 C.B. 986.

the acquirer prior to the reorganization) and the acquisition satisfies COBE.²⁵⁸

Until 2004, D reorganizations involving non-consolidated entities were subject to section 357(c) gain recognition on transfers of assets subject to liabilities that exceed the tax basis of the assets.²⁵⁹ The American Jobs Creation Act of 2004 (the “2004 Tax Act”) provided that section 357(c) no longer applies to acquisitive D reorganizations.²⁶⁰ As a result, taxpayers will no longer have to alter the structure of a merger to prevent a party with excess liabilities from serving as the transferor or forgive excess liabilities immediately prior to the transaction.²⁶¹ In addition, the IRS has ruled that section 357(c) is similarly inapplicable to a D reorganization that also qualifies as a section 351 transfer.²⁶²

If the transaction fails to qualify as a D reorganization, the transferee is treated as having purchased the transferor’s assets, and the transferor is treated as subsequently liquidating. The entire transaction is therefore taxable to the transferor corporation and also to its shareholders. However, an 80% or greater target

²⁵⁸ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

²⁵⁹ See Treas. Reg. § 1.1502-80(d)(1) (section 357(c) generally does not apply to transactions among consolidated group members). The IRS has also ruled that a parent’s cancellation of debt designed to avoid section 357(c) gain generally should be respected. See Rev. Rul. 78-330, 1978-2 C.B. 147.

²⁶⁰ See I.R.C. § 357(c)(1)(B).

²⁶¹ See generally Robert Willens, *Jobs Act Alters Ground Rules in Surprising Ways for ‘D’ Reorganizations*, Daily Tax Rep. (BNA), at J-1 (Dec. 29, 2004).

²⁶² Rev. Rul. 2007-8, 2007-1 C.B. 469; see also Richard W. Bailine, *The Trap of an Overlap*, 27 J. Corp. Tax’n 45 (May/June 2005). The IRS explained that Congress eliminated the applicability of section 357(c) to acquisitive D reorganizations because the transferor ceases to exist in the transaction and thus cannot be enriched by the assumption of its liabilities. In the 2004 Tax Act, Congress sought to conform the treatment of an acquisitive D reorganization to that of other acquisitive reorganizations, regardless of whether the applicable exchange also qualifies under section 351.

shareholder may separately qualify for tax-free treatment under section 332.²⁶³

When a corporation merges with an affiliate, including a DE owned by an affiliate, the transaction may qualify as an A reorganization and also as an acquisitive D reorganization. The IRS has concluded that such a transaction should be classified as a D reorganization, although the importance of this characterization has been substantially diminished now that the section 357(c) excess liability rule no longer applies to D reorganizations.²⁶⁴ Transactions that qualify as both C and D reorganizations are also treated as Ds for this purpose, unless the transaction also qualifies as a G²⁶⁵ or an F²⁶⁶ reorganization.

When Congress modified the Code to permit A2D and A2E triangular mergers, it did not make a similar change with regard to D reorganizations. Section 368(a)(1)(D) effectively requires that stock of the acquirer, rather than parent stock, be used in the transaction. The exchange of stock in an acquisitive D reorganization must qualify under section 354, which requires that securities of the target be exchanged for securities of a “party to the reorganization” and the controlled corporation’s parent is not a party to a D reorganization.²⁶⁷ Thus, a putative reorganization employing acquirer parent stock apparently may not qualify as a D reorganization. However, the continuing validity of this requirement is difficult to square with the IRS’s blessing of an all cash D reorganization in which no acquirer stock is issued. Query whether, at least in cases of complete overlapping ownership, parent stock issued in a D reorganization could (and should) be treated as boot and acquirer stock should be deemed to be issued, creating an “all boot” triangular D reorganization.

²⁶³ I.R.C. §332.

²⁶⁴ See I.R.C. § 368(a)(2)(A).

²⁶⁵ See I.R.C. § 357(c)(2)(B).

²⁶⁶ See Rev. Rul. 87-27, 1987-1 C.B. 134; Rev. Rul. 79-289, 1979-2 C.B. 145; Rev. Rul. 57-276, 1957-1 C.B. 126.

²⁶⁷ I.R.C. §§ 354(a), 368(b).

Reorganizations of affiliated corporations are often structured to qualify as D reorganizations.²⁶⁸ It is also important to note, however, that a D reorganization could also occur where a shareholder or group of shareholders that controls the acquirer also owns 20%, or perhaps even as little as 5%, of the target stock immediately before the transaction, because D reorganizations do not require that the shareholders controlling the acquirer after the merger also control the target before the merger.

5. Cash Election Mergers

Cash election mergers are typically designed to qualify as either A or A2D reorganizations in order to take advantage of the lenient rules for such reorganizations permitting the use of copious amounts of boot. Subject to “cash caps” designed to satisfy continuity of interest requirements (and in some cases an acquirer’s desire to further limit cash paid in the merger), target stockholders are typically given the opportunity to elect to receive stock, cash, or a combination of both in a cash election merger.

Calculation of the “cash cap” should include cash paid to dissenting shareholders, and should be calculated on the basis of a percentage of the number of outstanding target shares. For this purpose, the number of shares that represents 60% of all outstanding shares should then be reduced by any shares held by dissenters, and by newly issued shares held by employees of the acquirer and its affiliates as a result of exercising target options, in order to ensure that continuity of interest is satisfied in the case of a cash cap approaching 60%. Where tendering shareholders elect an aggregate amount of cash that exceeds the cash cap, the amount of cash they receive is typically reduced pro rata.

If the acquirer’s stock value fluctuates after the target shareholders elect to receive stock, cash or a combination of both, holders of the same amount of target stock may receive disproportionate consideration in the merger. The IRS has ruled that this result should be treated as a receipt of equal amounts of merger consideration by all shareholders, followed by a separate deemed transfer of value from shareholders actually receiving less

²⁶⁸ See P.L.R. 2007-32-001 (foreign entity’s conversion and recapitalization from public corporation to private corporation disregarded as transitory for U.S. tax purposes and acquisition of its assets by affiliate treated as D reorganization).

per share consideration to those actually receiving more.²⁶⁹ The deemed transfer would generally constitute ordinary income to the recipients and a capital expenditure by the transferors.²⁷⁰ As discussed in Section I.B.2.a. above, regulations now measure the value of consideration as of the date it becomes fixed pursuant to a binding contract.²⁷¹

One of the most important issues for target shareholders in a cash election merger is the tax treatment of the cash boot they receive. In this regard, individual shareholders generally prefer capital gain treatment, and corporations favor dividends. Pursuant to section 356, shareholders will recognize gain (but not loss), but not in excess of the value of boot, *i.e.*, cash received, and such gain will generally be treated as capital gain, except to the extent it “has the effect of the distribution of a dividend.”²⁷²

²⁶⁹ See Rev. Rul. 73-233, 1973-1 C.B. 179 (majority shareholder contribution of a portion of stock to capital and acceptance of only 50% of the merger consideration in exchange for minority shareholder approval of a tax-free reorganization treated as a post-reorganization transfer of stock from the majority shareholder to the minority shareholders).

Bob Willens believes the IRS would assert this position in public cash-election mergers despite the practical difficulties with creating and policing deemed transfers involving millions of shareholders not found in closely held corporations. See Robert Willens, *Judgment Call: A Sense of Proportion*, The Daily Deal (Sept. 4, 2002) (discussing cash election merger of Capsule and Covista).

²⁷⁰ See Rev. Rul. 73-233, 1973-1 C.B. 179.

²⁷¹ See T.D. 9225, 2005-2 C.B. 716; Treas. Reg. § 1.368-1(e).

²⁷² I.R.C. § 356(a). The Obama Administration has proposed repealing the section 356(a)(1) “boot within gain” limitation for reorganizations where the exchange “has the effect of the distribution of a dividend” within the meaning of section 356(a)(2). See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 133, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>; see generally *Proposed ‘Boot-Within-the-Gain’ Rule Change Might Need Broadening*, U.S. Treasury Official Says, 2009 TNT 200-8 (Oct. 19, 2009); Robert A. Rizzi, *Boot-Within-Gain: New Treatment of Non-Stock Consideration in Certain Reorganizations*, 37 Corp. Tax. 5, at 25 (Sept./Oct. 2010) (analyzing the tax consequences of a possible change to the “boot-within-gain” rule as was proposed in

To determine whether boot distributions have the effect of dividends (except in the case of mergers between members of a consolidated group²⁷³), stockholders are notionally treated as receiving additional acquirer stock in the merger that is then redeemed in exchange for the cash actually received in the merger.²⁷⁴ The section 302 provisions are applied to determine whether the notional redemption is treated as a dividend distribution.²⁷⁵ As a practical matter, the fact that only the target shareholders participate in the deemed redemption by the acquirer means it is virtually certain that most target shareholders that did not own acquirer stock prior to the reorganization will have a sufficient equity reduction to qualify for capital gain treatment for any cash received.²⁷⁶

In the rare case where a particular shareholder's circumstances would prevent cash received from qualifying for capital gain treatment, such as a CEO rolling over all of his or her stock and options, the cash will be treated as a dividend to such a shareholder to the extent of the holder's ratable share of the undistributed earnings and profits of "the corporation." Any excess gain will be treated as capital gain (assuming the stock is

H.R. 4213 "American Jobs and Closing Tax Loopholes Act of 2010").

²⁷³ Intragroup distributions are governed by Treasury Regulation section 1.1502-13(f)(3), which treats the distributions as occurring pursuant to a separate transaction governed by sections 311 and 302, rather than sections 361 and 356.

²⁷⁴ See *Clark v. Commissioner*, 489 U.S. 726 (1989); Rev. Rul. 93-61, 1993-2 C.B. 118 (adopting result in *Clark*).

²⁷⁵ See I.R.C. § 356(a)(2). In addition, under section 356(a)(2), the receipt of boot will be treated as a dividend to the extent of each shareholder's ratable share of undistributed earnings and profits of "the corporation". Commentators have suggested that CCA 201032035 implies mistakenly (and too broadly) that, in any non-triangular reorganization, the section 316 determination would include earnings and profits of both the target and issuing corporation in the determination of "the corporation". See Lisa A. Madden, *Boot as a Dividend—Whose E&P?*, 38 Corporate Tax'n 30 (Jan./Feb. 2011).

²⁷⁶ See I.R.C. § 302(b)(1); Rev. Rul. 93-61, 1993-2 C.B. 118; see also Rev. Rul. 76-385, 1976-2 C.B. 92 (any reduction in equity interest is meaningful in the case of shareholders with small equity interests and no involvement in management of the company).

held as a capital asset).²⁷⁷ It is not clear for this purpose whether the reference to “the corporation” means that the combined earnings and profits of the target and the acquirer are relevant to the determination of the dividend limitation.²⁷⁸ The Tax Court has historically looked only to the earnings and profits of the target corporation.²⁷⁹ By contrast, the IRS and the Fifth Circuit have looked to the combined earnings and profits of the acquirer and the target, but only in the context of commonly controlled companies.²⁸⁰ The latter approach may be more consistent with the Supreme Court’s view in *Clark* that the merger and deemed redemption are part of a single transaction, but the court’s opinion in *Clark* does not speak to this issue.

6. Transferee Liability in Asset Reorganizations

The IRS may assert that the acquirer in a tax-free asset reorganization is responsible for any unpaid tax liabilities of the target. Such transferee liability will generally arise after a tax-free asset reorganization between unrelated parties as a result of a contract,²⁸¹ a state or federal law,²⁸² or a below-market or

²⁷⁷ See I.R.C. § 356(a)(2).

²⁷⁸ See Robert Willens, *Whose E&P Can Support A Boot Dividend?*, 129 Tax Notes 341 (Oct. 18, 2010) (discussing ILM 2010-32-035 (Apr. 27, 2010) where the IRS continued its past practice and held that the combined E&P of acquirer and target can be accessed to support boot dividend, even though the IRS’s position has only been followed in *Davant v. Comm’r* (366 F.2d 874 (5th Cir. 1966)), where there was complete identity of stockholders).

²⁷⁹ See, e.g., *Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978), *aff’d*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970); *Estate of Bell v. Commissioner*, 30 T.C.M. (CCH) 1221 (1971).

²⁸⁰ *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Rev. Rul. 70-240, 1970-1 C.B. 81.

²⁸¹ Contractual transferee liability in an asset reorganization may exist when (i) the transferor is liable for the tax when the transfer is made and when transferee liability is asserted, (ii) the acquirer expressly assumes the transferor’s tax liability pursuant to a contract, and (iii) the contract is valid at the time that transferee liability is asserted. See, e.g., *Eddie Cordes, Inc. v. Commissioner*, 58 Fed. Appx. 422 (10th Cir. 2003).

fraudulent transfer involving an insolvent target corporation.²⁸³ While transferee liability in transactions between unrelated parties is generally limited to the situations described above, the IRS is not so limited with respect to asset reorganizations within a consolidated group,²⁸⁴ or transactions involving commonly controlled corporations used as a method for evading taxes or other liabilities.²⁸⁵ Because transferee liability applies on a joint and several basis, a transaction with multiple transferees may allow the IRS to collect payment for any amount of the liability from any party and no federal right of contribution exists between the parties.²⁸⁶

²⁸² See, e.g., *Lesser v. Commissioner*, 47 T.C. 564, 586 (1967) (holding in part that transferee liability arose under California statutes).

²⁸³ In order for the IRS to impose transferee liability without a contract or a statute after an asset reorganization, (i) the transferor must be liable for the tax when the asset transfer is made and when transferee liability is asserted, (ii) the transferor must be insolvent at the time of, or as a result of, the transfer, (iii) the transfer must be made for below-market consideration or with the intent to defraud creditors, (iv) the fair market value of the transferred assets must exceed the asserted tax liability, and (v) the government must exhaust all reasonable efforts to collect the tax from the transferor. See, e.g., F.S.A. 2001-50-001 (Dec. 14, 2001). This basis for transferee liability is known as transferee liability in equity.

²⁸⁴ See 2001 IRS C.C.A. LEXIS 290 (Apr. 3, 2001) (asserting transferee liability because a consolidated subsidiary corporation received the parent's assets in a C reorganization).

²⁸⁵ See *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3rd Cir.), cert. denied, 449 U.S. 836 (1980) (transferee liability imposed on acquiring corporation when sole shareholder liquidated one corporation and transferred its machinery, equipment, inventory, and employees to the other, resulting in a *de facto* merger); *Today's Child Learning Center Inc. v. United States*, 40 F. Supp. 2d 268 (E.D. Pa. 1988) (transferee liability imposed on successor corporation when common shareholders and directors of two corporations caused one to assume the business of the other in order to avoid its bad credit).

²⁸⁶ See, e.g., *Phillips v. Commissioner*, 283 U.S. 589 (1931); *Philip-Jones Corp. v. Parmley*, 302 U.S. 233 (1937).

E. Stock-for-Stock Reorganizations

1. B Reorganizations

In a B reorganization, the acquirer must acquire target shareholders' stock solely in exchange for voting stock of the acquirer (or stock of the acquirer parent, in a triangular B reorganization). The IRS has conceded that liabilities of the target, but not the shareholders, may be assumed in the exchange, as such assumption does not constitute additional nonqualifying consideration for the acquired stock.²⁸⁷ As discussed below, however, the assumption of shareholder-level liabilities, such as stock transfer taxes, would constitute boot that would disqualify the reorganization.²⁸⁸ The acquirer generally may distribute target assets and/or a portion of the target's stock and/or contribute target's stock or assets to subsidiaries, provided that the aggregate asset transfers do not cause the target to be treated as having liquidated for tax purposes, the acquirer does not distribute all of the target stock acquired in the transaction, the target remains a member of the acquirer's (or its parent's) qualified group and the acquisition satisfies COBE.²⁸⁹

The acquirer must control the target immediately after the stock exchange. For this purpose, control is defined in section 368(c) as direct ownership of at least 80% of the voting power of all classes of target stock entitled to vote, and at least 80% of each class of nonvoting target stock. Control need not be obtained in the reorganization;²⁹⁰ a creeping acquisition of control can qualify, as well as an increase in target stock ownership by a

²⁸⁷ See Rev. Rul. 98-10, 1998-1 C.B. 643.

²⁸⁸ See Rev. Rul. 70-65, 1970-1 C.B. 77; *see also* Rev. Rul. 79-4, 1979-1 C.B. 150; Rev. Rul. 73-54, 1973-1 C.B. 187.

²⁸⁹ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

²⁹⁰ See Rev. Rul. 69-585, 1969-2 C.B. 56. In 1999, the Clinton Administration proposed amending the section 368(c) control test to require ownership of at least 80% of the total voting power and at least 80% of the value of a corporation's stock. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2000 REVENUE PROPOSALS (Feb. 1999); *see also* NYSBA, *Report on the Administration's Proposal to Amend the "Control" Test in Section 368(c)* (July 8, 1999).

corporation that already controls the target, as long as any stock acquired for cash is old and cold at the time of the subsequent reorganization.²⁹¹ A series of stock-for-stock exchanges will be aggregated if they occur “over a relatively short period of time such as 12 months.”²⁹²

The target’s shareholders substitute their basis in the target stock they exchange as their new acquirer stock basis.²⁹³ The acquirer takes a carryover basis in the target stock acquired equal to the aggregate basis that the target shareholders held in such stock.²⁹⁴ If, as discussed below, the transaction qualifies as both a B and an A2E reorganization, the acquirer can choose as its target stock basis either the target’s net asset basis or the former target shareholders’ stock basis.²⁹⁵ The assets of the target, including the target’s tax attributes, are unaffected by the transaction.

²⁹¹ See I.R.C. § 368(a)(1)(B).

²⁹² Treas. Reg. § 1.368-2(c) (adapted from S. Rep. No. 93-1622, at 273 (1954)); see also *King Enter. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); *American Potash & Chem. Corp. v. United States*, 399 F.2d 194 (Ct. Cl.), *motion denied*, 402 F.2d 1000 (Ct. Cl. 1968).

²⁹³ See I.R.C. § 358(a)(1).

²⁹⁴ See I.R.C. § 362(b). Recognizing that it is not practical for a corporation to conduct a full basis study to determine the basis of each target shareholder in its surrendered stock, particularly because most publicly traded stock being held by a custodian precludes the determination of the ultimate beneficial owner’s identity, the IRS allows the outside basis in the target stock to be estimated using one of three basis determination safe harbors in Notice 2009-4, 2009-1 C.B. 251 (Dec. 12, 2008). See Rev. Proc. 2011-35, 2011-25 I.R.B. 1 (May 31, 2011) (expanding the safe harbor methods to permit acquiring corporations to use SEC Form 13F data to estimate basis). See generally *Practitioners Say Basis Safe Harbors Offer Clarity; Acquired Companies Still Face Issues*, Daily Tax Rep. (BNA), at G-1 (Dec. 19, 2008); *IRS Provides Safe Harbors to Address Market Practice Changes Since 1981 Guidance*, Daily Tax Rep. (BNA), at G-5 (Dec. 15, 2008). See generally WNTS Insight, *IRS allows taxpayers greater use of statistical sampling* (Aug. 29, 2011) (discussing Revenue Procedure 2011-42, which provides guidance on the use and evaluation of statistical samples to support tax returns items).

²⁹⁵ See Treas. Reg. § 1.358-6(c)(4), Ex. 2(c).

The consequences for the target's shareholders in a triangular B reorganization are the same as in a straight B reorganization. The acquirer's basis in its subsidiary stock is increased by the subsidiary's basis in the target stock, *i.e.*, the target shareholders' aggregate basis in such target stock. It should be noted that while voting stock of either the acquirer or its parent (in a triangular B) may be used as consideration in the transaction, a combination of both acquirer and acquirer parent stock is not permitted. If the transaction fails to qualify as a B reorganization, the acquirer is treated as having purchased the target stock, and the transaction is taxable to the target's shareholders, but not to the target.

The "solely for voting stock" requirement is unyielding on its face, and is strictly applied. Any receipt of boot by target stockholders in exchange for their target stock, even a *de minimis* amount, will disqualify the B reorganization.²⁹⁶ However, the requirement that solely voting stock be used as acquisition consideration focuses only on the consideration issued, directly or indirectly, by the acquirer to the stockholders of the target.²⁹⁷ Thus, the solely for voting stock requirement means, in effect, that neither the acquirer nor its affiliates may purchase target stock for cash from target stockholders.²⁹⁸ However, an acquirer can

²⁹⁶ *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, *reh'g denied*, 316 U.S. 710 (1942); Rev. Rul. 75-123, 1975-1 C.B. 115; *see also C.E. Graham Reeves*, 71 T.C. 727 (1979) (plurality opinion holding that cash purchases separate from exchange of voting stock by which control was obtained did not preclude B reorganization treatment).

²⁹⁷ *See* Rev. Rul. 73-54, 1973-1 C.B. 187 (cash transferred by acquirer to the target or its shareholders to pay shareholder expenses, investment or estate planning fees, shareholder legal or accounting fees or shareholder transfer taxes, constitutes boot). Rev. Rul. 73-102, 1973-1 C.B. 186 (acquirer's payment of dissenters' fees constitutes boot); Rev. Rul. 70-108, 1970-1 C.B. 78 (target shareholders' receipt of rights to acquire additional acquirer stock constitutes boot); Rev. Rul. 75-360, 1975-2 C.B. 110 (target dividends paid with acquirer cash or borrowed cash repaid by the acquirer constitutes boot).

²⁹⁸ *See* Rev. Rul. 85-138, 1985-2 C.B. 122; Rev. Rul. 85-139, 1985-2 C.B. 123.

purchase target stock directly from the target²⁹⁹ and may contribute cash to a target to repay target debt, even if such debt is guaranteed by a shareholder, as long as no direct economic benefit is provided to the target shareholders as a result of owning target shares.³⁰⁰ Although an acquirer can therefore provide a target with cash prior to and as part of its acquisition, cautious taxpayers will note the *Tribune Co.* decision illustrating the importance of avoiding the appearance of boot.³⁰¹

Moreover, the acquirer need not issue voting common stock to target stockholders; voting preferred stock and low-vote stock may also be used.³⁰² Nonqualified voting preferred stock will also satisfy the solely for voting stock requirement, although target shareholders will be subject to tax upon receipt of such stock.³⁰³ The parties to a B reorganization may also agree to subsequently issue an undetermined amount of additional stock, depending on certain facts and circumstances, such as the

²⁹⁹ See Rev. Rul. 72-522, 1972-2 C.B. 215 (satisfaction of B reorganization requirements not affected by purchase of target's authorized and unissued stock); G.C.M. 34 958 (July 21, 1972) (same); P.L.R. 90-37-031 (June 18, 1990) (acquirer's purchase of shares directly from target does not disqualify B reorganization).

³⁰⁰ See Rev. Rul. 79-89, 1979-1 C. B. 152 (pre-acquisition contribution of cash used to pay debt did not disqualify B reorganization); F.S.A. 715 (Feb. 8, 1993) (assumption of target debt which partially funded dividend to target shareholders by acquirer did not disqualify B reorganization); F.S.A. 2134 (July 7, 1997) (contribution of cash by the acquirer to cause target to discharge debt did not violate solely for voting stock rule); see also P.L.R. 82-47-085 (Aug. 25, 1982) (indemnity provided to target shareholder in his capacity as guarantor of target debt did not constitute boot in a C reorganization).

³⁰¹ See *Tribune Co. v. Commissioner*, 125 T.C. 140 (2005) (solely for voting stock requirement violated where, in addition to the receipt of voting stock by the target's shareholder, the target shareholder's parent was appointed the managing member of the acquiring parent's cash-rich LLC).

³⁰² See Rev. Rul. 63-234, 1963-2 C.B. 148 (separate class of stock that could elect 2 of 12 directors was "voting stock" for B reorganization purposes); see also Rev. Rul. 84-6, 1984-1 C.B. 178.

³⁰³ See H.R. Rep. No. 105-220, at 545 (1997); Rev. Rul. 79-4, 1979-1 C.B. 150 (assumption of target liability guaranteed by shareholder and treated as shareholder liability for tax purposes was boot).

performance of the target.³⁰⁴ Finally, target liabilities (that are not also shareholder liabilities) may be acquired or assumed by the acquirer.³⁰⁵

The solely for voting stock requirement also does not preclude cash payments to target stockholders where the source of the cash is either the target or third parties unrelated to the acquirer. For example, a target may pay an extraordinary dividend to its stockholders as part of a plan that includes a subsequent B reorganization.³⁰⁶ Similarly, a target can also redeem part of its stock for cash before a B reorganization.³⁰⁷ Cash paid for fractional shares in the acquirer as a rounding off mechanism will not violate the solely for voting stock requirement.³⁰⁸ Cash may also be paid to dissenters, but only out of funds provided by the target.³⁰⁹ The IRS has also ruled that a large acquirer shareholder may purchase stock of a target for cash for his own account (and not as agent for the acquirer) without violating the solely for voting stock requirement.³¹⁰ The acquiring corporation may also pay

³⁰⁴ See Rev. Rul. 66-112, 1966-1 C.B. 68.

³⁰⁵ See Rev. Rul. 70-41, 1970-1 C.B. 77; Rev. Rul. 69-91, 1969-1 C.B. 106.

³⁰⁶ See Rev. Rul. 70-172, 1970-1 C.B. 77; Rev. Rul. 69-443, 1969-2 C.B. 54; Rev. Rul. 68-435, 1968-2 C.B. 155. The receipt of such a dividend may, of course, be subject to the extraordinary dividend rules of section 1059.

³⁰⁷ See Rev. Rul. 68-285, 1968-1 C.B. 147; *see also* P.L.R. 2009-41-009 (July 10, 2009) (target's pre-acquisition redemption of nonvoting preferred stock with its own funds as part of a plan did not preclude B reorganization treatment).

³⁰⁸ See Rev. Rul. 66-365, 1966-2 C.B. 116. The IRS has also ruled privately that an acquirer may offer target shareholders the option to receive cash in a lieu of a fractional share or to receive the fractional share without running afoul of Revenue Ruling 66-365. *See* P.L.R. 89-23-021 (Mar. 10, 1989).

³⁰⁹ See Rev. Rul. 68-285, 1968-1 C.B. 147. The solely for voting stock requirement will be violated if acquirer assets are used to fund dissenters' payments. *See Turnbow v. Commissioner*, 368 U.S. 337 (1961), *aff'g* 286 F.2d 669 (9th Cir. 1960); Rev. Rul. 75-123, 1975-1 C.B. 115; Rev. Rul. 73-427, 1973-2 C.B. 301.

³¹⁰ See Rev. Rul. 68-562, 1968-2 C.B. 157.

costs associated with registering shares in the acquisition.³¹¹ Moreover, an acquirer may contribute cash to a target to pay off preexisting target obligations, or in return for authorized but unissued stock.³¹²

In some cases, an acquirer may need to, or wish to, acquire target stock held by its subsidiary. An acquirer may acquire such target stock as a dividend from its subsidiary (because no acquirer property is issued in exchange for a dividend),³¹³ but not by liquidating the subsidiary,³¹⁴ because in the latter case, the target stock would be obtained from the subsidiary in exchange for the parent's subsidiary stock rather than for acquirer stock.

In the case of a creeping B reorganization where a prior purchase of target corporation stock for cash may not be treated as old and cold, the acquirer may sell the tainted target stock before the acquisition to purge the taint from such stock, and thus satisfy the solely for voting stock rule.³¹⁵ There can be no arrangement between the acquirer and the purchaser regarding the purchaser's participation in a subsequent B reorganization; the purchaser must have freedom of action with regard to the shares. However, the buyer of the tainted stock need not be completely unrelated, since as discussed above a majority shareholder of the acquirer may acquire the stock for cash without violating the solely for voting stock rule.³¹⁶

The IRS significantly expanded the scope of property that can be exchanged tax-free in B reorganizations with the issuance

³¹¹ See Rev. Rul. 67-275, 1967-2 C.B. 142.

³¹² See Rev. Rul. 79-89, 1979-1 C.B. 152; Rev. Rul. 72-522, 1975-2 C.B. 215. If an acquirer contributes cash to pay target obligations, the IRS has required that the exchange not be conditioned on the cash contribution and that the fair market value of the stock received (and exchanged) be equal.

³¹³ See Rev. Rul. 69-585, 1969-2 C.B. 56.

³¹⁴ See Rev. Rul. 69-294, 1969-1 C.B. 110.

³¹⁵ See Rev. Rul. 85-139, 1985-2 C.B. 123; Rev. Rul. 72-354, 1972-2 C.B. 216.

³¹⁶ See Rev. Rul. 68-562, 1968-2 C.B. 157.

of Revenue Ruling 98-10.³¹⁷ The ruling provides that an exchange of target securities for acquirer securities in connection with an otherwise valid B reorganization is an exchange in pursuance of the plan of reorganization, and gain or loss realized by the debenture holders will be governed by sections 354 and 356. Accordingly, gain will be recognized only to the extent the principal amount of the securities received exceeds the principal amount of securities surrendered.³¹⁸ The IRS has now ruled that because noncompensatory options are characterized as zero principal amount securities, they can be exchanged on a tax-free basis in a B reorganization.³¹⁹

Although a B reorganization is in form an exchange of stock, such a reorganization may be effected by merging a first or second tier shell subsidiary of the acquirer with and into the target, with the target stockholders receiving solely acquirer stock.³²⁰ Effecting a B reorganization in this manner potentially provides a taxpayer with a second route to tax-free treatment, as a failed B may nonetheless qualify as an A2E if the relevant requirements are satisfied. The IRS apparently believes that a merger of an operating subsidiary with other assets with and into a target corporation cannot qualify as a B reorganization of the target, although it has never ruled on the question.

A B reorganization followed by a liquidation of the newly acquired target as part of the same plan has been classified by the

³¹⁷ Rev. Rul. 98-10, 1998-1 C.B. 643. Revenue Ruling 98-10 supersedes Revenue Ruling 69-142 and modifies Revenue Rulings 70-41, 1970-1 C.B. 77 and 78-408, 1978-2 C.B. 203, in each case to provide that section 354 applies to exchanges of stock for rights that constitute securities under the regulations. *See generally* Robert Willens, *Exchanging Securities in a Reorganization*, 2009 TNT 98-14 (May 26, 2009) (describing Revenue Ruling 98-10 as reaching an “eminently sensible” conclusion).

³¹⁸ *See* I.R.C. § 356(d)(2)(B).

³¹⁹ *See* Treas. Reg. §§ 1.354-1(d), Ex. 4; 1.354-1(e); 1.356-3(b), Ex. 7-9; 1.356-3(c); *see also* T.D. 8752, 1998-1 C.B. 611. In cases of significant overlap between target stockholders and security holders, it may be difficult to demonstrate that target shareholders received only stock in exchange for their stock, and securities in exchange for their securities.

³²⁰ *See* Rev. Rul. 67-448, 1967-2 C.B. 144.

IRS and the courts as a C reorganization.³²¹ By contrast, the IRS has respected the form of a B reorganization followed by a dividend of significant operating assets (less than 50% of total assets) of the target.³²² The IRS has also ruled that two sequential acquisitions may qualify as B reorganizations of two targets by the ultimate acquirer.³²³

A B reorganization may also qualify as a section 351 transaction, either separately or as part of a larger section 351 holding company acquisition, if the acquirer exchanges its voting stock directly with the target corporation and, as a result, the target shareholders control the target.³²⁴ The regulations suggest that a transaction in which a holding company whose only asset is target stock transfers that stock to another corporation solely for acquirer stock and subsequently liquidates might also be considered a C reorganization.³²⁵ Similarly, the IRS would likely view a putative B reorganization that follows the creation and transfer of assets to a new target as a taxable exchange of assets for stock, except in connection with a tax-free spinoff.³²⁶

The principal limitation inherent in B reorganizations is clear – no boot may be received by target stockholders in the acquisition. However, this limitation must be weighed against the significant benefits attendant to B reorganizations. First, since B

³²¹ See Rev. Rul. 67-274, 1967-2 C.B. 141; *Resorts Int'l v. Commissioner*, 60 T.C. 778 (1973), *aff'd*, 511 F.2d 107 (5th Cir. 1975); P.L.R. 95-39-018 (Sept. 29, 1995).

³²² See Rev. Rul. 74-35, 1974-1 C.B. 85.

³²³ See Rev. Rul. 73-16, 1973-1 C.B. 186 (X stock acquired by Y and Y stock acquired by Z treated as simultaneous acquisitions of X and Y by Z in straight and triangular B reorganizations, respectively).

³²⁴ See, e.g., Rev. Rul. 70-433, 1970-2 C.B. 82; P.L.R. 2006-50-010 (Dec. 15, 2006).

³²⁵ See Treas. Reg. § 1.368-2(f) (last sentence, by implication); see also Rev. Rul. 70-65, 1970-1 C.B. 77 (invalid B reorganization, due to liability assumption, still qualified as C reorganization).

³²⁶ See *West Coast Mktg. Corp. v. Commissioner*, 46 T.C. 32 (1966) (taxable exchange of assets for stock); Rev. Rul. 70-140, 1970-1 C.B. 73 (taxable exchange of assets for stock, even though acquired corporation was not liquidated). But see *Weikel v. Commissioner*, 51 T.C.M. 432 (CCH) (1986) (transaction not recharacterized).

reorganizations are stock acquisitions, the acquirer need not directly assume the target's liabilities and assets need not be directly transferred. Second, as stock acquisitions, failed Bs create only a single level of tax. Third, creeping acquisitions may qualify as B reorganizations. Finally, unlike triangular mergers, B reorganizations do not require that substantially all of the target's assets be acquired. That being said, perhaps the most common role for B reorganizations is serving as a second line of defense to A2E reorganization treatment for all-stock reverse triangular mergers that may not satisfy the substantially all requirement.

2. Reverse Subsidiary Mergers

In a reverse subsidiary merger – a so-called A2E reorganization – an acquirer subsidiary merges with and into the target, with the target as the surviving corporation. After the merger, the surviving target must hold substantially all of both its own properties (and its subsidiaries' properties) and the properties of the acquisition subsidiary (if any).³²⁷ The target's former shareholders must exchange "an amount of the stock of the surviving (target) corporation that constitutes control of such corporation" for acquirer parent voting stock.³²⁸ The remainder of the target stock may be acquired in exchange for taxable boot. For purposes of determining whether stock constituting control is acquired for voting stock, stock redeemed by the target prior to a merger is only considered outstanding if such a redemption is

³²⁷ The term "substantially all" has the same meaning as in section 368(a)(1)(C). See Treas. Reg. § 1.368-2(j)(3)(iii).

³²⁸ See I.R.C. § 368(a)(2)(E). See NYSBA, *Report on Selected Issues in Triangular Reorganizations*, reprinted in 2008 TNT 185-18 (Sept. 23, 2008) (recommending that Congress amend section 368 to authorize regulations addressing fluctuations in parent's stock value between signing and closing dates in applying A2E control test). See also Michael L. Schultz, *Are Tax-Free Mergers With 'Grandparent' Stock Now Possible?*, 128 Tax Notes 1249, (Sept. 20, 2010) (in contrast to the NYSBA recommendation in its Triangular Reorganizations Report of a legislative change to allow tax-free mergers with 'grandparent' stock, the author believes that the Treasury and the IRS could simply amend the COI-regulations to provide that any corporation treated as conducting the business of the acquired corporation under COBE qualifies as an 'issuing corporation' for purposes of the COI-test).

funded by the acquirer, rather than by the target.³²⁹ It should be noted that if such redemption is funded by the target, however, the redemption costs will count against satisfaction of the substantially all requirement, as discussed below.³³⁰ Finally, an indirect acquirer subsidiary cannot directly acquire a target in an A2E.³³¹

The requirement that the target hold substantially all of both its and the acquisition subsidiary's assets after the merger has historically cast serious doubt on the permissibility of dividends of significant target assets as part of a plan that includes an A2E reorganization.³³² However, Revenue Ruling 2001-25 explains that the "hold" requirement is imposed merely because a surviving corporation cannot logically "acquire" its own assets, and that the use of such term does not impose any requirement above what is required in a C or A2D reorganization, *i.e.*, that substantially all of the target's historic assets must be acquired in the merger.³³³

The surviving corporation in an A2E reorganization generally may distribute assets and/or contribute them to subsidiaries and its stock may also be contributed to subsidiaries, provided that the aggregate asset transfers do not cause the surviving corporation to be treated as having liquidated for tax purposes (disregarding any assets of the merger subsidiary), the

³²⁹ See Treas. Reg. § 1.368-2(j)(3)(i). See also Robert Willens, *Cleveland-Cliffs and Alpha Natural Resources: The 72 Percent Solution*, 120 Tax Notes 789 (Aug. 25, 2008) (merger may qualify as A2E reorganization even though parent voting stock represents less than 80% of aggregate merger consideration if target redeems a portion of its nonvoting stock with its own funds).

³³⁰ See Treas. Reg. § 1.368-2(j)(6)(iii), Ex. 3.

³³¹ See Rev. Rul. 74-564, 1974-2 C.B. 124.

³³² See P.L.R. 90-25-080 (Mar. 28, 1990) (suggesting that immediate dividend of stock acquired in A2E caused stock not to be considered "held" for substantially all purposes). The "substantially all" requirement is discussed in detail below in Section I.E.

³³³ See Rev. Rul. 2001-25, 2001-1 C.B. 1291. In Revenue Ruling 2001-25, the acquired target sold 50% of its operating assets for cash and retained the proceeds. See also Rev. Rul. 2001-24, 2001-1 C.B. 1290 (citing S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970); making sweeping statement that A2E and A2D reorganizations should be treated similarly).

surviving corporation remains a member of its parent's qualified group and the acquisition satisfies COBE.³³⁴

The target shareholders take a substituted basis in the acquirer stock they receive, *i.e.*, their basis in the target stock before the transaction, increased by any gain recognized and reduced by the amount of boot received.³³⁵ No gain is recognized by the target corporation in connection with the merger.³³⁶ The acquirer's basis in the target stock generally equals the target's net asset basis.³³⁷ If the transaction also qualifies as a B reorganization or section 351 exchange, the acquirer may choose instead to carry over the shareholders' aggregate target stock basis.³³⁸ In a failed A2E, the acquirer is treated as having purchased the target's stock.³³⁹ Thus, the transaction is taxable to the target's shareholders, but not to the target.³⁴⁰ Reverse subsidiary mergers utilizing shell acquisition subsidiaries that cannot qualify as A2Es, *e.g.*, because the substantially all requirement is not satisfied, may nonetheless qualify as B reorganizations if the relevant statutory requirements are satisfied.³⁴¹ The IRS has now ruled that an A2E followed by an upstream merger of the surviving target corporation is tested as an A reorganization.³⁴²

³³⁴ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above.

³³⁵ See I.R.C. § 358(a).

³³⁶ See I.R.C. § 361(a).

³³⁷ See I.R.C. § 362(b).

³³⁸ See Treas. Reg. § 1.358-6(c)(2)(ii); *see also* Treas. Reg. § 1.358-6(c)(2)(i)(C) (acquirer may elect to treat previously owned target stock as acquired in the acquisition or may keep its historical basis in its stock).

³³⁹ See Rev. Rul. 73-427, 1973-2 C.B. 301.

³⁴⁰ I.R.C. § 332(b); Treas. Reg. § 1.332-2(d); *Kansas Sand & Concrete, Inc. v. Commissioner*, 462 F.2d 805 (10th Cir. 1972). *But see* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of more than 80%-owned subsidiary treated as A reorganization to all parties).

³⁴¹ See Treas. Reg. § 1.368-2(j)(7), Ex. 4, 5; Rev. Rul. 67-448, 1967-2 C.B. 144.

³⁴² See Rev. Rul. 2001-46, 2001-2 C.B. 321 (Situation 2) (reverse subsidiary merger effected solely for voting stock followed by target's upstream merger into acquirer was an A reorganization). *See*

There is no prohibition against the use of an operating subsidiary with separate assets as the acquisition subsidiary in an A2E. Interesting issues may arise if an operating subsidiary is used, however, particularly as to whether control is acquired in the merger. It is clear as a threshold matter that the target shareholders must exchange at least 80% of the number of outstanding target shares in the merger, since the amount of target stock that constitutes control is determined before the merger.³⁴³ Query, however, whether such exchange will always produce the requisite acquisition of control. For example, it is not clear that the requisite control is acquired where target shareholders exchange 80% of the outstanding target shares, but the acquirer shares received in the merger do not represent 80% of the total merger consideration, because of the increased value of the retained target shares attributable to the surviving corporation's separate assets.³⁴⁴

A2E reorganizations achieve the same beneficial results as B reorganizations while permitting the use of a limited amount of boot, making A2Es perhaps the most popular vehicle for effecting tax-free acquisitions. The advantages of A2E reorganizations include the fact that target assets need not be transferred nor liabilities assumed; the acquirer's shareholders typically are not required to approve mergers in which less than 20% of the acquirer's outstanding stock is issued; and a failed A2E, like a failed B, produces only a single layer of tax. The only two A2E requirements that are more limiting than the corresponding B requirements are that 80% control must be acquired in exchange for parent voting stock in the A2E reorganization itself,³⁴⁵ and the surviving (target) corporation must hold substantially all of the target's assets after the merger. As discussed below, the IRS has

also P.L.R. 95-39-018 (Sept. 29, 1995); P.L.R. 98-31-013 (Apr. 30, 1998) (reverse subsidiary mergers followed by upstream mergers constituted A reorganization); P.L.R. 97-46-010 (Aug. 11, 1997) (same); P.L.R. 98-31-018 (Apr. 30, 1998) (same); P.L.R. 1999-15-013 (Jan. 4, 1999) (same); P.L.R. 1999-22-042 (Mar. 4, 1999) (same); P.L.R. 1999-24-038 (June 18, 1999) (same); P.L.R. 1999-24-042 (June 18, 1999) (same); P.L.R. 2000-10-031 (Dec. 9, 1999) (same); P.L.R. 2000-43-032 (July 27, 2000) (same).

³⁴³ See Treas. Reg. § 1.368-2(j)(6), Ex. 6.

³⁴⁴ Western Resources first utilized this structure in its 1998 acquisition of Kansas City Power & Light.

³⁴⁵ See Treas. Reg. § 1.368-2(j)(3)(i), (ii).

now ruled that a tender offer followed by a merger will be treated as a single integrated transaction for purposes of testing whether 80% control is acquired in the merger.³⁴⁶ The IRS has ruled privately that an A2E can also be effected through a downstream merger.³⁴⁷

Creeping reverse subsidiary mergers, and, generally, acquisitions of targets that have recently sold significant portions of their assets and distributed the sales proceeds or have recently been parties to spinoffs, cannot qualify as A2Es. However, as discussed below, the IRS has confirmed that A2Es and A2Ds should generally be treated similarly,³⁴⁸ reducing the length of time an acquiring corporation must hold target assets. The substantially all requirement for A2Es may also prove to be a problem if an acquirer intends to transfer target assets within its group, or sell such assets to third parties without retaining the sales proceeds, in either case, as part of a plan that includes the reorganization.

3. 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.³⁴⁹ They often occur as a step in

³⁴⁶ Rev. Rul. 2001-26, 2001-1 C.B. 1297 (citing *King Enter., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969)).

³⁴⁷ See P.L.R. 87-39-027 (June 29, 1987).

³⁴⁸ Rev. Rul. 2001-24, 2001-1 C.B. 1290.

³⁴⁹ I.R.C. § 368(a)(1)(F). See P.L.R. 2012-08-019 (Nov. 28, 2011) (Oldco's formation of Holdco and transfer of all Oldco assets and liabilities to Holdco qualified as an F reorganization despite the fact that Holdco merged into an LLC and transferred employees to the LLC, where such employees performed certain contracts held by Holdco); P.L.R. 2006-45-015 (Aug. 1, 2006) (creating separate series of common stock by restructuring a parent corporation to track economic performance of two operational groups is an F reorganization). See generally Debra J. Bennett, *The Flexible Code Sec. 368(a)(1)(F) Reorganization*, 85 Taxes 6 (June 2007); Steven L. Brinker, *A Stock Purchase for Tax Purposes and an Asset Purchase for Nontax Purposes – How to Use an F Reorganization to Get There*, 88 Taxes 4, at 25 (Apr. 2010) (separation of target business assets and related liabilities from remote and contingent liabilities

a larger, tax-free transaction, and they have long been granted a unique exemption from the application of the step transaction doctrine.³⁵⁰ F reorganizations may involve multiple entities as long as only one entity is an operating company (the “single operating company rule”).³⁵¹ F reorganizations may also involve foreign and domestic entities.³⁵² F reorganizations involving

prior to a stock sale by converting a corporation into a disregarded entity and effecting other pre-closing transactions, together, treated as an F reorganization); Jasper L. Cummings, Jr., *A General Theory of F Reorganizations*, 2012 TNT 238-7 (Dec. 10, 2012) (providing an overview and history of F reorganizations).

³⁵⁰ 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 an unspecified type of merger; reincorporation held to be a separate and valid F reorganization); Rev. Rul. 2003-48, 2003-1 C.B. 863 (conversions of mutual savings banks to stock savings banks qualified as F reorganizations, notwithstanding subsequent change in direct ownership of transferred company); P.L.R. 2008-03-005 (Jan. 18, 2008) (bankrupt corporation’s asset transfer to newly formed corporation treated as F reorganization); P.L.R. 2006-08-018 (Nov. 18, 2005) (domestic parent restructured foreign entities in F reorganization to allow repatriation of earnings without withholding tax); P.L.R. 2005-10-012 (Mar. 15, 2005) (forward triangular merger that followed payment of dividend and initial public offering of the transferred corporation stock qualified as an F reorganization); P.L.R. 2010-14-048 (Apr. 9, 2010) (contribution to a formerly dormant corporation of all foreign corporation’s assets and subsequent check-the-box liquidation of the formerly dormant corporation qualified as an F reorganization).

³⁵¹ H.R. Rep. No. 760, 97th Cong., 2d Sess. 541 (1982), 1982-2 C.B. 600, 634-635; see, e.g., P.L.R. 2006-22-025 (June 2, 2006) (merger of corporation into sister LLC that was taxed as a corporation treated as F reorganization). As discussed above, the government is considering whether a consolidation or amalgamation of two operating corporations can qualify as an F reorganization with respect to one corporation and an A reorganization with respect to the other. See T.D. 9242, 2006-1 C.B. 422.

³⁵² 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 corporations will often trigger additional tax consequences under sections 367 and 897.³⁵³ 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."³⁵⁴

While F reorganizations were historically required to satisfy the COI and COBE requirements for reorganizations,³⁵⁵ proposed regulations finalized in 2005 provide that COI and COBE are no longer requirements for F reorganizations.³⁵⁶ As the

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 B target constituted an F reorganization); P.L.R. 2010-01-002 (Jan. 8, 2010) (transfer of interests by domestic parent's foreign subsidiary to new foreign entity qualifies as F reorganization, thereby avoiding the closing of subsidiary's taxable year and resulting restrictions under section 381); P.L.R. 2007-31-002 (Aug. 3, 2007) (foreign corporation's redomestication into U.S. corporation in order to utilize interest deduction for foreign tax purposes treated as F reorganization).

³⁵³ Notice 88-50, 1998-1 C.B. 535.

³⁵⁴ 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 Treas. Reg. §§ 1.269B-1, 1.367(b)-2(g).

³⁵⁵ 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. Commissioner*, 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).

³⁵⁶ Treas. Reg. § 1.368-1(b), *as amended by* T.D. 9182, 2005-1 C.B. 713. Prior to issuing the final regulations, IRS rulings indicated, at a minimum, a more lenient interpretation of the COI and COBE rules, and a continuing exemption from the step transaction doctrine, to

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; the usual concern that the continuing link between the target assets and the target shareholders would become too tenuous to support reorganization status is not present, because they do not resemble sales and involve only “the slightest change in a corporation”.³⁵⁷ Nevertheless, virtually identical shareholder interest between the reorganized and predecessor corporation remains important.³⁵⁸

Revenue Ruling 96-29, which foreshadowed the elimination of the COI and COBE requirements, held that 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.³⁵⁹ 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, and the COI requirement was apparently satisfied.³⁶⁰ In the second situation, W’s subsidiary Y

protect F reorganizations. *See* Rev. Rul. 96-29, 1996-1 C.B. 50; P.L.R. 1999-02-004 (Oct. 7, 1998).

³⁵⁷ 69 Fed. Reg. 49836 (Aug. 12, 2004).

³⁵⁸ *See* P.L.R. 2005-46-015 (Aug. 8, 2005). In the letter ruling, Corp A and Corp B formed new Corp C. Pursuant to a plan, in the first step merger Corp A merged downstream into Corp C and immediately after Corp A shareholders held 99% of Corp C’s stock. Corp B then merged downstream into Corp C. The IRS ruled the transaction qualified as an F reorganization, followed by a separate A reorganization. As one commentator has noted, however, if the single share of stock held by Corp B and the resulting failure to satisfy complete identity of shareholder interest was not a significant issue, it would have been outside of the IRS’s ruling policy to grant the ruling on the first step merger. *See* Debra J. Bennett, *Further Developments in Code Sec. 368(a)(1)(F) Reorganizations*, 84 Taxes 2, 7 (Feb. 2006). *See also* P.L.R. 2011-52-015 (Dec. 30, 2011) (redemption following a purported F reorganization did not prevent qualification as an F reorganization).

³⁵⁹ Rev. Rul. 96-29, 1996-1 C.B. 50.

³⁶⁰ Revenue Ruling 96-29 also raised issues that were subsequently resolved by the later issuance of Treasury Regulation sections 1.368-

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 has 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.³⁶¹

These rulings suggest that a putative F reorganization may be isolated from other related transactions to satisfy the F reorganization requirements, and prior or subsequent transactions need not be taken into account, even if those transactions occur as part of a single plan. 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.³⁶² This degree of isolation is unique to F

1(e)(1)(ii) and 1.368-1(e)(8), Ex. 9 (target corporation's redemption of shares with its own funds is consistent with preserving COI and is not treated as other property or money under section 356). *See* T.D. 8898, 2000-2 C.B. 271; P.L.R. 2006-21-011 (Feb. 10, 2006) (target corporation's redemption of shares with non-target funds constitutes other property or money under section 356); *see also* Robert Willens, *Will Pre-Merger Distributions Affect Continuity of Interest*, 25 Tax Mgmt. Weekly Rep. 1047 (July 10, 2006) (requesting IRS clarification on discrepancy between Example 9 and P.L.R. 2006-21-011 for prereorganization redemptions/distributions).

³⁶¹ *See, e.g.*, P.L.R. 1999-02-004 (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.

³⁶² *See, e.g.*, Rev. Rul. 69-516, 1969-2 C.B. 51, *obsoleted by* 69 Fed. Reg. 49836 (Aug. 12, 2004) (first step putative F reorganization of

reorganizations, and it stands in stark contrast to the IRS's general policy of invoking the step transaction doctrine to integrate a series of steps that are focused on a particular result.³⁶³ 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.³⁶⁴ Since nothing has happened from the IRS's point of view, isolating the non-transaction does no injury to the step transaction doctrine.

b. Proposed Regulations

Proposed regulations issued in 2004 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").³⁶⁵ As discussed below, the

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* Rev. Rul. 96-29, 1996-1 C.B. 50 (to apply only to F reorganizations); *see also* P.L.R. 2007-50-009 (Sept. 12, 2007) (restructuring preceding section 355 distribution treated as F reorganization); P.L.R. 1999-02-004 (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); P.L.R. 2001-29-024 (July 20, 2001) (F reorganization, effected simultaneously with sales of 4 out of 5 group businesses, was isolated and respected); P.L.R. 2011-26-006 (July 1, 2011) (target reincorporation in another state before merger into subsidiary of acquirer treated as F reorganization notwithstanding subsequent merger into subsidiary of acquirer).

³⁶³ *Penrod v. Commissioner*, 88 T.C. 1415 (1987); Rev. Rul. 96-29, 1996-1 C.B. 50. Only the section 338 rules turn off the step transaction doctrine in a similar manner and those rules apply in a much more limited context.

³⁶⁴ *See* Rev. Rul. 96-29, 1996-1 C.B. 50. This treatment essentially allows the IRS to ignore the F reorganization as a non-transaction.

³⁶⁵ *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* 69 Fed. Reg. 49836 (Aug. 12, 2004) (the last two requirements for a mere

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.³⁶⁶ Thus, a transaction that introduces a new shareholder or involves new capital generally cannot qualify as an F reorganization.³⁶⁷ Consequently, 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, although 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.³⁶⁸

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.³⁶⁹ An 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.³⁷⁰ By contrast, in another example an asset acquisition involving a target and acquirer incorporated in different states did not qualify as an F reorganization where the acquirer contributed cash equal to the target's value to a Newco, Target subsequently merged into Newco, and the target's shareholder exchanged its target stock for Newco's cash in the merger. The latter example concludes that the

change in form reflect the statutory requirement that an F reorganization involve only one operating corporation).

³⁶⁶ See Prop. Reg. § 1.368-2(m)(1)(i)(A), (ii)(b).

³⁶⁷ See 69 Fed. Reg. 49836 (Aug. 12, 2004).

³⁶⁸ See 69 Fed. Reg. 49836 (Aug. 12, 2004).

³⁶⁹ 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).

³⁷⁰ Prop. Reg. § 1.368-2(m)(5), Ex. 2.

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 completely redeemed.³⁷¹ 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, whereas all of the transferring corporation's stock was redeemed in the second, which exceeds the permitted redemption of part of the transferring corporation's stock.³⁷²

The third requirement provides that the transferring corporation must completely liquidate in the transaction, although it need not legally dissolve and it may retain a nominal amount of assets solely to preserve the corporation's legal existence.³⁷³ 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.³⁷⁴ Although the proposed regulations do not describe what would be considered nominal for this purpose, they state that the "sole" purpose of the exception is to allow preservation of the transferring corporation's legal existence. Accordingly, more than the minimal amount of assets necessary to preserve such existence may not be

³⁷¹ Prop. Reg. § 1.368-2(m)(5), Ex. 1.

³⁷² 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 Robert A. Rizzi, "‘Mere Transaction’: Are ‘F’ Reorganizations Really Reorganizations?," 31 J. Corp. Tax'n 6 (Nov/Dec 2004).

³⁷³ Prop. Reg. § 1.368-2(m)(1)(i)(C), (ii)(A). See *Overlap Transaction Debate Affecting IRS Thoughts on Regs for F Reorgs*, 2011 TNT 99-2 (May 23, 2011) (IRS has confirmed that "a certain amount of shrinkage [of assets] would be tolerated" and a transaction, where a conversion of a corporation to an LLC (disregarded from its parent), followed by the distribution of one (but not all) assets to the parent and then a re-conversion of the LLC back into a corporation, could arguably be (but was not) treated as an F reorganization). See also Michael L. Schler, Eric Solomon, Karen Gilbreath Sowell, Jonathan J. Katz & Gary Scanlon, *Updating the Tax-Free Reorganization Rules: Attributes, Overlaps and More*, Taxes—the Tax Magazine (Mar. 2012), 87 (discussing location of attributes in F reorganization context).

³⁷⁴ See 69 Fed. Reg. 49836 (Aug. 12, 2004).

considered nominal. The fourth requirement is that the resulting corporation must be devoid of property and tax attributes³⁷⁵ immediately before the transfer, except as described below.³⁷⁶

The proposed regulations permit taxpayers to structure transactions to separate cash distributions made in connection with F reorganizations from the putative F reorganization itself.³⁷⁷ 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 302.³⁷⁸ Because the distribution is separated, 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).

In addition to confirming that the step transaction doctrine will not be applied to prevent F reorganizations, the proposed

³⁷⁵ Tax attributes include section 381(c) tax attributes, *e.g.*, NOL carryovers, E&P, and capital loss carryovers. See Michael L. Schler, Eric Solomon, Karen Gilbreath Sowell, Jonathan J. Katz & Gary Scanlon, *Updating the Tax-Free Reorganization Rules: Attributes, Overlaps and More*, Taxes—the Tax Magazine (Mar. 2012), 87 (discussing location of attributes in F reorganization context).

³⁷⁶ Prop. Reg. § 1.368-2(m)(1)(i)(D).

The resulting corporation may hold or have held (i) a nominal amount of assets, 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. Prop. Reg. § 1.368-2(m)(1)(ii)(B); 69 Fed. Reg. 49836 (Aug. 12, 2004).

³⁷⁷ A cash distribution that occurs in the same step as a putative F reorganization would disqualify the F reorganization.

³⁷⁸ Prop. Reg. § 1.368-2(m)(4); Treas. Reg. § 1.301-1(l); 69 Fed. Reg. 49836 (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); P.L.R. 1997-43-001 (Oct. 27, 1997) (same). For an example of a private letter ruling permitting a redemption of a corporation's stock in connection with an F reorganization, see Private Letter Ruling 2010-14-048 (Apr. 9, 2010) and Jasper L. Cummings, Jr., *Repatriation: Insuring Basis Recovery*, Daily Tax Rep. (BNA) at J-1, May 7, 2010.

regulations adopt a very flexible approach to integration. 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, such that even related events that precede or follow a transaction, or series of transactions, that constitute a mere change will not affect qualification as an F reorganization.³⁷⁹ The proposed regulations also explicitly confirm that qualification as an F reorganization will not affect the treatment of a simultaneous larger transaction.³⁸⁰

The proposed regulations also would not combine two transactions to produce a merger that would fail to qualify as an F reorganization, such as a merger of two operating companies.³⁸¹ Consequently, a multiple step merger of an operating subsidiary into a holding company parent may satisfy the single operating company rule (assuming no single step involves the merger of two operating companies), whereas a direct merger between an operating subsidiary and its operating parent would not.³⁸²

³⁷⁹ Prop. Reg. § 1.368-2(m)(3)(ii); 69 Fed. Reg. 49836 (Aug. 12, 2004).

³⁸⁰ Prop. Reg. § 1.368-2(m)(3)(ii).

³⁸¹ See Prop. Reg. § 1.368-2(m)(5), Ex. 7 (operating target merged into operating subsidiary and parent corporation then reincorporated by merging into a new subsidiary in another state; reincorporation treated as 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).

³⁸² 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 *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 (M.D. Tenn. 1973), *aff'd per curiam*, 501 F.2d 1338 (6th Cir. 1974) (merger of operating subsidiary into operating parent is an 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*

Although it is not clear what level of operations would cause a corporation to be considered an operating company, a “functioning” corporation has been held to constitute an “operating” corporation, and the nature and degree of its activity was not determinative where it was not newly-formed and had assets and income.³⁸³

To avoid the single operating company limitation, the following multiple step transactions may be used to isolate a putative F reorganization involving a subsidiary from the combination of operating affiliates.³⁸⁴ In the first step, (i) parent may create a new subsidiary into which the existing subsidiary merges,³⁸⁵ (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,³⁸⁶ or (iii) the subsidiary may convert to a partnership and then elect to

Income Taxation of Corporations and Shareholders, ¶ 12.28[4] (7th ed. 2002).

³⁸³ T.A.M. 92-11-003 (Nov. 25, 1991) (merger of one operating company into another operating company at the same time as the merger of 21 other corporations into the acquiring operating company was not an F reorganization because both corporations were operating companies).

³⁸⁴ 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, 2003-1 C.B. 863 (conversions of mutual savings banks to stock savings banks qualified as F reorganizations, as well as B reorganizations and section 351 transfers).

³⁸⁵ See, e.g., P.L.R. 1999-02-004 (Oct. 7, 1998); P.L.R. 2001-29-024 (July 20, 2001); Prop. Reg. § 1.368-2(m)(5), Ex. 5.

³⁸⁶ 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) and see also Douglas W. Charnas, Thomas E. Taylor & Jonathan G. Neal, “*IRS Rules that ‘F’ Reorganization can be used to strip retained assets before sale*” Practical US/Domestic Tax Strategies, Feb. 2011 (a contribution followed by a liquidation is useful for stripping/isolating retained assets before a sale to a third party).

be treated as a corporation for federal income tax purposes.³⁸⁷ The resulting entity after any of these first step F reorganizations may subsequently liquidate or merge into the parent in a tax-free section 332 liquidation or an A reorganization.³⁸⁸ 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 related events before or after a putative F reorganization will not be integrated to preclude qualification as an F reorganization.³⁸⁹

Notably, and potentially of significant benefit to taxpayers seeking F reorganization treatment, the preamble to the proposed regulations provides that the words “however effected” in the statutory definition of an F reorganization indicate that Congress intended to treat a series of transactions that result in a mere change when stepped together as an F reorganization.³⁹⁰ To effect this intent, the proposed regulations would affirmatively apply the

³⁸⁷ 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); F.S.A. 2002-37-017 (June 7, 2002) (same result).

³⁸⁸ 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 (M.D. 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).

³⁸⁹ Prop. Reg. § 1.368-2(m)(3)(ii); see also Rev. Rul. 69-516, 1969-2 C.B. 51, *revoked by* 69 Fed. Reg. 49836 (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).

³⁹⁰ 69 Fed. Reg. 49836 (Aug. 12, 2004); Prop. Reg. § 1.368-2(m)(3)(i).

step transaction doctrine for the first time to integrate a series of steps to produce a valid F reorganization. This new rule is illustrated by an example in which parent's formation of a new subsidiary, contribution of the stock of a current subsidiary to the new subsidiary, and subsequent upstream subsidiary's merger into the new subsidiary, will be integrated to constitute a valid F reorganization.³⁹¹ The only limitation on this rule appears to be that F reorganization treatment would not be available when a redemption of all transferred corporation stock occurs in the same step.³⁹²

F. The "Substantially All" Requirement

The transferee in a C or A2D reorganization must "acquire" substantially all of the properties of the transferor, and the transferee in an A2E reorganization must "hold" substantially all of its and the target's (and target subsidiaries') assets after the merger.³⁹³ A transferee in a D reorganization must also acquire substantially all the target's assets.³⁹⁴ A surprising number of crucial questions remain unanswered regarding the determination of substantially all of a target's assets, notwithstanding the broad application of the requirement. As discussed below, the issues range from questions concerning the contours of the requirement and the "90/70" IRS safe harbor (discussed below) to the types of property that should be considered in determining when the requirement is satisfied and the extent to which distributions and

³⁹¹ Prop. Reg. § 1.368-2(m)(5), Ex. 5.

³⁹² See Prop. Reg. § 1.368-2(m)(5), Ex. 1.

³⁹³ See Treas. Reg. § 1.368-2(b)(2) (A2D reorganizations); Treas. Reg. § 1.368-2(j)(3)(iii) (A2E reorganizations); see generally Robert H. Wellen, *New Guidance Is Needed for the 'Substantially All' Rule as Applied to Acquisitions*, 79 J. Tax'n 280 (Nov. 1993); Robert H. Wellen, *More Problems Complicate the Application of 'Substantially All' to Acquisitions*, 79 J. Tax'n 366 (Dec. 1993).

³⁹⁴ See I.R.C. § 354(b)(1)(A); see, e.g., *Armour v. Commissioner*, 43 T.C. 295 (1965) (51% of the corporation's assets - all of its operating assets - qualified as substantially all where the retained liquid assets were distributed in liquidation as part of the same plan); *Moffat v. Commissioner*, 363 F.2d 262 (9th Cir. 1966); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970).

property substitutions, either before or after acquisitions, are consistent with the requirement.³⁹⁵

The substantially all requirement is itself not a bright-line test, and the respective values and types of the assets transferred and retained, and the reasons assets are retained, generally determine whether the substantially all requirement has been satisfied.³⁹⁶ As a general rule, the retention of assets to satisfy historic liabilities is looked upon favorably, while the retention of assets to make distributions or payments to shareholders, or to pay reorganization expenses, is not.

A safe harbor for satisfaction of the substantially all requirement, the so-called “90/70 test,” is set forth in Revenue Procedure 77-37.³⁹⁷ The safe harbor is a purely quantitative test that makes no distinction between business and nonbusiness and tangible and intangible assets. The 90/70 safe harbor requires simply that the target assets acquired in the reorganization “represent” at least (i) 90% of fair market value of the net assets and (ii) 70% of fair market value of the gross assets, held by the transferor immediately prior to the reorganization. However, for purposes of the 90/70 test, target assets that are distributed to target shareholders as part of the plan of reorganization will be treated as held by the target immediately before the reorganization but not acquired in the reorganization.³⁹⁸

In determining whether the 70% gross asset prong of the safe harbor is satisfied, total gross assets acquired are compared to the transferor’s historic gross assets; no particular subset of assets need be transferred. The only requirement is that at least 70% of the fair market value of the transferor’s historic assets must be acquired in the reorganization. It should be noted, however, that in the case of a transferor with little or no leverage, the gross asset

³⁹⁵ Rev. Rul. 2003-79, 2003-2 C.B. 80 (only controlled corporation’s assets at time of distribution are considered when applying substantially all requirement with respect to controlled’s post-distribution acquisition in putative C reorganization).

³⁹⁶ See, e.g., Rev. Rul. 57-518, 1957-2 C.B. 253 (nature of retained properties evaluated); *Peabody Hotel Corp. v. Commissioner*, 7 T.C. 600 (1946); *Smith v. Commissioner*, 34 B.T.A. 702 (1936).

³⁹⁷ Rev. Proc. 77-37, 1977-2 C.B. 568.

³⁹⁸ Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.01.

test will be eclipsed by the net asset test, which will serve as the operative threshold for the quantum of assets that must be acquired. Notably, the IRS has ruled privately that a target's payment of the cash portion of merger consideration (financed with new target debt) will not reduce the target's gross assets in an A2D reorganization.³⁹⁹ In connection with a D reorganization, the IRS has also ruled that a target corporation's redemption of minority shareholders through a tender offer and its payment of cash to other minority shareholders in the merger (in each case, financed by new target debt) did not affect the target's net or gross assets.⁴⁰⁰ Taxpayers attempting to qualify a reorganization of an insolvent entity outside of bankruptcy (where G reorganization treatment and its relaxed substantially all rule may be available) must be particularly wary of the gross asset test when assets leave corporate solution to satisfy creditors.

With respect to the 90% net asset requirement, the reference to "net assets" is properly understood to refer to a balance sheet determination of gross assets less gross liabilities, and the value of acquired gross (rather than net) target assets acquired is presumably compared with the target's historic net assets.⁴⁰¹ There is also no authority addressing the treatment of contingent target liabilities for purposes of the 90/70 safe harbor. In the absence of authority, the author believes that contingent liabilities should not properly be taken into account unless the present value of such liabilities can be reasonably estimated.

³⁹⁹ P.L.R. 2000-40-023 (July 7, 2000). *See generally* NYSBA, *Report on Distributions in Connection with Acquisitions*, reprinted in 2008 TNT 120-25 (discussing Private Letter Ruling 2000-40-023).

⁴⁰⁰ P.L.R. 2001-41-040 (July 17, 2001).

⁴⁰¹ The plain language of IRS ruling guidelines supports comparing *gross* assets transferred with 90% of a target's net assets. *See* Rev. Proc. 77-37, 1977-2 C.B. 568 (requirement satisfied by transfer of "assets representing at least 90 percent of the fair market value of the net assets"); Rev. Proc. 86-42, 1986-2 C.B. 722 (amplifying Rev. Proc. 77-37) (requiring representation that the transferee will acquire "at least 90 percent of the fair market value of the net assets" held by the transferor). A contrary interpretation requiring a transfer of net assets equal to 90% of a target's net assets would produce the unreasonably harsh result that a highly leveraged target corporation transferring virtually all of its assets and all of its liabilities could fail the "substantially all" test if, for example, it retains and utilizes a small amount of its gross assets to pay reorganization expenses.

Intangible assets, *e.g.*, goodwill, going concern value and certain contractual relationships, and tangible assets are both considered in computing the assets of a target corporation for purposes of the substantially all requirement.⁴⁰² In certain cases where intangible assets comprise the bulk of a target's value, substantially all of a target's assets may be acquired despite the fact that very few operating assets are acquired.⁴⁰³ Little authority exists as to whether property used but not owned by the target, or perhaps only any premium element attributable to the underlying use agreements, should be treated as assets for purposes of substantially all.⁴⁰⁴ The courts and the IRS apparently do not view personal attributes and services of shareholders as target assets, even if the attributes and services have been utilized by the target, as they have not been so treated in cases or rulings for substantially all purposes.

Payments by a target to shareholders before or after reorganizations are not treated as acquired assets for purposes of the substantially all test. Thus, if the target is the source of cash or other boot received by shareholders in a reorganization, the amount of such boot will reduce the acquired target assets in determining whether the 90/70 safe harbor and/or substantially all requirements are satisfied.⁴⁰⁵ For example, payments by the target to dissenters,⁴⁰⁶ payments to shareholders as extraordinary dividends⁴⁰⁷ in redemption of their target stock,⁴⁰⁸ and tax-free

⁴⁰² See, *e.g.*, *Nat'l Bank of Commerce of Norfolk*, 158 F. Supp. 887 (D.C. Va. 1958) (goodwill); Rev. Proc. 89-50, 1989-2 C.B. 631 (corporate charter).

⁴⁰³ See, *e.g.*, *Smothers v. Commissioner*, 642 F.2d 894 (5th Cir. 1981) (goodwill was 85% of value of target assets).

⁴⁰⁴ See *DeGroff v. Commissioner*, 54 T.C. 59 (1970) (exclusive license to manufacture, sales network and availability of services of employee-shareholders).

⁴⁰⁵ See Treas. Reg. § 1.368-2(j)(7), Ex. 2.

⁴⁰⁶ See Rev. Rul. 77-307, 1977-2 C.B. 117; Rev. Rul. 73-102, 1973-1 C.B. 186.

⁴⁰⁷ See Rev. Rul. 74-457, 1974-2 C.B. 122.

⁴⁰⁸ See Treas. Reg. § 1.368-2(j)(3).

distributions of stock pursuant to a spinoff⁴⁰⁹ will reduce the amount (and percentage) of target assets acquired for purposes of the substantially all requirement. Reorganization expenses borne by a target also reduce acquired assets.⁴¹⁰ Thus, a target that has recently spun-off assets will likely fail to satisfy the substantially all requirement. Care must be taken to confirm that substantially all the target's assets are indeed acquired, after reducing the proportion of the target's assets that are acquired by the aggregate amounts of each of the above described payments. In particular, redemptions are traps for the unwary that can easily be avoided by having the acquirer fund such redemptions (and other payments) to the extent necessary to avoid a substantially all problem.

The target may substitute properties for its historical assets in order to satisfy the substantially all requirement, as long as such substitute assets (including cash) are acquired in the transaction.⁴¹¹ Although such substitute assets would not provide continuity of business enterprise, it is usually possible to satisfy that requirement even when significant asset substitutions occur. The IRS has permitted pre-reorganization sales of significant target assets, crediting sales proceeds retained by the target toward the substantially all requirement.⁴¹²

Under certain limited circumstances, new equity investments in the target and borrowed funds may also replace distributed assets for purposes of satisfying the 90/70 safe harbor; the IRS has permitted an acquirer to guarantee and even provide loans to targets in acquisitive transactions subject to the substantially all requirement.⁴¹³ On the other hand, the value of

⁴⁰⁹ See *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1938), *cert. denied*, 305 U.S. 605 (1938).

⁴¹⁰ See Treas. Reg. § 1.368-2(j)(3).

⁴¹¹ See Treas. Reg. § 1.368-2(j)(3).

⁴¹² See Rev. Rul. 88-48, 1988-1 C.B. 117 (transaction not divisive because sales proceeds transferred to acquirer and sale was to party unrelated to target shareholders).

⁴¹³ See P.L.R. 88-17-007 (Aug. 12, 1987) (loan proceeds from acquirer used to purchase assets from affiliate for spinoff to shareholders explicitly treated as substitute target asset; loan treated as liability of target); P.L.R. 87-47-038 (Aug. 25, 1987) (third party loan guaranteed by acquirer replaced target assets used to fund redemption prior to reorganization; representations indicated loans

assets sold in close proximity to a reorganization will likely be included in the calculation of a target's historical assets if sales proceeds are not retained or are used to reduce target liabilities.

Although the IRS has permitted distributions of selected target corporation properties after an A2D acquisition,⁴¹⁴ distributions historically were not permitted after reverse triangular mergers because the statute language requires that the target must "hold" substantially all of its historic properties after an A2E reorganization. However, the IRS has clarified that the term "hold" is used rather than "acquire" merely because it would be inapposite to require a surviving corporation to acquire its own assets, and that the use of such term does not impose any requirement beyond what is required in a C or A2D reorganization, *i.e.*, that substantially all of the target's historic assets must be acquired in a merger.⁴¹⁵

In addition, the COBE regulations and the Final -2k Regulations address stock and/or asset transfers after an A2D or A2E reorganization. The acquiring corporation in an A2D reorganization generally may distribute acquired assets and/or contribute them to subsidiaries and the acquirer's stock may also be contributed to subsidiaries, provided that the aggregate asset transfers do not cause the acquirer to be treated as having liquidated for tax purposes (disregarding assets held by the acquirer prior to the reorganization), the acquirer remains a member of its parent's qualified group, and the acquisition satisfies COBE.⁴¹⁶ Similarly, the surviving corporation in an A2E reorganization generally may distribute assets and/or contribute them to subsidiaries and its stock may also be contributed to

unlikely to be repaid), *supplemented by* P.L.R. 88-09-008 and revoked on other grounds; *see also Reef Corporation v. Commissioner*, 24 T.C.M. 379 (CCH) (1965), *aff'd*, 368 F.2d 125 (5th Cir. 1966) (target distributed its liquid assets and replenished such assets with borrowed funds in connection with D reorganization).

⁴¹⁴ See G.C.M. 6111 (Dec. 18, 1974).

⁴¹⁵ See Rev. Rul. 2001-25, 2001-1 C.B. 1291 (acquired target sold 50% of its operating assets for cash and retained the proceeds); *see also* Rev. Rul. 2001-24, 2001-1, C.B. 1291 (citing S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970); making the sweeping statement that A2E and A2D reorganizations should be treated similarly).

⁴¹⁶ See Treas. Reg. § 1.368-1(d), -2(k).

subsidiaries, provided that the aggregate asset transfers do not cause the surviving corporation to be treated as having liquidated for tax purposes (disregarding any assets of the merger subsidiary), the surviving corporation remains a member of its parent's qualified group, and the acquisition satisfies COBE.⁴¹⁷

Unique issues are raised by inversion transactions, *e.g.*, transactions in which a parent corporation is acquired by its own subsidiary, and A2D reorganizations in which a target and its subsidiaries are acquired, regarding the treatment of the subsidiary stock previously owned by the parent for substantially all purposes.⁴¹⁸ One such issue that has been favorably resolved is whether a parent may distribute its previously owned subsidiary stock directly to its shareholders in connection with an inversion transaction without violating the substantially all requirement.⁴¹⁹

G. Two-Step Reorganizations

Historically, 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 are simply focused toward a particular end result.⁴²⁰ Recent developments regarding two-step mergers have

⁴¹⁷ See Treas. Reg. § 1.368-1(d), -2(k). For a detailed discussion of COBE and the Final -2k Regulations, see Sections I.B and I.C above. One commentator has stated that the COBE regulations and the Final -2k Regulations suggest that “substantially all” is only a momentary concept because, immediately after a reorganization, the acquiring company can distribute, transfer or sell acquired assets as long as certain requirements are satisfied.

⁴¹⁸ See Robert H. Wellen, *More Problems Complicate the Application of ‘Substantially All’ to Acquisitions*, 79 J. Tax’n 366 (Dec. 1993).

⁴¹⁹ See Rev. Rul. 78-47, 1978-1 C.B. 113 (distribution of former subsidiary's stock in connection with inversion qualifies as C reorganization).

⁴²⁰ See generally Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 12.61[3] (6th Ed. 1998); S. Mintz & W. Plumb, Jr., *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. Inst. on Fed. Tax'n 247-48 (1954).

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. Commissioner*, 88 T.C. 1415 (1987). The binding

broadly applied the doctrine, facilitating satisfaction of the requirements for certain tax-free reorganizations and creating flexibility for taxpayers seeking tax-free reorganization treatment in contrast to the more limited application of the step transaction doctrine to post-reorganization dropdowns and pushups of stock and assets in order to isolate and protect tax-free reorganizations.

1. Tender Offers and Back End Mergers

One of the first two-step reorganization structures the IRS blessed is a tender offer followed by a back end merger, which is an approach often used when a consensual deal cannot be reached with the target. Although 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,⁴²¹ 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.⁴²² Revenue

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., *Commissioner 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).

⁴²¹ See *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995).

⁴²² Historically, it was not 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). See Treas. Reg. § 1.368-2(j)(3)(i), (ii). See also Robert Willens, *Squeeze-Out Mergers: Form Controls (Except when it Doesn’t)* (in the case of an acquisition of less than 80 percent of a target’s stock, the direction of a squeeze-out merger (forward or reverse) after a tender offer arguably should not matter); in the case

Ruling 2001-26 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.⁴²³

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.⁴²⁴

of an acquisition of at least 80% of the target stock in a tender offer for which no section 338 election is made, the acquirer should be afforded status as a historical shareholder under Treas. Reg. § 1.338-3(d), facilitating the satisfaction of the COI requirements; Rick Bailine, *A Trap for the Unwary in COI Regs*, The Tax Adviser (Apr. 2011) (a qualified stock purchase followed by a reorganization presents no COI concern, but a reorganization followed by a qualified stock purchase may well present significant COI concerns).

⁴²³ Rev. Rul. 2001-26, 2001-1 C.B. 1297 (citing *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969)). 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. 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. See also Robert Willens, *Failed But Not Forgotten: The Sequenom Tax*, CFO.com (Feb. 19, 2009), available at <http://www.cfo.com/article.cfm/13166032> (discussing failed takeover attempt of EXACT Sciences by Sequenom using tender offer followed by A2E).

⁴²⁴ *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969). 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. Believing that the acquirer intended the second step upstream merger from the outset, the court held that the two transactions constituted a unified A reorganization, since more than 50% of the target shareholders’ consideration was acquirer stock, and the acquirer held the target assets after the transactions. *King Enterprises v. United States*, 418 F.2d 511, 519 (Ct. Cl. 1969). Although the transferring

Revenue Ruling 2001-26 assumes away the question of the appropriate step transaction test to apply 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.⁴²⁵ 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 integrate two steps to create a tax-free reorganization, even if the first transaction was not conditioned on the occurrence of the second step merger. This result represents a significant expansion of the government's historical approach of requiring a common acquirer and target plan for integration.⁴²⁶

2. Double Mergers

a. Second Step Upstream Mergers

In Revenue Ruling 2001-46, the IRS addressed the potential integration of a first-step qualified stock purchase (a "QSP") with another transaction.⁴²⁷ 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

shareholders were apparently not consulted with respect to, and appeared to have no knowledge of, the intended second step upstream merger, the court was not troubled by the lack of a formal, bilateral plan that included both transactions and held that the relevant facts and circumstances demonstrated the existence of the requisite plan. *King Enterprises v. United States*, 418 F.2d 511, 519 (Ct. Cl. 1969) (citing *William H. Redfield*, 34 B.T.A. 967 (1936)).

⁴²⁵ See *Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001) (discussing Revenue Ruling 2001-26).

⁴²⁶ 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 liquidation may not be considered independently and will be recast as a C, rather than A2D, reorganization).

⁴²⁷ Rev. Rul. 2001-46, 2001-2 C.B. 321.

2001-46 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.⁴²⁸ Nevertheless, it is fair to conclude that the ruling represents the government's view of at least one situation in which step transaction principles will apply.⁴²⁹ Like the *King Enterprises* case, the application of step transaction in Revenue Ruling 2001-46 focuses on the end result test and does not appear to require a specific connection between the two transactions, since the ruling does not discuss a connection, or even confirm that any connection exists.⁴³⁰

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.⁴³¹ 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 integration would contravene section 338 policy.⁴³²

⁴²⁸ See *Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001) (discussing Revenue Ruling 2001-26).

⁴²⁹ Revenue Ruling 2004-83, 2004-2 C.B. 157, is another 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.

⁴³⁰ *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

⁴³¹ See Rev. Rul. 2001-46, 2001-2 C.B. 321.

⁴³² 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. Commissioner*, 104 T.C. 75 (1995). The description of this policy in the legislative history to section 338 provides that, as Congress

By contrast, 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 section 338 (such approach, the “non-integration exception”).⁴³³ 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 concludes that an exception to the non-integration exception is warranted where it would not frustrate Congress’s intention that section 338 serve as the only means of treating a stock purchase as an asset purchase.⁴³⁴

When a QSP and subsequent upstream merger would constitute a taxable asset transfer if integrated, section 338 policy

intended, section 338 serves as the only means – statutory or otherwise – to recharacterize a stock purchase as an asset purchase. H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

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 QSP.

⁴³³ Rev. Rul. 90-95, 1990-2 C.B. 67; Treas. Reg. § 1.338-3(d).

To protect section 338 policy, the IRS created this exception to the *Kimbell-Diamond* approach in order to step together stock purchases and subsequent upstream mergers and liquidations into asset acquisitions. See, e.g., *Kimbell-Diamond v. Commissioner*, 14 T.C. 74 (1950), *aff’d per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951).

⁴³⁴ Rev. Rul. 2001-46, 2001-2 C.B. 321 (citing H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982)). 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 it 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 unless doing so would frustrate another express policy. See also P.L.R. 2009-45-004 (Nov. 6, 2009) (QSP followed by prearranged upstream merger was not integrated where COI was not satisfied). See generally Robert Willens, *When to Collapse an Acquisition Merger and Upstream Merger*, 125 Tax Notes 1363 (Dec. 21, 2009) (concluding that integration is appropriate only when recasting the transaction produces a tax-free reorganization).

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.⁴³⁵ 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.⁴³⁶ 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.⁴³⁷

In response to practitioners' concerns, the government created another elective exception to the integration exception in

⁴³⁵ 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.

⁴³⁶ *Accord* NYSBA, *Report Responding to Rev. Rul. 2001-46, Dealing with Multi-Step Acquisitions*, reprinted in 2002 TNT 142-18 (July 23, 2002).

⁴³⁷ 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.

If a section 338 election is made, the second step upstream merger will qualify as an A reorganization for all target shareholders, because the minority target shareholders could qualify as historic shareholders of the new target corporation created by reason of the section 338 election. See Treas. Reg. § 1.338-1(b) (target treated as a new corporation for all income tax purposes after section 338 election). By contrast, absent a section 338 election, the upstream merger may not qualify as an A reorganization if the cash consideration in the first step merger precludes continuity of interest. 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). In that case, the target and acquirer would receive tax-free treatment under the anti-*Yoc Heating* regulations, but minority target shareholders would recognize gain on their exchange of target stock for acquirer stock. See Treas. Reg. §§ 1.368-1(e)(1)(i), (e)(6), Ex. 4; 1.338-3(d); 1.332-5; *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

Revenue Ruling 2001-46.⁴³⁸ Thus, even when an integrated stock acquisition and subsequent upstream merger or liquidation would qualify as a tax-free reorganization, possibly precluding 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 acquisition that constitutes a QSP.⁴³⁹ This election responds to the concern that Revenue Ruling 2001-46's integration of a QSP and a subsequent upstream merger may preclude a section 338(h)(10) election for the QSP because it is disregarded as part of the integrated reorganization.⁴⁴⁰ If the election is made, the second step liquidation or upstream merger will generally be treated as a separate transaction, restoring the result in Revenue Ruling 90-95 and Treasury Regulation section 1.338-3(d) on an elective basis.⁴⁴¹ 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 represents a significant departure from the traditional definition of form over substance.⁴⁴²

⁴³⁸ The exception in Revenue Ruling 2001-46 is itself an exception to the original non-integration exception provided in Revenue Ruling 90-95 and Treasury Regulation section 1.338-3(d).

⁴³⁹ Treas. Reg. § 1.338(h)(10)-1(c)(2) and (e), Ex. 11-13. *See also* P.L.R. 2010-07-045 (Nov. 18, 2009) (deemed transfer of stock constituted a QSP, resulting in availability of section 338(h)(10) election). *See generally* Robert Willens, *Foreclosure Doubles as a 'Qualified Stock Purchase'*, 44 Daily Tax Rep. (BNA), at J-1 (Mar. 9, 2010) ("In short, the provisions of Section 338 are 'elective' in the sense that they are available to any corporate taxpayer who structures, 'properly,' the acquisition of the stock of another corporation."); Robert Willens, *Step Transaction Doctrine Will Not Prevent Step-Up*, 112 Tax Notes 371 (July 24, 2006).

⁴⁴⁰ *See* T.D. 9071, 2003-2 C.B. 560; 68 Fed. Reg. 40848 (July 9, 2003).

⁴⁴¹ *See* Treas. Reg. § 1.338(h)(10)-1(c)(2) and (e), Ex. 12.

⁴⁴² 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 would 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.

Electivity extends only to water's edge, however, as it does not appear that a taxpayer can elect to "turn off" the step transaction doctrine in transactions involving foreign targets. The current regulations only apply to a section 338(h)(10) election, which is not available to foreign targets.⁴⁴³ Kim Blanchard has suggested that the IRS conform the treatment of domestic and foreign targets in this respect, extending the section 338(h)(10) treatment to section 338(g) elections.⁴⁴⁴

3. Variations on Double Mergers

a. No First Step Qualified Stock Purchase

No authority explicitly addresses 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.⁴⁴⁵ 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 disavowing 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

⁴⁴³ See I.R.C. § 338(h)(10)-1.

⁴⁴⁴ See Kimberly S. Blanchard, *Cross-Border Acquisition Patterns Implicating § 338: Recommendations for Reform*, 785 PLI/TAX 911, 926-27 (2008) (recommending step transaction principles be turned off when making a section 338(g) election); see also *Attorney Calls for Extension of Regs on Certain Elections in Multistep Transactions*, 2005 TNT 168-13 (Aug. 31, 2005) (Kim Blanchard recommended that step transaction "turn off" apply to both section 338(h)(10) and section 338(g) elections).

⁴⁴⁵ 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 related party. See I.R.C. § 338(d)(3); Treas. Reg. § 1.338-3(b)(2). 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.

consistent with the government's broader approach to reorganizations, although no authority so states.⁴⁴⁶

By contrast, if these integrated transactions would not constitute an A reorganization, either because integration would not be permitted, or because the resulting 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.⁴⁴⁷ This issue is no longer as important as it was before the repeal of *General Utilities*, when an integrated asset transfer produced a tax-free asset basis step up. Any step up in asset basis would now have a net present value cost, so if *Kimbell-Diamond* survives in the absence of a first step QSP, it may be largely as a high stakes trap for unwary taxpayers.⁴⁴⁸ The better answer 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.⁴⁴⁹

⁴⁴⁶ Cf. Rev. Rul. 2001-26, 2001-1 C.B. 1297; Rev. Rul. 2001-46, 2001-2 C.B. 321.

⁴⁴⁷ 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 permitted 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. See H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982); *Kimbell-Diamond v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951). See Rev. Rul. 90-95, 1990-2 C.B. 67; H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982).

⁴⁴⁸ Potential for whipsaw would still exist if all parties to the transaction are not subject to the same treatment, and there is no requirement of consistent treatment for all parties to a transaction. See, e.g., *Pressed Steel Car Co. v. Commissioner*, 20 T.C. 198 (1953); *Dallas Downtown Dev. Co. v. Commissioner*, 12 T.C. 114 (1949); *Steubenville Bridge Co. v. Commissioner*, 11 T.C. 789 (1948).

⁴⁴⁹ 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

b. 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. This could be a costly mistake, because regulations and a recent revenue ruling now confirm that the A reorganization treatment accorded an integrated reverse subsidiary merger and subsequent upstream merger in Revenue Ruling 2001-46 would not be available if a reverse subsidiary merger is followed by a second step liquidation rather than an upstream merger.⁴⁵⁰

section 332). Separate transaction treatment would be consistent with the IRS's approach in Revenue Ruling 75-521, in which the IRS treated two sequential stock purchases as separate from a later section 332 liquidation.

⁴⁵⁰ See Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 10; Rev. Rul. 2008-25, 2008-1 C.B. 986; *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 must be tested as a C, rather than A2D, reorganization). *See generally* Robert Willens, 'Stepping' Out of a Reorganization, 2008 TNT 117-50 (June 17, 2008).

In theory, this formalistic concern should not prevent A reorganization treatment for integrated transactions that include liquidations; once the government is prepared to apply step transaction principles to collapse the two transactions, there should be no bar to recasting the transactions as a direct merger of target into acquirer for all tax purposes. If the A reorganization requirements are applied to such a deemed direct merger, the acquirer would qualify as a party to the reorganization, and the merger would generally satisfy all other applicable requirements, without regard to the intervening liquidation. Despite the logic of this approach, the government has chosen not to disregard 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.

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'". *See* 69 Fed. Reg. 9771 (Mar. 2, 2004), *citing* H.R. Rep. No. 83-1337 at A134 (1954); Treas. Reg. § 1.368-1(d)(1). More generally, this reorganization policy has been

In Revenue Ruling 2008-25,⁴⁵¹ a parent corporation acquired all of a target corporation's outstanding stock in a part-cash reverse subsidiary merger and then liquidated the target in a related transaction that did not involve a statutory merger. Citing Revenue Rulings 2001-46 and 67-274,⁴⁵² the IRS determined that the two steps could not be analyzed independently of each other for purposes of determining whether the acquisition qualified as a reorganization. Accordingly, while parent stock represented 90% of the consideration delivered in the reverse subsidiary merger, the acquisition did not qualify as an A2E reorganization because the target did not hold substantially all of its and the merger subsidiary's assets after the second step of the transaction. The acquisition also failed to satisfy any of the other reorganization provisions.⁴⁵³

interpreted as ensuring 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.

⁴⁵¹ 2008-1 C.B. 986. *See generally* Michael L. Schultz, *Rev. Rul. 2008-25: More Step Transaction Confusion*, 125 Tax Notes 83 (Oct. 5, 2009) (criticizing Revenue Ruling 2008-25 as “another example of a more or less automatic application of the step transaction doctrine” without regard to “the policies of the relevant rules”). *See also* Robert Willens, *Did IRS Misuse ‘Step’ Doctrine in Revenue Ruling 2008-25*, Daily Tax Rep. (BNA) at J-1 (May 24, 2010) (noting that, relying on the *American Potash & Chemical* case, “a qualifying stock acquisition should not be denied such status on step transaction doctrine grounds because the integrated transaction (taking the ensuing liquidation into account) does not constitute a qualifying acquisition of assets”, the author believes that the transaction analyzed in Rev. Rul. 2008-25 should have been categorized as a tax-free stock acquisition (except to the extent of boot) followed by a Section 332 liquidation).

⁴⁵² *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).

⁴⁵³ *See* Rev. Rul. 2008-25, 2008-1 C.B. 986. In particular, the IRS noted that the acquisition failed to qualify as (i) an A reorganization because the target did not merge into the parent corporation, (ii) a C reorganization because the cash consideration precluded compliance

Consistent with Revenue Ruling 90-95 and Treasury Regulation section 1.338-3(d), the government did not integrate the reverse subsidiary merger and related liquidation to produce a taxable asset sale and cost basis in the target's asset, since that result would be inconsistent with section 338 policy.⁴⁵⁴ Instead, the government analyzed each step separately and treated the reverse subsidiary merger as a QSP and the second step liquidation as a tax-free complete liquidation under section 332.⁴⁵⁵

with the "solely for voting stock" test, and the acquisition did not satisfy the limited boot rule in section 368(a)(2)(B), (iii) a D reorganization because neither the target nor its sole shareholder (nor a combination thereof) was in control of the parent (within the meaning of section 368(a)(2)(H)(i)) immediately after the transfer, or (iv) a section 351 exchange because the target's sole shareholder did not control the parent (within the meaning of section 368(c)) immediately after the transfer. *See* Rev. Rul. 2008-25, 2008-1 C.B. 986.

As discussed above, the government previously announced that it was considering whether a stock acquisition followed by a conversion of the acquired corporation to a DE and/or by a change in the entity classification of the acquired entity from a corporation to a DE, should constitute an A reorganization. *See* T.D. 9242, 2006-1 C.B. 422; *see* American Bar Association, *Comments on Final Regulations Defining the Term "Statutory Merger or Consolidation"*, reprinted in 2007 TNT 113-21 (June 12, 2007) (stock purchase and related conversion should constitute an integrated A reorganization under current law; stock purchase and related check-the-box liquidation should not); NYSBA, *Section 368(a)(1)(A) Regulations Defining a "Statutory Merger or Consolidation"*, reprinted in 2006 TNT 200-17 (Oct. 17, 2006) (neither target's second step conversion nor its check-the-box liquidation should be integrated with related purchase of target stock and tested as an A reorganization under current law; both transactions lack necessary predicate of state law merger). *See also* C. Ellen MacNeil, Mary Baker, Josh Odintz, Eric Solomon & Del Threadgill, *Issues in Domestic Tax Reform*, Taxes—the Tax Magazine (June 2010), 67 (the administration continues to be concerned about abuses of the check-the-box rules).

⁴⁵⁴ Rev. Rul. 2008-25, 2008-1 C.B. 986. *See* discussion of this issue in Section II.B.1. above.

⁴⁵⁵ *See* Rev. Rul. 2008-25, 2008-1 C.B. 986.

c. 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 an acquirer LLC, a “disregarded entity”), rather than into the acquirer itself, as part of a single plan. 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.⁴⁵⁶ Moreover, a merger with an acquirer’s disregarded entity, like an upstream merger, would be tested as an A reorganization.⁴⁵⁷ 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 also generally supports testing an integrated second step merger into a disregarded entity as an A reorganization. It notes that the government was asked to confirm that the C reorganization treatment of an integrated A2D merger and subsequent liquidation of the surviving subsidiary 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.⁴⁵⁸ The preamble confirms that the merger of a disregarded entity into its sole shareholder will be disregarded because it does not “alter the tax identity of the tax owner of the former [target] assets”. This conclusion strongly supports treating a second step merger into a disregarded entity as tantamount to an upstream merger into the acquirer that would be tested as an A reorganization.

⁴⁵⁶ See Treas. Reg. § 301.7701-2(c)(2).

⁴⁵⁷ See T.D. 9038, 2003-1 C.B. 524.

⁴⁵⁸ See Rev. Rul. 72-405, 1972-2 C.B. 217.

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 create tax-free reorganizations to the extent consistent with reorganization policy.⁴⁵⁹ 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.⁴⁶⁰ Nonetheless, if the IRS were to test the integrated transactions as a C reorganization, a transaction that would not so qualify should be treated as a stock acquisition followed by a separate liquidation; the transactions should not be integrated to produce a taxable asset transfer.⁴⁶¹

d. Second Step Sideways Mergers

Commentators have suggested extending integrated transaction treatment to an otherwise taxable reverse subsidiary merger followed by a cross-chain merger of the target into another acquirer subsidiary if and when the integrated transaction would

⁴⁵⁹ See Treas. Reg. § 1.368-2(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 Treas. Reg. § 1.368-2(b)(1)(ii).

⁴⁶⁰ See *Step Transaction Doctrine Tested under Corporate Rulings*, 2001 TNT 196-3 (Oct. 9, 2001).

⁴⁶¹ 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).

qualify as an A2D reorganization.⁴⁶² 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 treatment of a first step stock acquisition as a separate taxable stock purchase in the case of a failed A2D reorganization would effectively permit taxpayers to utilize forward subsidiary mergers without the risk of corporate level tax.⁴⁶³

The IRS has ruled that a forward triangular merger followed by drop-downs of the acquirer's stock and a subsequent sideways merger of the acquirer with an affiliate of the issuing corporation would be treated as independent transactions.⁴⁶⁴

⁴⁶² See, e.g., Glen Kohl & Lea Anne Storum, *M&A Double Take: Why Two Mergers Are Better Than One*, 5 The M&A Lawyer 23 (Jan. 2002).

⁴⁶³ 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 it 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. Consistent with reorganization policy, the target could (and should) be deemed to merge directly into the acquirer subsidiary that will ultimately hold the target assets.

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.*, 30 J. Corp. Tax'n 32 (May/June 2003).

⁴⁶⁴ See P.L.R. 2008-42-029 (Oct. 17, 2008); see also Robert Willens, *Preserving Reorganization Treatment*, 2009 TNT 20-48 (Feb. 3, 2009).

H. Reorganizations Involving Affiliated Corporations

1. Upstream Mergers

There are several basic forms of upstream mergers, each of which is treated separately for tax purposes. The parent's tax consequences when an 80% owned subsidiary is liquidated are governed by the section 332 nonrecognition subsidiary-liquidation rules.⁴⁶⁵ Minority shareholders would receive tax-free A reorganization treatment if the parent's ownership were old and cold.⁴⁶⁶ The parent takes a carryover basis in the subsidiary's assets.⁴⁶⁷ Where the parent is a pure holding company, an upstream merger may also constitute an F reorganization.⁴⁶⁸ As discussed in Section G.3 below, insolvent subsidiaries are ineligible for tax-free upstream mergers and liquidations, and cannot be made eligible for tax-free treatment by a capital contribution immediately before the merger.

Where the parent purchases 80% or more of the stock of a target and immediately merges the purchased target upstream, the upstream merger may fail to satisfy the COI requirement, and such a merger may therefore fail to qualify as an A reorganization under section 334(b)(1).⁴⁶⁹ If the parent is a pure holding company, the transaction may nonetheless qualify as an F reorganization, which is not subject to the COI requirement.⁴⁷⁰ If reorganization

⁴⁶⁵ See I.R.C. § 332(b); Treas. Reg. § 1.332-2(d); *Kansas Sand & Concrete, Inc. v. Commissioner*, 462 F.2d 805 (10th Cir. 1972). But see Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of more than 80%-owned subsidiary treated as A reorganization to all parties; section 332 could not apply because of subsequent contribution of subsidiary's assets).

⁴⁶⁶ See I.R.C. § 354; Rev. Rul. 69-617, 1969-2 C.B. 57.

⁴⁶⁷ See I.R.C. § 334(b)(1).

⁴⁶⁸ See *Movielab, Inc. v. United States*, 494 F.2d 693 (Ct. Cl. 1974); *Performance Systems, Inc. v. United States*, 501 F.2d 1338 (6th Cir. 1974); *Eastern Color Printing Co. v. Commissioner*, 63 T.C. 27 (1974); Rev. Rul. 75-561, 1975-2 C.B. 129; cf. *Casco Products Co. v. Commissioner*, 49 T.C. 32 (1967).

⁴⁶⁹ See Rev. Rul. 90-95, 1990-2 C.B. 67; *Superior Coach of Fla. v. Commissioner*, 80 T.C. 895 (1983).

⁴⁷⁰ See Treas. Reg. § 1.368-1(b).

treatment is unavailable, minority shareholders will not benefit from tax-free treatment, although the parent and subsidiary will be protected from tax by sections 332 and 337, respectively. The parent would receive a carryover basis in the acquired assets, and would succeed to the subsidiary's tax attributes.⁴⁷¹

A purchase of less than 80% of a subsidiary's stock followed by an all stock merger may qualify as a tax-free reorganization, without regard to whether both transactions are viewed as part of a single plan, assuming that continuity of interest is satisfied.⁴⁷² In such case, the merger would be tax-free to the parent and the subsidiary, and to the subsidiary shareholders who receive parent stock in exchange for their subsidiary shares.⁴⁷³ However, if such a transaction failed to qualify as a tax-free reorganization, all parties, *i.e.*, parent, subsidiary and subsidiary shareholders, would be subject to tax.

2. Downstream Mergers

The term "downstream merger" is used to describe a merger of a parent corporation into its subsidiary. Although downstream mergers have been the subject of intense scrutiny by the IRS, tax-free reorganization treatment continues to be extended to downstream mergers. This treatment will likely continue unless and until regulations are issued under section 337(d) subjecting downstream mergers to tax. The IRS has historically conceded that mergers of an operating parent into its operating subsidiary

⁴⁷¹ The IRS has taken the position that a liquidation of a subsidiary under section 332 does not result in a liquidation of any lower-tier subsidiaries received by the parent in the liquidation. *See* C.C.A. 2002-30-026 (Apr. 15, 2002).

⁴⁷² As discussed above, taxpayers may not be able to avoid application of step transaction principles in multi-step transactions involving foreign targets, as authorities turning off the step transaction doctrine appear to apply only in the domestic context. *See* Kimberly S. Blanchard, *Cross-Border Acquisition Patterns Implicating § 338: Recommendations for Reform*, 785 PLI/TAX 911, 926-27 (2008).

⁴⁷³ The receipt of boot by subsidiary shareholders would, of course, be taxable to the recipients up to the amount of gain realized in the transaction. If the upstream merger does not qualify as a reorganization, subsidiary shareholders will also be subject to tax with respect to parent stock received in the merger.

qualify as A reorganizations;⁴⁷⁴ such reorganizations should also qualify as D reorganizations. Even when the parent owns less than 80% of the subsidiary's stock, and such stock is its principal asset, tax-free reorganization treatment should be available.⁴⁷⁵ A downstream merger may also qualify as a C or a nondivisive D reorganization,⁴⁷⁶ which provides important flexibility for foreign corporations.

I. Reorganizations Involving Insolvent Corporations

1. Current Law

Upstream mergers of insolvent subsidiaries generally cannot be accomplished in a tax-free manner. Section 332 does not apply to a liquidation of an insolvent subsidiary and A

⁴⁷⁴ See, e.g., Rev. Rul. 70-223, 1970-1 C.B. 79, P.L.R. 2010-16-051 (Apr. 23, 2010) (downstream merger of holding company into a non-wholly owned subsidiary treated as an A reorganization); P.L.R. 2010-20-008 (Feb. 19, 2010) (downstream merger of holding company into a wholly owned subsidiary treated as an A reorganization); P.L.R. 2011-09-002 (Mar. 4, 2011) (downstream merger of parent into a disregarded entity owned by a direct subsidiary of parent treated as an A reorganization). See also Robert Willens, *HLTH Corp. Set to Modify its Corporate Structure with 'Downstream' Merger*, 227 Daily Tax Rep. (BNA), at J-1 (Nov. 27, 2007) (HLTH Corp.'s downstream merger into WebMD Health Corp. should qualify as A reorganization).

⁴⁷⁵ See Rev. Rul. 78-47, 1978-1 C.B. 113 (downstream asset transfer to 5%-owned subsidiary followed by parent liquidation qualified as a C reorganization).

⁴⁷⁶ See Rev. Rul. 57-465, 1957-2 C.B. 250; P.L.R. 2009-10-026 (Mar. 6, 2009); P.L.R. 2007-47-006 (Nov. 23, 2007); P.L.R. 2007-09-037 (Mar. 2, 2007); P.L.R. 2005-15-012 (Apr. 15, 2005). See also Robert Willens, *Downstream Transfer Qualifies as Reorganization*, 123 Tax Notes 107 (Apr. 6, 2009) (downstream reorganization qualified as C reorganization, but gain recognized on distribution of subsidiary shares and other appreciated property to target shareholders); Robert Willens, *'Downstream' Transactions Will Not Be Recast as Liquidations*, 234 Daily Tax Rep. (BNA), at J-1 (Dec. 6, 2007) (IRS will not recast downstream reorganization as liquidation, even when parent's only asset on the transfer date is the acquiring subsidiary's stock; discusses Private Letter Ruling 2007-47-006).

reorganization treatment is also not available.⁴⁷⁷ Further, taxpayers cannot cure a subsidiary's insolvency in anticipation of a tax-free reorganization by making a capital contribution immediately before the merger.⁴⁷⁸

Special considerations apply to sideways mergers of insolvent subsidiaries into sister corporations. For example, it is not always clear who the owners of the proprietary interests in an insolvent company are, which can make satisfaction of the COI requirement difficult.⁴⁷⁹ However, when the parent corporation of an insolvent subsidiary is also a creditor, the COI requirement may be more clearly satisfied and a sideways merger may be accomplished as a tax-free reorganization.⁴⁸⁰ In addition, the IRS

⁴⁷⁷ See Treas. Reg. § 1.332-2(b) (section 332 applies to “only those cases in which the recipient corporation receives at least partial payment for the stock it owns” in the liquidating subsidiary); *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941) (applying section 332 predecessor, tax-free liquidation not available because no property received in cancellation of stock); *Spaulding Bakeries, Inc. v. Commissioner*, 252 F.2d 693 (2d Cir. 1958), *aff'g*, 27 T.C. 684 (1957) (section 332 requires a distribution on each class of subsidiary stock held by the parent); Rev. Rul. 59-296, 1959-2 C.B. 87 (neither section 332 nor section 368(a)(1)(A) available for upstream merger of insolvent subsidiary); Rev. Rul. 70-489, 1970-2 C.B. 53 (same); Rev. Rul. 2003-125, 2003-2 C.B. 1249 (superceding Revenue Ruling 70-489, but applying the same result to a deemed liquidation resulting from an election under Treasury Regulation section 301.7701-3). See also C.C.A. 2008-18-005 (May 2, 2008) (deemed liquidation of target in connection with section 338(h)(10) election did not qualify under section 332 where target would not have been solvent but for seller's cancellation of debt owed to it by target's subsidiary); Jasper L. Cummings, Jr., *How to Sell an Insolvent Subsidiary (Very Carefully)*, 94 Daily Tax Rep. (BNA), at J-1 (May 15, 2008).

⁴⁷⁸ See Rev. Rul. 68-602, 1968-2 C.B. 135 (applying step transaction principles to disregard the capital contribution).

⁴⁷⁹ When a corporation is insolvent, its creditors may instead be treated as the proprietary interest holders because of their priority over equity holders in bankruptcy. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 183 (1942) and *Ralphs Grocery Co. et al. v. Commissioner*, T.C. Memo. 2011-25.

⁴⁸⁰ See *Norman Scott v. Commissioner*, 48 T.C. 598 (1967) (COI satisfied in merger of two insolvent sister corporations because

proposed regulations that generally require an exchange of acquiring subsidiary stock that has value for the stock or assets of the target subsidiary in all reorganizations.⁴⁸¹ Taxpayers must also be wary of the substantially all requirement applicable to C, A2D and A2E reorganizations when assets need to be transferred out of the target corporation to satisfy creditors. Sideways restructurings structured as putative A or C reorganizations may be more easily qualified as D reorganizations because of the relaxed standards of control, and more lenient COI and substantially all tests in a D reorganization, as discussed in Section I.D.4. above.⁴⁸²

insolvent target shareholders received a proprietary interest in the acquiring corporation either as shareholders or creditors); *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir. 1968) (COI was satisfied where an insolvent corporation controlled by individual A merged into another corporation that was 1/6 owned by A; court concluded only that A received acquirer stock as either a creditor or shareholder).

⁴⁸¹ 70 Fed. Reg. 11903 (Mar. 10, 2005) (section 332 principles apply to reorganizations based on the language of sections 354 and 361, which relate, respectively, to tax treatment of an exchange of target stock for acquirer stock and exchange of target assets for acquirer stock). See NYSBA, *Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations*, reprinted in 2006 TNT 15-10 (Jan. 24, 2006) (discussing section 368 stock exchange requirement under current law).

⁴⁸² See, e.g., *Seiberling Rubber Co. v. Commissioner*, 169 F.2d 595 (6th Cir. 1948) (a transaction unable to qualify as another type of reorganization qualified as D reorganization); see, e.g., Rev. Rul. 70-240, 1970-1 C.B. 81 (sale of operating assets to a sister corporation for cash used to pay liabilities, followed by liquidation and distribution of remaining proceeds to a common shareholder, qualifies as D reorganization despite failure to satisfy ordinary COI requirements); Rev. Rul. 2004-83, 2004-2 C.B. 157 (transfer of subsidiary stock to another subsidiary followed by target subsidiary's liquidation qualified as D reorganization).

Revenue Ruling 70-240 addressed the D reorganization requirement that section 354 apply to a distribution by reasoning that an issuance and distribution in the case of 100% owned subsidiaries would have been a meaningless gesture. A pre-reorganization contribution to capital could also be employed to satisfy the section 354 distribution requirement if, for example, a minority interest prevented the distribution from being meaningless. See Rev. Rul. 78-330, 1978-2 C.B. 147.

Contributions to insolvent subsidiaries generally qualify for tax-free treatment under section 351.⁴⁸³ Although the IRS has revisited this conclusion in recent years,⁴⁸⁴ contributions to insolvent subsidiaries should continue to qualify for tax-free treatment in the absence of final Treasury Regulations.⁴⁸⁵

2. 2005 Proposed Regulations

The IRS issued proposed regulations in 2005 that would require an exchange or distribution of net value for stock in connection with tax-free liquidations, reorganizations, and contributions.⁴⁸⁶ The proposed regulations generally provide that the nonrecognition provisions of sections 332, 351 and 368 require a distribution or exchange of “net value” for stock.⁴⁸⁷ This requirement is consistent with existing case law interpreting

⁴⁸³ See, e.g., *Sohmer & Co. v. U.S.*, 86 F. Supp. 670 (S.D.N.Y. 1949) (stating generally that, if an incorporated proprietorship were insolvent, the incorporation would still qualify under predecessor provision to section 351); *Rosen v. Commissioner*, 62 T.C. 11 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975) (section 357(c) applies to incorporation of an insolvent business); G.C.M. 33915 (Aug. 26, 1968) (357(c) applies where liabilities assumed exceed value of property transferred).

⁴⁸⁴ See 70 Fed. Reg. 11903 (Mar. 10, 2005) (suggesting that section 351 requires the transfer of property with a net value and the receipt of valuable transferee stock); FSA 200023016 (Mar. 1, 2000) (section 351 requires the transfer of valuable assets), *rev'd*, FSA 200205003 (Oct. 5, 2001).

⁴⁸⁵ See NYSBA, *Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations*, reprinted in 2006 TNT 15-10 (Jan. 24, 2006) (discussing application of 351 to insolvent subsidiaries).

⁴⁸⁶ See 70 Fed. Reg. 11903 (Mar. 10, 2005); Prop. Reg. §§ 1.332-2, 1.351-1, 1.368-2; Reg. § 1.368-1.

⁴⁸⁷ See 70 Fed. Reg. 11903 (Mar. 10, 2005); Prop. Reg. §§ 1.332-2, 1.351-1, 1.368-2; Reg. § 1.368-1. The net value requirement for liquidations clarifies the existing requirements for tax-free liquidations described in Section H.1. above. The IRS stated in the preamble to the proposed regulations that the language of sections 351, 354, and 361, and the desire to create uniformity among tax-free liquidations, reorganizations, and contributions, justifies the net value requirements for reorganizations and contributions. 70 Fed. Reg. 11903 (Mar. 10, 2005).

section 332.⁴⁸⁸ In addition, the proposed regulations clarify that if section 332 does not apply because the parent does not receive at least partial payment for its stock, the parent is generally permitted a worthless stock deduction under section 165(g) with respect to any class of stock for which it receives no payment.⁴⁸⁹

Specifically, tax-free treatment under section 332 is limited to those cases in which the recipient corporation receives at least partial payment for each class of stock it owns in the liquidating corporation.⁴⁹⁰ In addition, a reorganization will not qualify under section 368 unless the fair market value of the acquirer's assets exceed its liabilities immediately after the exchange and (i) in the case of an asset acquisition, the aggregate fair market value of the transferred target assets exceeds the sum of (x) the target liabilities assumed by the acquirer, and (y) boot received by target shareholders, and (ii) in the case of a stock acquisition, the aggregate fair market value of the target assets exceeds the sum of (x) the target liabilities, and (y) boot received by target shareholders.⁴⁹¹ Liabilities owed to the acquiring corporation that

⁴⁸⁸ See Treas. Reg. § 1.332-2(b); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986); *Spaulding Bakeries, Inc. v. Commissioner*, 252 F.2d 693 (2d Cir. 1958).

⁴⁸⁹ See Prop. Reg. § 1.332-2(e), Ex. 2; Thomas W. Avent Jr., *Liquidations, Reorganizations and Contributions Involving Insolvent Corporations*, PLI Corporate Tax Practice Series, Chapter 154 (2012) (proposed regulations are generally taxpayer-friendly because they would allow the parent corporation to deduct a capital or ordinary loss on the stock of its subsidiary).

⁴⁹⁰ See Prop. Reg. § 1.332-2(b), (e), Ex. 2.

⁴⁹¹ See Prop. Reg. § 1.368-1(f). Notably, these requirements do not apply to (i) E and F reorganizations, or (ii) acquisitive D reorganizations. Instead, for acquisitive D reorganizations, the proposed regulations require that the fair market value of property transferred exceeds the amount of liabilities assumed and that the fair market value of the acquiring subsidiary's assets exceeds the amount of its liabilities immediately after the exchange. In addition, NQPS (defined below) is not treated as boot for purposes of determining whether net value is transferred. See Prop. Reg. § 1.368-1(f)(2)(i).

The preamble to the new temporary regulations interpreting the Distribution Test for D reorganizations explained that the new regulations do not apply the proposed “no net value”, and the government continues to consider whether final regulations should

are eliminated in an asset acquisition are treated as having been assumed by the acquirer.⁴⁹² As a result, the merger of an insolvent target into its creditor could not satisfy the net value requirement.⁴⁹³

Finally, section 351 treatment would be denied if (i) the fair market value of property transferred to the transferee corporation is less than the sum of liabilities assumed by the transferee corporation and any boot received by the transferor, or (ii) the fair market value of the transferee corporation's assets does not exceed its liabilities immediately after the transfer.⁴⁹⁴ The NYSBA has argued that this approach is inconsistent with the section 351 policy of facilitating the incorporation of a business without any tax impediments.⁴⁹⁵ Accordingly, the NYSBA has recommended that this net value requirement be modified to require only the transferee to issue stock that has value in exchange for property transferred in a putative section 351 transaction, based on what a third party would pay for the stock, rather than the corporation's net asset value, which does not appropriately measure going concern value.⁴⁹⁶

3. 2008 Final Regulations on Creditor Continuity

In December 2008, the IRS finalized the portion of the 2005 proposed regulations that addressed when a corporation's creditors will be treated as shareholders for purposes of satisfying

subject D reorganizations to a solvency requirement. T.D. 9303, 2007-1 C.B. 329, *as amended by* Announcement 2007-48, 2007-1 C.B. 1274.

⁴⁹² See Prop. Reg. § 1.368-1(f)(2)(i).

⁴⁹³ See Prop. Reg. § 1.368-1(f)(5), Ex. 5 (insolvent target's merger into acquiring corporation that owns all of target's debt and 70% of its stock failed to satisfy net value requirement because the target liabilities were treated as assumed in the transaction).

⁴⁹⁴ See Prop. Reg. § 1.351-1(a)(1)(iii).

⁴⁹⁵ See NYSBA, *Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations*, reprinted in 2006 TNT 15-10 (Jan. 24, 2006).

⁴⁹⁶ See NYSBA, *Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations*, reprinted in 2006 TNT 15-10 (Jan. 24, 2006).

the COI reorganization requirement.⁴⁹⁷ Under these rules, a creditor's claim against a target will represent a proprietary interest if the target is in a title 11 or similar case, or the amount of the target's liabilities exceeds the fair market value of its assets immediately before the transaction.⁴⁹⁸ If any creditor receives

⁴⁹⁷ See T.D. 9434, 2009-1 C.B. 339. See generally Robert Willens, *Reorganizations of Insolvent Corporations*, 2009 TNT 7-50 (Jan. 13, 2009); *Some Creditor Stock Can Count for COI In and Out of Bankruptcy*, *IRS Says in Rules*, Daily Tax Rep. (BNA), at G-1 (Dec. 12, 2008); Robert Willens, *Bankruptcy Corporation Undergoes G Reorganization*, Daily Tax Rep. (BNA), at J-1 (July 29, 2010); Robert Willens, *The Continuity of Interest and Insolvency Reorganizations*, 2011 TNT 18-8 (Jan. 24, 2011) (the COI requirement, in some respects, is applied more stringently in a G reorganization since a substantial number of former owners must receive stock in the transferee, and those former owners must emerge with a significant percentage of the transferee's total equity in order for COI to be satisfied, whereas in non-insolvency reorganizations, neither the percentage of the transferee's equity obtained by the target's former owners, nor the number of former owners who receive stock in the transferee is relevant in determining whether COI is met). See also; P.L.R. 2010-32-009 (Aug. 13, 2010) (exchange of claims held by senior claim holders and more junior creditors for at least 40% of the fair market value of the total consideration, which consists of new common stock and warrants in a G reorganization, satisfies the COI requirement); Robert Willens, *A Surprising Continuity-Of-Interest Ruling*, CFO.com (Sept. 7, 2010), available at <http://www.cfo.com/printable/article.cfm/14522844> (discussing Private Letter Ruling 2010-32-009 and the ability to use warrants to satisfy the COI test).

⁴⁹⁸ See Treas. Reg. § 1.368-1(e)(6)(i). This modification represents an adoption of the approach in *Atlas Oil & Refining Co. v. Commissioner*, 36 T.C. 675 (1961). *Atlas* adopted a "relation back" approach to determine which creditors should be treated as equity holders for COI purposes. Commentators have expressed the view that this modification to the COI rules renders the net value requirement unnecessary. See NYSBA, *Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations*, reprinted in 2006 TNT 15-10 (Jan. 24, 2006).

Theresa Abell (Special Counsel in the IRS Office of Chief Counsel (Corporate)) has clarified that the final regulations were not intended to exclude upstream mergers. See *Continuity of Interest May be*

acquirer stock in exchange for its claim, each member of that class and *pari passu* and junior classes (in addition to the shareholders) will be treated as proprietary interest holders.⁴⁹⁹ The value of a creditor's proprietary interest in the target will generally equal the fair market value of the creditor's claim.⁵⁰⁰ The most senior class of claims (including all *pari passu* classes) are bifurcated and the value of its proprietary interest in the target is determined by multiplying the claims by a fraction equal to the fair market value of the aggregate acquirer stock received in exchange for such claims over the aggregate consideration (including stock) received in exchange for such claims.⁵⁰¹

In addition to the 2008 Final Regulations on Creditor Continuity, the Tax Court in *Ralphs*, relying on *Alabama Asphaltic*,⁵⁰² held that creditors must take "effective command" over an insolvent corporation's properties in order for such creditors to be treated as shareholders for purposes of satisfying the COI reorganization requirement.⁵⁰³ Surprisingly, the creditors were not treated as shareholders in *Ralphs* because (i) the bankruptcy filing was voluntary rather than involuntary, (ii) the debtor operated as a debtor in possession, (iii) the debtor rather than the creditors proposed the plan of reorganization and (iv) the plan did not maintain absolute priority of senior creditors over junior creditors.⁵⁰⁴ Since *Ralphs* involved a pre-2008 transaction, it remains to be seen what, if any, impact *Ralphs* may have on restricting the applicability of tax-free qualification to future bankruptcy reorganizations.⁵⁰⁵

Preserved in Upstream Transaction, IRS Says, 2009 TNT 100-2 (May 28, 2009).

⁴⁹⁹ See Treas. Reg. § 1.368-1(e)(6)(i).

⁵⁰⁰ See Treas. Reg. § 1.368-1(e)(6)(ii)(B).

⁵⁰¹ See Treas. Reg. § 1.368-1(e)(6)(ii)(A).

⁵⁰² *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

⁵⁰³ *Ralphs Grocery Co. et al. v. Commissioner*, T.C. Memo. 2011-25.

⁵⁰⁴ *Ralphs Grocery Co. et al. v. Commissioner*, T.C. Memo. 2011-25.

⁵⁰⁵ See *Tax Court Finds Corporate Transaction Did Not Qualify as a Reorganization*, Daily Tax Rep. (BNA), at K-2 (Jan. 28, 2011); Robert Willens, *Identifying the Owners of an Insolvent Corporation*, 2011 TNT 62-7 (Mar. 31, 2011) (regulations regarding the COI requirement for the reorganizations of an insolvent corporation do not seem to incorporate the effective command notion that the

J. Nonqualified Preferred Stock

Section 351(g)(2) provides that the receipt of so-called nonqualified preferred stock (“NQPS”), which is preferred stock with certain debt-like characteristics, will not be treated as the receipt of stock for purposes of determining a holder’s gain or loss in connection with otherwise tax-free reorganizations and

Ralphs case requires and that if effective command over the insolvent corporation’s properties is also required to transform those creditors into equity owners, some insolvency transactions that are intended to qualify as reorganizations may be unable to pass muster because of the failure of the creditors to take the necessary proactive steps to assert their hegemony over the target’s properties); Alexander Roberts, *Tax Court Applies Pre-Regulation Continuity of Interest Doctrine to Determine that Bankruptcy Transaction Lacked Continuity of Interest Under Section 368(a)*, Practical US/Domestic Tax Strategies (Mar. 2011) (arguing that the significance of the court’s opinion may be limited because current regulations address when creditors may be treated as possessing a proprietary interest in a target corporation for COI purposes); Debra J. Bennett, *Continuity of Interest of Creditors: The Effective Command Rule of Alabama Asphaltic*, Taxes—The Tax Magazine (Apr. 2011), 7 (arguing that the analysis of *Ralphs* may be incorrect as to the application of the effective command rule, but the ultimate outcome of the Tax Court may have been right); Jasper L. Cummings, Jr., *The Rule of Ralphs*, 2011 TNT 54-7 (Mar. 21, 2011) (arguing that, under facts that are more typical of bankruptcy reorganizations, the rule of *Ralphs* potentially disconnects the tax treatment of a bankruptcy reorganization from its economics because *Ralphs* potentially forces the insolvent debtor’s shareholders to be treated as its sole equity owners, even though the equity of the debtor is worthless (in *Ralphs*, the target corporation, and its owner, were solvent, and, accordingly, the direct shareholder economically was entitled to the stock received in the acquiring corporation; usually, in bankruptcy settings, the shareholders are not entitled economically to the stock of the acquiring corporation because the creditors own the positive value of the target)); Barnet Phillips, *When the Shoe Is On The Other Foot—Ralphs Grocery Co. and Subsidiaries v. Commissioner: The Service Fails to Prove A Tax-Free Reorganization*, unpublished Tax Club paper on file with the author (May 23, 2011) (arguing that, in the case where a corporation is neither insolvent nor engaged in a bankruptcy reorganization, creditors should not be required to take effective command of the debtor’s assets for the transaction to qualify as a reorganization in light of Treas. Reg. § 1.368-1(e)(6)).

incorporations occurring after June 8, 1997.⁵⁰⁶ By contrast, however, NQPS will continue to be treated as stock for all other purposes, such as for determining whether control and other definitional requirements for a reorganization, such as COI, are satisfied, unless and until regulations provide differently.⁵⁰⁷ Under sections 354 and 356, taxpayers exchanging property for NQPS will generally recognize gain,⁵⁰⁸ and may recognize loss, except in connection with (i) exchanges of NQPS for other NQPS in reorganizations, and (ii) exchanges of NQPS in connection with certain recapitalizations of family-owned corporations.⁵⁰⁹ Although NQPS has been targeted by the IRS as a proxy for debt, it is certainly a poor substitute, since dividends on NQPS produce no interest-like deductions. The purpose of the NQPS rules may have been best captured by the following statement of Karen Gilbreath, then an attorney-advisor at Treasury: “The point of these changes is to not issue any more of these instruments . . . if you want to issue debt, just issue debt.”⁵¹⁰

NQPS must be limited and preferred as to dividends and cannot participate in corporate growth to any significant extent. Participation in corporate growth to any significant extent requires

⁵⁰⁶ In 2012 the Obama Administration proposed to repeal the NQPS provision and all other cross-referencing provisions of the Code that treat NQPS as boot, because the inconsistent treatment of NQPS adds unnecessary complexity to the Code. This proposal would take effect January 1, 2013. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 177, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

⁵⁰⁷ The Taxpayer Relief Act of 1997 added section 351(g).

⁵⁰⁸ This is true even if the exchange occurs in the intercompany reorganization context. *See* W. Wade Sutton, Jr. & Matthew Michaelangelo, *Nonqualified Preferred Stock in Intercompany Redemptions and Reorganizations: An Accident of History Waiting to Happen*, 39 Corporate Tax’n (Mar./Apr. 2012) (this result likely obtains because the intercompany transaction rules were promulgated before the enactment of section 351(g), which considers NQPS as boot for section 356 purposes, and provides no applicable exceptions).

⁵⁰⁹ *See* I.R.C. § 354(a)(2)(C)(i), (ii).

⁵¹⁰ Daily Tax Rep. (BNA), at G-7 (Mar. 13, 1998).

a “real and meaningful likelihood” that the shareholder will actually participate in the corporation’s earnings and growth.⁵¹¹ Such stock will constitute NQPS if it also possesses one or more of the following characteristics: (a) the issuer or a related person⁵¹² is required to redeem the stock;⁵¹³ (b) the holder of the stock has the right to require the issuer or a related person to redeem the stock;⁵¹⁴ (c) the issuer has the right to redeem the stock, and as of the issue date it is more likely than not that such right will be exercised;⁵¹⁵ or (d) the dividend rate on such stock varies directly or indirectly, in whole or in part, with reference to interest rates, commodity prices, or other similar indices (such stock, “Index Based NQPS”).⁵¹⁶

There are two exceptions to qualification as NQPS, even if stock satisfies the definitions set forth above. First, preferred stock other than Index Based NQPS will not be classified as NQPS on the basis of a redemption feature if (i) the stock cannot be redeemed for 20 years, or (ii) redemption is subject to a contingency that makes “remote” the likelihood that the stock will be redeemed.⁵¹⁷ Second, preferred stock will not be classified as NQPS if (i) none of the NQPS, the stock exchanged therefor, or the stock of affiliates of either stock issuer is publicly traded, and the NQPS may be redeemed only upon the death, disability, or incompetence of the holder; or (ii) the NQPS is transferred in connection with the performance of services and may be redeemed only upon termination of the holder’s employment.⁵¹⁸

NQPS has anomalous consequences for holders and issuers. NQPS is treated as boot (rather than as stock or securities), for purposes of determining the tax consequences of holders who receive or exchange NQPS in an otherwise tax-free

⁵¹¹ I.R.C. § 351(g)(3)(A); *see also* S. Rep. No. 108-192 at 185 for examples of illusory participation in corporate growth.

⁵¹² Related party status is determined under sections 267(b) and 707(b).

⁵¹³ *See* I.R.C. § 351(g)(2)(A)(ii), (g)(3)(A).

⁵¹⁴ *See* I.R.C. § 351(g)(2)(A)(i).

⁵¹⁵ *See* I.R.C. § 351(g)(2)(A)(iii).

⁵¹⁶ *See* I.R.C. § 351(g)(2)(A)(iv).

⁵¹⁷ *See* I.R.C. § 351(g)(2)(B).

⁵¹⁸ *See* I.R.C. § 351(g)(2)(C).

reorganization⁵¹⁹ or section 351 exchange.⁵²⁰ By contrast, the Conference Report makes clear that NQPS will continue to be treated as stock for purposes of meeting the section 368(c) control requirement, and generally for all other purposes, unless and until regulations subsequently provide to the contrary.⁵²¹ The legislative history does not contain a specific statement that NQPS provides COI, but because NQPS is generally to be considered stock for all unspecified purposes, it should be treated as stock for COI purposes.⁵²² Similarly, the general nonrecognition rules of section 351(a) continue to apply to persons exchanging property for NQPS and stock, and NQPS is considered “stock” for purposes of determining whether an exchange qualifies for tax-free treatment under section 351, again unless and until regulations provide otherwise.⁵²³ A technical correction to the NQPS rules confirms, however, that a transferor in a multi-party section 351 exchange who receives only NQPS would be treated as engaging in a wholly taxable section 1001 exchange outside of section 351 for purposes of determining its gain or loss.⁵²⁴

The NQPS rules raise a myriad of questions, including when preferred stock constitutes NQPS and what the tax consequences are to holders of NQPS in reorganizations and section 351 exchanges. An NYSBA report that requests additional guidance highlights several of the most pressing issues: (i) stock with a meaningful conversion feature should be treated as participating in corporate growth to a significant extent, and therefore should not be classified as NQPS; (ii) the right of a stockholder to put preferred stock to the issuer on a “change of control” or similar event should be considered a remote contingency that should not cause stock to constitute NQPS solely as a result of such a put; (iii) NQPS should continue to be treated

⁵¹⁹ See I.R.C. §§ 354(a)(2)(C), 355(a)(3)(D) and 356(e). Section 354(a)(2)(C)(ii) provides an exception to boot treatment for NQPS exchanges in connection with certain recapitalizations, but *not* incorporations, of family owned corporations.

⁵²⁰ See I.R.C. § 351(b).

⁵²¹ H. R. Rep. No. 105-220, at 545 (1997).

⁵²² The IRS confirmed this conclusion in public statements. See Daily Tax Rep. (BNA), at G-7 (Mar. 13, 1998).

⁵²³ See I.R.C. § 351(g)(2)(A); H. R. Rep. No. 105-220, at 544 (1997).

⁵²⁴ See I.R.C. § 351(g)(1)(B).

as stock in determining whether a transaction otherwise qualifies for nonrecognition treatment under sections 351 and 368; (iv) NQPS issued in a reorganization should be tested for dividend treatment under section 356(a)(2) in the same manner as other “boot” received in a reorganization; (v) an exchange of NQPS-for-NQPS should generally be tax-free without regard to “comparability” of the two issues, and tax-free treatment should be permitted, if possible, for certain exchanges of preferred stock in addition to exchanges of NQPS for NQPS; (vi) the treatment of NQPS for purposes of sections 302 and 304 should be clarified; (vii) installment sale principles should be extended to the reporting of gain upon the receipt of NQPS; and (viii) a provision that resets the dividend rate on preferred stock to a current market rate should not cause the stock to constitute NQPS if the reset frequency is limited.⁵²⁵

As discussed below, several of the topics suggested by the NYSBA as requiring additional guidance raise the question of whether such guidance should be based on, or derived from, principles from other areas of the tax law, either with or without alteration. One such fundamental issue is when preferred stock should be treated as meaningfully participating in the corporate growth of the issuing corporation such that it would not constitute NQPS. Other such issues include untoward reorganization consequences of exchanging NQPS, and unexpected results that may subsequently obtain under other sections of the Code with respect to NQPS received in a reorganization.

It may be tempting to utilize the section 305 rules regarding participating preferred stock to determine whether preferred stock should be excluded from the NQPS regime by reason of a material participation feature. However, while the section 305 rules are a logical starting point in defining meaningful participation, they are unduly restrictive in certain respects, *e.g.*, for section 305 purposes, meaningful participation in growth cannot be obtained through a conversion feature. As a result, the author believes that those rules should not be imported without modification.⁵²⁶ Instead, for example, the author believes that meaningful participation may be

⁵²⁵ NYSBA, *Report on Recently Enacted Nonqualified Preferred Stock Provisions*, reprinted in *Highlights & Documents*, at 431 (Apr. 13, 1998).

⁵²⁶ See Treas. Reg. § 1.305-5(a).

effected solely by means of a meaningful dividend participation right and/or a favorable conversion feature, even if the stock does not participate in corporate earnings (except to the extent of its liquidation preference) upon liquidation. In this regard, the statement in the NQPS legislative history that a conversion feature “will in no event . . . automatically be considered to participate in corporate growth to any significant extent” should not be read to mean that a valuable conversion feature would not constitute a meaningful participation in corporate growth.⁵²⁷ By contrast, a right to convert into stock of the issuer only at an extremely high premium could fairly be treated as not demonstrating the requisite material participation.

The lack of guidance regarding basic concepts such as when a contingency is “remote” and when a redemption right is more likely than not to be exercised raises additional issues. These issues include whether customary change-of-control provisions or other contingencies not within a typical holder’s control, such as an issuer’s liquidation, insolvency or bankruptcy, or a merger or initial public offering involving the issuer’s stock, should be treated as remote contingencies. The author believes these events should be treated as remote contingencies even in the absence of authority, unless public information indicates that such an event is likely to occur.

Preferred stock that includes an issuer redemption right upon the occurrence of a non-remote contingency would nonetheless not constitute NQPS if it is more likely than not that the redemption right will not be exercised. In the absence of authority, the section 305 definition of when a redemption right is more likely than not to be exercised may serve as a reasonable proxy for NQPS purposes.⁵²⁸ In making this determination, both the probability that the contingency will not occur and the

⁵²⁷ See H.R. Rep. No. 105-220, at 545 (1997). Stock convertible into stock of a corporation other than the issuer, *e.g.*, the issuer’s parent, will not qualify as stock that significantly participates in corporate growth by reason of such a conversion feature. See H.R. Rep. No. 105-220, at 545 (1997).

⁵²⁸ Treasury Regulation section 1.305-5(b)(3) treats a redemption right for preferred stock as *not* more likely than not to be exercised if (i) the issuer and holder are unrelated; (ii) no arrangements exist that would compel an issuer to redeem the stock and (iii) exercise of the redemption right would not reduce the yield of the stock.

probability that the redemption right would not be exercised even if the contingency occurs, should properly be taken into account. Thus, if a contingency that triggers a redemption right has a 60% chance of occurring, and there is also a 50% chance that the stock will be redeemed if the contingency occurs, there should be only a 30% chance that the redemption would occur. In these circumstances, it would be more likely than not that the redemption would not occur, and such preferred stock therefore should not constitute NQPS.

The seemingly broad carve-out from the NQPS rules for preferred stock with a redemption right that is not exercisable for 20 years after such stock is issued conceals a particularly nasty trap for the unwary. Government officials have now confirmed in public statements that an exchange of such stock for identical stock of an acquirer in a reorganization, whether or not the target preferred stock is then redeemable, *e.g.*, 2 years or 22 years after issuance, would cause the newly issued preferred stock to constitute NQPS, since the new stock would be redeemable within 20 years after issuance.⁵²⁹ The IRS would presumably view such a preferred stock exchange as taxable by reason of the issuance of NQPS.

Exchanges of NQPS also produce several surprising reorganization-related tax consequences and raise additional issues. The consequences of treating NQPS as stock that is continuity-giving include allowing B and C (and presumably A2E) reorganizations with more than 60% boot (in the form of NQPS). Acquirers may also succeed to a target's tax attributes, *e.g.*, net operating losses, tax credits, earnings and profits and asset bases, in asset reorganizations in which few, if any, target stockholders exchange their stock tax-free.⁵³⁰ Preserving section 351 qualification for transactions in which "stock" may consist

⁵²⁹ See Daily Tax Rep. (BNA), at G-8 (Mar. 13, 1998).

⁵³⁰ The NYSBA Report on NQPS notes that, since NQPS qualifies as neither stock nor securities, at least a *de minimis* amount of other stock or securities of an acquirer must be distributed to stockholders in D and G reorganizations in order for such transactions to qualify as tax-free reorganizations under the relevant statutory provisions. NYSBA, *Report on Recently Enacted Nonqualified Preferred Stock Provisions*, reprinted in Highlights & Documents, at 436 (Apr. 13, 1998). A *de minimis* amount of other stock may also need to be exchanged in a C reorganization.

principally (or solely) of NQPS also produces anomalous results, such as the potential disqualification of a section 351 exchange by reason of a disposition of NQPS pursuant to a binding obligation. Taxpayers receiving NQPS may benefit from the treatment of taxable section 351 transactions as taxable exchanges under section 1001, which would permit transferors to recognize loss (to the extent permitted under the loss disallowance rule and section 267). As further food for thought, query whether the acquisition of 80% or more of a corporation's stock in exchange for NQPS (and/or other non-stock consideration) may be treated as a qualified stock purchase under section 338.

The legislative history both expands and limits the statutory carve-out for tax-free NQPS exchanges. The legislative history limits the statutory exception for NQPS-for-NQPS exchanges pursuant to section 368 reorganizations to exchanges of NQPS for "comparable" NQPS of "equal or lesser value."⁵³¹ Since the statute contains neither of these limitations, they should not apply until regulations are promulgated that follow the legislative history. On the other hand, the legislative history also provides that the following two additional NQPS exchanges will qualify as tax-free: an exchange of NQPS for common stock and an exchange of debt for NQPS of equal or lesser value.⁵³² It is not clear whether these references to value are to fair market value or liquidation preferences. It is also not clear whether the IRS will acquiesce in the treatment of these additional exchanges as tax-free in the absence of regulations.

Curiously, no reason is given in the legislative history for the exceptions that permit tax-free exchanges of NQPS in connection with reorganizations. While the "same or lesser value" limitation discussed above might be derived from the "excess principal amount" boot rules for securities, the "comparability" requirement seems to have no antecedent. Permitting these limited tax-free exchanges of debt for NQPS in connection with otherwise

⁵³¹ H.R. Rep. No. 105-220, at 544 (1997). The legislative history of section 351(g) indicates that NQPS for NQPS exchanges may be tax-free only to the extent stock of equal value is received. *See* Sen. Rep. No. 105-33, 105th Cong. Sess., at 465 (1997). However, the IRS has indicated that NQPS issued for NQPS of a target company pursuant to an acquisition at a premium will satisfy the value for value requirement.

⁵³² H.R. Rep. No. 105-220, at 544 (1997).

tax-free reorganizations, but not in section 351 transactions, may follow from the prohibition against tax-free receipt of securities in section 351 transactions, although this conclusion is also not confirmed. The legislative history provides, however, that reorganization transactions that also qualify as section 351 exchanges will be entitled to the reorganization exceptions from taxation for certain NQPS exchanges.⁵³³

Until regulations to the contrary are issued, NQPS will be treated as stock for purposes of sections 302 and 304, as well as under other sections of the Code. Since section 302 applies only to property distributions,⁵³⁴ and not to stock distributions, and NQPS is currently treated as stock for this purpose, the author believes it is not completely clear (although the IRS will presumably confirm) whether NQPS received in a reorganization will be treated, like other boot, as a dividend under section 356 (which applies section 302 principles).⁵³⁵ If the receipt of NQPS were not treated as a dividend, individual recipients of NQPS would have the fortunate result of being subject to tax at favorable capital gains rates (assuming section 305 did not apply to the receipt of NQPS), while corporate recipients would be denied any dividends-received deduction. If, instead, the receipt of NQPS is subject to the same dividend characterization as other forms of boot, but the NQPS is treated as stock for all other purposes, subsequent transactions may contain significant pitfalls. For example, an individual NQPS holder who receives NQPS in a reorganization and subsequently exchanges his or her NQPS in a section 304 transaction could be subject to tax at ordinary income rates for a second time if the deemed redemption rules of section 304 apply to the NQPS exchange. Corporate holders would be entitled to dividends-received deductions under those circumstances with respect to subsequent dividends paid on NQPS.

K. Tax Treatment of Stock Rights in Reorganizations

Final regulations issued under sections 354 and 356 (the “Warrant Regulations”) have fundamentally altered the tax consequences of exchanging and receiving warrants and other stock rights in tax-free reorganizations. Historically, stock rights

⁵³³ H.R. Rep. No. 105-220, at 544 (1997).

⁵³⁴ See I.R.C. §§ 302(a); 317.

⁵³⁵ See I.R.C. § 356(a)(2).

have been treated as boot, and consequently holders of such rights were not entitled to tax-free treatment under section 354 on the exchange of their stock rights in an otherwise tax-free reorganization.⁵³⁶ Option holders would typically exercise stock rights in advance of a reorganization in order to exchange the stock received upon exercise of the rights in the reorganization.

The Warrant Regulations now treat “rights” to acquire stock issued by a corporation that is a party to a reorganization as securities with a zero principal amount, rather than boot for purposes of sections 354, 355 and 356. As a result, stock rights can now be exchanged tax-free in connection with reorganizations under most circumstances.⁵³⁷ It should be noted that the scope of the regulations is explicitly limited to exchanges of stock rights governed by sections 354 through 356. As a result, stock rights, like other securities, will continue to constitute boot in section 351 exchanges.⁵³⁸ Moreover, stock options subject to sections 83 and 421 through 424 will continue to be governed by such sections rather than by the Warrant Regulations.⁵³⁹

⁵³⁶ See Rev. Rul. 78-408, 1978-2 C.B. 203 (prior to modification by Revenue Ruling 98-10). *But see* P.L.R. 95-39-020 (Sept. 27, 1995) (tax-free exchange of investment options for mirror acquirer options in reorganization).

⁵³⁷ See Treas. Reg. §§ 1.354-1(d), Ex. 4; 1.354-1(e); 1.356-3(b), Ex. 7-9; 1.356-3(c); T.D. 8752, 1998-1 C.B. 611. *See generally* Robert Willens, *When Warrants are Received in a Reorganization*, 125 Tax Notes 805 (Nov. 16, 2009) (predicting greater use of warrants as a form of acquisition currency); David Libman, *Nonrecognition of Warrants Exchanged in a Corporate Reorganization*, 18 M&A Tax Rep. 5 (Feb. 2010) (same); Robert Rizzi, *With a Warrant: The Use of Noncompensatory Stock Rights in Reorganizations*, 38 Corporate Tax’n 34 (Nov./Dec. 2011) (summarizing the Warrant Regulations).

⁵³⁸ See Treas. Reg. § 1.356-3(b).

⁵³⁹ See Treas. Reg. § 1.354-1(e). Exchanges, substitutions or assumptions of nonqualified stock options as part of a reorganization should be tax-free to the holders of such options, either on the theory that such an exchange is a continuing “open transaction,” or because the options constitute liabilities assumed by the acquirer. *See, e.g.*, Rev. Rul. 68-637, 1968-2 C.B. 158 (substitution of target stock with acquirer stock under terms of target employee stock options qualified as an assumption of liability under section 368(a)(1)(C) of the Code); P.L.R. 89-41-069 (July 19, 1989) (conversion of nonstatutory

The only statement in the Warrant Regulations that passes for a definition of stock rights is a statement that the term is to have the same meaning for purposes of the Warrant Regulations as it has under sections 305 and 317(a).⁵⁴⁰ Under those sections, a stock right is defined as the right to acquire stock of the issuer of the right. Thus, cash-settled warrants and rights to acquire stock of a corporation other than the issuer, apparently do not qualify as stock rights that constitute zero principal amount securities under the regulations.⁵⁴¹ Temporary regulations also confirm that rights to acquire NQPS do not constitute stock rights for tax purposes.⁵⁴² The lack of a specific definition of stock rights also raises issues as to when options to acquire issuer stock are (and are not) governed by the Warrant Regulations. It is not clear, for example, that options that permit or require an issuer to simply pay the option spread⁵⁴³ in the form of issuer stock, rather than having the holder pay the strike price to exercise the option and receive additional issuer stock, will qualify as stock rights. The author believes that treating these types of options as stock rights is consistent with both the statutory language of section 305 and the policy of the Regulations.

It has historically been the case that securities may be exchanged tax-free as part of a reorganization to the extent the principal amount of the securities received does not exceed the

compensatory stock options into acquirer stock options in A2E reorganization was tax-free to holders of such options); P.L.R. 88-08-032 (Nov. 27, 1987) (providing similar result in a B reorganization); *see also Attorneys Urge Treasury to Issue Guidance on Treatment of Warrants*, Highlights and Documents, at 1971 (Aug. 28, 1998).

⁵⁴⁰ See Treas. Reg. § 1.354-1(e).

⁵⁴¹ See Treas. Reg. § 1.354-1(e). See NYSBA, *Request for Formal Guidance on the Tax Consequences of Warrant Exercises*, reprinted in 2008 TNT 186-32 (Sept. 24, 2008) (requesting that IRS confirm that (i) a warrant exercisable in stock or cash at the warrant holder's option constitutes a right to acquire stock, and (ii) an exchange of a warrant for stock in cashless exercise can qualify as recapitalization).

⁵⁴² See Temp. Reg. § 1.356-6T(a)(2).

⁵⁴³ The option spread is the difference between the value of the stock to be issued upon option exercise and the amount paid to exercise the option.

principal amount of the securities surrendered.⁵⁴⁴ Consequently, treating stock rights as securities that have a zero principal amount means that any amount of such rights generally can be exchanged in a reorganization without gain recognition to a holder.⁵⁴⁵ The Warrant Regulations permit a stockholder to exchange stock and stock rights solely for stock, or stock for stock and stock rights tax-free.⁵⁴⁶ There is, however, one circumstance in which stock rights cannot be exchanged tax-free in connection with a reorganization: a stockholder cannot exchange stock solely for stock rights without also receiving stock in the exchange.⁵⁴⁷ This trap can be avoided if stock is included along with the stock rights a holder receives in a reorganization.⁵⁴⁸

Shortly after the Warrant Regulations were issued, the IRS also issued Revenue Ruling 98-10. The Revenue Ruling holds that an exchange of stock rights treated as zero principal amount securities in connection with an otherwise tax-free B reorganization was separate from, but pursuant to, the reorganization.⁵⁴⁹ As a result, holders exchanging such rights were protected from recognition of gain or loss pursuant to section 354, under the rules discussed above.⁵⁵⁰ Notably, the ruling assumes that a substantial number of the target stockholders did not also hold warrants. As a result, it was reasonably clear that the requisite B reorganization requirement that stockholders receive only stock in their capacity as stockholders was satisfied. It is not clear whether the IRS would be willing to issue a similar ruling in

⁵⁴⁴ I.R.C. § 354(a)(2).

⁵⁴⁵ See Treas. Reg. §§ 1.354-1(e); 1.356-3(b).

⁵⁴⁶ See Treas. Reg. § 1.356-3(b) (providing that stock rights are not other property regardless of whether securities are surrendered in an exchange).

⁵⁴⁷ See Treas. Reg. § 1.354-1(d), Ex. 4; *see also* I.R.C. § 354(a)(2)(A)(ii).

⁵⁴⁸ See Treas. Reg. § 1.356-3(c), Exs. 7-9.

⁵⁴⁹ See Rev. Rul. 98-10, 1998-1 C.B. 643.

⁵⁵⁰ See Rev. Rul. 98-10, 1998-1 C.B. 643. Revenue Ruling 98-10 supersedes Revenue Ruling 69-142 and modifies Revenue Ruling 70-41, 1970-1 C.B. 77, and Revenue Ruling 78-408, 1978-2 C.B. 203 to provide that section 354 applies to exchanges of stock rights that constitute securities under the regulations. Rev. Rul. 98-10, 1998-1 C.B. 643.

cases of substantial overlap between target stockholders and warrant holders where it might be more difficult to establish that stockholders received only acquirer stock, and not acquirer warrants, in exchange for their stock.

Stock rights have not historically been treated as equity interests that provide continuity, and there is no suggestion in the Warrant Regulations that tax-free treatment for exchanges of stock rights is intended to imbue stock rights with continuity-giving characteristics. Thus, notwithstanding the fact that there may be little economic difference between a right to acquire stock that is substantially certain to be exercised and actual ownership of such stock, it remains the case that stock rights do not provide continuity.

L. Variable Stock Consideration in Reorganizations

Taxpayers often employ variable or contingent consideration in connection with reorganizations in order to secure representations and warranties, allocate target liabilities to target shareholders, and determine consideration paid to target shareholders when the target's value is not immediately ascertainable. The popularity of these arrangements tends to increase with uncertainty and stock market fluctuation.⁵⁵¹ There are three primary forms of variable stock arrangements: (i) stock escrows, (ii) contingent stock rights, and (iii) convertible instruments, each of which generally provides additional stock to target shareholders when liabilities are resolved or when certain performance goals are achieved. The treatment of these variable stock arrangements can create uncertainty regarding satisfaction of COI and other reorganization requirements.

1. Escrows

Escrowed stock is generally not treated as boot for purposes of section 368.⁵⁵² If the target shareholders receive the indicia of ownership of escrowed stock, *e.g.*, the right to dividends

⁵⁵¹ See Robert Willens, *Contingent Stock Acquisitions Gain Popularity in Uncertain Times*, Daily Tax Rep. (BNA), at J-1 (June 23, 2003).

⁵⁵² See *Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga., 1980); *McAbee v. Commissioner*, 5 T.C. 1130 (1945) (title to stock placed in escrow passed to target shareholders; escrow to secure liabilities was a mere security device).

and the ability to exercise voting power, they should generally be viewed as the owners of such stock.⁵⁵³ The requirements for receiving a private letter ruling for a tax-free reorganization with escrowed stock are listed in Revenue Procedure 84-42.⁵⁵⁴ In addition, the IRS has concluded that no imputed interest will arise under section 483 when the escrowed shares are distributed if dividends are distributed on such shares when paid.⁵⁵⁵

The treatment of escrowed stock in determining satisfaction of the COI requirement is not entirely clear, and treating target shareholders as owners of escrowed stock is intuitively difficult when receipt of the stock is uncertain.⁵⁵⁶ Further, no guidance exists regarding the tax treatment of escrowed stock returned to an

⁵⁵³ See Rev. Rul. 72-256, 1972-1 C.B. 222; Rev. Rul. 76-334, 1976-2 C.B. 108; Rev. Rul. 78-376 1978-2 C.B. 149; Rev. Rul. 70-120, 1970-1 C.B. 124; *Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga. 1980); *McAbee v. Commissioner*, 5 T.C. 1130 (1945). See also Rev. Proc. 84-42, 1984-1 C.B. 521 (IRS acquiesced in conclusion).

⁵⁵⁴ See Rev. Proc. 84-42, 1984-1 C.B. 521. Revenue Procedure 84-42 requires that (i) a valid business reason exists for the escrow (such as the difficulty in valuing one or both of the parties), (ii) the stock subject to the escrow is issued and outstanding on the acquirer's balance sheet and under applicable state law, (iii) any dividends are distributed currently to target shareholders, (iv) voting rights are exercisable by the shareholders or their authorized agent, (v) no shares are subject to return because of death, failure to continue employment or similar restrictions, (vi) all stock is released within 5 years after the closing date, (vii) at least 50% of the maximum number of shares is not subject to the arrangement, (viii) the return of stock cannot be triggered by an event that is within the control of the shareholders, (ix) the return of stock cannot be triggered by the result of an IRS audit of the shareholders or the corporation (a) with respect to the reorganization in which the escrowed stock is issued, or (b) if the reorganization in which the escrowed stock is issued involves related persons and (x) the mechanism for calculating the number of shares of stock to be returned is objective and readily ascertainable.

⁵⁵⁵ See Rev. Rul. 76-334, 1976-2 C.B. 108; Rev. Rul. 72-256, 1972-1 C.B. 222; Rev. Rul. 70-120, 1970-1 C.B. 124; prior law Treas. Reg. § 1.483-1(b)(6), Ex. 8 (1983).

⁵⁵⁶ See generally NYSBA, *Report on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004).

acquirer.⁵⁵⁷ Proposed regulations regarding the appropriate measure of acquirer stock for COI purposes would treat escrowed stock used to secure representations and warranties as issued and outstanding for all purposes.⁵⁵⁸ The treatment of escrowed stock escrowed for purposes other than securing representations and warranties, and the treatment of such returned escrowed stock, is unclear.

2. Contingent Stock Rights

Contingent stock rights (also referred to as contingent value rights) are also not boot for purposes of the reorganization provisions.⁵⁵⁹ The IRS originally took the position that such instruments were boot, but ruled that contingent stock rights will generally be treated as “stock” for purposes of section 354 after losing two consecutive cases on the issue; Revenue Ruling 66-112 held that contingent stock rights were not boot in a B reorganization.⁵⁶⁰ Revenue Procedure 84-42 contains a list of

⁵⁵⁷ See generally NYSBA, *Report on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004). The NYSBA has questioned whether the IRS could take the position that a return of stock to the acquirer could be treated as a redemption, which would seem inappropriate in light of the differences between a cash redemption and a return of stock.

⁵⁵⁸ See Prop. Reg. § 1.368-1(e)(2)(iii), (7)(i), Ex. 10.

⁵⁵⁹ See *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960) *nonacq.*; *Hamrick v. Commissioner*, 43 T.C. 21 (1964); Rev. Rul. 66-112, 1966-1 C.B. 68.

⁵⁶⁰ See *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960) *nonacq.*; *Hamrick v. Commissioner*, 43 T.C. 21 (1964), *acq.*, remanded by agreement, 17 AFTR 2d 357 (4th Cir. 1965); Rev. Rul. 66-112, 1966-1 C.B. 68; Rev. Rul. 67-90, 1967-1, C.B. 79 (same result when receipt of shares was contingent on value of acquirer’s stock).

In *Carlberg*, shareholders of two target corporations received stock and negotiable certificates of contingent interests in acquirer stock that was authorized and reserved but not issued. The certificates, which were used because of unresolved litigation and tax liabilities of the target, were transferable, and entitled the holders to cash in lieu of dividends when ultimately distributed, and to the issuance of additional stock based on a fixed formula. The IRS argued that the certificates were boot because they were transferable and therefore carried a value separate from the underlying stock. The court held that the certificates were “stock” within the meaning of Section 354

criteria that must be satisfied in order to receive a favorable private letter ruling for a tax-free reorganization that includes contingent stock rights.⁵⁶¹ While *Carlberg* and *Hamrick* treat the stock rights as stock equivalents, it is not clear how such rights will be treated for COI purposes. The rights could be valued when issued and treated as stock for COI purposes, treated as boot, or ignored for purposes of COI determinations; it is not clear which treatment the IRS would assert.

Unless interest is separately calculated and paid on shares subsequently received pursuant to the contingent stock rights, a portion of the additional shares will be treated as imputed interest to compensate for their deferred receipt.⁵⁶² When contingent stock

for the taxpayer based on the policy of the reorganization provisions, the underlying economic substance of the certificates and the business requirements that led to their issuance.

Hamrick involved the formation of a new corporation and a transfer of patent rights by two inventors and cash by a group of financial investors. Both sets of transferors received stock of the new corporation in exchange for their contributions, and the inventors also received rights to additional shares based on the earnings of the corporation during the 7-year period following the contribution. Although the IRS argued that the contingent stock rights constituted boot, the Tax Court held that the rights were stock within the meaning of Section 354 because the owner of such rights could never receive anything other than stock.

⁵⁶¹ See Rev. Proc. 84-42, 1984-1 C.B. 581. Revenue Procedure 84-42 requires that (i) all stock will be issued within 5 years, (ii) there is a valid business purpose for the arrangement, (iii) the maximum number of shares that may be issued is stated, (iv) at least 50% of the maximum number of each class of stock is issued on the closing date, (v) the right to receive stock is not assignable (except by operation of law), not readily marketable and is not evidenced by any certificate, (vi) only additional stock of the corporation making the distribution may be received, (vii) the stock issuance cannot be triggered by the result of an IRS audit of the shareholders or the corporation (a) with respect to the reorganization in which the escrowed stock is issued, or (b) when the reorganization in which the escrowed stock is issued involves related persons and (ix) the mechanism for calculating the additional stock to be issued is objective and readily ascertainable.

⁵⁶² See *Fox v. United States*, 510 F.2d 1330 (3d Cir. 1974); Rev. Rul. 70-300, 1970-1 C.B. 125; Rev. Rul. 72-35, 1972-1 C.B. 139; Rev. Rul. 72-32, 1972-1 C.B. 48; Rev. Rul. 73-298, 1973-2 C.B. 173.

rights are issued, a target shareholder's basis is initially allocated among the maximum number of shares that could potentially be received and later reallocated when the contingency is fixed and the actual number of shares issued is determined (unless the maximum number of shares is actually issued).⁵⁶³

3. Convertible Stock

Convertible stock, which is typically issued as convertible preferred stock, is generally not treated as boot. Such stock may be received tax-free in reorganizations, and is treated as stock for purposes of the COI requirement.⁵⁶⁴ By contrast, convertible debt received by target shareholders would constitute boot and would not satisfy COI or other requirements for tax-free reorganizations.

4. Unresolved Issues

As discussed above, the treatment of variable stock consideration is unclear in many cases, particularly as it relates to COI. Because this characterization may determine the tax-free nature of transactions in which boot is issued to target shareholders in addition to stock and variable stock consideration, the NYSBA has requested that the IRS provide guidance on how variable stock consideration should be treated for COI purposes. Taxpayers have generally handled this issue by using complicated formulas to determine the minimum amount of stock that can be used as consideration, assuming that the IRS will be successful in imposing the most unreasonable COI determination. Not surprisingly, these structures have prevented taxpayers from pursuing their preferred business terms in many transactions. The NYSBA has recommended treating all forms of variable stock consideration as a stock equivalent with a value equal to the variable stock consideration's fair market value on the signing date

The acquirer's ability to deduct the imputed interest depends on whether the obligation is deemed to be debt. *See* I.R.C. § 163(l).

⁵⁶³ *See* Prop. Reg. § 1.453-1(f)(2), Ex. 4; P.L.R. 89-38-062 (June 29, 1989); Rev. Rul. 76-334, 1976-2 C.B. 108.

⁵⁶⁴ *See, e.g.*, P.L.R. 87-46-040 (Aug. 18, 1987) (exchange of convertible stock in section 351 transfer gave rise to control and was not treated as boot).

of an acquisition.⁵⁶⁵ This approach would be consistent with recently proposed COI regulations regarding the appropriate value of stock for COI purposes. It would factor in the appropriate risk discounts and would provide taxpayers with certainty regarding the qualification of their transaction.

M. Reorganizations Involving S Corporations

S corporations may engage in acquisitive reorganizations, and the rules of Subchapter C (including sections 351 and 368) will apply to S corporations to the extent that they are consistent with Subchapter S.⁵⁶⁶ The preservation of S corporation status in connection with a reorganization is also possible if certain pitfalls are avoided, such as (i) the addition of ineligible stockholders, (ii) exceeding the 100 shareholder limit, (iii) creating a disqualified

⁵⁶⁵ See generally NYSBA, *Report on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004). The NYSBA identified five potential approaches for characterization of variable stock consideration arrangements for COI purposes: (i) an “open transaction” approach where satisfaction of COI is determined after all consideration becomes fixed, (ii) a “closed transaction” approach that treats the variable stock consideration as a separate, non-proprietary right in the initial exchange, (iii) a “closed transaction” approach that treats the variable stock consideration as indistinguishable from the underlying stock, (iv) a “closed transaction” approach that ignores variable stock consideration and (v) a “closed transaction” approach that treats variable stock consideration as a separate proprietary right with a value based on its fair market value on the signing date of the transaction.

⁵⁶⁶ See I.R.C. § 1371(a). See, e.g., P.L.R. 2008-50-013 (Dec. 12, 2008) (S corporation asset transfer to newly formed controlled corporation in exchange for all of its stock, followed by a distribution of such stock to one or more shareholders, qualified as D reorganization); P.L.R. 2008-50-014 (Dec. 12, 2008) (tax-free D reorganization where (i) C corporation with 3 separate shareholder groups divided assets among newly formed controlled corporations, which elected S corporation status, and (ii) C corporation distributed stock of each new controlled corporation to shareholder groups and liquidated); P.L.R. 2011-15-006 (Apr. 15, 2011) (distribution involving S corporation qualified as a D reorganization and distributing’s momentary ownership of controlled stock will not cause controlled to have an ineligible shareholder under section 1361(b)(1)(B))

second class of stock, and (iv) acquiring a non-qualified subsidiary.⁵⁶⁷

Tax-free asset acquisitions involving S corporations can generally qualify as A reorganizations, assuming satisfaction of the definitional requirements.⁵⁶⁸ Mergers of C corporations into S corporations generally will not terminate the surviving S corporation's S election unless the corporation fails to continue to qualify as an S corporation by reason of the acquisition, *e.g.*, the addition of a disqualified shareholder. The built-in gains on C corporation assets assumed by the S corporation will continue to be subject to a corporate-level tax in the S corporation's hands for 10 years.⁵⁶⁹ A surviving S corporation would also be subject to restrictive rules if C corporation earnings and profits carry over to the S corporation.⁵⁷⁰

A tax-free A reorganization in which an S corporation merges into a C corporation with the C corporation surviving will terminate the S corporation's existence, and therefore its S election.⁵⁷¹ The surviving corporation will gain the benefits of the post-termination transition rules that apply following a C corporation's acquisition of an S corporation's assets in a section 381(a)(2) transaction.⁵⁷² Similarly, the S election of an S corporation acquired in a C or D reorganization will terminate by reason of its required liquidation after either type of reorganization. Under certain circumstances, however, the acquirer need not wait

⁵⁶⁷ See I.R.C. § 1361(b), (c); *see also* Rev. Rul. 77-220, 1977-1 C.B. 263 (ruled against use of multiple corporations to avoid stockholder limit).

⁵⁶⁸ See Rev. Rul. 69-566, 1969-2 C.B. 165 (statutory merger of C corporation into S corporation qualified as an A reorganization and S election not terminated).

⁵⁶⁹ See I.R.C. § 1374(d)(8).

⁵⁷⁰ See I.R.C. §§ 1362(d)(3) (excessive passive investment income rules); 1368 (accumulated earnings and profits anti-bailout rules and penalty tax).

⁵⁷¹ See Rev. Rul. 64-94, 1964-1 C.B. 317 (S election remained valid for S corporation's final taxable year).

⁵⁷² See Treas. Reg. § 1.1377-2(b).

the usual five year period before making another S election.⁵⁷³ The tax attributes of the S corporation, *e.g.*, its earnings and profits, suspended C corporation-year carryovers, and its accumulated adjustments account, carry over to the acquirer, as in any asset-based reorganization.⁵⁷⁴

An S corporation can acquire a C corporation in a tax-free A reorganization without endangering its S election (assuming that the acquiring S corporation continues to satisfy the requirements for S status after the acquisition).⁵⁷⁵ An S corporation should also be able to acquire a C corporation in a C or D reorganization without terminating its S election,⁵⁷⁶ even though under those circumstances S corporation stock would be impermissibly issued to the corporate target (prior to distribution of the stock to the target shareholders). It is now also possible under the qualified Subchapter S subsidiary rules for an S corporation to acquire stock of a C corporation in a B or an A2E reorganization. By contrast, when the S corporation is acquired in a B reorganization, its S status would terminate by reason of its new corporate stockholder.⁵⁷⁷

N. Reorganizations Involving LLCs

The law regarding tax-free reorganizations of and by LLCs, including reorganizations involving Disregarded Entities, has been the subject of significant developments. Final regulations now provide that mergers involving Disregarded Entities *e.g.*, LLCs with a single corporate owner, qualified REIT subsidiaries and

⁵⁷³ The acquirer may qualify as a successor corporation under section 1362(g) that can immediately elect S status. *See* Treas. Reg. § 1.1362-5(a) (circumstances under which the IRS may shorten the five-year waiting period); *see also* Rev. Rul. 70-232, 1970-1 C.B. 178 (no five year re-election ban after consolidation of two S corporations).

⁵⁷⁴ I.R.C. § 381.

⁵⁷⁵ *See* Rev. Rul. 69-566, 1969-2 C.B. 165; Rev. Rul. 79-52, 1979-1 C.B. 283.

⁵⁷⁶ *See* Rev. Rul. 72-320, 1972-1 C.B. 270 (D Reorganization permitted); G.C.M. 39768 (Dec. 1, 1988) (C reorganization); P.L.R. 97-21-010 (Feb. 13, 1997) (D reorganization); P.L.R. 91-11-055 (Dec. 19, 1990) (same); P.L.R. 91-08-059 (Nov. 29, 1990) (same).

⁵⁷⁷ *See* I.R.C. § 1362(d)(2).

qualified subchapter S subsidiaries, (such mergers, “C-DE Mergers”) may qualify as tax-free A reorganizations.⁵⁷⁸ In order to qualify as an A reorganization, the assets and liabilities (other than those satisfied or discharged in the transaction) of a target corporation and its DEs must become the assets and liabilities of the acquirer (held through its DEs), and the target corporation must cease its separate legal existence for all purposes.⁵⁷⁹ By contrast, a merger of a DE into a corporation will only qualify as an A reorganization if the DE’s parent corporation also merges with and into the corporation.⁵⁸⁰ In the latter case, all of the DE’s parent corporation’s assets may not be transferred to the acquirer absent a merger of the DE’s parent corporation.

The regulations also require that the DE be owned by a corporate entity and prohibit target shareholders from receiving interests in the disregarded entity.⁵⁸¹ However, unlike the prior temporary regulations, the target corporation, the acquirer, and the disregarded entity are not required to be US entities under the final regulations.⁵⁸²

The regulations remove the requirement that an A reorganization take place under “corporation laws,” requiring instead only that the merger take place under the laws of the United States, one of the fifty states, or the District of Columbia.⁵⁸³

⁵⁷⁸ See T.D. 9038, 2003-1 C.B. 524; Treas. Reg. § 1.368-2(b)(1).

⁵⁷⁹ See Treas. Reg. § 1.368-2(b)(1)(ii). The reference to “all of the assets” being transferred in the merger is intended to ensure that divisive reorganizations do not qualify as A reorganizations, but is not intended to apply the “substantially all” requirement to C-DE A reorganizations. T.D. 9038, 2003-1 C.B. 524; *see also* P.L.R. 2002-36-005 (May 23, 2002) (merger of target into disregarded LLC wholly owned by acquirer treated as an A reorganization); Rev. Rul. 2000-5, 2000-1 C.B. 436 (state law mergers that were essentially divisive reorganizations, not section 368(a)(1)(A) mergers, must satisfy section 355 requirements to receive tax-free treatment).

⁵⁸⁰ See Treas. Reg. § 1.368-2(b)(iii) and (b)(iv), Ex. 1 and 6.

⁵⁸¹ See Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 5 and 7.

⁵⁸² See Treas. Reg. § 1.368-2(b)(1)(iii). The regulations also permit A reorganizations involving foreign corporations. *See* T.D. 9242, 2006-1 C.B. 422; Treas. Reg. § 1.368-2(b)(1)(i).

⁵⁸³ See Treas. Reg. § 1.368-2(b)(1)(iii). A merger of an LLC and a corporation is allowed, for example, under Delaware corporate law.

Although the merger must occur pursuant to local law, the result of the regulations is consistent with the economic substance of the underlying transaction. Because the DE's existence is disregarded for all other tax purposes (local law recognition of the DE does not alter the fact that the DE is a "tax nothing"),⁵⁸⁴ a C-DE merger would be treated for all other tax purposes as an acquisition of target assets by the DE's parent in exchange for its stock.

In addition, the regulations confirm with an example that the status of an entity as a DE is tested immediately after the transaction.⁵⁸⁵ As a result, a target corporation's merger into a partnership that becomes a DE pursuant to the merger can qualify as an A reorganization. Prior to the release of the regulations, a commentator had questioned whether the acquiring entity must constitute a DE both immediately before and after the merger.⁵⁸⁶

Under the regulations, a merger of a target corporation into a DE will qualify as an A reorganization, provided the other A reorganization requirements are satisfied.⁵⁸⁷ Further, a forward triangular merger of a target corporation into a DE in exchange for stock of the corporate parent two levels up a corporate chain may qualify as an A reorganization, provided the requirements for an A2D reorganization are satisfied.⁵⁸⁸ These outcomes are logical and consistent with the underlying principles of section 368(a)(1)(A), since the acquirer would be treated as holding the target's assets directly for all other federal tax purposes.

See Delaware General Corporation Law, § 264; see also Delaware Limited Liability Company Act, § 18-209.

⁵⁸⁴ *See* Treas. Reg. § 301.7701-3 (preamble).

⁵⁸⁵ *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 11.

⁵⁸⁶ *See* T.D. 9242, 2006-1 C.B. 422. The government requested comments regarding the U.S. federal income tax consequences of the partnership's termination in the merger, including the extent to which the principles of Revenue Ruling 99-6, 1999-1 C.B. 432, apply in these situations. *See American Bar Association, Comments on Final Regulations Defining the Term "Statutory Merger or Consolidation", reprinted in* 2007 TNT 113-21 (June 12, 2007).

⁵⁸⁷ *See* Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 2; *see also* T.D. 9038, 2003-1 C.B. 524.

⁵⁸⁸ *See* Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 4.

The preamble to the previously issued temporary regulations confirmed that an immediate merger, or presumably, liquidation of the acquiring DE into its corporate parent would not affect the outcome of the merger of the target corporation into the DE, because neither transaction would alter the tax ownership of the target assets, and notes that an additional example was not necessary to illustrate this result.⁵⁸⁹ Accordingly, a transitory DE that is immediately merged into its corporate owner may be used to effect a tax-free reorganization.⁵⁹⁰ By contrast, a merger of a DE into an acquiring corporation will not qualify as an A reorganization unless the DE parent corporation also merges into the same corporation. Without both mergers, some or all of the DE parent corporation's assets may not be transferred to the acquirer, producing a divisive reorganization.⁵⁹¹

An acquisition of corporate target assets by a DE for DE parent voting stock or an acquisition of DE target assets by a corporation can also qualify as a C reorganization, *e.g.*, as an

⁵⁸⁹ See T.D. 9038, 2003-1 C.B. 524. The preamble described one commentator's suggestion that the recast in Revenue Ruling 72-405 of an A2D merger followed by a liquidation of the surviving subsidiary as a C reorganization should not disqualify an otherwise tax-free A reorganization of a target corporation into a DE when the DE immediately thereafter merges into its corporate parent. The preamble generally agreed with this conclusion and stated that the merger of a target corporation into a DE followed by the merger of the DE into its corporate parent "does not implicate the principles of Revenue Ruling 72-405." See T.D. 9038, 2003-1 C.B. 524. The preamble did not explicitly confirm, however, that an A-DE merger followed by a liquidation (rather than merger) of the DE will be treated as an A, rather than a C, reorganization.

⁵⁹⁰ See T.D. 9038, 2003-1 C.B. 524. Such a result would also be consistent with the treatment of two-step corporate reorganizations. See, *e.g.*, Rev. Rul. 2001-46, 2001-2 C.B. 321.

⁵⁹¹ See Treas. Reg. § 1.368-2(b)(1)(iii) and (b)(iv), Exs. 1 & 6; see also T.D. 9038, 2003-1 C.B. 524. Philip J. Levine, *Recent IRS "North-South" Rulings*, Practical U.S./Domestic Tax Strategies, Volume 10, No. 9 (Sept. 2010) (noting that in several recent spinoff rulings the IRS required a representation that the contribution of assets to the distributing corporation and its distribution of controlled subsidiary stock were not 'mutually interdependent'; these representations are less restrictive than the 'but for' test that the IRS has used in applying Treasury regulation section 1.301-1(l)).

acquisition of target assets in exchange for acquirer voting stock. The IRS has not confirmed whether the referenced target must be a corporation rather than a DE. However, the preamble to prior proposed regulations prohibiting A reorganizations with DEs correctly suggests that the merger of a DE into a C corporation could qualify as a C reorganization if the other C reorganization requirements are satisfied and the DE's parent liquidates as part of the transaction.⁵⁹² If, for example, a target DE's parent is a holding corporation with few, if any, assets, a merger involving the target DE would result in the acquisition of substantially all of the corporate parent's (and DE's) assets.

Acquisitions of target stock by DEs in exchange solely for DE parent voting stock should qualify as B reorganizations in which the DE parent exchanges its stock for target stock, although the final regulations notably do not address this fact pattern. A DE could presumably effect acquisitions through triangular B and C reorganizations with a DE subsidiary, in each case using DE parent stock as consideration, or with a DE, using DE grandparent stock. The final regulations indicate that forward triangular mergers into DEs in exchange for DE grandparent stock can qualify as A2D reorganizations.⁵⁹³ Finally, transfers of target assets to a DE in exchange for DE parent stock, after which the transferors control the DE parent for purposes of section 368(c), should also qualify as tax-free section 351 exchanges under current law.

O. Reorganizations Involving REITs

A real estate investment trust (a "REIT") is a pass-through entity that holds interests in real property, including debt secured by real property. An entity intending to qualify as a REIT must satisfy certain requirements regarding its form and ownership,⁵⁹⁴

⁵⁹² See 65 Fed. Reg. 3111 (May 16, 2000).

⁵⁹³ See Treas. Reg. § 1.368-2(b)(1)(iv), Ex. 4.

⁵⁹⁴ A REIT may be a corporation, trust, or association and must be managed by trustees or directors. I.R.C. § 856(a)(1). A REIT must be owned by 100 or more individuals holding transferable shares or certificates, and no more than 50% of the value of its shares may be owned, directly or indirectly, by five or fewer individuals at any time during the last half of its taxable year. I.R.C. §§ 856(a), (h)(1), 542(a)(2).

assets⁵⁹⁵ and income⁵⁹⁶ both before and after it is involved in a reorganization in order to maintain its status as a REIT. Subject to the stringent REIT qualification rules and practical considerations, REITs can acquire target corporations in a number of tax-free reorganizations.

⁵⁹⁵ At the close of each quarter of its taxable year, at least 75% of a REIT's assets must consist of real estate assets, cash and cash items, and government securities. I.R.C. § 856(c)(4)(A). The term "real estate assets" refers to real property interests (*e.g.*, fee ownership, leasehold interests and improvements on land), mortgages on real property, and shares in other REITs. *See* I.R.C. § 856(c)(5)(B). Except for securities of taxable REIT subsidiaries ("TRSs") and government securities, securities of any one issuer must not account for more than (i) 5% of the value of the REIT's total assets, (ii) 10% of the issuer's total voting power, and (iii) 10% of the total value of the issuer's outstanding securities. I.R.C. § 856(c)(4)(B)(ii). Securities of a TRS must account for no more than 20% of a REIT's total asset value. I.R.C. § 856(c)(4)(B)(iii). Further, a REIT cannot constitute a financial institution (as defined in section 582(c)(2) of an insurance company governed by subchapter L. I.R.C. § 856(a)(4).

A REIT cannot avoid the asset tests by placing "bad" assets in subsidiaries other than a TRS because qualified REIT subsidiaries are disregarded for federal income tax purposes and REITs are deemed to own their proportionate share of a partnership's assets. I.R.C. § 856(i)(1); Treas. Reg. § 1.856-3(g).

⁵⁹⁶ At least 75% of a REIT's gross income for each taxable year must consist of income from real estate assets (*e.g.*, rents from real property, interest on obligations secured by mortgages on real property or interests in real property, gain from the disposition of real property) or certain qualified temporary investment income, and at least 95% of a REIT's gross income for each taxable year must be composed of such items or dividends, interest, gain from the disposition of stock and securities (other than stock and securities held for sale to customers), and hedging income. I.R.C. § 856(c).

A REIT's annual dividends paid deduction must equal or exceed 90% of its taxable income for the year plus 90% of the excess of the net income from foreclosure property over the tax imposed on the income minus any excess non-cash income. I.R.C. § 857(a).

1. Preliminary Considerations for REITs

A REIT may need to reorganize as a C corporation prior to effecting a tax-free reorganization if it is formed as a business trust.⁵⁹⁷

A REIT seeking to acquire a target in a tax-free reorganization must be wary of the investment company rules under section 368 that only provide tax-free treatment with respect to a diversified investment company (*e.g.*, a regulated investment company (a “RIC”), or a corporation with a diversified portfolio).⁵⁹⁸ A non-REIT investment company can only be acquired tax-free if it qualifies as a RIC or if 50% or more of the value of its total assets consist of stock and securities, and 80% or more of the value of its total assets are held for investment.⁵⁹⁹

A target corporation merging into a qualified REIT subsidiary (a “QRS”) would be treated as transferring its assets to the QRS’s REIT shareholder, which transfer may trigger tax under Section 337(d). In general, a C corporation converting to a REIT, or a C corporation whose assets are acquired by a REIT in an otherwise tax-free asset reorganization must either immediately

⁵⁹⁷ For example, A reorganizations require a merger or consolidation pursuant to state law and a merger of a business trust may not be permitted under the law of certain states. Business trust REIT reincorporation can qualify as an F reorganization. I.R.C. § 368(a)(1)(F); P.L.R. 87-24-030 (Mar. 16, 1987); P.L.R. 80-45-085 (Aug. 15, 1980).

⁵⁹⁸ I.R.C. § 368(a)(2)(F)(i). Since REITs are generally diversified, the acquisition of a REIT by another REIT can generally be achieved tax-free.

⁵⁹⁹ I.R.C. § 368(a)(2)(F)(iii). Regulations defining “held for investment” under section 368(a)(2)(F) were proposed in 1980 and withdrawn in 1998 without explanation. Those regulations described an asset as “held for investment” if it was (i) held for gain from appreciation in value or for production or collection of passive income, or (ii) was not held primarily for sale to customers in the ordinary course of business. Prop. Reg. § 1.368-4, withdrawn, 63 Fed. Reg. 71047 (Dec. 23, 1998). Stocks and securities will be considered held for investment unless they are (i) held primarily for sale to customers in the ordinary course of business, or (ii) used in the trade or business of banking, insurance, brokerage, or a similar trade or business. Treas. Reg. § 1.351-1(c)(3).

recognize any net built-in gain in its assets, or the REIT must elect to be taxed under section 1374 on the C corporation's net built-in asset gain.⁶⁰⁰

In addition, a C corporation target with accumulated E&P could prevent the acquiring REIT from satisfying the REIT requirements after an acquisition.⁶⁰¹ Accordingly, the target must eliminate all of its E&P through dividend distributions either prior to the reorganization or in any case, prior to the end of the acquirer's taxable year. These distributions must be carefully structured to ensure the continued qualification of the tax-free acquisition. Such a pre-merger dividend distribution would presumably count against the substantially-all test. Further, an improperly structured dividend could be treated as part of the acquisition consideration, resulting in boot to the target shareholders and a failure of the target to distribute its E&P.⁶⁰²

2. A Reorganization

A target's merger with and into a REIT or a QRS of a REIT will qualify as an A reorganization if the other A reorganization requirements are satisfied.⁶⁰³ As required in all A reorganizations, at least 40% of the target shareholders' consideration given to target shareholders must consist of the REIT's stock.⁶⁰⁴

⁶⁰⁰ Treas. Reg. § 1.337(d)-7.

⁶⁰¹ A corporation will not qualify as a REIT for any taxable year if it has any accumulated E&P from a non-REIT year at the end of its taxable year. I.R.C. § 857(a)(2)(B); Treas. Reg. § 1.857-11(b).

⁶⁰² See *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970) (pre-acquisition dividend of notes repaid with money lent by acquirer recast as part of purchase price); cf. P.L.R. 98-13-004 (Dec. 17, 1997) (pre-acquisition dividend funded with excess cash fund borrowing secured by target's assets respected).

⁶⁰³ I.R.C. § 368(a)(1)(A). Under Treasury Regulations governing DE mergers discussed above in Section I.K., a merger of a target into a Disregarded Entity, including a QRS, in exchange for the stock of the DE's owner will qualify as an A reorganization. Treas. Reg. § 1.368-2(b)(iv), Ex. 2.

⁶⁰⁴ See Section I.D.1., above.

3. C Reorganization

An acquisition of substantially all of the target's assets and liabilities by a REIT or its subsidiary in exchange for the REIT's voting stock can be structured as a C reorganization, assuming satisfaction of the general C reorganization requirements discussed in Section I.C.2., above.⁶⁰⁵ The target must liquidate after the transfer and distribute the REIT stock to the former shareholders of the target.⁶⁰⁶

4. Forward Subsidiary Merger

The merger of a target with and into a REIT subsidiary with the subsidiary surviving may qualify as a tax-free A2D or A reorganization if the subsidiary is a TRS or a QRS (which is a Disregarded Entity), respectively.⁶⁰⁷ Notably, however, if the target is a REIT, a merger into a TRS would subject REIT assets to corporate tax.

5. B Reorganization

An exchange of target stock solely for voting stock of a REIT may qualify as a B reorganization.⁶⁰⁸ The stock exchange can occur either directly or by merging a subsidiary of the REIT with and into the target, with the target surviving. After the exchange, the REIT must hold 80% by value of the target's voting stock and 80% of all other classes of (nonvoting) stock of the

⁶⁰⁵ I.R.C. § 368(a)(1)(C). The IRS has ruled that REITs may acquire S corporations and other REITs, and REITs may be acquired, in valid C reorganizations. *See, e.g.*, P.L.R. 96-06-005 (Nov. 8, 1995) (acquisition of substantially all of target S corp's assets); P.L.R. 83-39-046 (June 27, 1983) (REIT's acquisition of substantially all of the assets of a target REIT); P.L.R. 82-38-072 (June 24, 1982) (bank holding company's acquisition of substantially all of a REIT's assets).

⁶⁰⁶ I.R.C. § 368(a)(2)(G).

⁶⁰⁷ *See* I.R.C. § 368(a)(2)(D); Temp. Reg. § 1.368-2T(b)(iv); Ex. 1; Stefan F. Tucker, *Unofficial Transcript of IRS Hearing on Allowing REITs to Merge Tax-Free*, 2000 TNT 164-16, at 23 & 41 (Aug. 23, 2000).

⁶⁰⁸ I.R.C. § 368(a)(1)(B), (C).

target.⁶⁰⁹ In addition, the target must be rated as a TRS immediately following the acquisition if the REIT does not want the transaction to be treated as an asset acquisition, which could endanger its REIT status and cause the target to recognize any built-in gain in its assets.

A B reorganization followed by the liquidation of the target has historically been treated as a C reorganization.⁶¹⁰ For example, if a REIT acquires and holds 100% of the target stock and does not elect to treat the target as a TRS, the target will be deemed to liquidate and will be treated as a QRS, which is a Disregarded Entity for federal tax purposes, and the transaction will be tested as a C reorganization.⁶¹¹ However, a B reorganization followed by a liquidation of the target can be modified to avoid application of the restrictive C reorganization rules in favor of the more lenient A reorganization rules by merging the target into a DE, such as a QRS, in a planned second step (rather than liquidating), to permit the transaction be tested as an A reorganization.⁶¹²

6. D Reorganization

A D reorganization is an asset reorganization between related parties in which the target transfers substantially all of its assets to the acquiring REIT if one or more of the target's shareholders is in control of the acquiring REIT and the REIT stock and securities are distributed in a tax-free transaction.⁶¹³ Unlike other reorganizations, the control requirement of a D reorganization is satisfied if the target or one or more of its shareholders owns at least 50% of the acquirer's stock, by vote or value, immediately after the merger.⁶¹⁴ An acquirer that has liabilities in excess of the basis of the transferred assets will trigger taxable gain in a D reorganization to the extent of such excess.⁶¹⁵

⁶⁰⁹ I.R.C. § 368(c).

⁶¹⁰ See Rev. Rul. 69-6, 1969-1 C.B. 104.

⁶¹¹ I.R.C. § 856(i)(2).

⁶¹² Rev. Rul. 2001-46, 2001-2 C.B. 321.

⁶¹³ I.R.C. § 368(a)(1)(D).

⁶¹⁴ See Section I.D.4., above.

⁶¹⁵ I.R.C. § 357(a)(1).

7. Reverse Subsidiary Merger

An acquisition by a REIT can be structured as a tax-free A2E reverse subsidiary merger if a subsidiary of the acquiring REIT merges with and into the target with the target surviving.⁶¹⁶ The target shareholders must exchange at least 80% of the target's voting stock and 80% of each class of nonvoting stock, for REIT voting stock in the merger,⁶¹⁷ and the substantially all requirement must also be satisfied.⁶¹⁸ A reverse subsidiary merger that causes a target to be treated as a TRS should not be used for acquisitions of existing REITs.

A reverse subsidiary merger will be treated as an A reorganization if the target is treated as a QRS (a Disregarded Entity), rather than a TRS, after the merger. As discussed above in Section I.F., a two-step acquisition in which the target's assets are held immediately after the transaction in a DE, such as a QRS, is taxed as an A reorganization.⁶¹⁹ In addition, the IRS has ruled that the merger of a target REIT into an acquiring REIT's newly formed subsidiary (other than a TRS) would be treated as a merger of a target REIT into the acquiring REIT in an A reorganization.⁶²⁰

8. Double Dummy Acquisition

An acquisition by a REIT could also be structured as a tax-free double dummy acquisition in which the shareholders of both the target and the acquiring REIT exchange their stock for stock of a holding company through separate reverse subsidiary mergers

⁶¹⁶ I.R.C. § 368(a)(2)(E); *see* Section I.E.2.

⁶¹⁷ Treas. Reg. § 1.368-2(j)(6), Ex. 2.

⁶¹⁸ Treas. Reg. § 1.368-2(j)(3)(iii).

⁶¹⁹ Rev. Rul 2001-46, 2001-2 C.B. 321.

⁶²⁰ Treas. Reg. § 1.368-2(b)(iv), Ex. 2 (merger of corporation into acquirer's DE qualifies as A reorganization); P.L.R. 89-03-074 (Oct. 26, 1988) (citing section 856(i) (defining QRS) as authority but not discussing the form of the reverse subsidiary merger); *see also* P.L.R. 95-12-020 (Dec. 29, 1994) (treating the merger of a S corporation into a QRS as a merger of a S corporation into a REIT, but not specifically ruling under section 368(a)(1)(A)); P.L.R. 94-09-035 (Dec. 7, 1993) (treating partnership's merger into QRS as acquisition of the partnership's assets by REIT).

with dummy subsidiaries of the holding company.⁶²¹ The holding company would make a REIT election, which would convert each of the target and the REIT into disregarded QRSs, since they would each be wholly owned by the holding company after the mergers.⁶²²

It should be noted that transfers to an investment company do not qualify for nonrecognition treatment under Section 351 unless the transfer will not result in a diversification of the transferor's interest (*e.g.*, each transferor transfers a diversified portfolio).⁶²³ Such a prohibited transfer to a REIT would occur if a transfer results, directly or indirectly, in the diversification of the transferor's interests.⁶²⁴

II. HOLDING COMPANY ACQUISITION STRUCTURES UNDER SECTION 351

A. Section 351

Section 351 provides for tax-free treatment in circumstances where, for valid corporate business purposes, one or more persons (the "transferors") transfer property to a new or existing corporation (the "transferee") in exchange for stock of the transferee, and immediately after the transfer, the transferors are in "control" of the transferee.⁶²⁵ Direct transfers to indirectly

⁶²¹ I.R.C. § 351. If the holding company only issues voting stock, the transfers may also qualify as B reorganizations.

⁶²² This would avoid the disqualification of the acquirer and the target as REITs because of the 100 shareholder requirement. *See* I.R.C. § 856(a)(5). However, the holding company must be careful not to violate the asset diversification requirement of section 856(c)(4)(B).

⁶²³ I.R.C. § 351(e).

⁶²⁴ Treas. Reg. § 1.351-1(c)(1). A transfer to an investment company also applies when transferee is a RIC or a corporation where more than 80% of the value of its assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are marketable stocks or securities, or are interests in RICs or REITs. Treas. Reg. § 1.351-1(c)(1).

⁶²⁵ In addition, the IRS takes the view that property transferred in a section 351 transaction must have value, and has advised that transfers of worthless property in exchange for stock do not qualify for tax-free treatment under section 351, because such transfers do

controlled lower-tier corporations have also been permitted as valid section 351 transfers if there is a significant business purpose.⁶²⁶ If these requirements are met, the receipt of transferee stock is generally tax-free. Transferors, however, will be taxed on any gain realized on the transfer to the extent they transfer property subject to liabilities in excess of basis or receive boot (including NQPS) as part of the transaction.⁶²⁷ The IRS has ruled that the necessary control can be acquired through a two party joint venture structure using an existing subsidiary of one party.⁶²⁸ In this ruling the IRS excepted transactions involving multiple contributions from the application of the step transaction doctrine; as a result, acquisitions can now employ simplified transaction structures that satisfy the control requirement.⁶²⁹ It should be noted, however,

not comply with the “in exchange for stock” requirement and because they lack a business purpose. *See* F.S.A. 2002-33-016 (May 9, 2002) (stock contributions within a controlled group necessary to enable a stapled stock transaction would only qualify as section 351 contributions if there was a valid business purpose). F.S.A. 2000-43-007 (July 22, 2000); F.S.A. 2001-35-001 (July 16, 1999) (transfer of loss property by one party and gain property by another party in order to net gains and losses not eligible for tax-free treatment under section 351); F.S.A. 2001-34-008 (Aug. 27, 2001 (parent’s purchase of subsidiary preferred stock not eligible for tax-free treatment under section 351 in part because transaction lacks business purpose); F.S.A. 2000-20-035 (Feb. 16, 2000) (transfer of property for estate planning purpose, rather than corporate business purpose, not eligible for tax-free treatment under section 351); C.C.A. 2001-17-039 (Apr. 27, 2001) (stripped lease transaction not eligible for tax-free treatment under section 351 in part because transaction lacks business purpose). C.C.A. 2002-35-005 (May 22, 2002) (same).

⁶²⁶ *See* P.L.R. 2000-31-039 (May 5, 2000); P.L.R. 97-10-018 (Dec. 5, 1996); P.L.R. 94-22-057 (Apr. 4, 1997).

⁶²⁷ *See* I.R.C. §§ 351(b)(1), 357(c).

⁶²⁸ *See* Rev. Rul. 2003-51, 2003-1 C.B. 938.

⁶²⁹ *See* Rev. Rul. 2003-51, 2003-1 C.B. 938 (the requisite control under section 351 was present in each step of (i) transfer of corporation A’s assets to its newly formed subsidiary B, (ii) corporation A’s transfer of B stock to a wholly owned subsidiary X of unrelated corporation Y, and (iii) Y’s contribution of cash and assets to X for additional Y stock). *See also* P.L.R. 2008-20-020 (Feb. 13, 2008) (shareholders of LLC contributed assets to Newco1 in exchange for Newco1 stock, Newco1 shareholders contributed their stock to Newco2 in exchange

that a previous ruling on this subject, Revenue Ruling 70-140, invoked the step transaction doctrine to deny tax-free section 351 treatment.⁶³⁰ The IRS distinguished Revenue Ruling 2003-51 from Revenue Ruling 70-140 on an “alternative form” of the transaction rationale. Whereas in Revenue Ruling 70-140 the taxpayer could not have achieved the same result in a different tax-free transaction, such an “alternative tax-free form” of the transaction was available to the taxpayer in Revenue Ruling 2003-51. This ‘alternative form’ rule represents a significant development for section 351 transactions. However, because of its novelty, cautious practitioners may hesitate to extend the approach in the ruling beyond its specific facts.

Section 351 is often used as part of an acquisition structure in situations where, because of its nature, the transaction would otherwise not qualify as a section 368 reorganization, *e.g.*, for lack of COI or failure to acquire either control or substantially all the target’s assets, and for mergers of equals, where a parent-to-parent merger raises liability concerns or neither company is willing to be the company that is “acquired.”⁶³¹ Taxpayers have also used section 351 structures in combination with put and call rights to

for Newco2 stock, Newco2 shareholders contributed their stock to Newco3 in exchange for less than 80% of Newco3 stock, shareholders of X contributed their stock to Newco3 in exchange for “b percent” of Newco3 and Newco2 merged with and into Newco3; IRS found that transaction satisfied section 351 because LLC shareholders could have transferred interests in LLC to Newco3, and X shareholders could have simultaneously transferred X stock to Newco3, all in exchange for 100% of Newco3 stock); Robert Willens, *IRS Reaffirms Willingness to Ignore Technical Violation of Control*, Daily Tax Rep. (BNA), at J-1 (discussing same).

⁶³⁰ See Rev. Rul. 70-140, 1970-1 C.B. 73. In the ruling, taxpayer A contributed assets to A’s wholly owned corporation X in exchange for additional X stock; A then transferred all of its X stock to unrelated corporation Y in exchange for Y voting stock. If both steps are respected as separate, the first would qualify as a tax-free section 351 transaction, and the second would qualify as a non-taxable B reorganization. Instead, the IRS ignored the first step as transitory and treated A as having contributed the assets directly to Y. Consequently, the transaction was taxable because A did not control Y immediately after the exchange.

⁶³¹ See P.L.R. 2012-22-014 (June 1, 2012) (section 351 transaction involving a corporation and partnership that would not have qualified for reorganization treatment under section 368).

lock in a guaranteed return to shareholders of an acquired corporation.⁶³²

B. The National Starch Technique

In some cases, certain shareholders may want tax-free treatment, *e.g.*, wealthy individuals who want to hold their stock to obtain a stepped-up tax basis upon their death. Where such shareholders do not own enough target stock to meet the 40% COI requirement for a section 368 reorganization, tax-free reorganization treatment is not possible. In these cases, consideration should be given to the “*National Starch*” approach.⁶³³ In a *National Starch* transaction, the buyer forms a new corporation (“Holdco”) to which it contributes cash for all the Holdco common stock; the target shareholders desiring tax-free treatment exchange their target stock for nonvoting, nonconvertible preferred Holdco stock structured to avoid the NQPS rules (bearing a fixed dividend and redeemable only after the shareholder’s death, unless neither target nor acquirer stock is publicly traded, for 20 years), and Holdco purchases the remaining target shares for cash.⁶³⁴

C. The “Double Dummy” Technique

Section 351 can also be used as part of an acquisition technique known as the “horizontal double dummy technique” pursuant to which a new holding company is formed to hold the

⁶³² See generally Lee Sheppard, *Giving the Boot to Ice Cream*, 96 Tax Notes 1183 (Aug. 26, 2002) (discussing Nestle-Dreyers transaction).

⁶³³ Unilever first utilized this technique in its 1978 acquisition of National Starch Corporation. See also Robert Willens, *Dow Jones and News Corp. Will Use the ‘National Starch’ Structure for Their Merger*, The Daily Deal (Aug. 8, 2008).

⁶³⁴ The acquisition of the target shares from the public is typically effected through a reverse subsidiary merger in which a newly organized subsidiary of Holdco (“Dummy Sub”) is merged into the target, with the target as survivor; in the merger, the target shareholders are given the choice to receive either Holdco preferred stock or cash. The IRS disregards the formation of the Dummy Sub and views the transaction as a transfer by the target shareholders of the stock of the target to Holdco in exchange for cash or preferred stock, as the case may be. See, *e.g.*, Rev. Rul. 79-273, 1979-2 C.B. 125.

stock of both the target and the acquirer.⁶³⁵ This technique is typically employed, like the *National Starch* approach, in situations where less than 40% of the consideration to be received by the target shareholders consists of acquirer stock (thus rendering the section 368 tax-free reorganization provisions inapplicable).⁶³⁶ Unlike the *National Starch* technique, in which target shareholders typically receive preferred stock of a Holdco that owns solely the stock of the target and cash, this technique allows the target shareholders to receive stock (generally common stock) in a publicly traded holding company that holds the combined businesses of both the target and the buyer.

In this acquisition structure, a new corporation (“Newco”) is formed with two shell subsidiaries, which are merged with and into the target and the acquirer, respectively. The target acquirer shareholders may each receive some combination of Newco (common) stock and boot (such as cash, debt securities and NQPS).⁶³⁷ Typically, however, the acquirer shareholders receive solely Newco common stock.

The IRS ignores the formation and subsequent mergers of the two acquisition subsidiaries and treats the transactions as transfers by the target and acquirer shareholders of their shares to Newco in exchange for the relevant merger consideration. In such case, the overall transaction qualifies as a tax-free incorporation of Newco under section 351, and the shareholders are taxed only to the extent they received boot.⁶³⁸ Section 351 transactions that

⁶³⁵ See generally Robert Willens, *Smart Use of “Double Dummy”*, Tax Notes, at 73 (Apr. 2, 2007).

⁶³⁶ Disney utilized the double dummy technique in its acquisition of Capital Cities/ABC and in Time Warner’s acquisition of Turner Broadcasting.

⁶³⁷ In Revenue Ruling 84-71, the IRS ruled that an acquisitive section 351 transaction is not subject to COI. Selected shareholders of the target may therefore exchange stock tax-free without regard to the percentage of the total consideration that consists of stock. Rev. Rul. 84-71, 1984-1 C.B. 106.

⁶³⁸ See Rev. Rul. 76-123, 1976-1 C.B. 94. But see Rev. Rul. 68-349, 1968-2 C.B. 143; Rev. Rul. 84-44, 1984-1 C.B. 105. The requisite 80% control for purposes of section 351 is measured after both mergers have occurred. For example, after the Disney-Capital Cities/ABC transaction was completed, former Capital Cities/ABC

include the formation of a new holding company must demonstrate that the holding company was formed for a legitimate (non-tax) business purpose, but this requirement is much easier to satisfy than in the case of spinoffs or even tax-free reorganizations.⁶³⁹

D. Loss Importation and Duplication Rules

As part of the 2004 Tax Act, Congress amended sections 362 and 334 in order to eliminate taxpayers' ability to claim losses in certain section 351 transactions and reorganizations it perceived as abusive.⁶⁴⁰

1. Loss Importation Rules

Inbound section 351 transfers and reorganizations in which built-in loss property, *i.e.*, property with a tax basis in excess of fair market value, is transferred by a non-U.S. entity or a U.S. tax-exempt entity would generally result in the acquisition of built-in losses that were generated outside of the U.S. tax system. To combat this "loss importation", section 362(e)(1) limits any transferee with built-in losses in an inbound section 351 transaction or reorganization to a fair market value basis in the acquired property in order to eliminate the creation of built-in loss for U.S. tax purposes.⁶⁴¹ An identical rule applies to inbound corporate liquidations.⁶⁴²

shareholders owned approximately 22% of the New Disney (Holdco) stock, but together with the Disney shareholders they owned 100% of New Disney, thus satisfying the control requirement.

⁶³⁹ Rev. Rul. 76-123, 1976-1 C.B. 94 (formation of new holding company that effected change of state of incorporation of transferred business was for valid business purpose). *Cf.* Rev. Rul. 68-349, 1968-2 C.B. 143 (no valid business purpose for holding company that was a mere continuation of corporate transfer or formed solely to qualify transaction as section 351 exchange).

⁶⁴⁰ The transactions at issue received intense scrutiny after their use by Enron to increase the company's reported book income while generating tax deductions from the "importation" and "duplication" of tax losses.

⁶⁴¹ I.R.C. § 362(e)(1).

⁶⁴² I.R.C. § 334(b).

Section 362(e)(1) applies only (i) if transferred property is imported into the U.S. tax system, *i.e.*, prior to the transaction gain or loss on the property is not subject to U.S. tax in the hands of the transferor, and (ii) the transferor has a built-in loss on a net basis, taking its aggregate asset bases and aggregate fair market values of all transferred assets into account.⁶⁴³ As the NYSBA notes, under this definition section 362(e)(1) may apply due to fluctuations in asset values between the signing and closing date of an acquisition. The NYSBA has recommended the IRS publish regulations permitting taxpayers to rely on asset values on the day prior to signing a binding contract in the same manner as the new COI rules.⁶⁴⁴

Because the loss importation rules only apply if the transferee has a built-in loss after netting the aggregate tax bases and fair market values of all transferred assets, certain losses could be imported despite these rules, as long as the transferee has an equivalent amount of built-in gains in other assets. Thus, transferors with significant built-in losses will have an incentive to “stuff” a transferee with built-in gain property to preserve existing built-in losses, since a transferee that receives assets with a single dollar of net built-in loss will be limited to a fair market value basis in all of the assets it receives. Query whether such contributions, although not necessarily consistent with the spirit of section 362(e), could be viewed as permissible since the rules suggest that importing built-in gain items is a legitimate basis to avoid the application of section 362(e).

2. Loss Duplication Rules

The second anti-abuse measure adopted in the 2004 Tax Act is designed to prevent the duplication of tax losses where built-in loss property is transferred to a corporation in exchange for stock in a section 351 transaction.⁶⁴⁵ Absent the application of section 362(e)(2), the transferee corporation could receive built-in loss property with a carryover basis and the transferor could receive stock with the same built-in loss. Section 362(e)(2) applies

⁶⁴³ I.R.C. § 362(e)(1)(B), (C).

⁶⁴⁴ See NYSBA Tax Section Letter and Report No. 1101 on Basis Adjustment Rules in Corporate Reorganizations Under Tax Code Sections 362(e), 334(b), Daily Tax Rep. (BNA) (Jan. 6, 2006).

⁶⁴⁵ See I.R.C. § 362(e)(2).

to transactions (i) that are not subject to the section 362(e)(1) loss importation rules, and (ii) in which the transferee's aggregate bases in all property transferred in the transaction exceed the aggregate fair market values of such property.⁶⁴⁶ If section 362(e)(2) applies, the aggregate bases of the transferred properties are reduced so that they do not exceed their aggregate fair market values. By contrast to the pure mark-to-market approach of the loss importation rules, the basis reduction rules under section 362(e)(2) do not eliminate all built-in losses, but merely reduce aggregate built-in losses to equal the amount of built-in gains in transferred assets. In lieu of reducing asset basis, the transferor and transferee may instead elect to reduce the basis in the transferor's stock received in the exchange (the "Stock Basis Reduction Election").⁶⁴⁷

In 2006, the government issued proposed regulations interpreting section 362(e).⁶⁴⁸ First, the proposed regulations clarify that the statute applies on a transferor-by-transferor basis⁶⁴⁹ and that a transferee increases its tax basis in transferred property to reflect any gain recognized by the transferor in the transaction before determining whether property has a built-in loss.⁶⁵⁰ Second, the proposed regulations would exempt a transfer of assets in a potential loss duplication transaction more than two years before entering the U.S. tax system by generally presuming that the aggregate fair market value of the transferred assets equals their aggregate adjusted tax basis in the transferee's hands immediately after the transfer, provided that the parties effected neither the

⁶⁴⁶ See I.R.C. § 362(e)(2)(A)(i), (ii).

⁶⁴⁷ See I.R.C. § 362(e)(2)(C).

⁶⁴⁸ 71 Fed. Reg. 62067 (Oct. 23, 2006). See generally Jeffrey L. Rubinger, *Section 362(e)(2) Built-In Loss Prop. Regs. Provide Clarity and Planning Opportunities*, 18 J. Int'l Tax'n 44 (June 2007); Joseph M. Calianno & Joseph M. Spitzenberger, *Congress and Treasury's Attack on Importing Taxpayer-Favorable Tax Attributes*, 36 Tax Mgmt. Int'l J. 214 (May 11, 2007).

⁶⁴⁹ See Prop. Reg. § 1.362-4(b)(2). While the statutory language plainly contemplates a transferor-by-transferor determination, the legislative history stated that section 362(e)(2) would apply in cases where "the aggregate adjusted bases of property contributed by a transferor (or controlled group of which the transferor is a member) to a corporation exceeded the fair market value of the property transferred". See S. Rep. No. 108-192, 125.

⁶⁵⁰ See Prop. Reg. § 1.362-4(b)(4)(ii).

original transfer nor the subsequent entry of assets into the U.S. tax system with a view to reducing any person's U.S. tax liability or duplicating any loss by avoiding section 362(e)(2).⁶⁵¹ Third, the government also proposes to exempt transactions where the loss duplication potential is eliminated by the transferor's distribution of the transferee's stock without gain recognition (*e.g.*, a section 355 transaction), provided that no person holds any asset with a tax basis determined by reference to the transferor's tax basis in the transferee stock.⁶⁵² Finally, the proposed regulations implement the Notice 2005-70⁶⁵³ interim rules for making the Stock Basis Reduction Election and also provide additional methods and time periods in which to make the election and expand the class of persons who can attach the required election statement to a tax return.⁶⁵⁴

⁶⁵¹ See Prop. Reg. § 1.362-4(b)(7). This presumption applies solely for purposes of section 362(e)(2). See Prop. Reg. § 1.362-4(b)(7).

⁶⁵² See Prop. Reg. § 1.362-4(b)(6).

⁶⁵³ 2005-2 C.B. 694. The interim rules (i) provide a statement that, if made by the transferor (or its controlling U.S. shareholder, in the case of a controlled foreign corporation), would exempt the transferee from any obligation to file the election, and (ii) explain that the IRS will also accept other statements made on or with respect to the parties' tax returns as effective elections if the applicable statement discloses sufficient information for the IRS to determine the parties involved, the transaction at issue and that the election is being made. See IRS Notice 2005-70, 2005-2 C.B. 694.

⁶⁵⁴ See Prop. Reg. § 1.362-4(c)(5). The proposed regulations also allow a "protective election", because the government recognizes that taxpayers may not always be able to determine with reasonable certainty whether section 362(e)(2) will, in fact, apply. See 71 Fed. Reg. 62067 (Oct. 23, 2006). In the preamble, the government requested comments on several issues, including (i) the adequacy of the instructions with respect to the Stock Basis Reduction Election, (ii) whether the basis tracing rules in Treasury Regulation section 1.358-2 should apply to a section 362(e)(2)(C) transaction, (iii) the treatment of partnership transfers in a section 362(e)(2) transaction, and (iv) the application of section 336(d) to property previously transferred in a section 362(e)(2) transaction. See 71 Fed. Reg. 62067 (Oct. 23, 2006).

See generally Thomas Hayes & David Hering, *Beware Asset Basis Reductions in Carryover-Basis Transactions*, 38 Corporate Tax'n 18 (July/Aug. 2011) (provides circumstances where making section 362(e)(2)(C) election may be advisable).

E. Investment Company Restrictions Under Section 351(e)

Section 351 treatment is not available for transactions that permit transferring shareholders to diversify their portfolio assets through the creation of “investment companies” without realizing gain.⁶⁵⁵ The 1997 Tax Reform Act (“1997 Act”) significantly expanded the scope of the investment company rules by expanding the definition of an investment company for section 351(e) purposes. Transfers of property to an investment company in exchange for its stock will be treated as transferring such property in a fully taxable exchange.⁶⁵⁶ A transferor corporation in a section 351(e) exchange will nonetheless be protected from the recognition of gain or loss upon receipt of property for its stock under section 1032. The corporation will receive a fair market value basis in the property received, and its holding period for the property will begin on the day after the transaction.⁶⁵⁷

A transfer to an investment company occurs if the transfer results, directly or indirectly, in a diversification of the interests of the transferor’s assets⁶⁵⁸ and the transferee is (i) a RIC; (ii) a REIT; or (iii) a corporation more than 80% of the value of whose assets are held for investment and are readily marketable stocks or securities in RICs or REITs.⁶⁵⁹ Investment company status is generally determined immediately after a putative section 351 transfer; however, subsequent changes contemplated at the time of

⁶⁵⁵ In response to the development of “swap funds” in the 1960’s which enabled investors to exchange appreciated holdings for shares in a newly organized mutual fund without realizing any gain, Congress enacted section 351(e)(1) in 1996 to deny nonrecognition treatment to transfers of property to an “investment company.”

⁶⁵⁶ See Treas. Reg. § 1.351-1(c)(1).

⁶⁵⁷ See Treas. Reg. § 1.1032-1(d); Rev. Rul. 66-7, 1966-1 C.B. 188.

⁶⁵⁸ It is unclear how section 351(e) applies to a group of several transferors, one or more of which have achieved diversification, while others have not. See NYSBA, *Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F)*, reprinted in 2011 TNT 250-7 (Dec. 29, 2011).

⁶⁵⁹ See Treas. Reg. § 1.351-1(c)(1).

an original transfer will also be taken into account in determining investment company status.⁶⁶⁰

“Readily marketable” stocks or securities were historically defined as publicly traded or quoted stocks and securities, as well as other instruments which are convertible into publicly traded or quoted stock.⁶⁶¹ As discussed below, this definition now includes non-traded stocks. Stocks and securities are presumed to be “held for investment” unless they are held primarily for sale to customers or used in the trade or business of banking, insurance, brokerage, or a similar trade or business.⁶⁶² A look-through rule provides that a parent corporation will be treated as owning its ratable share of a subsidiary corporation’s assets if it owns 50% or more (by vote or value) of the subsidiary stock.⁶⁶³ The look-through rule is described in the 1997 Blue Book as applying to “any shareholder (whether a corporation or other entity),” making it clearer that partnerships may claim look-through treatment for more than 50%-owned subsidiaries.⁶⁶⁴

Transfers of identical assets do not result in diversification. Thus, transfers by a single transferor and transfers of identical assets by two or more transferors to a newly formed corporation will not result in diversification. In determining whether identical assets are transferred, transfers of small amounts of non-identical

⁶⁶⁰ See Treas. Reg. § 1.351-1(c)(2).

⁶⁶¹ See Treas. Reg. § 1.351-1(c)(3).

⁶⁶² See Treas. Reg. § 1.351-1(c)(3).

⁶⁶³ See Treas. Reg. § 1.351-1(c)(4). “Look-through” treatment survives the 1997 Act changes. See S. Rep. No. 105-33, at 131 (1997).

There are no attribution rules under section 351(e) when determining whether the 50% threshold is met. Therefore, if a subsidiary is owned by multiple members of a related group, and no single member owns 50% of the subsidiary, the look-through rule seems to be inapplicable, and those members of the related group would be considered corporations, more than 80% of the value of whose assets are held for investment. See NYSBA, *Report on Investment Company Provisions: Sections 351(e) and 368(a)(2)(F)*, reprinted in 2011 TNT 250-7 (Dec. 29, 2011).

⁶⁶⁴ See STAFF OF THE JOINT COMM. ON TAX’N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, 105th Cong., 1st Sess., at 203 (the “1997 Blue Book”).

assets will be ignored, and transfers of identical assets that are part of a plan ultimately resulting in diversification will be stepped together.⁶⁶⁵ Transfers of property to a corporation that is not newly organized will result in diversification unless the transferee's assets are identical to the transferred property.⁶⁶⁶ A transfer of a diversified portfolio of stocks and securities also will not be subject to the investment company rules.⁶⁶⁷ A portfolio is considered diversified if not more than 25% of the value of the assets is invested in any one issuer and not more than 50% of the value of the assets is invested in five or fewer issuers.

The 1997 Act amendments to section 351(e) effectively nullify the "readily marketable" limitation on stock and securities by including assets without a readily ascertainable value in the determination as to whether a corporation is an investment company, limiting the number of transactions that will qualify for tax-free treatment under section 351.⁶⁶⁸ In addition, the 1997 Act also expanded the list of "investment assets" for purposes of the 80% value test in the regulations to include: (i) stocks and securities (whether or not readily marketable); (ii) money; (iii) other equity interests in a corporation and evidences of indebtedness; (iv) options, forward or futures contracts; (v) notional principal contracts and derivatives; (vi) foreign currency; (vii) publicly traded partnership and common trust fund interests; (viii) interests in precious metals not used in an actively conducted trade or business after the transfer; (ix) interests in noncorporate entities that are convertible or exchangeable into any of the foregoing investment assets; and (x) interests in any entity, substantially all of whose assets consist of the foregoing investment assets.⁶⁶⁹ In addition, the Treasury Department may issue regulations treating interests in other entities as investment assets (to the extent attributable to the foregoing assets) and may also either add or remove items from the laundry list of items set forth above.⁶⁷⁰

⁶⁶⁵ See Treas. Reg. § 1.351-1(c)(5).

⁶⁶⁶ See Prop. Reg. § 1.351-1(c)(5)(ii).

⁶⁶⁷ See I.R.C. § 368(a)(2)(F); Treas. Reg. § 1.351-1(c)(6)(i).

⁶⁶⁸ 1997 Blue Book, at 184.

⁶⁶⁹ See I.R.C. § 351(e)(1)(B).

⁶⁷⁰ See I.R.C. § 351(e)(1)(B).

Even after the 1997 amendments, however, a corporation or partnership should not be classified as an investment company for section 351(e) purposes if at least 20% of its assets consist of such non-investment assets as real estate and interests in partnerships that own operating businesses, real estate or other non-listed assets.⁶⁷¹

III. SECTION 355 TAX-FREE DISTRIBUTIONS

A. General Section 355 Requirements

A distribution of stock generally qualifies as a tax-free spinoff under section 355 (a “section 355 distribution”) if the following conditions are satisfied:

- Immediately before consummation of the distribution, the distributing corporation must own stock of the corporation to be distributed (such corporation, the “controlled corporation”) possessing at least 80% of the total combined voting power of all classes of controlled corporation stock and 80% of each class of nonvoting controlled corporation stock.⁶⁷²

⁶⁷¹ See Treas. Reg. § 1.351-1(c)(1)(ii).

⁶⁷² I.R.C. § 355(a)(1)(A). In a private letter ruling indicative of the growing popularity of LLCs, the IRS permitted a temporary reclassification of membership interests as stock in order to accomplish a tax-free distribution under sections 368(a)(1)(D) and 355. See P.L.R. 2004-05-009 (Sept. 30, 2003). See also P.L.R. 2010-07-050 (stating that a section 368(a)(1)(E) unwind will not cause an internal spinoff to fail to satisfy the “controls immediately before” requirement of section 355(a)(1)(A)). Regarding private letter rulings generally, see Amy S. Elliott, *The New Limits on Corporate Letter Rulings Explained*, 2012 TNT 20-1 (Jan. 31, 2012) (in the past, practitioners have tried to increase their chances of receiving a favorable ruling by obtaining preferred IRS attorneys to handle their transactions; the IRS has implemented new rules designed to limit the effectiveness of those strategies). In addition, a distribution involving a distributing corporation and controlled corporation that elect to be treated as S corporations may qualify as a section 355 distribution. See P.L.R. 2012-40-013 (Oct. 5, 2012).

- The distributing corporation must distribute such stock of the controlled corporation to distributees in their capacity as shareholders and security holders of the distributor.⁶⁷³ If controlled corporation securities are distributed to security holders, such holders must surrender their securities in exchange for securities with a greater principal amount.⁶⁷⁴
- The distribution must have a valid business purpose at the time of the distribution.⁶⁷⁵

⁶⁷³ I.R.C. § 355(a)(1)(A)(i), (ii). *See also* P.L.R. 2012-30-008 (July 27, 2012) (distribution to distributing corporation warrant holders treated as a distribution to distributing corporation shareholders for section 355 purposes); Jasper L. Cummings, *Overlaps and Warrants as Stock*, 2012 TNT 181-17 (Sept. 18, 2012) (discussing Private Letter Ruling 2012-30-008); Robert Willens, *Ruling Addresses Warrants and Deductible Liabilities in a Spinoff*, 2012 TNT 183-8 (Sept. 20, 2012) (same).

⁶⁷⁴ I.R.C. § 355(a)(3)(A).

⁶⁷⁵ *See* Treas. Reg. § 1.355-2(b). Tailoring the assets of a U.S. parent in order to facilitate a tax-free acquisition of the distributing company after the consummation of a distribution constitutes a good and valid business purpose. Rev. Proc. 96-30, 1996-1 C.B. 696. Increasing the combined share value of the distributing and controlled corporations is also a good business purpose if the spinoff allows either corporation (or both) to increase the value of its employee compensation or facilitate future acquisitions. A good business purpose at the time of the distribution is sufficient, even if, as a result of subsequent changes in circumstances, such business purpose cannot be achieved following the distribution. *See* Rev. Rul. 2003-55, 2003-1 C.B. 961; *see also* Robert Willens, *A New Era For the Business Purpose Requirement*, 50 Tax Prac. 41 (Apr. 21, 2006). Under certain circumstances, the separation of the distributing and controlled corporations can have a valid business purpose even where, following the distribution, the distributing and controlled corporations have overlapping corporate directors or other intercompany arrangements designed to facilitate the separation of the two businesses. *See* Rev. Rul. 2003-74, 2003-2 C.B. 77; Rev. Rul. 2003-75, 2003-2 C.B. 79; P.L.R. 2010-10-023 (Mar. 12, 2010) (business purpose for ruling was risk reduction); P.L.R. 2011-17-009 (Apr. 29, 2011) (spinoff structured because six family shareholder groups have had significant disagreements concerning the management and operation of distributing); FAA 20100301F (May

- The distributor must distribute stock of the controlled corporation constituting control (as defined in section 368(c)) of the controlled corporation.⁶⁷⁶ If the distributing corporation retains controlled corporation stock, it must establish that its retention of the stock is not pursuant to a plan that has a principal purpose of avoiding U.S. tax.⁶⁷⁷
- Immediately after the distribution, the distributing corporation and controlled corporation must each be engaged in the active conduct of a trade or business.⁶⁷⁸

15, 2005) (separation of distributing and controlled may occur notwithstanding the provision of certain goods and services by distributing to controlled at fair market value for a certain period of time after the distribution).

⁶⁷⁶ I.R.C. § 355(a)(1)(D); Treas. Reg. § 1.355-2(e). “Control” means the ownership of stock possessing at least 80% of the total combined voting power of a corporation and 80% of the number of shares of all classes of nonvoting stock of such corporation. I.R.C. § 368(c). *See* P.L.R. 2010-05-022 (Oct. 28, 2009) (U.S. parent corporation owned by a foreign corporation is in control of a subsidiary for section 368(c) purposes despite a proxy agreement between the U.S. parent and the government that generally ceded voting control to U.S. citizens chosen by the U.S. parent and insulated the subsidiary from the influence of an indirect foreign parent); *IRS Official Discusses Necessity of Obtaining PLR for Retention of Stock*, Daily Tax Rep. (BNA), at G-3 (Mar. 24, 2010).

⁶⁷⁷ I.R.C. § 355(a)(1)(D)(ii). *See* P.L.R. 2009-44-026 (Oct. 30, 2009) (company’s distribution of 80% of its controlled corporation stock to its shareholders and retention of the remaining 20% “to ensure investment grade debt ratings for both companies, provide capital flexibility to enable both companies to achieve their strategic objectives, avoid increased future financing costs and avoid raising equity capital,” qualified as a valid 355 transaction and was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax); Robert Willens, *Ralcorp’s Plans for its Retained Post Shares Revealed in Ruling*, 2012 TNT 110-13 (June 4, 2012) (business purposes for retention were to enable the distributing corporation to repurchase shares without jeopardizing its investment grade credit rating and minimize short-term volatility in the trading price of the controlled corporation stock).

⁶⁷⁸ I.R.C. § 355(a)(1)(C).

- The distribution of controlled corporation stock must not be used principally as a device to distribute earnings and profits.⁶⁷⁹
- Any distributed stock of a controlled corporation acquired in a taxable transaction within the five years preceding the distribution will be treated as boot (so-called “hot stock”).⁶⁸⁰ The IRS has ruled privately, however, that stock acquired in exchange for intellectual property interests will not be treated as boot.⁶⁸¹

Taxpayers seeking comfort that a planned distribution would be tax-free under section 355 have traditionally had the option of seeking a private ruling from the IRS.⁶⁸² However, the IRS has limited this option over time. In Revenue Procedure 2003-48, the IRS announced that it would no longer issue private rulings relating to whether a distribution (i) satisfies the business purpose requirement, (ii) is not principally a device for the distribution of earnings and profits, or (iii) is not part of a prohibited plan with an acquisition under section 355(e).⁶⁸³ Instead, the IRS intends to

⁶⁷⁹ I.R.C. § 355(a)(1)(B).

⁶⁸⁰ I.R.C. § 355(a)(3)(B). The final and temporary regulations on “hot stock” are discussed below. *See* T.D. 9435, 2009-1 C.B. 333.

⁶⁸¹ *See* P.L.R. 2002-17-051 (Jan. 28, 2002).

⁶⁸² Taxpayers may submit ruling requests involving one or more issues regarding the tax consequences or characterization of a section 355 transaction without requiring the taxpayer to request a ruling on the entire transaction. *See* Rev. Proc. 2009-25, 2009-1 C.B. 1088.

⁶⁸³ Rev. Proc. 2003-48, 2003-2 C.B. 86. Similarly, the Revenue Procedure states that the IRS will not issue supplemental private rulings relating to spinoffs due to a change in circumstances. However, the IRS has issued several supplemental rulings based on a change in circumstances that required the taxpayer to take an action it initially represented it would not take. *See, e.g.*, P.L.R. 2005-27-004 (July 8, 2005) (taxpayer represented it would not recapitalize controlled for 5 years after the ruling; difficulties resulting from two outstanding classes of stock required a recapitalization into one class of stock within such period); P.L.R. 2001-18-018 (May 4, 2001) (taxpayer represented that it had no plan or intention to recapitalize controlled; unanticipated market and business conditions required a recapitalization into one class of stock). *See* P.L.R. 2010-04-001

increase the volume of published guidance under section 355. Over the two-month period following the issuance of the Revenue Procedure, the IRS, in fact, issued six new Revenue Rulings under section 355 addressing (i) the active trade or business requirement, (ii) the business purpose requirement, and (iii) the distribution of control requirement.⁶⁸⁴ Notably, however, the IRS has only issued two revenue rulings interpreting section 355 since 2003.⁶⁸⁵

In Revenue Procedure 2013-3, the IRS announced that it will no longer issue private letter rulings relating to (i) whether the pre-distribution control requirement is satisfied, if in anticipation of the planned distribution, the distributing corporation acquires the requisite voting control in a recapitalization in which low vote stock or securities were exchanged for high vote stock, (ii) whether a distribution of any controlled corporation debt or equity in exchange for, and in retirement of, distributing corporation debt issued in anticipation of the distribution is tax-free and (iii) whether related but formally separate transfers of property into and

(Jan. 29, 2010) (the IRS appears to have violated its no-ruling policy by concluding that a taxpayer's reclassification that caused a vote shift among its shareholders was not part of a plan under section 355(e)); *IRS Issued a Ruling in a No-Rule Area, Official Says*, 2010 TNT 56-1 (Mar. 23, 2010). *See also* P.L.R. 2010-37-026 (Sept. 17, 2010) (disregarding circular flow of cash in restructuring prior to a section 355 distribution); P.L.R. 2011-44-014 (July 29, 2011) (distributing issued cash dividend to sole shareholder equal to the value of controlled and shareholder then purchased controlled from distributing with dividend proceeds; circular cash flow between distributing and shareholder disregarded and transaction treated as a section 355 distribution).

⁶⁸⁴ *See* Rev. Rul. 2003-38, 2003-1 C.B. 811 (active trade or business requirement); Rev. Rul. 2003-52, 2003-1 C.B. 960 (business purpose requirement); Rev. Rul. 2003-55, 2003-1 C.B. 61 (business purpose requirement); Rev. Rul. 2003-75, 2003-2 C.B. 79 (business purpose requirement); Rev. Rul. 2003-79, 2003-2 C.B. 80 (control test for section 355 and "substantially all" test for tax-free reorganizations). Despite the spate of published guidance, some commentators are concerned about the trend of curtailing private rulings. *See* Richard W. Bailine, *The Curtailment of Letter Rulings – A Bad Deal for All*, Vol. 30 No. 5 J. Corp. Tax'n 40 (Sept./Oct. 2003).

⁶⁸⁵ Rev. Rul. 2007-42, 2007-2 C.B. 44 (active trade or business requirement); Rev. Rul. 2005-65, 2005-2 C.B. 684 (section 355(e)).

out of a corporation, *i.e.*, north-south transactions, are respected as separate transactions.⁶⁸⁶

In Revenue Procedure 2013-32, the IRS announced that it will no longer rule on whether a transaction qualifies for nonrecognition treatment under section 355; however, the IRS will rule on one or more issues relating to section 355 to the extent that the issue is significant.⁶⁸⁷ A “significant issue” is an issue of law the resolution of which is not free from doubt and that is germane to determining the tax consequences of the transaction.⁶⁸⁸

B. The Control Requirement

It is possible to satisfy the control requirement and issue more than 20% of the controlled corporation’s stock to third parties prior to a distribution, or to recapitalize a subsidiary to obtain control while third parties retain more than 20% of the economics, through the use of high and low-vote stock structures, as long as

⁶⁸⁶ Rev. Proc. 2013-3, 2013-1 I.R.B. 113. *See also* Amy S. Elliot, *Officials Justify Halt in Rulings on North-South and Common Spin Transactions*, 2013 TNT 15-3 (Jan. 23, 2013) (Bill Alexander commenting that it is unclear whether there will be any change in enforcement policy with respect to the no-ruling areas); Lydia Beyoud, *IRS to Fully Review Rulings on Corporate Securities for Debt Exchanges, Official Says*, Daily Tax Rep. (BNA), at G-4 (Jan. 29, 2013) (old and cold debt of the distributing corporation may still be eligible for a ruling); Alison Bennett, *IRS Encouraging Taxpayers to Discuss Sec. 355 Deals No-Ruling List, Officials Say*, Daily Tax Rep. (BNA), at G-2 (Feb. 25, 2013) (IRS may consider commercial paper issued around the time of a distribution as issued in anticipation of a distribution); Amy S. Elliot, *Debt Refinancing Likely Falls Under Leveraged Spinoff No-Rule*, 2013 TNT 37-2 (March 4, 2013) (a refinancing of existing debt—even if it is just at a lower interest rate—may be considered as being issued in anticipation of a distribution, resulting in the refinancing falling within the no ruling area).

⁶⁸⁷ Rev. Proc. 2013-32, 2013-28 I.R.B. 1. Revenue Procedure 2013-32 also applies to sections 332, 351, 368 and 1036.

⁶⁸⁸ If, for instance, two different Code sections provide for the same tax consequences but qualification under the first Code section is free from doubt, the taxpayer must explain why the resolution of the issue relating to the second Code section is germane to determining its tax consequences for the IRS to rule on the issue. Rev. Proc. 2013-32, 2013-28 I.R.B. 1.

such structures are permanent.⁶⁸⁹ A pre-distribution recapitalization can also be effected to tailor shareholder interests in anticipation of a non-pro rata split-off.⁶⁹⁰ Following a

⁶⁸⁹ See Rev. Rul. 69-407, 1969-2 C.B. 50 (permitting distributing to acquire control of controlled in a pre-distribution recapitalization); see also P.L.R. 2002-05-035 (Oct. 31, 2001); P.L.R. 2003-11-023 (Mar. 14, 2003); see generally Robert Willens, *Lucent Spin Off of Agere Systems Continues to Plumb Depths of Section 355(e)*, Daily Tax Rep. (BNA), at J-1 (May 21, 2002); Robert Willens, *Gaining Control of a Partially Owned Subsidiary in Anticipation of a Spinoff*, Daily Tax Rep. (BNA), at J-1 (Feb. 11, 2002); J. William Dantzler, Jr., *Spinoffs: Still Remarkably Tax Friendly*, 129 Tax Notes 683 (Nov. 8, 2010) (illustrating, through the spinoff of Chipotle Mexican Grill Inc. and the spinoff of Reinsurance Group of America Inc., that the high and low-vote stock structures may be undone after the spinoff if sufficient time lapsed between the two steps, assuming both intervention by the board of directors and a shareholder vote); P.L.R. 2011-160-01 (Apr. 22, 2011) (recapitalization followed by spinoff). But see Robert Willens, *Unwinding a High-Vote/Low-Vote Stock Structure Is Not Difficult*, 11 TNT 102-14 (May 23, 2011) (belief that voting structure effected by recapitalization need remain in effect only briefly, perhaps for as little as 30 days following the spinoff); Robert Willens, *Cargill's Recapitalization Will be Undone*, 132 Tax Notes 535 (Aug. 1, 2011) (a recent ruling confirms that the IRS will approve the prompt undoing of a preliminary recapitalization as long as no legal obligation to unwind exists at the time of the distribution); P.L.R. 2010-05-022 (Feb. 5, 2010) (notwithstanding a proxy agreement placing voting rights of controlled into the hands of an independent party to insulate controlled from any influence by its indirect foreign parent, the IRS ruled that distributing owned at least 80% of the total voting power of controlled).

⁶⁹⁰ See P.L.R. 2004-03-19 (Jan. 16, 2004) and P.L.R. 2007-31-025 (Aug. 3, 2007) (intra-group transaction to eliminate hook stock (*i.e.*, parent stock owned by its subsidiary) involving (i) a recapitalization of controlled into two classes of stock, (ii) a distribution of both classes of controlled stock to parent, (iii) an exchange by parent of one class of controlled stock for hook stock of the parent subsidiary treated as tax-free distribution under section 355, and (iv) a contribution of the other class of controlled stock down the chain to the subsidiary). See generally P.L.R. 2011-35-025 (Sept. 2, 2011) (parent had three series of publicly traded common stock, and controlled reorganized its single class of common stock into the same three series of; subsequent split-off of controlled shares qualified as D reorganization).

distribution of a subsidiary with a recapitalized voting structure, the IRS has permitted a reverse recapitalization to effect a single class of voting stock when the controlled corporation demonstrated that when the original recapitalization occurred the voting structure was intended to be permanent, and the unwinding was prompted by unexpected events such as unanticipated disparities in the trading prices of classes of stock that occurred after the distribution.⁶⁹¹ Notably, however, acquisition of control through a controlled corporation's redemption of shares may prevent a distribution from qualifying for tax-free status under section 355 until the distributing corporation has operated the "acquired" subsidiary's business for five years.⁶⁹²

The IRS has eliminated the recast risk that historically applied to a so-called "reverse-*Morris Trust*" transaction, in which, as part of a single plan, a distribution is followed by a combination of the controlled corporation and an unrelated corporation.⁶⁹³ If

⁶⁹¹ See P.L.R. 2000-50-017 (Sept. 13, 2000); P.L.R. 2001-18-018 (Jan. 31, 2001); P.L.R. 2001-39-011 (June 28, 2001).

⁶⁹² See *McLaulin v. Commissioner*, 115 T.C. 255 (2000), *aff'd*, 276 F.3d 1269 (11th Cir. 2001). The Tax Court in *McLaulin* indicated that, if the cash used to redeem the subsidiary's shares did not come from the distributing corporation, a valid section 355 distribution could still obtain. See *McLaulin v. Commissioner*, 115 T.C. 255, 264-65 (2000), *aff'd*, 276 F.3d 1269 (11th Cir. 2001). However, on appeal the Eleventh Circuit held that any redemption, regardless of the source of funds, would require a 5-year delay prior to a section 355 distribution. See *McLaulin v. Commissioner*, 276 F.3d 1269, 1275 (11th Cir. 2001). The IRS has requested comments on the effect of redemptions on compliance with the active trade or business requirement. See 72 Fed. Reg. 26012 (May 8, 2007). See also NYSBA, *Report on Proposed Rules Regarding Active Trade or Business Under Section 355(b)*, reprinted in 2008 TNT 9-50 (Jan. 11, 2008).

⁶⁹³ See generally Robert Willens, *Judgment Call: Split Screen*, The Daily Deal (Dec. 25, 2003); Robert Willens, *Point of Order*, The Daily Deal (May 7, 2003); Robert Willens, *New IRS Ruling Focuses Attention on "Control" in Section 355 Transactions*, 89 J. Tax'n 5 (July 1998). Examples of reverse-*Morris Trust* transactions include: Alltel's spinoff of its wireline business and merger with Valor Communications, for which the taxpayer obtained P.L.R. 2006-29-2007 (July 21, 2006), and Weyerhaeuser's spinoff of its fine paper business and merger with Domtar, Inc., for which the taxpayer obtained P.L.R. 2007-18-024 (May 4, 2007).

the IRS were to reorder the steps in such a transaction, so that the combination preceded the distribution, if more than 20% of the distributed corporation were acquired, the distributing company would lack the required 80% control and as a result, the distribution would not qualify for tax-free treatment. The IRS announced in 1998 that it would no longer seek to apply the step-transaction doctrine to events following the distribution in order to find control lacking in the distribution and has issued recent private rulings to this effect.⁶⁹⁴

Continuing the trend of refraining from applying the step transaction in section 355 distributions the IRS has also treated a partial liquidation followed by a distribution as separate transactions, even though the taxpayer conceded the transactions were part of an overall plan.⁶⁹⁵ Finally, the IRS has consistently

⁶⁹⁴ See Rev. Rul. 2003-79, 2003-2 C.B. 80 (transfer of one line of business to the new subsidiary followed by tax-free section 355 distribution and then acquisition of subsidiary's assets in a C reorganization; notably, the "substantially all" requirement was satisfied in the subsidiary acquisition but would not have been satisfied in an acquisition of the same assets directly from the distributing corporation); Rev. Rul. 98-27, 1998-1 C.B. 1159; Rev. Rul. 98-44, 1998-2 C.B. 315; P.L.R. 2003-50-002 (Sept. 5, 2003) (General Motors Corp.-Hughes Electronics tax-free spinoff in which Class A stock representing more than 80% of subsidiary's voting power was distributed and Class B stock sold to an unrelated acquirer, followed by the reverse subsidiary merger of distributed corporation with the acquirer subsidiary); P.L.R. 2003-10-005 (Nov. 21, 2002) (Heinz Co.-Del Monte ruling; transfer of non-core businesses to newco, followed by distribution of newco and acquisition of newco by unrelated corporation in an A2E reorganization qualified as a tax-free section 355 distribution).

⁶⁹⁵ P.L.R. 2006-26-016 (Mar. 24, 2006). A corporation operating two businesses decided to cease operation of one division. As part of a plan, the corporation sold the unwanted operating assets to an unrelated buyer for cash and notes, distributed part of the proceeds to its shareholders in partial liquidation of their stock, and then distributed stock of its wholly owned subsidiary to its shareholders pro rata. The taxpayer was afforded sale or exchange treatment on the partial liquidation under section 302(b)(4) and the subsequent distribution was tax-free under section 355. Compare Robert Willens, *Recasting a Spinoff*, 112 Tax Notes 1175 (Sept. 25, 2006) (partial liquidation and spinoff should be stepped together and integrated), with Kevin B. Shea, *Responding to 'Recasting a Spinoff'*,

viewed a sole shareholder's contribution of assets to distributing, followed by distributing's distribution of controlled corporation stock to the shareholder, as separate steps.⁶⁹⁶ In this case, the asset contribution to distributing should qualify as a tax-free section 351 exchange, and the distribution of controlled corporation stock to the sole shareholder should qualify as a section 355 transaction.

2006 TNT 215-34 (Nov. 7, 2006) (partial liquidation and spinoff properly respected as individual transactions). *See also* P.L.R. 2010-47-016 (Nov. 26, 2010) (subsidiary's merger into a newly formed LLC undertaken as an intermediary step in a spinoff transaction was respected as a complete liquidation under section 332).

⁶⁹⁶ *See, e.g.*, P.L.R. 2006-11-006 (Mar. 17, 2006) (distributing's contribution of property to controlled, followed by controlled's distribution of its subsidiary to distributing and distributing's distribution of controlled stock to shareholders qualified as D reorganization); P.L.R. 2004-11-021 (Mar. 12, 2004) (parent contributed property to distributing, followed by distributing's distribution of controlled stock); P.L.R. 2003-45-049 (Nov. 7, 2003) (after receiving a distribution of controlled stock, distributing's shareholder contributed property to distributing as part of a bankruptcy reorganization, followed by a distribution of distributing stock to shareholders; qualified as a G reorganization); P.L.R. 2011-36-009 (Sept. 9, 2011) (parent's contribution of partnership interests to controlled followed by distribution of controlled stock qualified as D reorganization). *See also* NYSBA, *Formal Guidance for Stock Buybacks and 'North South' Transactions*, reprinted in 2008 TNT 161-14 (Aug. 19, 2008) (requesting that IRS issue formal guidance treating transfer of contributed assets in North/South transaction separately from subsequent section 355 distribution); Amy S. Elliot, *Alexander Explains Expanding 'North-South' Ruling Position*, 2012 TNT 35-7 (Feb. 22, 2012) (key to recent rulings addressing north-south transactions is that taxpayers make a 'no-compulsion rep,' which confirms that there is no compulsion causing distributing to make the relevant contribution as a condition to controlled making a cash distribution); Amy S. Elliot, *Alexander Addresses Electivity of Exchange Transactions*, 2012 TNT 78-5 (Apr. 23, 2012) (recent private letter rulings have provided that a contribution followed by a distribution will not be integrated as an exchange, as long as equivalent value passes between the two entities and the taxpayer documents that the north and south legs constitute an exchange).

C. The Active Trade or Business Test

A distribution must satisfy the active trade or business test in section 355(b).⁶⁹⁷ In order to do so, distributing and controlled must each (i) be engaged immediately after the distribution in an active trade or business, (ii) have actively conducted the trade or business for at least five years ending on the distribution date, and (iii) not have acquired such trade or business within five years of the distribution date in a transaction in which gain or loss was recognized in whole or in part (the “Asset Acquisition Rule”).⁶⁹⁸ Moreover, neither distributing nor controlled can acquire (directly or through one or more corporations) stock representing section 368(c) control of the corporation conducting the active trade or business within five years of the distribution date in a transaction in which gain or loss was recognized in whole or in part (the “Stock Acquisition Rule”, together with the Asset Acquisition Rule, collectively the “Acquisition Rules”).

Historically, a corporation often needed to move assets (*i.e.*, through distributions, contributions, mergers or otherwise) within its affiliated group to ensure, for example, that substantially all its assets consisted of stock or securities of corporations engaged in an active trade or business. Under current law, however, all members of a corporation’s separate affiliated group constitute one corporation for purposes of applying the active trade or business test.⁶⁹⁹ Following the distribution, distributing’s

⁶⁹⁷ See I.R.C. § 355(a)(1)(C).

⁶⁹⁸ See I.R.C. § 355(b)(1)-(2); *see generally* Robert Willens, *A Surprising Interpretation of the Active Business Test*, 117 Tax Notes 479 (Oct. 29, 2007). *See also* Robert Willens, *Cypress Semiconductor and SunPower – Revisiting a Spinoff*, 118 Tax Notes 957 (Feb. 25, 2008) (one way to spin off a recently acquired business is to drop that business into a new holding company, along with a good 5-year active trade or business); Robert Willens, *EMC Spinoff of VMware Possible with Finesse of ‘Active Business’ Requirement*, Daily Tax Rep. (BNA), at J-1 (Oct. 25, 2007); Robert Willens, *Can EMC Spin Off VMware?*, Daily Deal (Oct. 12, 2007); Robert Willens, *IRS Exhibits Surprising Flexibility Regarding Active Business Test*, 2007 TNT 123-24 (June 26, 2007).

⁶⁹⁹ See I.R.C. § 355(b)(3)(B). The relevant legislative history indicates that the amendment is designed to eliminate the need for corporations (primarily those that use holding company structures) to engage in elaborate and complex group restructurings to satisfy the

separate affiliated group consists of distributing as the common parent and all corporations affiliated with distributing through stock ownership representing at least 80% (by vote and value) of the entity's stock, and controlled's separate affiliated group is similarly measured.⁷⁰⁰ Consequently, distributing's and controlled's separate affiliated groups can each rely on any active businesses located within their respective separate affiliated group.

A direct or indirect acquisition of a trade or business by one affiliated group member from another affiliated group member (e.g., pursuant to a cross-chain sale, upstream sale or taxable distribution) will not preclude satisfaction of the active trade or business requirement, even if gain or loss is recognized in connection with such an acquisition.⁷⁰¹

In addition, the active trade or business requirement permits distributing or controlled to create, purchase or otherwise acquire a trade or business that is an expansion of an existing trade or business.⁷⁰² The Tax Technical Corrections Act of 2007 (the

active trade or business requirement. *See* H.R. Rep. No. 109-304, 109th Cong., 2d. Sess. 54 (2005); *see also* Robert Willens, *Attempting, Once Again, to Rationalize the Active Business Requirement*, Daily Tax Rep. (BNA), at J-1 (July 12, 2005). Applying the active trade or business test on a group basis eliminates the distinction between directly and indirectly carrying on a trade or business. For example, the active trade or business test will be satisfied if distributing is a holding company and the parent of an affiliated group, as long as the affiliated group is engaged in an active trade or business. This modification to the active trade or business requirement, which was initially effective only for distributions occurring between May 18, 2006 and December 31, 2010, was made permanent by the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 (2006).

⁷⁰⁰ *See* I.R.C. § 355(b)(3)(B).

⁷⁰¹ *See* Treas. Reg. § 1.355-3(b)(4)(iii) and (iv); *see also* Notice 2007-60, 2007-2 C.B. 466 (IRS will not challenge applicability of Treasury Regulation section 1.355-3(b)(4)(iii) to distributions effected on or before date of publication in Federal Register of temporary or final regulations modifying Treasury Regulation section 1.355-3(b)(4)(iii)).

⁷⁰² *See* Treas. Reg. § 1.355-3(b)(3)(ii); *Athanasios v. Commissioner* T.C. Memo. 1995-72. Thus far, the IRS has taken a relatively narrow view of expansion in published guidance and has only ruled

“2007 Tax Act”) treats distributing’s or controlled’s acquisition of a separate affiliated group member’s stock within the five year period as an asset purchase that may qualify as an expansion of distributing’s or controlled’s existing active trade or business.⁷⁰³

In May, 2007, the Treasury Department issued proposed regulations addressing active trade or business issues under the separate affiliated group rule (the “Proposed Active Trade or Business Regulations”), which would change the analysis of whether a corporation was acquired in a taxable transaction during

favorably on a horizontal expansion (*i.e.* new product lines). *See* Rev. Rul. 2003-18, 2003-1 C.B. 467 (automobile dealership and service center expands to sell and service a new brand, and discontinues activities with respect to original brand, less than five years to prior to a distribution). It is not clear whether the IRS would issue a favorable ruling with respect to a vertical expansion (*i.e.* new business activities). *See generally* Robert Willens, *Finessing the Active Business Test of Section 355*; Robert Willens, *IRS Concession Allows Taxpayers to Avoid the Five Year Rule*, Daily Tax Rep. (BNA), at J-1 (Aug. 26, 2002); Robert Willens, *Regulations Render Nielsen Decision Obsolete*, 131 Tax Notes 1187 (June 13, 2011). *But see* P.L.R. 1999-37-014 (June 15, 1999) (permitting taxable acquisition of a corporation engaged in installation of the type of products acquirer manufactures within five years of a distribution); Robert Willens, *Corporate Reorganizations: The ‘Expansion’ Doctrine Insulates a ‘Tainted’ Control Acquisition*, 30 Tax Mgmt, Weekly Rep. 1056 (Sept. 5, 2011) (suggesting that the expansion doctrine may provide an implicit exception to section 355(b)(2)(D)). The Proposed Active Trade or Business Regulations utilize a facts and circumstances test to determine whether an acquired business is in the same line of business as the original business for purposes of expansion. *See* Prop. Reg. § 1.355-3(b)(3)(ii) (including examples of factors addressing product similarity, identical business activity, and whether experience and know-how developed in the original business is necessary for the acquired business’ operation).

⁷⁰³ *See* Tax Technical Corrections Act of 2007, Pub. L. No. 110-172. The NYSBA has recommended that the government include an example in the section 355(b) regulations addressing the amount of time that must pass after an expansion purchase before the acquired business could qualify as controlled’s only active business. *See* NYSBA, *Report on Proposed Rules Regarding Active Trade or Business Under Section 355(b)*, reprinted in 2008 TNT 9-50 (Jan. 11, 2008).

the relevant five year period.⁷⁰⁴ The Proposed Active Trade or Business Regulations would expressly apply the separate affiliated group rule in determining whether there has been an impermissible acquisition within the five year period preceding a distribution, and by doing so would generally recast a stock acquisition that causes an acquired corporation to become a distributing or controlled separate affiliated group member as an asset acquisition, consistent with the approach of treating each separate affiliated group as a single entity for active trade or business purposes and thus disregarding the separate existence of group members.⁷⁰⁵

The Acquisition Rules preclude distributing from using assets (instead of its equity) to acquire a new trade or business and then distributing this new business to its shareholders in a section 355 distribution.⁷⁰⁶ The Proposed Active Trade or Business Regulations would provide limited exceptions to the literal application of the Acquisition Rules when gain or loss is recognized but the purposes of section 355 are not violated.⁷⁰⁷

Finally, the Proposed Active Trade or Business Regulations would add a new requirement to be engaged in an active trade or

⁷⁰⁴ See 72 Fed. Reg. 26012 (May 8, 2007). The proposed regulations would apply to distributions occurring after the date the regulations are published in final form.

⁷⁰⁵ See 72 Fed. Reg. 26012 (May 8, 2007). As stated above, Congress already enacted this rule in the 2007 Tax Act.

⁷⁰⁶ See 72 Fed. Reg. 26012 (May 8, 2007).

⁷⁰⁷ Prop. Reg. § 1.355-3(b)(4)(iii); see NYSBA, *Report on Proposed Rules Regarding Active Trade or Business Under Section 355(b)*, reprinted in 2008 TNT 9-50 (Jan. 11, 2008). The proposed regulations would disregard the Acquisition Rules where gain or loss is recognized in the following transactions: (i) acquisitions by the controlled separate affiliated group from the distributing separate affiliated group if the distributing separate affiliated group controls controlled immediately after the acquisition; (ii) acquisitions that are tax-free, except for gain or loss recognized with respect to cash in lieu of fractional shares; and (iii) acquisitions of distributing corporations by distributee corporations whose basis in distributing's stock is determined by reference to the transferor's basis. See Prop. Reg. § 1.355-3(b)(4)(iii)(A)-(C).

business.⁷⁰⁸ The relevant corporation (or its separate affiliated group, or partnership) would now be required to own both the company's goodwill and significant trade or business assets.⁷⁰⁹ The proposed regulations also respond to the question of when a corporation that owns a partnership interest may satisfy the active trade or business requirement through activities performed by the partnership.⁷¹⁰ If (i) the corporate partner or its separate affiliated group owns a significant interest in the partnership, or (ii) the partner or its affiliates perform active and substantial management functions with respect to the trade or business assets and activities and the partner owns a meaningful interest in the partnership, then the partnership's trade or business assets are attributed to the partner.⁷¹¹

Recently, the IRS said that finalizing the Proposed Active Trade or Business Regulations is one of its top priorities. The government is considering whether to require the relevant corporation (or its separate affiliate group, or a partnership) to own both the company's goodwill and significant trade or business assets, or to adopt another variation closer to the existing rules that require the relevant corporation to perform active and substantial management and operation functions.⁷¹²

D. The Device Test

A distribution will not qualify as a tax-free distribution under section 355 if it is employed principally as a "device" to distribute the earnings and profits of the distributing corporation,

⁷⁰⁸ Robert Willens, *IRS Proposes Changes to the Active Trade or Business Regs.*, 115 Tax Notes 959 (June 4, 2007).

⁷⁰⁹ Prop. Reg. § 1.355-3(b)(2)(iii).

⁷¹⁰ Rev. Rul. 2007-42, 2007-2 C.B. 44 (even though the corporation did not directly perform active and substantial management functions for a partnership, the corporation's one third interest in the partnership was "significant" and thus the corporation was treated as engaged in the partnership's active trade or business). *See also* Robert Willens, *IRS Proposes Changes to the Active Trade or Business Regs.*, 115 Tax Notes 959 (June 4, 2007).

⁷¹¹ Prop. Reg. § 1.355-3(b)(2)(v).

⁷¹² *See IRS Focusing on Rules Covering Active Trade or Business Requirement Under 355(b)*, Daily Tax Rep. at G-1 (Nov. 19, 2010).

the controlled corporation or both.⁷¹³ In the typical scenario, a transaction constitutes a prohibited device if the shareholders of the distributing corporation are to receive controlled corporation stock in a spinoff and then sell their controlled corporation stock for cash shortly thereafter, achieving the same result as a distributing corporation sale of the controlled corporation's assets and payment of a cash dividend to its shareholders.⁷¹⁴ Since the recent liberalization of the section 355(e) regulations, discussed below, the device test has become a much more significant concern for distributions and acquisitions that occur in close proximity. However, a well advised taxpayer can avoid the device concern that arises in an acquisition that follows a distribution by employing a tax-free merger without boot.⁷¹⁵

Determining whether a spinoff constitutes a prohibited device requires a facts and circumstances analysis.⁷¹⁶ Among the factors suggesting a device are (i) a pro rata distribution, (ii) a sale

⁷¹³ I.R.C. § 355(a)(1)(B).

⁷¹⁴ See, e.g., *S. Tulsa Pathology Lab., Inc. v. Commissioner*, 118 T.C. 84 (2002) (prohibited device present where privately held distributing corporation makes a pro rata distribution of its controlled subsidiary stock and, pursuant to a prearranged plan, the recipient shareholders sell the controlled corporation stock on the same day). Cf. *Pulliam v. Commissioner*, 73 T.C.M. (CCH) 3052 (1997), *nonacq.*, 1998-2 C.B. 664 (valid business purpose overrides the device factor where a distribution of controlled corporation stock to the distributing corporation's sole shareholder was undertaken for the sole purpose of facilitating the sale of 49% of the controlled corporation to a key employee).

⁷¹⁵ See Treas. Reg. § 1.355-2(d)(2)(iii)(E); Rev. Rul. 75-406, 1975-2 C.B. 125 (obsoleted on other grounds). The regulations permit an "insubstantial" amount of gain to be recognized on the exchange. However, little guidance has been provided on what constitutes an insubstantial amount. See Rev. Rul. 78-251, 1978-1 C.B. 89 (distribution followed by a tax-free acquisition of the distributing corporation not a device where 5% of the distributing corporation's shareholders dissented and received cash). The regulations disregard gain treated as a dividend pursuant to section 356(a)(2) and section 316 in determining the presence of device, since such gain cannot qualify for capital gains treatment or as recovery of basis.

⁷¹⁶ See Treas. Reg. § 1.355-2(d)(1).

of distributing or controlled stock after the distribution,⁷¹⁷ (iii) existence of assets of distributing or controlled corporation not used in a five-year active trade or business, and (iv) a business of the distributing corporation or controlled corporation that exists to service another business of the distributing or controlled corporation and which can be sold without an adverse effect.⁷¹⁸ If stock of the distributing or controlled corporation is sold, the amount of stock sold by the shareholder and the level of negotiations for the sale that occur before the distribution will be

⁷¹⁷ The IRS has ruled that a spinoff satisfied the section 355 requirements even though the distributing corporation planned to redeem more than 20% of its outstanding stock after the spinoff. *See, e.g.*, P.L.R. 2007-41-013 (Oct. 12, 2007); P.L.R. 2006-45-011 (Nov. 10, 2006); *see generally* Robert Willens, *Repurchases of Stock Following a Spinoff – A New Breakthrough?*, 2006 TNT 248-19 (Dec. 27, 2006) (IRS ruling that permitted post-distribution repurchases in excess of 20% limit set forth in Revenue Procedure 96-30 after distribution should provide comfort to similarly situated taxpayers); Robert Willens, *Can a Morris Trust Transaction be Jeopardized by the Distributing Corporation's Repurchase of Stock Shortly After the Transaction is Completed?*, Daily Deal (May 2, 2006) (consistent with the approach that stock buybacks are not taken into account for continuity of interest purposes in reorganizations, the IRS will likely conclude a repurchase after a spinoff is not part of a plan and 355(e) will not be an issue). *See also* Robert Willens, *Can The Device Test Be Used Offensively?*, 2010 TNT 102-7 (May 7, 2010) (arguing that a spinoff may be used as a corporate defense mechanism against a third party unsolicited tender offer because of the uncertain application of the device test).

⁷¹⁸ *See* Treas. Reg. § 1.355-2(d)(2)(ii)-(iv). A strong business purpose for the separation of a secondary business can overcome other device factors. *Compare Pulliam v. Commissioner*, 73 T.C.M. (CCH) 3052 (1997) (providing equity interest to a key employee “sanitized” the transaction even though there was a prearranged sale of spun-off company’s stock to the key employee), *with* Treas. Reg. § 1.355-2(d)(4), Ex. 1 (concluding that providing an equity interest to key employee is a device because distributing could have issued additional shares to the key employee directly rather than the key employee purchasing distributing shares from distributing’s sole shareholder after distribution). As Mike Schler has observed, it is not clear what the motivation behind the secondary business factor was and why a “secondary business” that can be sold is different than any other business that can be sold. *See* Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 SMU L. Rev. 239, 255 (2006).

taken into account. A sale or exchange pursuant to an arrangement negotiated or agreed upon before the distribution is substantial evidence of device.⁷¹⁹ A sale that is not negotiated or agreed upon prior to a distribution can provide evidence of device.⁷²⁰

The absence of device is suggested by (i) a valid corporate business purpose, (ii) public trading of the distributed corporation's stock and an absence of 5% shareholders, and (iii) distributing corporation shareholders that are themselves corporations and which are eligible for the dividends-received deduction.⁷²¹ Device will not be present when there are no current or accumulated earnings and profits, and no such earnings would be created by the distribution,⁷²² or when each shareholder would be entitled to capital gain treatment under section 302 if a split-off were taxable.⁷²³

Revenue Procedure 96-30⁷²⁴ provides a safe harbor whereby stock purchases after a distribution will not violate the device test. In order to be protected by the safe harbor, the taxpayer must establish that (i) there is a sufficient business purpose for the stock purchase, (ii) the stock to be purchased is widely held, (iii) the stock purchases will be made in the open market, and (iv) there is no plan or intention that the aggregate

⁷¹⁹ See Treas. Reg. § 1.355-2(d)(2)(iii)(B). A sale is negotiated or agreed upon before the distribution if (i) enforceable rights to buy or sell existed before the distribution, or (ii) the buyer and seller discussed such a sale or exchange before the distribution and reasonably anticipated such sale or exchange.

⁷²⁰ See Treas. Reg. § 1.355-2(d)(2)(iii)(C). The IRS will no longer issue private letter rulings determining whether a transaction is being used principally as a device. See Rev. Proc. 2003-48, 2003-2 C.B. 86.

⁷²¹ See Treas. Reg. § 1.355-2(d)(3)(ii)-(iv).

⁷²² See Treas. Reg. § 1.355-2(d)(5)(ii). For a detailed discussion of E&P allocation in a spinoff by a consolidated group, see Bryan P. Collins, Andrew W. Cordonnier & Darin A. Zywan, *Allocation of E&P In a Spin Off By a Consolidated Group: New Developments Answer Some Questions But Leave Many Unanswered*, 889 PLI/TAX 233 (2008).

⁷²³ See Treas. Reg. § 1.355-2(d)(5)(iv); see generally Robert Willens, *Navigating the Device Test for Stock Buybacks After Spinoffs*, Daily Tax Rep. (BNA), at J-1 (Sept. 20, 2006).

⁷²⁴ 1996-1 C.B. 696, § 4.05, as in effect prior to the release of Revenue Procedure 2003-48, 2003-2 C.B. 86.

amount of stock purchases will equal or exceed 20% of the relevant corporation's outstanding stock.⁷²⁵

Taxpayers' motivation to employ a tax-free spinoff as a device to bail out earnings and profits was substantially diminished by the reduction of the maximum long-term capital gains tax rate to 15%⁷²⁶ by the Jobs and Growth Tax Relief Reconciliation Act of 2003 and has remained popular after subsequent increase of that rate to 20% by the American Taxpayer Relief Act of 2012.⁷²⁷ The uniform dividend and capital gain tax rates moot the primary policy rationale for the device test (*i.e.*, preventing section 355 distributions from being employed to distribute earnings and profits at favorable capital gains tax rates).⁷²⁸ However, the IRS apparently still views device as a useful limit on tax-free spinoffs, since taxpayers that prearrange a sale of stock after a distribution would still be afforded the advantage of basis recovery that would not be available with respect to payment of a dividend.⁷²⁹ Since the device test remains applicable under the technical language of the statute and regulations and the revenue procedure for seeking a private letter ruling under section 355 requires a representation as

⁷²⁵ See Rev. Proc. 96-30, 1996-1 C.B. 696, § 4.05, as in effect prior to the release of Revenue Procedure 2003-48, 2003-2 C.B. 86. This safe harbor should still be effective notwithstanding the IRS's current refusal to issue rulings on the device issue. See also Robert Willens, *Navigating the Device Test for Stock Buybacks After Spinoffs*, Daily Tax Rep. (BNA), at J-1 (Sept. 20, 2006).

⁷²⁶ Although initially scheduled to sunset for taxable years beginning after December 31, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the 15% rate for dividends and capital gains for two years, and this preferential rate is now scheduled to sunset for taxable years beginning after December 31, 2012. See P.L. 111-312.

⁷²⁷ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27 (2003); American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 (2013).

⁷²⁸ Currently, long-term capital gains and qualified dividends are taxed at a 20% rate. See American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 (2013). Beginning on January 1, 2013, an additional net investment income tax of 3.8% applies to dividends and capital gains of individuals with adjusted gross income above statutory thresholds. See I.R.C. § 1411.

⁷²⁹ See also Treas. Reg. § 1.355-2(d)(1).

to the absence of device, the IRS evidently intends to continue to apply the device test in its current form.⁷³⁰

E. Hot Stock

As discussed above, any distributed controlled corporation stock acquired in a taxable transaction within five years of the distribution constitutes boot (the “hot stock rule”).⁷³¹ In December 2008, the IRS issued final and temporary regulations⁷³² applying the hot stock rule to the acquisition of controlled corporation stock by distributing’s separate affiliated group (“SAG”) (the “Temporary Hot Stock Regulations”).⁷³³ In October 2011, the IRS and Treasury finalized the Temporary Hot Stock Regulations without change (the “Final Hot Stock Regulations”).⁷³⁴

The Final Hot Stock Regulations provide several exceptions to the hot stock rule. For example, the hot stock rule should not apply to an acquisition of controlled stock if controlled is a member of distributing’s SAG at any time after the acquisition, but prior to the distribution, of controlled.⁷³⁵ Moreover, the rule

⁷³⁰ Rev. Proc. 2003-48, 2003-2 C.B. 86, § 4.02(1).

⁷³¹ I.R.C. § 355(a)(3)(B).

⁷³² See T.D. 9435, 2009-1 C.B. 333. See generally Robert Willens, *Hot Stock*, 2009 TNT 12-64 (Jan. 22, 2009); Jasper L. Cummings, Jr., *New Temporary Regulations Cool Off the Hot Stock Rule for Divisive Transactions*, 109 J. Tax’n 69 (Feb. 2009); *Corporate Taxes: Panel Addresses Hot Stock Questions, Creditor Continuity of Interest Regulations*, Daily Tax Rep. (BNA), at G-6 (Jan. 13, 2009); *Corporate Reorganizations: IRS Unveils Long-Awaited Regulations on Hot Stock, Wins Praise from Taxpayers*, Daily Tax Rep. (BNA), at GG-1 (Dec. 15, 2008).

⁷³³ See Treas. Reg. § 1.355-2(g)(1). Distributing’s SAG is the affiliated group determined under section 1504(a) as if distributing were the common parent, regardless of whether the group members are includible corporations under section 1504(b). Treas. Reg. § 1.355-2(g)(3).

⁷³⁴ T.D. 9548, 2011-2 C.B. 716.

⁷³⁵ See Treas. Reg. § 1.355-2 (g)(2)(i). See also Robert Willens, *Time Warner Snags Spin Off Rule Tax Advantage*, CFO.com (June 1, 2009), available at <http://www.cfo.com/article.cfm/13764821?f=related> (arguing that the hot stock rules should not impede Time Warner’s ability to divest

disregards transfers of controlled corporation stock owned by distributing's SAG immediately before and after the transfer.⁷³⁶ In addition, the hot stock rule does not apply to distributing's acquisition of controlled stock from a member of the affiliated group⁷³⁷ of which distributing was a member.⁷³⁸

The preamble to the Final Hot Stock Regulations notes that the IRS and Treasury Department declined to expand the scope of the final regulations to cover additional situations.⁷³⁹ Previously, the IRS and Treasury Department indicated that they were considering issuing additional guidance under the hot stock rule.⁷⁴⁰ For example, the preamble to the Temporary Hot Stock Regulations asked for comments on *Dunn Trust v. Commissioner*.⁷⁴¹ In *Dunn Trust*, distributing acquired stock of target in a taxable transaction and subsequently effected a nontaxable contribution of the target stock to controlled in exchange for controlled stock. The Tax Court ruled that the controlled stock was not hot stock, based on a technical statutory interpretation. The court also examined the legislative history and concluded that the hot stock rule was intended to prevent the indirect acquisition of controlled corporation stock via purchase by a related entity but not the acquisition of the stock of an

of AOL tax-free in a series of transactions that includes Time Warner purchasing some of the outstanding shares of AOL immediately before the spinoff).

⁷³⁶ Treas. Reg. § 1.355-2(g)(1).

⁷³⁷ For this purpose, an “affiliated group” is an affiliated group as defined in section 1504(a) (without regard to section 1504(b)), except that the term “stock” includes nonvoting stock described in section 1504(a)(4). See Treas. Reg. § 1.355-3(b)(4)(iv).

⁷³⁸ See Treas. Reg. § 1.355-2(g)(2)(ii). The IRS and Treasury Department continue to study the interrelationship between hot stock rules and the active trade or business requirement. See T.D. 9548, 2011-2 C.B. 716.

⁷³⁹ T.D. 9548, 2011-2 C.B. 716.

⁷⁴⁰ The preamble to the Temporary Hot Stock Regulations notes that such guidance would be in addition to, rather than in replacement of, the temporary regulations. See T.D. 9435, 2009-1 C.B. 333.

⁷⁴¹ 86 T.C. 745 (1986), *acq.* 1997-1 C.B. 1 (acquiescing in result only).

underlying, active subsidiary which was not actually distributed.⁷⁴² Although the IRS acquiesced under the specific facts of *Dunn Trust*, it also stated that it may challenge a transaction in which purchased stock is transferred to a holding company in order to avoid the hot stock rule, which may form the basis for its request for comments.⁷⁴³ The Final Hot Stock Regulations do not address this issue.

The preamble to the Temporary Hot Stock Regulations also requested comments on “predecessor” issues, including: (i) determining whether distributing’s SAG should be treated as effecting a taxable acquisition of controlled stock by reason of a taxable purchase of stock of a corporate shareholder of the controlled corporation⁷⁴⁴ and (ii) treating distributing’s SAG as effecting any acquisition made by a predecessor of a member of distributing’s SAG.⁷⁴⁵ Further, the preamble to the Temporary Hot Stock Regulations indicated that future guidance may provide that controlled’s issuance of stock to distributing in a taxable transaction does not create hot stock. The IRS and Treasury Department requested comments regarding whether distributing must own a minimum percentage of controlled when stock is issued and the extent to which such transactions are adequately addressed by the device and disqualified investment corporation rules.⁷⁴⁶ These issues remain unaddressed in the Final Hot Stock Regulations.

⁷⁴² See S. Rep. No. 83-1622, at 267-68 (1954); H.R. Conf. Rep. No. 83-2543, at 38 (1954).

⁷⁴³ See A.O.D. 1997-007 (May 2, 1997).

⁷⁴⁴ The preamble to the Temporary Hot Stock Regulations states that the hot stock rule may be implicated where distributing’s SAG acquires target stock during the pre-distribution period in a taxable transaction and controlled subsequently acquires the target in a section 381(a) transaction. See T.D. 9435, 2009-1 C.B. 333. The IRS and Treasury Department believe that this transaction raises an issue as to whether target or controlled is the “real controlled” for purposes of the hot stock rule.

⁷⁴⁵ For this purpose, a “predecessor” is a corporation that transfers its assets in a section 381(a) transaction. See T.D. 9435, 2009-1 C.B. 333.

⁷⁴⁶ See T.D. 9435, 2009-1 C.B. 333.

Finally, the IRS and Treasury Department requested comments regarding the effect of controlled stock redemptions under the hot stock rule. The government believes that the redemption of controlled stock from a shareholder other than distributing should be treated as distributing's purchase of controlled stock from the redeemed shareholder to the extent distributing funds the redemption. The government is continuing to study whether distributing's increased ownership in controlled due to controlled stock redemptions from other shareholders should constitute hot stock.⁷⁴⁷

The NYSBA commented on the Temporary Hot Stock Regulations, recommending that (i) the current law exception for transfers of controlled stock among affiliated group members from the application of the hot stock rules should be retained, (ii) section 355(a)(3)(B) should not apply to indirect acquisitions of controlled stock except in limited circumstances, (iii) issuances of controlled stock should be excluded from the ambit of the hot stock rules and (iv) the IRS and Treasury should not adopt disguised acquisition rules applicable to controlled's redemption of its stock using cash or other assets provided by distributing.⁷⁴⁸

F. Disqualified Distributions

1. Background of Section 355(d)

Section 355(d) was enacted to prevent taxpayers from circumventing the repeal of the *General Utilities* doctrine, in particular by disposing of subsidiaries in transactions that resembled sales but nonetheless qualified for tax-free treatment under section 355⁷⁴⁹, and obtaining basis increases before taxable

⁷⁴⁷ See T.D. 9435, 2009-1 C.B. 333.

The IRS is also considering issuing guidance under section 355(a)(3)(B) that will harmonize section 355(a)(3)(B) with the rules on reorganizations under section 336(e). See Alison Bennett, *More Guidance on Hot Stock Possible as IRS Works in Reorganizations Area, Official Says*, Daily Tax Rep. (BNA), at G-3 (Apr. 2, 2012).

⁷⁴⁸ See NYSBA, *Report on Temporary Regulations Regarding the Hot Stock Rules Under Section 355(a)(3)(B)*, reprinted in 2009 TNT 190-54 (Oct. 2, 2009).

⁷⁴⁹ Before Congress enacted section 355(d), taxpayers could effectively dispose of an unwanted subsidiary in a tax-free transaction. In

sales through section 355 distributions.⁷⁵⁰ Accordingly, section 355(d) generally requires a distributing corporation to recognize gain (but not loss) in any “disqualified distribution” as if the distributing corporation had sold its controlled corporation stock to the shareholders at its fair market value.⁷⁵¹ Such a “disqualified distribution” occurs if, immediately after a distribution, any person holds “disqualified stock” (defined below)

Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), Mobil Oil publicly tendered for Esmark shares, and, pursuant to an agreement entered into before the public tender, Esmark exchanged the shares held by Mobil Oil for the shares of the unwanted subsidiary. This transaction was tax-free under former section 311(d)(2)(B). See generally Robert Willens, *More Esmark*, 2012 TNT 83-17 (Apr. 4, 2012); Lee A. Sheppard, *Esmark v. Commissioner: Of Form And Substance and Aesthetics*, 2012 TNT 83-14 (Apr. 4, 2012). After Congress repealed this provision, taxpayers realized they could accomplish the same tax-free result through a split-off. See Robert Willens, *Disqualified Distributions*, 118 Tax Notes 1245 (Mar. 17, 2008); Robert Willens, *Windstream Will Split Off its Yellow Pages Business*, 114 Tax Notes 573 (Feb. 5, 2007).

⁷⁵⁰ See H.R. Rep. No. 101-881, at 341 (1990). For example, before Congress enacted section 355(d), a taxpayer could obtain a stepped-up basis in the stock of a controlled subsidiary by purchasing a historic shareholder’s interest in the distributing corporation prior to a distribution, because the taxpayer’s basis in the controlled corporation stock received in the spinoff was determined by reference to the shareholder’s high basis in its distributing corporation stock, rather than the distributing corporation’s typically low basis in its controlled corporation stock.

⁷⁵¹ I.R.C. § 355(d)(1). A 50% or greater interest generally means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the total value of shares of all classes of stock. For purposes of determining whether a person holds a 50% or greater interest, all shares of stock within a single class are considered to have the same value (*i.e.*, control premiums and minority and blockage discounts are not considered). Treas. Reg. § 1.355-6(c)(2). Acquisitions by all related persons, and those persons acting pursuant to a formal or informal plan to acquire distributing or controlled corporation stock, are aggregated to determine whether a person has acquired an impermissible controlling interest in distributing or controlled corporation stock, respectively. See Treas. Reg. § 1.355-6(c)(4)(i). See also P.L.R. 2001-20-030 (Feb. 15, 2001) (aggregating a corporation and two partnerships that acted in concert to acquire stock by purchase within the five years preceding a spinoff).

representing a 50% or greater interest in the distributing or controlled corporation. Tax is imposed under section 355(d) only on a distributing corporation and not on its shareholders or the controlled corporation, although a controlled corporation will nonetheless be jointly and severally liable for any tax owed by the distributing corporation whenever the distributing and controlled corporations are members of the same consolidated group for federal income tax purposes.⁷⁵²

2. Section 355(d) Regulations

On its face, the language of section 355(d) is extremely broad and would impose tax on transactions that do not conflict with the intended purpose of section 355.⁷⁵³ In light of the statute's extreme breadth, Congress granted the Treasury Department the right to grant regulatory exemptions for certain transactions which "do not violate the purposes" of section 355(d) (the "Purpose Exception").⁷⁵⁴ The Treasury Regulations issued in 2000⁷⁵⁵ provide important additional guidance regarding the operation of section 355(d), including a description of distributions that qualify for the Purpose Exception under section 355(d).⁷⁵⁶ As the regulations explain, the Purpose Exception generally applies when a distribution does not cause a so-called "disqualified person" to increase its direct or indirect ownership interest in the distributing or controlled corporation.⁷⁵⁷

⁷⁵² Treas. Reg. § 1.1502-6(a).

⁷⁵³ *ABA Section of Taxation Comments Concerning Guidance Under Section 355(d)*, 2011 TNT 148-12 (Aug. 1, 2011) (arguing that the mechanical rules under section 355(d) result in taxation in circumstances that are inconsistent with the statute's purposes).

⁷⁵⁴ See H.R. Conf. Rep. No. 101-964, at 1091 (1990).

⁷⁵⁵ T.D. 8913, 2001-1 C.B. 300.

⁷⁵⁶ Treas. Reg. § 1.355-6(b)(3).

⁷⁵⁷ A shareholder is a "disqualified person" if, immediately after a distribution, the shareholder's stock in either the distributing or controlled corporation (i) was acquired by purchase during the five year period immediately preceding the distribution, or was received in the distribution with respect to distributing corporation stock acquired by purchase, and (ii) constitutes a 50% or greater interest in the distributing or controlled corporation.
Treas. Reg. § 1.355-6(b)(3)(ii)(A), (B).

a. Purchased Stock

Stock acquired by “purchase” during the five year period preceding the spinoff is generally “disqualified stock.”⁷⁵⁸ More specifically, any stock acquired during that five year period is treated as purchased stock unless (i) the acquirer carried over the transferor’s basis in the acquired stock, (ii) the stock was acquired in a transaction qualifying under sections 351, 354, 355 or 356,⁷⁵⁹ or (iii) the stock was received as a stock dividend.⁷⁶⁰ Generally, if a target corporation is acquired in a carryover basis transaction, the acquirer is deemed to have purchased the target stock received as of the date the target’s former shareholders purchased their shares.⁷⁶¹

Stock acquired in a tax-free transaction that included boot will not be treated as purchased stock simply because gain was recognized on the receipt of boot.⁷⁶² However, NQPS received in a tax-free transaction will generally be treated as purchased on the date received, unless such NQPS is received in exchange for NQPS in a section 368 reorganization.⁷⁶³ In response to commentators’ concerns, the final regulations generally disregard any increase in a disqualified person’s interest in the distributing or controlled corporation occurring solely as a result of cash paid in lieu of fractional shares.⁷⁶⁴

⁷⁵⁸ I.R.C. § 355(d)(3). The five year testing period for any stock or securities is suspended for any period of time during which the holder’s risk of loss with respect to such stock or securities, or with respect to any portion of the underlying corporation’s activities, is (directly or indirectly) substantially diminished by (i) an option, (ii) a short sale, (iii) any special class of stock (*e.g.*, tracking stock), or (iv) any other device or transaction. I.R.C. § 355(d)(6).

⁷⁵⁹ I.R.C. § 355(d)(5)(A); Treas. Reg. § 1.355-6(d)(1)(i). Note that the regulations clarify that stock not treated as purchased stock because it was acquired in a section 355 transaction includes all section 355 distributions, whether pro rata or in exchange for stock. See Treas. Reg. § 1.355-6(d)(1)(ii).

⁷⁶⁰ See Treas. Reg. § 1.355-6(d)(2)(ii).

⁷⁶¹ I.R.C. § 355(d)(5)(C).

⁷⁶² Treas. Reg. § 1.355-6(d)(2)(i)(A)(1).

⁷⁶³ Treas. Reg. § 1.355-6(d)(2)(i)(A)(2).

⁷⁶⁴ See Treas. Reg. § 1.355-6(b)(3)(iv).

Stock acquired in a taxable transaction for which a section 338 election (or section 338(h)(10) election) is made is also not treated as purchased stock.⁷⁶⁵ However, any stock of a target affiliate also acquired in such a transaction (*e.g.*, stock of a target subsidiary) will be treated as purchased stock, unless a separate section 338 election (or section 338(h)(10) election) is also made with respect to that stock.⁷⁶⁶

The rule governing stock acquired in a tax-free transaction is of particular importance to taxpayers considering an intragroup restructuring that includes an internal spinoff of a recently acquired corporation. Prior to such a spinoff, an acquirer must determine the holding periods of the former target shareholders.⁷⁶⁷ Under the final regulations, knowledge of the former target shareholders' holding periods is acquired through (i) deemed knowledge of publicly filed documents, and (ii) actual knowledge. Unless a corporation has actual knowledge to the contrary, it may generally assume that all schedules and forms contained in publicly filed documents are accurate and complete.⁷⁶⁸ Further, unless a company has actual knowledge to the contrary, it may generally assume that all shareholders holding less than 5% acquired their stock more than five years prior to the transaction.⁷⁶⁹ However, this presumption does not apply to any less-than 5% shareholder

⁷⁶⁵ See Treas. Reg. § 1.355-6(d)(2)(iv).

⁷⁶⁶ See Treas. Reg. § 1.355-6(d)(2)(iv).

⁷⁶⁷ See Treas. Reg. § 1.355-6(f)(1). Generally, "a distributing corporation is deemed to have knowledge of the existence and contents of all schedules, forms, and other documents filed with or under the rules of the Securities and Exchange Commission, including without limitation any Schedule 13D or 13G (or any similar schedules) . . . with respect to any relevant corporation." Treas. Reg. § 1.355-6(f)(2).

It is unclear whether the deemed knowledge rule also applies to SEC Schedules 13F filed by institutional investors, which may not necessarily involve one or more 5% shareholder and which contain only the quarterly share balances, and do not reference the acquisition date of stock. See J. Russell Hamilton & Shane Webster, *Actual Knowledge of Shareholders in Tax-Free Spinoffs*, 2001 TNT 122-127 (June 25, 2001).

⁷⁶⁸ Treas. Reg. § 1.355-6(f)(3).

⁷⁶⁹ Treas. Reg. § 1.355-6(f)(4).

who (i) is related to a 5% or greater shareholder, (ii) acted pursuant to a plan or arrangement to acquire the corporation's stock with a 5% or greater shareholder, or (iii) holds stock or securities that are attributed to a shareholder that is or was a 5% or greater shareholder at any time during the prior five year period.⁷⁷⁰

It is also important to note that it is possible to purge purchased stock of its taint during the prior five year period if (and when) the basis in stock acquired by purchase would no longer be taken into account in determining gain or loss on a subsequent sale or exchange of such stock.⁷⁷¹ This result often occurs in connection with basis elimination transactions.⁷⁷² For example, if the distributing corporation purchases and then distributes controlled corporation stock, the distributing corporation's cost basis in its purchased stock is eliminated and the distributed stock no longer constitutes purchased stock.

b. Special Rules for Section 351 Transactions

A significant exception to the general non-purchase treatment of stock acquired in a nonrecognition transaction is the treatment of stock received in a section 351 transaction in exchange for cash, a cash item, marketable stock, securities or debt of the transferor (collectively "Cash Items") as purchased stock, subject to two exceptions discussed below.⁷⁷³ When more than one class of stock or securities is received in the transfer, the portion of stock or securities acquired by purchase is determined in

⁷⁷⁰ Treas. Reg. § 1.355-6(f)(4)(i)-(iii).

⁷⁷¹ Treas. Reg. § 355-6(b)(2)(iii).

⁷⁷² Treas. Reg. § 355-6(b)(2)(iii)(C). If a shareholder's purchased basis is allocated between two or more corporations, the determination of whether purchased basis is eliminated is made individually for each corporation. *See* Treas. Reg. § 1.355-6(b)(2)(iii)(D).

⁷⁷³ I.R.C. § 355(d)(5)(B); Treas. Reg. § 1.355-6(d)(3)(i)(A). *See* P.L.R. 2007-41-002 (Oct. 12, 2007) (parent could use section 355(d)(5)(B) rather than section 355(d)(5)(C) in determining the amount of subsidiary stock treated as purchased by the parent in a tax-free acquisition because parent obtained a private ruling and entered into a closing agreement); *Calculating How Much Acquired Sub Stock is Treated as Purchased*, 108 J. Tax'n 43 (Jan. 2008). *See also* Treas. Reg. § 1.355-6(d)(5)(ii).

a manner consistent with the allocation of basis among multiple classes of stock under section 358.⁷⁷⁴

The regulations provide two exceptions to the above described general rule for Cash Items. Stock acquired in exchange for Cash Items will not be treated as purchased if (i) the transferred assets and liabilities (including debt incurred in the ordinary course of the trade or business) are used in an active trade or business of the transferor,⁷⁷⁵ (ii) the transferred items do not exceed the reasonable needs of the trade or business,⁷⁷⁶ (iii) the assets and liabilities are transferred as part of the transfer of a trade or business, and (iv) the transferee continues to actively conduct the trade or business.⁷⁷⁷ The “reasonable needs of the trade or business” are narrowly defined to include only those Cash Items that a “prudent business person apprised of all relevant facts would consider necessary for the present and reasonably anticipated future needs of the business,” and for which the transferor and transferee have “specific, definite, and feasible plans.”⁷⁷⁸ Cash Items may be contributed to controlled subsidiaries after an acquisition without causing the transferee to fail the active trade or business test, provided the test would have been satisfied upon a direct transfer of the assets to the final transferee.⁷⁷⁹

A second exception to purchased stock treatment for transfers of Cash Items between members of an affiliated group provides that an acquisition of stock in a section 351 transaction in exchange for a Cash Item is not a purchase if (i) the transferor and transferee corporations are members of the same affiliated group

⁷⁷⁴ Treas. Reg. § 1.355-6(d)(3)(i)(B).

⁷⁷⁵ The active trade or business test is applied both before the transfer (with respect to the transferor) and after the transfer (with respect to the transferee) rather than immediately after a distribution. The business must have been conducted for a sufficient period of time before the distribution to establish that it is a viable and ongoing business. *See* Treas. Reg. § 1.355-6(d)(3)(iv)(B).

⁷⁷⁶ *See* Treas. Reg. § 1.355-6(d)(3)(iv)(C).

⁷⁷⁷ Treas. Reg. § 1.355-6(d)(3)(iv)(A). This test is based on all facts and circumstances surrounding the transfer. *See* Treas. Reg. § 1.355-6(d)(3)(iv)(D).

⁷⁷⁸ Treas. Reg. § 1.355-6(d)(3)(iv)(C).

⁷⁷⁹ Treas. Reg. § 1.355-6(d)(3)(iv)(E).

before the section 351 transaction, (ii) the transferor (or another member of the transferor's affiliated group) did not acquire the Cash Items from a nonmember in a related transaction, and (iii) none of the transferor corporation, the transferee corporation, or any distributed corporation cease to be members of the same affiliated group in any transaction that is part of a plan that includes the section 351 transaction.⁷⁸⁰

c. Treatment of Options

Options outstanding at the time of a distribution will be treated as exercised on the date they were issued or most recently transferred if (i) an option's exercise (alone or in conjunction with the exercise of one or more other options) would cause the holder to become a disqualified person, and (ii) immediately after the distribution, it is reasonably certain that the option will be exercised.⁷⁸¹ The following instruments are treated as options for purposes of determining whether a 50% interest is held: (i) a call option, (ii) a warrant, (iii) a convertible obligation, (iv) the conversion feature of convertible stock, (v) a put option, (vi) a redemption agreement (including the right to cause the redemption of stock), (vii) a notional principal contract that provides for the payment of amounts of stock, (viii) a stock purchase agreement or similar arrangement, and (ix) any other instrument that provides for the right to purchase, issue, redeem, or transfer stock (including an option on an option).⁷⁸²

Certain modifications and events affecting options will constitute a new issuance or transfer of the options, if the

⁷⁸⁰ Treas. Reg. § 1.355-6(d)(3)(v)(A). *See Attorneys Seek Guidance for Spinoff Transactions*, 2009 TNT 135-10 (July 16, 2009) (recommending amendment to Treasury Regulation section 1.355-6(d)(3)(v) to expand the exception to the definition of "purchase" for transfers between affiliated group members to remove an impediment to intragroup spinoffs involving foreign affiliates).

⁷⁸¹ Treas. Reg. § 1.355-6(c)(3)(ii). Whether an option is reasonably certain to be exercised is determined under all the facts and circumstances. *See* Treas. Reg. § 1.355-6(c)(3)(vii). Note that, in contrast to other fair market value determinations under section 355(d), control premiums and minority and blockage discounts are generally taken into account for purposes of determining an option's likelihood of exercise. *See* Treas. Reg. § 1.355-6(c)(3)(vii).

⁷⁸² Treas. Reg. § 1.355-6(c)(3)(v).

modification or event materially increases the likelihood that an option will be exercised. Such events include (i) an exchange of an option for another option, (ii) an adjustment to the terms of an option, (iii) an adjustment to the terms of the underlying stock, (iv) a change in the issuing corporation's capital structure, and (v) a change in the fair market value of the issuing corporation's stock as a result of an asset transfer (other than regular, ordinary dividends) or through any other means.⁷⁸³ However, if an option is exchanged for another option without a material increase in likelihood that the option will be exercised, the substituted option will be treated as issued or transferred on the date the existing option was most recently issued or transferred.⁷⁸⁴ Compensatory options are treated as issued on the date the option holder can freely transfer the option.⁷⁸⁵

Certain options are exempt from the general rules discussed above, unless they were written, transferred or listed with the principal purpose of averting the application of section 355(d) or the final regulations.⁷⁸⁶ These generally exempt options include (i) options issued as part of a security arrangement in a typical lending transaction (*i.e.*, an escrow, pledge or option contingent upon default under a loan),⁷⁸⁷ (ii) compensatory options which are (x) granted to employees, directors, or independent contractors of the distributing corporation, controlled corporation or a related person, (y) nontransferable,⁷⁸⁸ and (z) do not have a readily ascertainable fair market value,⁷⁸⁹ (iii) certain conversion features with respect to stock convertible no less than five years after the date of issuance and in exchange only for the stock being converted,⁷⁹⁰ (iv) options which are exercisable only upon death,

⁷⁸³ Treas. Reg. § 1.355-6(c)(3)(iii)(A).

⁷⁸⁴ Treas. Reg. § 1.355-6(c)(3)(iii)(C).

⁷⁸⁵ Treas. Reg. § 1.355-6(c)(3)(iii)(B).

⁷⁸⁶ Treas. Reg. § 1.355-6(c)(3)(vi).

⁷⁸⁷ Treas. Reg. § 1.355-6(c)(3)(vi)(A).

⁷⁸⁸ Treas. Reg. § 1.355-6(c)(3)(vi)(B)(1)(i); *see* P.L.R. 2006-15-007 (Jan. 10, 2006).

⁷⁸⁹ Whether an option has a readily ascertainable fair market value is defined under Treasury Regulation section 1.83-7(b). Treas. Reg. § 1.355-6(c)(3)(vi)(B)(1)(ii).

⁷⁹⁰ Treas. Reg. § 1.355-6(c)(3)(vi)(C).

disability, mental incompetency or separation from service,⁷⁹¹ (v) rights of first refusal,⁷⁹² and (vi) any other instruments designated by the Commissioner.⁷⁹³ The exemption of options granted to independent contractors is particularly welcome because it allows corporations to compensate investment bankers and other advisors with options without fear of triggering tax under section 355(d).⁷⁹⁴

G. Limitations on Acquisitions in Connection with Distributions

In 1997, Congress enacted section 355(e), the so-called “anti-Morris Trust” provision, to prevent taxpayers from using spinoffs to avoid corporate level tax on related transfers of selected businesses.⁷⁹⁵ Section 355(e) imposes corporate level tax⁷⁹⁶ on a

⁷⁹¹ Treas. Reg. § 1.355-6(c)(3)(vi)(D).

⁷⁹² Treas. Reg. § 1.355-6(c)(3)(vi)(E).

⁷⁹³ Treas. Reg. § 1.355-6(c)(3)(vi)(F).

⁷⁹⁴ Note that this same exclusion does not apply to the corporate level tax triggered by section 355(e) as discussed below in Section III.D.

⁷⁹⁵ Section 1012 of the 1997 TRA. “Anti-Morris Trust” refers to *Commissioner v. Mary Archer W. Morris Trust*, 367 F.2d 794 (4th Cir. 1966), *acq.*, Rev. Rul. 68-603, 1968-2 C.B. 148. This case stands for the proposition that a target corporation can shed assets that an acquirer does not want by preceding a tax-free acquisition with a spinoff of unwanted assets. Tax-free distributions of assets after an acquisition were also possible before section 355(e) was enacted. *See, e.g.*, Rev. Rul. 75-406, 1975-2 C.B. 125, restricted by Rev. Rul. 96-30, 1996-1 C.B. 36 (no negotiations regarding subsequent merger before spinoff).

⁷⁹⁶ If section 355(e) applies, the distributing corporation must recognize its built-in gain in the controlled corporation stock as of the distribution date, and neither the distributing nor the controlled corporation is permitted to increase its stock or asset basis as a result of the deemed taxable sale. H.R. Conf. Rep. No. 105-220, at 528, 531 (1997). H.R. 4187, introduced in late 2005 by Representative Eric Cantor, if enacted, would have limited the amount of gain recognized under section 355(e) to the lesser of (i) the “excess relative leverage” at the time of the distribution, and (ii) the gain realized as a result of the distribution. The bill defines “excess relative leverage” as the amount by which the acquired corporation’s actual indebtedness exceeds such corporation’s “maximum permitted

distributing corporation in connection with an otherwise tax-free spinoff if 50% or more⁷⁹⁷ of the distributing corporation's controlled stock or the stock of any controlled corporation it distributes in a spinoff is acquired as part of a plan or series of

indebtedness". A corporation's maximum permitted indebtedness is the greater of (i) the amount of indebtedness that would result in a debt to equity ratio of at least 2 to 1, or (ii) the amount of indebtedness that would result in a ratio that does not exceed the debt-to-equity ratio of the other party to the spinoff by more than 25 basis points. The bill also provided that the acquired company would step-up the tax basis of its assets by the amount of gain recognized under section 355(e). *See, e.g.,* Robert Willens, *Reforming 'Anti-Morris Trust' Rules: Bill Would Rein in Coverage of Section 355(e)*, Daily Tax Rep. (BNA), at J-1 (Nov. 25, 2005).

⁷⁹⁷ Section 355(e) and the final regulations do not explicitly provide that the 50% ownership determination is made at the ultimate shareholder level, nor do they clearly provide that attribution rules apply for purposes of making this determination. *See, e.g.,* P.L.R. 2010-03-009 (Jan. 22, 2010) (contribution of controlled corporation stock to a partnership following a spinoff of controlled did not violate section 355(e) in a transaction where foreign parent transferred controlled corporation stock to a newly formed company, which later contributed the stock to a partnership). In addition, rules regarding the timing of ownership determinations and the treatment of overlapping shareholders are vague. Further, there is no guidance on the effect of a shift in value between relative classes of stock that may cause a change in ownership without a physical transfer of shares. The NYSBA raised these issues in its report on the previous set of temporary and proposed section 355(e) regulations. *See* NYSBA, *Report on Section 355(e) "Non-Plan" Issues*, (Jan. 13, 2004). Finally, some IRS rulings provide that a corporation's reconfiguration of its board of directors to include designees will not be taken into account in the section 355(e) analysis. *See* P.L.R. 2007-08-016 (Feb. 23, 2007); P.L.R. 2006-24-001 (June 16, 2006); *see also* Robert Willens, *Avoiding Application of the 'Anti-Morris Trust' Rule*, 112 Tax Notes 999 (Sept. 11, 2006) (overlapping shareholders would prevent a 355(e) trigger in AmerisourceBergen and Kindred Healthcare coordinated spinoffs and related merger even though both companies' shareholders intended to receive exactly 50% of the merged corporation's stock); *see also* P.L.R. 2007-34-013 (Aug. 24, 2007); P.L.R. 2007-33-025 (Aug. 17, 2007); Robert Willens, *Corporate Reorganizations: Expedia's Spin-Off of Tripadvisor Appears to Escape Section 355(e)*, 31 Tax Mgmt. Weekly Rep. 712 (May 21, 2012) (discussing the impact of a number of ancillary transactions, including open market repurchases and a voting proxy arrangement, on the applicability of section 355(e)).

related transactions that includes the distribution (a “plan”).⁷⁹⁸
 Acquisitions occurring within two years of a distribution are

⁷⁹⁸ Direct and indirect acquisitions are both relevant in determining whether a 50% or greater acquisition has occurred, and aggregation rules generally apply. I.R.C. § 355(e)(4)(C). The significance of aggregation is unclear since the statute contemplates multiple acquisitions by “1 or more persons.” This provision may have been inadvertently retained from an earlier bill, and in some cases of previous indirect ownership it may be possible to use the attribution rules to avoid the application of section 355(e). Note, however, that section 355(e) does not apply to distributions and acquisitions wholly within an affiliated group. *See* I.R.C. § 355(e)(2)(C). For purposes of this affiliated group rule, a predecessor is treated as continuing in existence following a transfer of its property to a distributing or controlled corporation, and the distributing and controlled corporations are treated as continuing in existence after a transfer of property to a successor. *See* Prop. Reg. § 1.355-8(f). The proposed regulations exclude certain acquisitions in determining whether a distribution is part of a plan, including acquisitions of stock in distributing or controlled to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease. *See* I.R.C. § 355(e)(3)(A)(iv); Robert Willens, *Excluded Acquisitions and the ‘Anti-Morris Trust’ Rule*, 117 Tax Notes 179 (Oct. 8, 2007) (inferring that, to the extent each continuing shareholder’s ownership interest did not decrease, each continuing shareholder’s interest would be disregarded in applying section 355(e) to AmerisourceBergen Corp. and Kindred Healthcare Inc.’s simultaneous reverse Morris Trust transactions). The IRS has ruled that, for purposes of section 355(e)(2)(A)(ii), non-exchanging shareholders should also exclude the increase in ownership of the distributing corporation’s stock, which occurs solely as a result of a split-off. *See* P.L.R. 2010-17-031 (Apr. 30, 2010); Robert Willens, *Split-Offs and Section 355(e)*, Daily Tax Rep. (BNA) at J-1 (June 15, 2010); Robert Willens, *C Reorganization Can Be the ‘Back End’ of a Morris Trust*, Daily Tax Rep. (BNA) at J-1 (Mar. 23, 2011) (a C reorganization may qualify as the back end of a reverse morris trust because, under Revenue Ruling 2003-79, 2003-2 C.B. 80, the substantially all test in a C reorganization is applied with reference to assets held by controlled immediately after the contribution rather than assets held by distributing immediately prior to the contribution); P.L.R. 2012-28-033 (July 13, 2012) (reverse morris trust transaction where the acquisition of the controlled corporation comprised of a two-step transaction that was treated as an A reorganization).

presumed to occur pursuant to such a plan.⁷⁹⁹ The “anti-Morris Trust” provision was enacted to preclude prearranged transactions in close proximity with a distribution, and the legislation enacted went beyond what was foreseen by the committee when Chairman Archer stated that their “only intention” [was] “. . .to cure what we believe to be an abuse.”

Regulations issued during 2005 provide important guidance as to what constitutes a plan for section 355(e) purposes.⁸⁰⁰ The final regulations continue to apply the sensible factors and safe harbors method from the 2002 temporary regulations for determining whether section 355(e) applies.⁸⁰¹ The regulations apply to distributions occurring after April 19, 2005, and taxpayers may elect to apply the regulations to any distribution occurring on or after April 27, 2002. Consistent with the 2002 temporary regulations, the regulations eliminate several areas of concern found in the earliest versions of the section 355(e) regulations and provide taxpayers with flexibility to pursue legitimate business

⁷⁹⁹ If the assets of a distributing or controlled corporation are acquired in an A, C or D reorganization, the shareholders of the acquiring corporation (as determined immediately before the acquisition) are treated as acquiring the stock of the target corporation for section 355(e) purposes. I.R.C. § 355(e)(3)(B). Notwithstanding section 355(e), certain subsequent asset acquisitions from historic corporations may not qualify as C or D reorganizations because the assets distributed in the section 355 transaction are considered historic target assets when determining whether the acquisition satisfies the “substantially all” requirement. *See Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937). Although the IRS has ruled that the post-spin acquisition of a newly-formed controlled corporation can qualify as a C reorganization, section 355(e) may apply to the distribution. *See* Rev. Rul. 2003-79, 2003-2 C.B. 80; P.L.R. 2003-03-034 (Jan. 17, 2003).

⁸⁰⁰ *See* T.D. 9198, 2005-1 C.B. 972; *see generally* Mark J. Silverman & Lisa M. Zarlenga, *Anti-Morris Trust Plan Regulations: The Final Chapter in the Saga*, 100 Tax Notes 967 (Feb. 27, 2006).

⁸⁰¹ This sensible approach was well received by tax practitioners. *See Final Anti-Morris Trust Regs Well-Received*, 2005 TNT 78-32 (Apr. 25, 2005); Robert Willens, *Final “Anti-Morris Trust” Regulations Exceedingly Taxpayer-Friendly*, Daily Tax Rep. (BNA), at J-1 (May 2, 2005).

combinations and distributions without compromising the original intent of section 355(e).⁸⁰²

1. Plan or Series of Related Transactions

Whether a distribution and acquisition are part of a plan generally depends on the relevant facts and circumstances under the regulations.⁸⁰³ Different rules apply depending on the order in which a distribution and acquisition occur, and whether the acquisition(s) includes a public offering.⁸⁰⁴ Recognizing that acquisitions in connection with public offerings are fundamentally unique, the regulations provide new rules for public offerings.

The regulations include a non-exclusive list of good and bad factors that tend to indicate the existence of a plan (or not); each factor may be given different weight depending on the facts of the particular case.⁸⁰⁵ The regulations also provide a number of

⁸⁰² Another anti-reverse Morris Trust proposal was introduced into the Senate as part of the Moving Ahead for Progress in the 21st Century Act in 2011. This proposal, if enacted, generally would treat as taxable boot debt securities issued by a controlled subsidiary in a divisive D reorganization, regardless of whether distributing then uses the securities to repay its own debt. S. 1813, 112th Cong. (2011). See also Amy S. Elliot, *Practitioners Wary of Transportation Bill's Anti-Reverse Morris Trust Provision*, 2012 TNT 44-3 (Mar. 6, 2012).

⁸⁰³ See Treas. Reg. § 1.355-7(b)(1). See also *IRS Official Explains 'Fine Line' Between Plan, Non-Plan Rulings Under Section 355(e)*, Daily Tax Rep. (BNA), at G-4 (Nov. 18, 2011) (IRS may be willing to interpret words or phrases in section 355(e) regulations without directly addressing the issue of whether an acquisition is part of a plan).

⁸⁰⁴ The final regulations clarify that a public offering refers to an acquisition of stock for cash where the terms are established by the acquired corporation or seller with one or more investment bankers, and acquirers cannot negotiate the terms. See Treas. Reg. § 1.355-7(h)(11). Under this definition, a private placement offering generally would not qualify. See T.D. 9198, 2005-1 C.B. 972.

⁸⁰⁵ The regulations make clear that certain aspects of distributions are not taken into account in determining whether a plan exists. For example, the fact that a distribution created publicly traded controlled company stock, or increased the trading volume of the distributing or controlled company stock is not taken into account.

examples and safe harbors, discussed below, that provide valuable insight as to how various factors are weighed to determine whether transactions outside the safe harbors are part of a plan.

a. Two Super Factors

A close reading of the regulations indicates that the IRS views two particular factors (the “super factors”) to be of paramount importance in establishing that a distribution and an acquisition (other than a public offering) are not part of a plan. These factors are: (i) that the distribution was motivated at all times in whole or substantial part by a “nonacquisitive business purpose” (*i.e.*, a business purpose other than to facilitate the acquisition or a similar acquisition), and (ii) that the distribution would have occurred at the same time and in a similar form, regardless of the acquisition (or similar acquisition).⁸⁰⁶ In effect, the government has finally accepted the self-evident truth that an acquisition that does not influence the time or manner of a distribution can hardly be part of a plan. Notably, each super factor applies to all distributions and acquisitions, regardless of their order and whether or not they involve a public offering.⁸⁰⁷

The determination of whether the business purpose that motivated a distribution was related (in whole or in part) to a specific acquisition (or similar acquisition) is informed by two specific “operating rules.”⁸⁰⁸ Under those rules, internal discussions and discussions with outside advisors by distributing or controlled corporation officers or directors (or people acting on their behalf) may indicate an acquisition-related business purpose. Such discussions may also increase the weight accorded an acquisition business purpose, or weaken the importance of a non-

See Treas. Reg. § 1.355-7(c)(3). Similarly, the regulations ignore the adverse consequences of section 355(e), and the existence of a contractual obligation by the controlled corporation to indemnify the distributing corporation for any tax under section 355(e) caused by an acquisition involving the controlled company is disregarded for purposes of determining whether a plan exists. *See* Treas. Reg. § 1.355-7(c)(4).

⁸⁰⁶ *See* Treas. Reg. § 1.355-7(b)(2), (b)(4)(v) and (vi).

⁸⁰⁷ These factors may be given less weight in the context of a public offering.

⁸⁰⁸ *See* Treas. Reg. § 1.355-7(c).

acquisition business purpose.⁸⁰⁹ Fortunately, however, an acquisition business purpose is no longer inferred in the absence of discussions merely because an acquisition involving the distributing or controlled corporation is reasonably certain, as under prior regulations.⁸¹⁰ This change is also consistent with the government's evolving view that a plan cannot exist without contacts between the parties (if an acquisition occurs first) or substantial negotiations or an arrangement or agreement (after a distribution).⁸¹¹

A second operating rule provides that a distributing corporation having discussions with a potential acquirer, and also distributing a subsidiary, in whole or substantial part to avoid the takeover of one of the corporations by separating it from the likely takeover target, indicates a business purpose to facilitate the acquisition of the takeover target.⁸¹²

b. Similar Acquisitions

The regulations focus only on the actual acquisition that takes place, and so-called "similar acquisitions".⁸¹³ The definition of a "similar acquisition" confirms that a general intent to engage in an undefined acquisition at the time of a distribution will not constitute a plan. An actual acquisition other than a public offering is "similar" to a potential acquisition only if the actual acquisition combines (directly or indirectly) all or a significant portion of the same business operations with substantially the same ultimate

⁸⁰⁹ See Treas. Reg. § 1.355-7(c)(1).

⁸¹⁰ The IRS clarified this position in the 2002 temporary regulations issued under section 355(e). See T.D. 8988, 2002-1 C.B. 929 (clarifying that such an inference would no longer be made).

⁸¹¹ Private letter rulings also support the view that contacts between two parties are required for a prohibited plan to exist. See P.L.R. 2002-11-019 (Dec. 13, 2001) (distribution followed by a conversion to an LLC through the use of a merger is not part of a plan); P.L.R. 2003-01-11 (July 2, 2002) (unilateral intent by distributing corporation to dispose of retained controlled subsidiary stock not part of a prohibited plan).

⁸¹² See Treas. Reg. § 1.355-7(c)(2).

⁸¹³ See Treas. Reg. § 1.355-7(h)(12).

owners as would have been effected by the potential acquisition.⁸¹⁴ By contrast, public offerings are subject to a broader definition of a “similar acquisition” – two acquisitions may be similar even though there are changes in the terms of the stock, the class of stock offered, the size of the offering, the timing of the offering, the price of the stock or the participants in the offering.⁸¹⁵

Two examples in the regulations illustrate the scope of a “similar” acquisition. Example 6 examines whether substantial negotiations to acquire a distributing corporation and a subsequent acquisition of the distributing corporation by a party unrelated to the potential acquirer, but engaged in the same line of business, will not be considered similar.⁸¹⁶ Despite the fact that both corporations are engaged in the same line of business, the actual and potential acquisitions are not similar because they do not represent combinations of the same “business operations.”

Example 7 examines similar acquisitions involving a corporation engaged in six related lines of business.⁸¹⁷ The corporation engages in substantial negotiations with an acquirer interested in acquiring only four of the six businesses (the “desired businesses”). Thereafter, the distributing corporation decides to retain one of the desired businesses, and so contributes only three of the four desired businesses to its controlled subsidiary, which it then distributes to its shareholders. The controlled subsidiary and the acquirer subsequently negotiate and agree upon an acquisition of the controlled subsidiary for acquirer stock. The example finds that although the original negotiations took place with a different corporation, and only three of the four desired businesses were ultimately acquired, the acquisition represents a combination of a significant portion of the business operations that would have been combined in the proposed acquisition. As a result, the potential acquisition discussed with the distributing corporation and the subsequent acquisition of the controlled subsidiary are similar acquisitions.

⁸¹⁴ See Treas. Reg. § 1.355-7(h)(12).

⁸¹⁵ See Treas. Reg. § 1.355-7(h)(12).

⁸¹⁶ See Treas. Reg. § 1.355-7(j), Ex. 6.

⁸¹⁷ See Treas. Reg. § 1.355-7(j), Ex. 7.

c. Aggregation Rules

Each acquisition of stock that is considered to be part of a plan with a distribution is aggregated in order to determine whether a 50% or greater interest in the distributing or controlled corporation has been acquired.⁸¹⁸ In the case of multiple acquisitions, the facts and circumstances regarding each acquisition are separately examined to determine whether each acquisition is part of a plan. Only those acquisitions that are part of a plan are aggregated.

2. Rules for Distributions Before Acquisitions

a. Relevant Facts and Circumstances

Unless one of the safe harbors discussed below applies, whether a distribution and acquisition are part of a plan is determined based on all the relevant facts and circumstances.⁸¹⁹ The facts and circumstances the regulations identify as relevant for distributions before acquisitions focus primarily on the timing of any agreement, understanding, arrangement or substantial negotiations regarding the acquisition and the business purpose motivating the distribution.

To avoid the application of section 355(e), a taxpayer must demonstrate that it did not intend, at the time of a distribution, that an acquisition would occur in connection with the distribution. To this end, the regulations provide a non-exclusive list of factors tending to demonstrate the existence or absence of a plan. In effect, the regulations import the “end result” test from the world of step transactions – if, when the smoke clears, an acquisition was discussed (or occurred) in close proximity with a distribution, and (taking into account any intervening factual developments) there was no other business reason for the distribution, a plan may be presumed.⁸²⁰

⁸¹⁸ See Treas. Reg. § 1.355-7(c)(5).

⁸¹⁹ See Rev. Rul. 2005-65, 2005-2 C.B. 684.

⁸²⁰ Under the end result test, a series of transactions are stepped together if they are prearranged components of a single transaction with an intended final result. See generally Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts* ¶ 608.1 (Jan., 2008).

The regulations explicitly provide that a distribution and a later acquisition (other than a public offering) will be treated as part of a plan only if there was “an agreement, understanding, arrangement, or substantial negotiations” regarding the acquisition (or similar acquisition) during the two-year period before the distribution.⁸²¹ This very important limitation means that, so long as the sole motivation for an acquisition of a distributing or controlled company was a non-acquisition business purpose, an acquirer can now approach the target immediately after a distribution without fear that the acquisition could constitute part of a plan. More generally, this statement confirms what most practitioners have always believed – that an acquirer’s unilateral intentions cannot constitute a plan, and that a single initial conversation between the parties will not taint later substantial negotiations or agreements.

While the parties need not reach agreement on all significant economic terms to have an arrangement, a binding contract will clearly evidence such an agreement, understanding or arrangement.⁸²² Substantial negotiations are now defined as discussions of the significant economic terms of a transaction.⁸²³ Further, any such agreement or negotiations must occur between one or more officers, directors or controlling shareholders of the distributing or controlled company (or persons acting with their implicit or explicit permission) with their counterparts at the acquirer, or by an acquirer that is a controlling shareholder of the distributing or controlled corporation immediately after the acquisition with the transferor (or persons acting on their behalf), in order to be taken into account.⁸²⁴

⁸²¹ See Treas. Reg. § 1.355-7(b)(2).

⁸²² See Treas. Reg. § 1.355-7(h)(1)(i).

⁸²³ See Treas. Reg. § 1.355-7(h)(1)(iv).

⁸²⁴ See Treas. Reg. § 1.355-7(h)(1). As the preamble to the temporary regulations that preceded the final regulations indicated, “both the content of, and persons engaging in, the discussions are probative of whether discussions are properly treated as substantial negotiations.” See Temp. Reg. § 1.355-7, preamble. The NYSBA has expressed concern that the definition of “substantial negotiations” is too vague and could, for example, be construed to include a brief discussion where price per share was raised and dismissed out-of-hand, but not a prolonged negotiation where, at the advice of counsel, price was

As discussed above, the presence of the super factors, *i.e.*, a wholly non-acquisition business purpose, and “same time, similar manner” distribution, is strong evidence that distribution and later acquisition are not part of a plan.⁸²⁵ The importance of these factors is highlighted by the provision stating that the presence of both of these super factors may be sufficient evidence that a distribution and subsequent acquisition are not part of a plan, *even if* a binding acquisition agreement was in place prior to a distribution.⁸²⁶

The business purpose motivating a distribution before an acquisition will be closely scrutinized for evidence of a plan. A purely non-acquisition business purpose is one of the super factors that offers strong proof that a plan does not exist. By contrast, a distribution with a business purpose of facilitating the acquisition (or a similar acquisition) tends to demonstrate that a plan exists.⁸²⁷ As one commentator has observed, the IRS has historically focused on the business motivations for a distribution at the time the distribution is announced publicly.⁸²⁸ The regulations clearly limit the proscribed acquisition business purpose to the specific (or similar) acquisition that occurs before or after a distribution.⁸²⁹ This focus on a more limited group of similar acquisitions is both helpful and appropriate. Taxpayers considering a distribution should work closely with their investment bankers to identify and document the non-acquisition, *e.g.*, “fit and focus”, business

not discussed. See NYSBA 355(e) Report. This view should obviously not prevail.

⁸²⁵ See Treas. Reg. § 1.355-7(b)(4)(v), (vi).

⁸²⁶ See Treas. Reg. § 1.355-7(b)(2); *see also* Treas. Reg. § 1.355-7(j), Ex. 4 (discussed below). See, *e.g.*, Robert Willens, *No Future Tax Shock for Bristol Myers*, CFO.com (Nov. 25, 2009), available at <http://www.cfo.com/article.cfm/14457426> (expressing the view that the Bristol Myers divestiture of Mead-Johnson should be tax-free regardless of any subsequent acquisition of Mead-Johnson because Bristol Myers should be able to demonstrate that business purposes other than facilitating the acquisition motivated the acquisition); Robert Willens, *Spinoff Options Abound for Bristol-Myers Squibb*, CFO.com (Oct. 19, 2009), available at <http://www.cfo.com/article.cfm/14448209> (same).

⁸²⁷ See Treas. Reg. § 1.355-7(b)(3)(v).

⁸²⁸ See Robert Willens, *Planning Issue*, The Daily Deal (July 18, 2002).

⁸²⁹ See Treas. Reg. § 1.355-7(b)(3)(v).

purpose(s) motivating the distribution to avoid any implication of an acquisition business purpose.

The presence of an agreement, understanding, arrangement or substantial negotiations concerning the acquisition at any point during the two-year period ending on the date of the relevant distribution will tend to demonstrate that a plan exists.⁸³⁰ The regulations provide that the weight accorded an agreement, understanding, arrangement or substantial negotiations as evidence of a plan depends on their nature, extent and timing, with the existence of an agreement, understanding or arrangement on the date of the distribution being given substantial weight.⁸³¹ A private letter ruling provides helpful confirmation that a vague unilateral intent by the distributing corporation to dispose of its retained controlled corporation stock as a source of cash will not constitute part of a prohibited plan.⁸³²

The regulations do not clarify how the “substantial weight” accorded certain agreements, understandings and arrangements is affected by the varying weight accorded these same facts depending on the nature, extent and timing of an agreement, understanding, arrangement or substantial negotiations.⁸³³ However, the regulations do make clear that even the substantial weight given to an acquisition agreement reached before the distribution date is not dispositive evidence of a plan if the super

⁸³⁰ See Treas. Reg. § 1.355-7(b)(3)(i).

⁸³¹ See Treas. Reg. § 1.355-7(b)(3)(i).

⁸³² See P.L.R. 2003-01-011 (July 2, 2002).

⁸³³ The substantial weight of certain agreements, understandings and arrangements before a distribution is not controlling, and their importance appears to be diminished when negotiations do not occur until after a distribution is publicly announced. See Rev. Rul. 2005-65, 2005-2 C.B. 684 (no plan existed where distributing announced the distribution before any merger discussions); P.L.R. 2001-33-035 (May 17, 2001) (no plan existed where acquisition agreement was executed before distribution but after public announcement of the distribution; taxpayer represented that no discussions took place prior to public announcement date); P.L.R. 2001-15-001 (Apr. 28, 2000) (no plan where acquisition agreement existed before distribution but after public announcement of the distribution, and taxpayer did not engage in negotiations until after public announcement date).

factors are satisfied, *i.e.*, the distribution is wholly motivated by a non-acquisition business purpose and would have occurred at approximately the same time and in a similar manner whether or not the acquisition occurred.⁸³⁴ In other words, if an acquirer can demonstrate that the distribution conducted by a target distributing company was motivated solely by a non-acquisition business purpose, and can establish that the distribution would have occurred at approximately the same time and in a similar manner whether or not the acquisition occurred, the acquisition will not be considered part of a plan even if the acquisition was negotiated between the announcement and consummation date.

Finally, the regulations also indicate that an identifiable, unexpected change in market or business conditions that occurs after the date of a distribution and results in the acquisition will also tend to demonstrate the independence of the two transactions.⁸³⁵ The sudden and unanticipated nature of these changes lends support to an assertion that the parties did not intend to engage in an acquisition on the date of an earlier distribution. This factor may be helpful, for example, to companies with stock prices that are particularly vulnerable to shifts in market conditions.

A so called “unexpected change” is not defined.⁸³⁶ However, additional guidance is available in the several favorable private rulings the IRS issued under the 2001 proposed regulations, which rely in part on an identifiable, unexpected shift in business conditions.⁸³⁷ Additionally, while the regulations refer only to

⁸³⁴ See Treas. Reg. § 1.355-7(b)(2) (notwithstanding execution of acquisition agreement before distribution is consummated, a plan may not exist if the super factors are established).

⁸³⁵ See Treas. Reg. § 1.355-7(b)(4)(ii). An unexpected change occurring between an acquisition and later distribution also tends to demonstrate the independence of the two transactions. See Treas. Reg. § 1.355-7(b)(4)(iv).

⁸³⁶ See Robert Willens, *Stepping Out*, The Daily Deal (Sept. 7, 2006) (management buyout is likely not an “unexpected event”).

⁸³⁷ P.L.R. 2001-15-001 (Apr. 16, 2001) (Viacom ruling) (permitting distributing corporation’s acquisition of third party after the announcement of a split-off from its subsidiary; unanticipated regulatory change permitted distributing corporation to pursue acquisition); P.L.R. 2001-33-035 (Aug. 20, 2001) (Lucent ruling)

unexpected changes occurring after the date a distribution is consummated, the IRS private letter rulings demonstrate that identifiable, sudden and unexpected changes occurring after the public announcement of a distribution also demonstrate the absence of a plan.⁸³⁸

b. Relevant Examples

The regulations provide an important example of a distribution before an acquisition that is not part of a plan, even though the transactions fall outside the safe harbors.⁸³⁹ In Example 3, a widely-held corporation announces its intent to distribute the stock of its wholly owned subsidiary, and then does so. The controlled subsidiary has a contractual obligation to indemnify the distributing corporation for any tax imposed under section 355(e) as a result of its actions. The distribution is motivated by a business purpose to improve the distributing corporation's access to preferred-rate financing. At the time of the distribution, it is reasonably certain that the distribution will result in an agreement, understanding, arrangement or substantial negotiations regarding an acquisition of the controlled subsidiary. As anticipated, the controlled subsidiary is approached and acquired within 6 months after the distribution.

No factors in the example indicate the existence of a plan. Moreover, as the regulations provide, even though the acquisition occurs within six months after the distribution, the transactions are not part of a plan because there were no substantial negotiations (or agreement) regarding the acquisition (or a similar acquisition) before the distribution. Consistent with the operating rules, the controlled subsidiary's indemnification obligation is not considered, and the controlled subsidiary's status as a likely acquisition target is no longer evidence of a plan.⁸⁴⁰

(permitting acquisition of distributing corporation after the announcement of a spinoff of its subsidiary; distributing corporation's stock unexpectedly declined by more than 85%).

⁸³⁸ See P.L.R. 2001-33-035 (May 17, 2001); P.L.R. 2001-15-001 (Apr. 28, 2000).

⁸³⁹ See Treas. Reg. § 1.355-7(j), Ex. 3.

⁸⁴⁰ Jeffrey Paravano, senior adviser to the Assistant Secretary of the Treasury for tax policy, has confirmed that, "[i]f a corporation distributes a subsidiary for a good non-acquisition business purpose,

c. Relevant Safe Harbors

Three of the safe harbors provided in the regulations apply specifically to distributions before acquisitions. A comparison of these safe harbors demonstrates the importance placed on a strong non-acquisition business purpose for the distribution.

Under the first safe harbor, a distribution followed by an acquisition will not be considered part of a plan if (i) the distribution was motivated in whole or substantial part by a non-acquisition business purpose, and (ii) the acquisition occurred more than six months after the distribution, and there was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition (or similar acquisition) during the 18-month period beginning twelve months before the distribution and ending six months after the distribution (such period, the “18-month straddle period”).⁸⁴¹ This safe harbor is now appropriately limited to the specific acquisition that occurs (or a similar acquisition), rather than any acquisition, which is how the previous iteration of the safe harbor read.

The second safe harbor allows limited transfers of stock of the distributing or controlled corporation that are unrelated to a subsequent acquisition. Under safe harbor II, a distribution followed by an acquisition will not be considered part of a plan if (i) the distribution was motivated by a non-acquisition business purpose, (ii) the acquisition occurred more than six months after the distribution, and there was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition (or a similar acquisition) during the 18-month straddle period ending six months after the distribution, and (iii) no more than 25% of the stock of the acquired corporation was acquired, or was the subject of an agreement, understanding, arrangement or substantial negotiations, during the 18-month straddle period.⁸⁴²

even into a hot market where it is possible or even reasonably certain that an acquisition of the subsidiary will occur, the distribution and later acquisition will not be part of a plan for purposes of section 355(e) if there were no substantial negotiations regarding the acquisition before the distribution.” Lee A. Sheppard, *Huge Liberalization in New Anti-Morris Trust Regs*, 95 Tax Notes 639 (Apr. 29, 2002).

⁸⁴¹ See Treas. Reg. § 1.355-7(d)(1).

⁸⁴² See Treas. Reg. § 1.355-7(d)(2).

The acquisition business purpose, *i.e.*, to transfer up to 25% of the acquired corporation's stock, can be a significant business purpose for the distribution since the regulations only require that a non-acquisition business purpose motivate the distribution.

Accordingly, this safe harbor is particularly beneficial for distributing and controlled corporations seeking to tap public or private equity markets or make small acquisitions using their stock as currency.⁸⁴³ The IRS has issued several private letter rulings under prior, more restrictive regulations for stock offerings qualifying under the analogous safe harbor.⁸⁴⁴

A third safe harbor also applies to distributions before acquisitions that may have been negotiated before a distribution. Under safe harbor III, a distribution and subsequent acquisition will not be considered part of a plan if there was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition (or similar acquisition) at the time of the distribution or within one year after the distribution.⁸⁴⁵ This safe harbor permits taxpayers considering a distribution to entertain merger opportunities prior to a distribution, and even reach an agreement (terminated before the distribution), provided that no agreement, understanding, arrangement or substantial negotiations exists on the actual date of the distribution and no further "substantial negotiations" occur until one year after the distribution. This approach is helpful in resolving the conflict

⁸⁴³ See, *e.g.*, P.L.R. 2001-18-050 (May 4, 2001); P.L.R. 2001-18-044 (May 4, 2001).

⁸⁴⁴ In these rulings, the IRS required the controlled corporation to represent that (i) there was no agreement, understanding, arrangement, or substantial negotiations concerning the stock offering at the time of the distribution or within six months thereafter, and (ii) apart from the stock offering and the issuance of compensatory stock and options, the controlled corporation has no plan or intention to engage in any transaction with respect to its stock, and required the distributing corporation to represent that the distribution is not part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of the distributing or controlled corporation entitled to vote, or stock possessing 50% or more of the total value of all classes of stock of the distributing or controlled corporation, within the meaning of section 355(e).

⁸⁴⁵ See Treas. Reg. § 1.355-7(d)(3).

between the prior regulations and a corporation's duty to entertain offers that could increase shareholder value.

3. Distributions After Acquisitions

a. Relevant Facts and Circumstances

Most significantly, the 2005 regulations liberalize the rules regarding the definition of a plan in the case of distributions after acquisitions, more closely aligning them with the rules applicable to distributions before acquisitions. Nevertheless, the rules applicable to distributions after acquisitions remain stricter; the presence of mere "discussions" rather than an agreement or substantial negotiations prior to a distribution tends to indicate a plan.⁸⁴⁶ More specifically, discussions regarding a distribution between the distributing or controlled company and the acquirer during the two-year period prior to the acquisition tend to demonstrate that a plan exists.⁸⁴⁷ However, the term "discussions" was limited by the 2005 regulations to discussions by one or more officers, directors or controlling shareholders of the distributing or controlled corporation (or people acting with their permission) with the acquirer (or people acting with the acquirer's permission).⁸⁴⁸ The plain meaning of the word "discussion" also makes it clear that an offer that is immediately rebuffed is not a discussion, although the regulations do not specifically address this issue. In addition, it is not clear why a focus on discussions regarding "a distribution" is the appropriate standard if, for example, a different subsidiary of the distributing corporation was distributed.⁸⁴⁹

The existence of a plan is also indicated if a person other than the distributing or controlled corporation intends to cause a distribution, and as a result of the acquisition, can meaningfully participate in the decision of whether or not the distribution occurs.⁸⁵⁰ The regulations identify acquisitions by ten-percent shareholders or coordinated groups of shareholders, and

⁸⁴⁶ See T.D. 9198, 2005-1 C.B. 972.

⁸⁴⁷ See Treas. Reg. § 1.355-7(b)(3)(iii).

⁸⁴⁸ See Treas. Reg. § 1.355-7(h)(6).

⁸⁴⁹ NYSBA 355(e) Report.

⁸⁵⁰ See Treas. Reg. § 1.355-7(b)(3)(iii).

acquisitions of more than twenty percent of the acquired corporation's shares in the aggregate, as situations where an acquirer may influence a distribution after the distribution has been announced.⁸⁵¹ Presumably, this factor could also be neutralized by carefully drafting the acquisition agreement to appropriately limit the acquirer's influence with respect to the occurrence of the distribution.

The business purpose motivating a distribution after an acquisition will, of course, be closely scrutinized, and a business purpose to effect a distribution to facilitate the acquisition is evidence of a plan.⁸⁵² By contrast, a pure non-acquisition business purpose, one of the two super factors, is an important indication that a plan does not exist. In addition, establishing the other super factor, *e.g.*, that the time and manner of the distribution would not be affected by the acquisition, is also important evidence that no plan exists. Consistent with the example discussed below, taxpayers able to establish both super factors can establish that a plan does not exist even if other bad factors were present.

In addition to the super factors, the regulations identify two other factors that demonstrate the absence of a plan. First, an identifiable, unexpected change in market or business conditions that occurs after the acquisition and results in the distribution is evidence that no plan exists.⁸⁵³ Second, the absence of discussions between the distributing or controlled corporation and the acquirer regarding the distribution during the two-year period prior to the acquisition or first public announcement regarding the distribution indicates that no plan exists.⁸⁵⁴ However, the absence of discussions is only helpful if, other than the distributing or controlled corporation, no one who intends to cause the distribution can also meaningfully influence the distribution decision after the acquisition.⁸⁵⁵

⁸⁵¹ See T.D. 9198, 2005-1 C.B. 972; Treas. Reg. § 1.355-7(d)(4), (5), (j), Ex. 4.

⁸⁵² See Treas. Reg. § 1.355-7(b)(3)(v).

⁸⁵³ See Treas. Reg. § 1.355-7(b)(4)(iv).

⁸⁵⁴ See Treas. Reg. § 1.355-7(b)(4)(iii).

⁸⁵⁵ See Treas. Reg. § 1.355-7(b)(4)(iii).

Another favorable private ruling under the prior, more restrictive regulations provides additional insight to the application of the facts and circumstances test of section 355(e) for distributions after acquisitions.⁸⁵⁶ The ruling, which foreshadowed the approach taken in the 2002 regulations, held that a series of four acquisitions made by a parent corporation using its stock, which occurred shortly before a distribution of its controlled subsidiary which was being considered at the time, would not be taken into account for purposes of section 355(e). With respect to the acquisitions, the parent corporation represented to the IRS that (i) the distribution was not discussed with the acquired corporations, (ii) the distribution was not motivated by a business purpose to facilitate the acquisition of parent stock in the acquisitions, (iii) the distribution would have occurred at the same time and in a similar form regardless of the acquisitions, (iv) the acquisitions occurred at a time when the parent corporation had not yet made a final decision to proceed with the distribution, and (v) regulatory approval for the distribution had not yet been received at the time of the acquisitions (and thus it was uncertain whether the distribution would occur). The IRS did not rule as to whether a fifth acquisition that was made after the public announcement of the distribution was part of a plan.

b. Relevant Examples

Example 4 in the regulations describes a distribution occurring after an acquisition that will not be treated as part of a plan.⁸⁵⁷ In the example, a publicly traded corporation makes a public announcement that it plans to distribute its wholly owned subsidiary pro rata to its shareholders. After the announcement date and before the distribution, publicly traded corporation becomes available as an acquisition target. No discussions occur between the distributing or controlled corporation and the target before the distribution announcement. The distributing corporation then negotiates a merger with the public target corporation that closes six months before the distribution, with target shareholders receiving 10% of the distributing corporation's stock. At no time before the distribution were any of the target's shareholders controlling or 10% shareholders. Because of this fact, and because less than 20% of the distributing corporation's stock was

⁸⁵⁶ P.L.R. 2002-05-035 (Oct. 31, 2001).

⁸⁵⁷ See Treas. Reg. § 1.355-7(j), Ex. 4.

transferred in the merger, the distribution would not be part of a plan with the acquisition and would be eligible for safe harbor V discussed below.

c. Relevant Safe Harbors

Safe harbor IV, which applies to distributions after acquisitions, was significantly expanded by the 2005 regulations for certain types of acquisitions. Under the regulations, a pre-distribution acquisition that does not involve a public offering, will not be treated as part of a plan with a distribution if the acquisition occurs before the first so-called “disclosure event” regarding the distribution. A disclosure event generally includes any communication to the acquirer or any other person by an officer, director, controlling shareholder or employee of the distributing or controlled corporation (or their advisors) regarding the possibility of the distribution.⁸⁵⁸ This safe harbor does not apply to acquisitions (i) by a controlling or ten-percent shareholder or coordinating group of shareholders, or (ii) of more than twenty percent of the acquired corporation’s shares in the aggregate, because of the influence an acquirer could exercise with respect to the distribution in such circumstances.⁸⁵⁹ By contrast, the prior regulations required a significant period of time to pass between transactions in order for this safe harbor to apply.⁸⁶⁰

The regulations add a new safe harbor for pro rata distributions after an acquisition that does not involve a public offering. This safe harbor V applies if an acquisition occurs after the date of a public announcement regarding the distribution and neither the distributing nor controlled corporation had any

⁸⁵⁸ See Treas. Reg. § 1.355-7(d)(4), (h)(5). It is important to note that a distributing company may qualify for this safe harbor even if it considers, or even agrees to, a distribution of its subsidiary prior to a merger, as long as any such agreement is withdrawn before an acquisition occurs and is not revived during the six-month cooling-off period thereafter.

⁸⁵⁹ See Treas. Reg. § 1.355-7(d)(4)(ii).

⁸⁶⁰ Under prior regulations, this safe harbor required two years to pass after an acquisition, and required that there was no agreement, understanding, arrangement or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter. See Temp. Reg. § 1.355-7(d)(4), prior to amendment by T.D. 9198, 2005-1 C.B. 972.

discussions with the acquirer regarding the distribution on or before such announcement date.⁸⁶¹ This safe harbor applies the IRS private ruling standard that the date of a distributing corporation's first public announcement regarding its intention to distribute its controlled corporation is the proper date to measure the parties' intent and determine the existence of a plan. This safe harbor also does not apply to acquisitions (i) by a controlling or ten-percent shareholder or coordinated group of shareholders, or (ii) of more than twenty percent of the acquired corporation's shares in the aggregate, because of the influence an acquirer could exercise with respect to the distribution in such circumstances.⁸⁶²

4. Distributions Involving Public Offerings

a. Relevant Facts and Circumstances

Under the regulations, distributions and acquisitions involving public offerings are subject to separate rules that consider unique facts and circumstances.⁸⁶³ The regulations focus on discussions that the distributing and/or controlled corporation have with investment bankers regarding a public offering. This focus is underscored by a special definition in the regulations, which states that whether an agreement, understanding, or arrangement or substantial negotiations exists regarding a public offering will be based on distributing or controlled discussions with an investment banker.⁸⁶⁴ The regulations are curiously silent

⁸⁶¹ See Treas. Reg. § 1.355-7(d)(5)(i).

⁸⁶² See Treas. Reg. § 1.355-7(d)(5)(ii).

⁸⁶³ For purposes of these rules, if (i) an option is issued for cash, (ii) the terms of the option and its acquisition are established by the corporation whose stock is subject to the option with the involvement of an investment banker, and (iii) the potential acquirer has no ability to negotiate the terms of the option or its acquisition, an acquisition pursuant to the exercise of such an option will be treated as an acquisition involving a public offering on the date the option is exercised.

⁸⁶⁴ See Treas. Reg. § 1.355-7(h)(1)(vi). As Bob Willens has sensibly suggested, discussions with bankers should only be accorded significant weight if the purpose of the distribution is to "facilitate" the offering, within the meaning of Revenue Procedure 96-30. See Robert Willens, *IRS Revises the "Plan" Concept in the 355(e) Temp. Regs. to Infuse More Practicality*, 97 J. Tax'n 6 (July 2002).

as to how, if at all, the business purpose for the public offering affects the determination of whether a plan exists.

In the case of a distribution before a public offering, discussions between the distributing or controlled corporation and investment bankers regarding a public offering (or a similar acquisition)⁸⁶⁵ during the two years preceding the distribution date tend to show that the distribution and acquisition were part of a plan.⁸⁶⁶ The weight accorded such discussions may vary depending on their nature, extent and timing.⁸⁶⁷

In the case of a distribution after a public offering, discussions between the distributing or controlled company and investment bankers regarding a distribution during the two-year period ending on the public offering date will tend to demonstrate the existence of a plan.⁸⁶⁸ The weight accorded such discussions depends on their nature, extent and timing.⁸⁶⁹ Accordingly, taxpayers considering a public offering should give thought to avoiding, or limiting, any discussions regarding a future

⁸⁶⁵ As noted above, in the case of a public offering or other stock offering for cash, the term “similar” acquisition is more broadly defined.

⁸⁶⁶ See Treas. Reg. § 1.355-7(b)(3)(ii). Although the regulations specifically refer to discussions regarding the “acquisition,” a logical reading of the regulations limits the term to acquisitions of stock in the public offering. Other acquisitions of distributing or controlled corporation stock apart from the public offering will presumably be tested under the general rules for acquisitions and distributions discussed above and then aggregated with any public offerings that are part of a plan.

⁸⁶⁷ See Treas. Reg. § 1.355-7(b)(3)(ii).

⁸⁶⁸ See Treas. Reg. § 1.355-7(b)(3)(iv). Notably, the final regulations do not limit this factor to a discussion of “the” distribution or a similar distribution. While discussions regarding the distribution ultimately effected, or discussions regarding a distribution of the same line or lines of business will presumably be given more weight, it is unclear if and to what extent discussions regarding distribution of an unrelated line of business may be considered evidence of a plan. Such unrelated discussions should be given very little weight, consistent with the regulations’ general focus on the specific (or similar) acquisition subsequently effected.

⁸⁶⁹ See Treas. Reg. § 1.355-7(b)(3)(iv).

distribution before the public offering is consummated, particularly because even discussions that do not involve significant economic terms may be evidence of a plan.

The non-acquisition business purpose and “same time and similar manner” super factors also apply to acquisitions involving public offerings, but it is unclear whether they are as important in the case of public offerings. Nonetheless, the IRS will certainly closely scrutinize the business purpose that motivated a distribution occurring before or after a public offering, and the business purpose of facilitating an acquisition that includes a public offering (or similar acquisition) will tend to demonstrate that a plan exists.⁸⁷⁰

The regulations contain two other factors that demonstrate the absence of a plan. In the case of distributions before public offerings, the absence of discussions regarding a public offering between the distributing or controlled corporation and an investment banker during the two-year period preceding a distribution demonstrates the absence of a plan.⁸⁷¹ Notably, there is no similar non-plan factor for distributions occurring after public offerings. An identifiable, unexpected change in market or business conditions occurring after a distribution that results in a public offering also demonstrates that a plan does not exist.⁸⁷² An identifiable, unexpected change in market or business conditions occurring after a public offering that results in a distribution also demonstrates the absence of a plan.⁸⁷³

b. Relevant Examples

These factors are applied in Example 2 in the regulations.⁸⁷⁴ In this example, the distributing corporation’s managers and directors discuss the possibility of a public offering of the distributing corporation’s stock with an investment banker. Pursuant to these discussions, it is determined that a 20% interest in the distributing corporation should be sold to the public. In

⁸⁷⁰ See Treas. Reg. § 1.355-7(b)(3)(v).

⁸⁷¹ See Treas. Reg. § 1.355-7(b)(4)(i).

⁸⁷² See Treas. Reg. § 1.355-7(b)(4)(ii).

⁸⁷³ See Treas. Reg. § 1.355-7(b)(4)(iv).

⁸⁷⁴ See Treas. Reg. § 1.355-7(j), Ex. 2.

order to facilitate this public offering, the distributing corporation distributes its subsidiary pro rata to its shareholders. The public offering occurs seven months later. The example states that the discussions between the distributing corporation and the investment banker tend to demonstrate that the acquisition (*i.e.*, the public offering) and distribution occurred pursuant to a plan. In addition, the business purpose of facilitating the public offering also tends to demonstrate the existence of a plan. None of the non-plan factors are present in Example 2. Thus, the example concludes that the distribution and public offering are part of a plan.

The regulations also add three new examples addressing distributions and acquisitions involving public offerings. Example 8 addresses two public offerings with different purposes.⁸⁷⁵ In the example, the distributing corporation's managers, directors and an investment banker discuss the possibility of a public offering of the distributing corporation's stock to fund an acquisition of a target corporation's assets. The parties decide to conduct a public offering of 20% of the distributing corporation's stock, and the distributing corporation distributes its subsidiary stock to facilitate this offering. The 20% public offering is completed two months after the distribution, and the acquisition of the target's assets is completed four months after the distribution. Seven months after the distribution, the distributing corporation's managers, directors and investment banker discuss a second public offering of the distributing corporation's stock in order to fund an acquisition of the assets of another unrelated target corporation. One year after the distribution, 40% of the distributing corporation's stock is sold in the second public offering, and one month after this offering the assets of the second target are acquired. Example 8 concludes that because the first and second public offerings have different objectives, *i.e.*, funding the acquisitions of a different target's assets, the second public offering is not similar to the initial potential acquisition and therefore the second offering will not be treated as part of a plan with the first offering and distribution.⁸⁷⁶

Examples 9 and 10 analyze two public offerings that occur during a short period of time.⁸⁷⁷ In example 9, the distributing

⁸⁷⁵ See Treas. Reg. § 1.355-7(j), Ex. 8.

⁸⁷⁶ See Treas. Reg. § 1.355-7(j), Ex. 8.

⁸⁷⁷ See Treas. Reg. § 1.355-7(j), Exs. 9-10.

corporation's managers, directors and investment banker discuss and decide to proceed with a public offering of 20% of the distributing corporation's stock, to raise funds for general corporate purposes, after the corporation distributes all of the stock of its subsidiary. The distribution occurs a month later, and the 20% stock offering is completed two months after the distribution. Eight months after the distribution the managers, directors and investment banker discuss and effect a second public offering of 10% of the distributing corporation's stock to raise funds for general corporate purposes. Because both public offerings have the same purpose, the two public offerings are similar.⁸⁷⁸ Accordingly, the second public offering would be part of a plan with the first public offering and the distribution. By contrast, example 10, which examines a second public offering that occurs fourteen months (rather than eight months) after the distribution on otherwise identical facts, holds that the two public offerings are not similar, and therefore the second offering is not part of a plan that includes the first offering and distribution.⁸⁷⁹

c. Safe Harbor

The regulations contain a new safe harbor for public offerings that confirms the IRS's view that a distribution and public offering are unlikely to be part of a plan if the acquirers are unaware that a distribution will occur.⁸⁸⁰ Under safe harbor VI, a distribution after an acquisition involving a public offering will not be part of a plan if the public offering occurs before the first public disclosure event regarding the distribution (if the stock is not publicly traded) or before the date of the first public announcement regarding the distribution (if the stock is publicly traded).⁸⁸¹

5. Acquisitions Caused by Public Trading

The regulations recognize that public trading in stock among smaller shareholders unrelated to the distributing or controlled corporation generally should not be considered part of a plan. Accordingly, safe harbor VII provides that acquisitions of distributing or controlled corporation stock caused by public

⁸⁷⁸ See Treas. Reg. § 1.355-7(j), Ex. 9.

⁸⁷⁹ See Treas. Reg. § 1.355-7(j), Ex. 10.

⁸⁸⁰ See T.D. 9198, 2005-1 C.B. 972.

⁸⁸¹ See Treas. Reg. § 1.355-7(d)(6).

trading is generally not part of a plan unless (i) the corporation whose stock is being transferred knows, or has reason to know, that the transferor, transferee, or a coordinating group of which such person is a member, intends to become a controlling or 10% shareholder⁸⁸² of the acquired corporation within two years after the distribution, or (ii) the transferor, the transferee, or any coordinating group of which the transferor or transferee is a member is (v) the acquired corporation, (w) a corporation in which the acquired corporation holds 80% of the total combined voting power and at least 80% of the total number of shares of all other

⁸⁸² A person will be considered a 10% shareholder of a public corporation if, immediately before or after the transfer, the person owns, directly or by attribution, 10% or more of any class of stock of the corporation whose stock is transferred. A person will be considered a 10% shareholder of a non-public corporation if, immediately before or after the transfer, the person owns, directly or by attribution, 10% or more of the total voting power of the stock of the corporation whose stock is transferred. All options owned by a person are deemed exercised for purposes of making this determination. Absent actual knowledge, public corporations may rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 10% shareholders. *See* Treas. Reg. § 1.355-7(h)(14). A “coordinating group” refers to two or more persons that join in one or more coordinated acquisitions or dispositions of stock pursuant to a formal or informal understanding, such as when the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. *See* Treas. Reg. § 1.355-7(h)(4).

A person will be considered a controlling shareholder of a public corporation if the person is a 5% shareholder who actively participates in the management or operation of the corporation. For this purpose, a corporation’s director is treated as actively participating in the management of the corporation. A person will be considered a controlling shareholder of a non-public corporation if the person owns stock, including stock the person owns constructively under the rule of section 318 (without regard to section 318(a)(4)) and treating the options as exercised, that possesses voting power representing a meaningful voice in the governance of the corporation. If a distribution precedes an acquisition, controlled corporation’s controlling shareholder immediately after the distribution and distributing corporation are included among controlling shareholders at the time of distribution. *See* Treas. Reg. § 1.355-7(h)(3).

classes of stock, (x) a member of a controlled group of corporations,⁸⁸³ (y) a controlling shareholder of the acquired corporation, or (z) a 10% shareholder of the acquired corporation.⁸⁸⁴

Safe harbor VII also demonstrates the government's concern with vote-shifting transactions that avoid triggering a 50% change of control by excluding transactions that utilize stock with exploding or other shifting voting rights.⁸⁸⁵ More specifically, if the transfer of stock results immediately, or upon a subsequent event or the passage of time, in an indirect acquisition of voting power by a person other than the transferee, safe harbor VII will not prevent the acquisition of stock (measured by the voting power such stock will ultimately have) from being treated as part of a plan.⁸⁸⁶

The regulations also provide an example of how such vote shifting transactions are treated. In Example 5, a distributing corporation is seeking to merge with a larger closely held

⁸⁸³ A "controlled group of corporations" refers to (i) one or more chains of corporations connected through stock ownership with a common parent in which 80% of each corporation (by vote and value) is owned within the chain, and the common parent owns 80% of at least one of the other corporations (by vote and value), and (ii) a brother-sister group in which two or more corporations owned by five or fewer individuals, estates or trusts holding at least 80% of each corporation (by vote and value) and more than 50% of each corporation (by vote and value) taking into account stock held by each person only when it is identical with respect to each corporation. *See* I.R.C. § 1563(a).

⁸⁸⁴ *See* Treas. Reg. § 1.355-7(d)(7). *See also* P.L.R. 2010-37-024 (June 8, 2010) (a taxpayer may disregard any increase or decrease in the percentage, by vote or value, of distributing stock as a result of open market repurchases by distributing, following a D reorganization, to the extent such repurchases are not part of a plan, or motivated by the desire, to increase or decrease the ownership percentage of any particular shareholder or group of shareholders, and instead are motivated by the desire to address the undervalued distributing stock price).

⁸⁸⁵ *See* T.D. 8988, 2000-2 C.B. 271; Treas. Reg. § 1.355-7(d)(7)(ii)(B), (j), Ex. 5.

⁸⁸⁶ *See* Treas. Reg. § 1.355-7(d)(7)(ii)(B).

corporation engaged in the same line of business.⁸⁸⁷ In order to facilitate the acquisition, the distributing corporation agrees to distribute its subsidiary and enters into a merger agreement. The merger is subject to several conditions, one of which is that the distributing corporation must recapitalize into two classes of stock after the spinoff. Class A shares, which the target shareholders will receive in the merger, will be entitled to 10 votes to elect directors under all circumstances. Class B shares, which the distributing corporation shareholders will receive after the spinoff, will initially be entitled to 10 votes to elect directors, and to one vote for directors after any transfer of the shares. One month after the merger agreement is signed, the distributing corporation spins off its subsidiary, the distributing corporation recapitalizes, distributing Class B shares to its shareholders, and then the target shareholders receive class A shares in the merger.

During the month following the merger, public trading of the class B shares causes the voting power of the distributing corporation shareholders' class B shares to decrease from 51% immediately after the merger to 48%. The example states that voting power shifted to the target shareholders as a result of public trading will be attributed to the stock acquired by the target shareholders in the merger. The additional voting power in the example triggers a change of control transaction that constitutes part of a plan with the spinoff.⁸⁸⁸

The regulations' treatment of shifting vote transactions is very likely a response to the cleverly designed Jif-Smucker transactions. Smucker agreed to acquire Jif immediately after its spinoff from Proctor & Gamble ("P&G") in a transaction that might, if concluded with plain vanilla stock, have run afoul of section 355(e). Accordingly, the Jif shareholders received a special class of Smucker stock crafted to provide subsequent purchasers of the stock with reduced voting rights on extraordinary corporate events such as mergers, asset sales and liquidations.

Public filings confirm that transfers of the Jif shares were expected to occur shortly after the spinoff in light of the number of Jif institutional "short-term" shareholders. Thus, it was expected that the diminished voting rights would quickly take effect, causing

⁸⁸⁷ See Treas. Reg. § 1.355-7(j), Ex. 5.

⁸⁸⁸ See Treas. Reg. § 1.355-7(j), Ex. 5.

the acquirer shareholders to hold more than 50% of the vote on these matters. Nonetheless, the Jif-Smucker deal would not be excluded from safe harbor VII, because it was very carefully structured not to similarly limit the Jif shareholders' voting rights (which are *pari passu* with the other classes of Smucker stock) with respect to the election of directors, which is the undisputed sole measure of the voting power of stock.⁸⁸⁹ Thus, while the Jif-Smucker deal surely sensitized the government to the power of shifting vote stock, the IRS has appropriately ruled that section 355(e) will not apply to the transactions.⁸⁹⁰

6. Compensatory Stock Acquisitions

Acquisitions of stock as compensation for the performance of services, including through qualified retirement plans, are generally disregarded in determining whether a plan exists. Under safe harbor VIII, stock of the distributing or controlled corporation acquired in a transaction to which section 83 or section 421(a) or (b) applies in connection with the performance of services as an employee, director or independent contractor of the distributing or controlled corporation, or for a person related to the distributing or controlled corporation,⁸⁹¹ will not be considered part of a plan as

⁸⁸⁹ See, e.g., Rev. Rul. 84-6, 1984-1 C.B. 178; *cf. Alumax v. Commissioner*, 165 F.3d 822 (11th Cir. 1999), *aff'g* 109 T.C. 133 (1997) (although shareholders had sufficient voting power to elect directors, court declined to measure shareholder voting rights by the ability to elect directors because restrictions on board's power to manage taxpayer's business reduced shareholder's voting power).

⁸⁹⁰ See P.L.R. 2002-34-044 (May 17, 2002) (Jif-Smucker ruling). For an excellent discussion of the Jif-Smucker ruling, see Robert Willens, *Smooth Fit*, *The Daily Deal* (Sept. 12, 2002).

⁸⁹¹ A related person refers to (i) a family member, (ii) an individual and a corporation, 50% of the stock (by value) of which is owned directly or indirectly by such individual, (iii) a person and a partnership 50% of the profits or capital interest in which is held by such person, (iv) two corporations that are members of the same controlled group (substituting 50% for 80% as the relevant threshold), (v) persons with certain fiduciary, grantor and beneficiary relationships through a trust or trusts, (vi) a person and a charitable organization controlled by such person's family members, (vii) corporations, S corporations and partnerships that share a common 50% owner, and (viii) an executor and beneficiary of an estate. See I.R.C. §§ 355(d)(7); 267(b); 707(b)(1).

long as the stock is not excessive in relation to the services performed.⁸⁹² This safe harbor does not apply if the recipient of such stock, or a coordinating group of which the acquirer is a member, is a controlling or a 10% shareholder of the acquired corporation immediately after the acquisition.⁸⁹³ The regulations helpfully clarify that an option issued by a predecessor corporation that becomes exercisable against the successor is eligible for this safe harbor.⁸⁹⁴

Finally, safe harbor IX provides that, during the four-year period beginning two years before distribution, up to 10% of the stock of the distributing or controlled corporation may be acquired by a retirement plan of such corporation that qualifies under section 401(a) or 403(a), or by any other person that is treated as the same employer under section 414(b), (c), (m), or (o), without being treated as part of a plan.⁸⁹⁵ Safe harbor IX does not apply to the extent that the stock acquired by all of the persons qualifying under Safe Harbor IX during the four-year period represents more than 10% of the stock of the acquired corporation (by vote or value).⁸⁹⁶

7. Options

The regulations include rules to prevent taxpayers from circumventing section 355(e) by issuing, or agreeing to issue, options that will become exercisable, triggering a change in control, after the presumption of a prohibited plan no longer exists. Options to acquire the stock of the distributing or controlled corporation that are written with the principal purpose of

⁸⁹² See Treas. Reg. § 1.355-7(d)(8)(i).

⁸⁹³ See Treas. Reg. § 1.355-7(d)(8)(ii). One commentator has suggested that this safe harbor should be amended to include any unrelated acquisitions of stock by a service provider or group of service providers that owns at least 10% of the acquired corporation. See *Attorney Comments on Anti-Morris Trust Regs.*, 2002 TNT 163-15 (Aug. 22, 2002) (Ron Creamer of Sullivan & Cromwell suggesting a more narrowly tailored approach that targets Management LBOs and going private transactions undertaken in connection with a distribution).

⁸⁹⁴ See T.D. 9198, 2005-1 C.B. 972; Treas. Reg. § 1.355-7(d)(8)(i).

⁸⁹⁵ Treas. Reg. § 1.355-7(d)(9).

⁸⁹⁶ Treas. Reg. § 1.355-7(d)(9)(ii).

circumventing section 355(e) will be treated as an agreement, understanding, arrangement, or substantial negotiations,⁸⁹⁷ to acquire the underlying stock on the date of the distribution. Other options to acquire distributing or controlled corporation stock will generally be treated as an agreement, understanding, arrangement or substantial negotiations to acquire such stock on the earliest of the date that the option was written, transferred or modified, if on such a date there was a 51% or greater chance of the option being exercised, or, in the case of a modification, if the modification materially increases the likelihood of the option being exercised as of such date.⁸⁹⁸ The likelihood of an option being exercised is based on all facts and circumstances, and control premiums and minority and blockage discounts are taken into account in determining the fair market value of the stock underlying the option, although for all other purposes the regulations treat shares of stock within a single class as having the same value without regard to control premiums or minority and blockage discounts.⁸⁹⁹ Taxpayers cannot circumvent these general stock option rules by merely agreeing to write an option, since such an agreement, understanding or arrangement to write an option will be treated as written on the date of the agreement, understanding or arrangement.⁹⁰⁰

Certain options that would be treated as an agreement to acquire stock under the rules discussed above will be disregarded if they are not written, transferred or listed with the principal purpose of circumventing the application of section 355(e) or the regulations. These disregarded options include (i) options issued as part of a security arrangement in a typical lending transaction (*i.e.*, stock escrow, pledge or option contingent upon default under a loan), (ii) options which are only exercisable upon death, disability, mental incompetency or separation from service, (iii) rights of first refusal, and (iv) any other instruments designated by the Commissioner.⁹⁰¹

⁸⁹⁷ See Treas. Reg. § 1.355-7(e)(1)(i).

⁸⁹⁸ See Treas. Reg. § 1.355-7(e)(1)(ii).

⁸⁹⁹ See Treas. Reg. § 1.355-7(e)(1)(i), (g).

⁹⁰⁰ See Treas. Reg. § 1.355-7(e)(1)(ii).

⁹⁰¹ See Treas. Reg. § 1.355-7(e)(4).

8. Distributions of Multiple Controlled Corporations

The regulations also provide guidance regarding the distribution of multiple controlled corporations. Under the regulations, if part of a corporate group is distributed, and one or more of the distributed subsidiaries are acquired pursuant to a plan involving the distribution, the distributing corporation will only recognize gain equal to the built-in gain attributable to its stock in such acquired distributed corporation(s).⁹⁰² By contrast, if the stock of the distributing corporation itself is acquired pursuant to a plan, the distributing corporation will recognize gain with respect to the stock of all of the distributed corporations.⁹⁰³ Therefore, a well-advised corporation considering the distribution of multiple entities may be able to reduce its potential tax exposure by ensuring that the distributing corporation does not become an attractive takeover target and does not engage in substantial negotiations regarding an acquisition of itself or its businesses in close proximity to the distribution.

9. Statute of Limitations

Under section 355(e)(4)(E), if there is a distribution to which section 355(e)(1) applies, the statutory period for assessing tax on the distribution to which section 355(e) applies will not expire until 3 years from the date the taxpayer notifies the Secretary “that such distribution occurred.” Under one possible reading of the statute, this provision would extend the statute of limitations in perpetuity, unless the taxpayer notifies the Secretary, not only of a distribution but that the distribution is subject to tax under section 355(e), even if the taxpayer believed that section 355(e) was not applicable.⁹⁰⁴ Such a result would be contrary to the general policy that an unlimited statute of limitations is only

⁹⁰² Treas. Reg. § 1.355-7(f). For an example of a private letter ruling involving the distribution of multiple controlled corporations, *see* P.L.R. 2012-52-017 (Sept. 28, 2012).

⁹⁰³ Treas. Reg. § 1.355-7(f).

⁹⁰⁴ *See Ernst & Young Comment on Proposed Regulations (REG-107566-06) Regarding Scope of Plan or Series of Related Transactions Under I.R.C. Section 355(e)*, reprinted in *Daily Tax Rep. (BNA)* (May 15, 2001) (commenting on 2001 proposed regulations).

applicable in cases of taxpayer misconduct such as fraud or willful evasion of taxes.⁹⁰⁵

10. Predecessors and Successors

Proposed regulations issued in late 2004 treat certain predecessors and successors of a distributing or controlled corporation as the distributing or controlled corporation for purposes of section 355(e).⁹⁰⁶ In general, a predecessor of the distributing corporation is a corporation whose assets are transferred (including through successive transfers) in part to the distributing corporation and in part to the controlled corporation in section 381 carryover basis transaction(s). This result may occur when (i) the distributing corporation transfers some (but not all) of the acquired predecessor's assets to the controlled corporation, or (ii) the controlled corporation's stock represents some but not all of the acquired predecessor's assets.⁹⁰⁷

A predecessor of the controlled corporation refers to a corporation that transfers assets to the controlled corporation in a section 381 carryover basis transaction.⁹⁰⁸ If more than one corporation transfers property to either the distributing or controlled corporation in tax-free asset reorganizations or

⁹⁰⁵ See I.R.C. § 6501(c)(1), (2).

⁹⁰⁶ 69 Fed. Reg. 67873 (Nov. 22, 2004).

⁹⁰⁷ See Prop. Reg. § 1.355-8(b)(1).

⁹⁰⁸ See Prop. Reg. § 1.355-8(b)(2). The NYSBA issued a report recommending that the final regulations include a "plan" concept that would identify a party as a predecessor only if the "combining transfer" and the "separating transfer" are both part of a plan with the distribution. The report argues that the proposed regulations contemplate the possibility that an acquired entity can become a predecessor even where the intent to separate the acquired entity only emerges after such entity is acquired in the "combining transfer". The report properly concludes that the proposed regulations are not intended to require companies to trace assets after any acquisition of a target corporation solely because the acquired assets may be transferred to a controlled corporation at some point in the future. See NYSBA, *Report on Proposed Regulations Dealing With "Predecessors" and "Successors"*, reprinted in 2005 TNT 123-13 (June 23, 2005).

liquidations, each transferor may be a predecessor.⁹⁰⁹ A successor of the distributing or controlled corporation is any corporation that receives property from the distributing or controlled corporation in a carryover basis transaction to which section 381 applies.⁹¹⁰ Therefore, the distributing and controlled corporations can each have more than one successor.

Each person that held distributing corporation stock immediately before the distributing corporation acquired the predecessor's property is treated as also owning a corresponding portion of the predecessor's stock.⁹¹¹ As a result, the potential application of section 355(e) to one or more acquisitions that are part of a plan with a distribution must be tested not only with respect to the stock of the distributing and controlled corporations, but also with respect to the stock of any predecessor(s) of either the distributing or controlled corporation.

Similar rules apply to determine whether section 355(e) applies to an acquisition of stock of a successor to a distributing or controlled corporation. More specifically, acquisitions of successor stock, and any acquisitions of distributing or controlled corporation stock, that are pursuant to a plan are aggregated to determine whether section 355(e) could apply to the acquisitions.⁹¹²

If section 355(e) applies to an acquisition of more than 50% of the stock of a distributing corporation's predecessor and/or the distributing corporation itself, the distributing corporation must recognize the full gain inherent in the controlled corporation stock.⁹¹³ However, if 50% or more of a distributing corporation predecessor's stock is acquired as part of a plan with a distribution,

⁹⁰⁹ See Prop. Reg. § 1.355-8(b)(4)(iii). The proposed regulations do not, however, look back to predecessors of predecessors.

⁹¹⁰ See Prop. Reg. § 1.355-8(c); CCA 201023056 (June 11, 2010) (controlled was not a successor corporation to distributing for purposes of Treasury Regulation section 1.381(a)-1(b)(3)(i) because controlled was not a successor corporation to distributing under state law).

⁹¹¹ See Prop. Reg. § 1.355-8(d)(1).

⁹¹² See Prop. Reg. § 1.355-8(d)(2), (3).

⁹¹³ See Prop. Reg. § 1.355-8(e).

the distributing corporation's gain recognized will not exceed the gain that the predecessor would have recognized on a section 351 transfer of its property, including any controlled corporation stock, to a new corporation followed by a cash sale of such corporation's stock to an unrelated party at fair market value.⁹¹⁴ In addition, if predecessor shareholders receive 50% of the distributing corporation stock when the predecessor is acquired, and the acquisition is part of a plan with a distribution, the distributing corporation's gain will not exceed the gain that it would have recognized had it not (i) transferred assets of the predecessor to the controlled corporation, or (ii) acquired the controlled corporation stock from the predecessor.⁹¹⁵ If more than one predecessor is acquired, each gain recognition limitation is aggregated up to the amount of gain that would be recognized if the controlled corporation were sold for cash at its fair market value.⁹¹⁶

As an NYSBA report describes, the regulations proposed to implement these special gain limitation rules are highly technical and confusing, which will likely cause administrative difficulties for the application of the gain limitation rules, including problems relating to tracing and valuing assets after the predecessor's assets are acquired in an arm's length transaction.⁹¹⁷ At the same time, the report notes that the complex and technical nature of the proposed regulations may present substantial tax planning opportunities.

H. Monetization Strategies to Extract Value from Controlled

Distributing may seek to retain a portion of controlled's value in a section 355 distribution in order to offset the decrease in distributing's value resulting from its distribution of controlled stock. More specifically, distributing may seek to combine a section 355 distribution with a liability assumption, leveraged distribution, debt for debt exchange, debt for equity exchange, pre-

⁹¹⁴ See Prop. Reg. § 1.355-8(e)(2).

⁹¹⁵ See Prop. Reg. § 1.355-8(e)(2).

⁹¹⁶ See Prop. Reg. § 1.355-8(e)(1), (4).

⁹¹⁷ See NYSBA, *Report on Proposed Regulations Dealing With "Predecessors" and "Successors"*, reprinted in 2005 TNT 123-13 (June 23, 2005).

distribution initial public offering, sponsored spinoff or a combination thereof (collectively, “monetization strategies”).⁹¹⁸

1. Liability Assumptions

As part of a D reorganization, distributing typically transfers assets to controlled, and controlled often assumes some or all of distributing’s liabilities. That exchange is tax-free up to distributing’s tax basis in the assets contributed to controlled (a

⁹¹⁸ I.R.C. § 368(a)(1)(D). The following discussion assumes that (i) a divisive D reorganization precedes the section 355 distribution, (ii) distributing and controlled are members of a consolidated group, and (iii) controlled is newly formed. A distribution of controlled stock will qualify as a divisive D reorganization if (i) distributing contributes all or part of its assets to controlled, (ii) distributing or its shareholders hold section 368(c) control of controlled immediately after the contribution, and (iii) distributing distributes the stock or securities of controlled in a section 355 distribution. The relevant tax consequences for the distribution of an “old and cold” controlled are generally determined under the consolidated return regulations. *See, e.g.*, Treas. Reg. §§ 1.1502-19; -32. *See also* Robert Willens, *A Look at Verizon’s Latest Reverse Morris Trust Transaction*, Daily Tax Rep. (BNA), at J-1 (June 2, 2009) (divisive D reorganization followed by section 355 distribution may be combined with liability assumption and debt for debt exchange). *See generally* Debra J. Bennett, *Obtaining Value from an Investment in a Controlled Corporation*, Taxes—The Tax Magazine (Dec. 2011), 9 (summarizing various section 355 monetization techniques); Deborah L. Paul, *Spin-offs, Leverage and Value Extraction—A Spin by Any Other Name ...*, Taxes—The Tax Magazine (Mar. 2013), 99 (arguing that the current law relating to leverage and value extraction in section 355 transactions is form driven, and true reform of the law in this area would require upending concepts such as the identity of the transferor and the realization requirement); Jeffrey T. Sheffield, *Spin-offs, Corporate Capital Structure and Disguised Sales*, Taxes—the Tax Magazine (Mar. 2013), 119 (suggesting that current law is guided by two principles: (i) shifting existing, old and cold debt to a subsidiary should be tax-free, even where the amount of debt assumed by the subsidiary exceeds the tax basis of assets transferred to the subsidiary, and (ii) receipt of cash generated through increased leverage in anticipation of a spin-off should not be tax-free, where the proceeds are separated from the obligation to repay the increased leverage even if the amount of such debt does not exceed the basis of assets transferred to the subsidiary).

“liability assumption”);⁹¹⁹ controlled’s assumption of any liabilities in excess of distributing’s tax basis (“excess liabilities”) would generally create an excess loss account (“ELA”) under the consolidated return regulations.⁹²⁰ Section 357(c) also applies if controlled leaves distributing’s consolidated group as part of the same plan or arrangement as the assumption and requires distributing to recognize taxable gain equal to the amount of any excess liabilities.⁹²¹

2. Leveraged Distributions

Distributing may cause controlled to borrow from third party lenders to fund a cash distribution to distributing in connection with the D reorganization (a “leveraged distribution”).⁹²² Pursuant to the D reorganization plan of reorganization, distributing can redistribute part or all of the cash received to its shareholders as certain dividends or share repurchases⁹²³ and/or to repay certain indebtedness.⁹²⁴

⁹¹⁹ I.R.C. § 357(a), (c)(1). *See also* P.L.R. 2012-30-008 (July 27, 2012) (deductible liabilities excluded for section 357(c) purposes); Jasper L. Cummings, *Overlaps and Warrants as Stock*, 2012 TNT 181-17 (Sept. 18, 2012) (discussing Private Letter Ruling 2012-30-008); Robert Willens, *Ruling Addresses Warrants and Deductible Liabilities in a Spinoff*, 2012 TNT 183-8 (Sept. 20, 2012) (same).

⁹²⁰ Treas. Reg. § 1.1502-80(d)(1).

⁹²¹ I.R.C. § 357(c)(1). If tax avoidance were the principal purpose for controlled’s assumption of distributing liabilities and the assumption were to lack a bona fide business purpose, every dollar of liabilities assumed would constitute boot. I.R.C. § 357(b)(1); Treas. Reg. § 1.1502-80(d)(1). *See generally*, Jeffrey T. Sheffield, *Spin-offs, Corporate Capital Structure and Disguised Sales*, Taxes—the Tax Magazine (Mar. 2013), 119 (discussing under what circumstances, including when section 357(c) is implicated, a spin-off should trigger corporate-level gain to distributing’s affiliated group).

⁹²² *See* P.L.R. 2007-18-024 (May 4, 2007). For an example of a non-leveraged distribution of cash by a subsidiary that will remain in the distributing group in connection with a spinoff, see Private Letter Ruling 2010-39-014 (Oct. 1, 2010).

⁹²³ It is unclear whether a distribution of cash to shareholders to fund a regular dividend or repurchase of shares pursuant to a pre-existing buyback program would constitute a qualified distribution to distributing’s shareholders. *See* Thomas F. Wessel, et al., *Tax Strategies for Corporate Acquisitions, Dispositions, Spin Offs, Joint*

The 2004 Tax Act limits the amount of cash that distributing may redistribute to its creditors tax-free to the tax basis in the assets distributing contributed to controlled in the D reorganization (as reduced for any liabilities controlled

Ventures, Financings, Reorganizations & Restructurings, 781 PLI/TAX 311, 369 (2007) (some individuals at the IRS may not be inclined to issue a favorable ruling regarding regular, quarterly, dividends; commentators are hopeful that that the IRS would be receptive to a favorable ruling if, for example, the regular, quarterly dividend would be reduced or debt-funded in the absence of the section 361 transaction).

⁹²⁴ I.R.C. § 361(b)(1)(A), (b)(3). *See* P.L.R. 2009-44-026 (Oct. 30, 2009) (distributing will use cash received from controlled to repay some indebtedness not incurred in connection with section 355 transaction); P.L.R. 2008-10-024 (May 7, 2008) (distributing will use cash to repay existing indebtedness not incurred in connection with transaction); P.L.R. 2008-05-010 (Nov. 7, 2007) (debentures that distributing will retire with cash were not issued in anticipation of distribution); P.L.R. 2006-29-007 (July 21, 2006) (distributing will use cash to repay existing indebtedness not incurred in connection with distribution). *See generally* Robert Willens, *Corporate Reorganizations: Careful Negotiation of Rules Required in Retiring Debt in Connection with Spin Off*, Daily Tax Rep. (BNA), at J-1 (July 7, 2008); Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507 (Feb. 5, 2007).

The IRS generally requires that distributing maintain the controlled cash in a segregated account and distribute it within one year after the distribution to ensure that the cash distribution to shareholders and/or creditors is effected pursuant to the plan of reorganization. *See* P.L.R. 2009-44-026 (Oct. 30, 2009) (distributing will segregate cash received from controlled in separate account and will then distribute the entire cash proceeds within one year of controlled's distribution); P.L.R. 2007-01-010 (Jan. 5, 2007) (cash received from controlled will be maintained in separate account, and distributing will take into account all items of income, gain, deduction or loss associated with funds in separate account; distributing will use earnings on funds to pay principal and interest on distributing debt); P.L.R. 2006-45-012 (Aug. 7, 2006) (distributing will segregate cash received from controlled in separate account); P.L.R. 2006-29-007 (July 21, 2006) (distributing will deposit cash received from controlled into segregated account). *But see* P.L.R. 2006-32-008 (Aug. 11, 2006) (distributing may invest cash received from controlled in non-segregated accounts); P.L.R. 2006-08-016 (Feb. 24, 2006) (distributing does not expect to segregate cash received from controlled).

assumes).⁹²⁵ Any cash distributed to distributing's creditors in excess of distributing's tax basis in the contributed assets ("excess distribution") would be taxable to distributing.⁹²⁶ In addition, the consolidated return regulations may require distributing to recognize gain if and to the extent a leveraged distribution qualifies as tax-free under section 361, but creates an ELA in the controlled stock. Distributing would generally recognize any such ELA when controlled deconsolidates in the distribution.⁹²⁷

3. Debt for Debt Exchanges

Controlled may also issue securities to distributing as partial consideration for the contributed assets.⁹²⁸ Thereafter, distributing can transfer the controlled securities it receives to distributing's creditors in retirement of historic distributing debt (a "debt for debt exchange").⁹²⁹

⁹²⁵ I.R.C. § 361(b)(3).

⁹²⁶ I.R.C. § 361(b)(3).

⁹²⁷ I.R.C. §§ 358(a)(1)(A) and 361; Treas. Reg. § 1.1502-19. The basis limitation rule in section 361(b)(3) only applies to creditors, and at least one commentator believes that any excess distribution to shareholders should not result in gain to distributing. See Robert Willens, *What's a Reverse Sponsored Spinoff?*, Corporate Dealmaker (Sept.-Oct. 2007).

⁹²⁸ I.R.C. § 361(a). In Private Letter Ruling 2010-32-017 (Aug. 3, 2010), the IRS ruled that controlled securities received by distributing must be distributed to creditors or shareholders to avoid gain recognition, treating the securities, in effect, as "other property or money" and requiring the distribution of those securities to avoid gain recognition with respect to the receipt of those securities. As Bob Willens observes, the IRS seems to have "take[n] liberties with ... settled rules." See Robert Willens, *Since When Are Securities 'Other Property'*, Daily Tax Rep. at J-1 (Oct. 7, 2010).

⁹²⁹ See, e.g., P.L.R. 2010-32-017 (Aug. 13, 2010) (distributing transferred controlled securities to distributing's creditors as part of a D reorganization); P.L.R. 2007-08-017 (Feb. 23, 2007), supplementing P.L.R. 2006-29-001 (July 21, 2006); P.L.R. 2006-44-010 (Nov. 3, 2006), supplementing P.L.R. 2006-29-007 (July 21, 2006). Alltel effected a liability assumption, leveraged distribution and debt for debt exchange in connection with its wireline business spinoff in 2006. See Robert Willens, *Alltel's Spinoff Model Provides a Blueprint for Others*, 113 Tax Notes 273 (Oct. 16, 2006).

Taxpayers often seek to effect a debt for debt exchange because, unlike in the case of a liability assumption or leveraged distribution, sections 355 and 361 do not limit the amount of securities that controlled can issue, or amount of historic debt that distributing can retire with the controlled securities.⁹³⁰ Thus,

⁹³⁰ I.R.C. §§ 361(b)(3); 357(c). *See generally* Robert Willens, *Corporate Reorganizations: Careful Negotiation of Rules Required in Retiring Debt in Connection with Spin Off*, Daily Tax Rep. (BNA), at J-1 (July 7, 2008). *But see* Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong. § 3703 (proposal by Rep. Rangel, Chairman of the House Ways and Means Committee, to treat controlled securities as money or other property, which would limit the amount of controlled securities (and any other boot) to the basis in the assets that distributing contributes to controlled in the D reorganization); The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. (proposal to treat debt securities issued by a controlled subsidiary in a divisive D reorganization that exceed asset basis as triggering gain recognition). Eric Solomon, a former Treasury official, believes that such change in law would be an unwarranted extension of the policy reflected in section 357(c) because the stock basis of the controlled corporation disappears in section 355 distributions. *See* Amy S. Elliott, *Extenders Proposal Targets Debt Securities Issues in Spinoffs*, 2010 TNT 191-1 (Oct. 4, 2010); Amy S. Elliot, *Practitioners Consider How Current Code Distorts Leveraged Spinoff Decisions*, 2012 TNT 220-5 (Nov. 14, 2012) (Deborah Paul commenting that, if lawmakers were to rewrite the law, they might consider one of four possible approaches to determining the result when a distributing corporation receives cash exceeding its basis in spinning off a controlled corporation: (i) the alter ego theory, under which the spinoff isn't taxable because distributing and controlled both remain in corporate solution with essentially the same shareholders; (ii) the sale theory -- variant 1, under which the spinoff is taxable if distributing receives cash in excess of its basis in controlled; (iii) the sale theory -- variant 2, under which the spinoff is taxable if there is a separate pool of assets combining with one of the two companies; and (iv) the sale theory -- variant 3, under which the spinoff is taxable if distributing receives cash in excess of its basis in controlled and there is a separate pool of assets combining with the leveraged company). Of course, there are commercial constraints on the amount of debt controlled can have outstanding at the time of the distribution. In addition, controlled cannot be so highly leveraged that the securities would fail to qualify as indebtedness of controlled for tax purposes. In that extreme case, distributing would fail to distribute to its shareholders stock of

subject to general debt/equity considerations, distributing can maximize the value it extracts from controlled by utilizing a debt for debt exchange as part of a combination of monetization strategies. However, as discussed below, distributing must consider certain additional issues before effecting debt for debt exchanges, including the possible application of the consolidated return regulations, the section 361 “historic debt” requirement, and, assuming the parties utilize an investment bank to effect the exchange, principal/agency issues.⁹³¹

a. Consolidated Return Regulations

Since controlled securities constitute intercompany obligations while held by distributing, the current consolidated

controlled representing section 368(c) control, *i.e.*, because the controlled securities would be treated as a class of controlled nonvoting stock.

⁹³¹ See also P.L.R. 2012-32-014 (Aug. 10, 2012); Robert Rizzi, *IRS Opens the Gates: Sara Lee’s Spinoff Ruling*, Corporate Taxation (Jan/Feb 2013) (summarizing the notable aspects of the Sara Lee spin-off as: (i) distributing issues new distributing securities to third party investors for cash at least 5 days before the declaration date of the spin-off and at least 14 days prior to the actual spin-off; (ii) distributing contributes assets to controlled in exchange for, among other things, cash and controlled stock and securities; (iii) at least 14 days after the new distributing securities are purchased by investors, distributing transfers the controlled common stock to an exchange agent, who holds those shares on behalf of Sara Lee’s shareholders; (iv) contemporaneous with the spin-off, distributing delivers the new controlled securities to the third party investors to pay off the new distributing securities and other distributing loans; (v) immediately following the spin-off, a special dividend is paid to controlled shareholders, (vi) distributing repays some of its outstanding debt with cash from controlled, and (vii) in a transaction intended to qualify as a B reorganization, subject to section 367(a), controlled is acquired by a non-U.S. corporation in a pure stock-for-stock exchange); Amy S. Elliot, *ABA Meeting: Sara Lee’s Leveraged Spinoff Ruling Breaks New Ground*, 2012 TNT 181-3 (Sept. 18, 2012) (discussing Private Letter Ruling 2012-32-014 involving Sara Lee’s spinoff of its coffee and tea business that did not utilize an investment bank intermediary to facilitate the debt exchange and noting that the “5-14” terms were not inserted into an exchange agreement but were included in the notes themselves, effectively eliminating risk normally borne by distributing with respect to entering into the exchange agreement).

regulations may require distributing to recognize gain when the controlled securities become non-intercompany obligations in the debt for debt exchange,⁹³² even if the exchange qualifies as tax-free under section 361.⁹³³

Current consolidated return regulations deem the controlled securities to be satisfied for cash equal to their fair market value immediately before the controlled stock distribution and reissued for the same amount immediately after such distribution.⁹³⁴ Thus, distributing's consolidated group may recognize cancellation of indebtedness income to the extent that the controlled securities are deemed satisfied for an amount less than their adjusted issue price, or repurchase premium to the extent that the controlled securities are deemed satisfied for an amount greater than their adjusted issue price.⁹³⁵ The corresponding adjustments to distributing's tax basis in its controlled stock could create an ELA in distributing's

⁹³² Treas. Reg. § 1.1502-13(g).

⁹³³ Treas. Reg. § 1.1502-13(g). Some practitioners believe that section 361 should trump Treasury Regulation section 1.1502-13(g) under all circumstances. *See, e.g.,* Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507, 509 (Feb. 5, 2007) (intercompany debt rule should not apply to a debt for debt exchange because distributing's acquisition of controlled securities is only a temporary step in debt for debt exchange that is part of larger transaction).

⁹³⁴ Treas. Reg. § 1.1502-13(g).

⁹³⁵ Treas. Reg. § 1.61-12(c)(2). In several private rulings, the IRS has ruled that generally distributing will not recognize any income, gain, loss or deduction upon the transfer of the controlled securities in the related debt for debt exchange, other than (i) an amount that offsets a corresponding amount recognized by controlled, (ii) deductions attributable to distributing debt redeemed at a premium, (iii) income attributable to distributing debt redeemed at a discount, (iv) accrued interest expense on the distributing debt and (v) gain or loss attributable to any appreciation or depreciation in the controlled securities after their acquisition and prior to their disposition by distributing. *See, e.g.,* P.L.R. 2008-08-006 (Feb. 25, 2008); P.L.R. 2008-02-009 (Oct. 5, 2007). *See also* Robert Willens, *Ruling Illustrates Potential for Shifting Debt Through Spinoff*, Daily Tax Rep. (BNA), at J-1 (Dec. 10, 2007).

controlled stock, which distributing would be required to recognize on controlled's departure from distributing's consolidated group.⁹³⁶

Recently finalized regulations sensibly eliminate these issues by exempting transactions applying section 361 from any deemed satisfaction and reissuance under Treasury Regulation section 1.1502-13(g).⁹³⁷ These regulations clarify that Treasury Regulation section 1.1502-13(g) generally does not trump section 361.

b. Section 361 Historic Debt Requirement

For advance ruling purposes, the IRS generally requires a distributing corporation to retire in the debt for debt exchange only its debt that has been outstanding for a certain period of time prior to the distribution. This requirement is described as necessary to ensure that the relevant debt holders will be respected as "creditors" for purposes of section 361 (the "historic debt requirement").⁹³⁸ Section 361, by its terms, does not impose an historic debt requirement. Moreover, the Treasury Department has never exercised its authority under section 361 to promulgate regulations as may be necessary to prevent the avoidance of tax through abuse of the provisions permitting tax-free distributions to creditors.⁹³⁹

If the retired distributing debt were issued in anticipation of the distribution, the IRS may seek to disregard the distributing debt holder's qualification as *bona fide* creditors of distributing.⁹⁴⁰ If

⁹³⁶ Treas. Reg. §§ 1.1502-11(a); -19(a); -32(b).

⁹³⁷ See Treas. Reg. § 1.1502-13(g)(3);

⁹³⁸ Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507, 509 (Feb. 5, 2007) (IRS Associate Chief Counsel (Corporate) Bill Alexander stated that the statutory line of section 361 is "not economic," and, in the IRS's view, section 361 demands "old and cold" creditors).

⁹³⁹ See S. Rep. No. 100-445, at 462 (1988).

⁹⁴⁰ See, e.g., P.L.R. 2007-32-002 (Aug. 10, 2007); P.L.R. 2007-08-017 (Feb. 23, 2007); P.L.R. 2006-44-010 (Nov. 3, 2006); P.L.R. 2006-29-007 (July 21, 2006); P.L.R. 2006-29-001 (July 21, 2006). Other private rulings apply different standards, such as requiring distributing to represent that it did not incur the relevant debt "in connection with" the distribution. See, e.g., P.L.R. 2007-15-004

the IRS was successful, section 361 would not apply, and distributing would recognize gain on the distribution of the controlled securities to distributing's debt holders.⁹⁴¹

Alternatively, the IRS could seek to recast the transaction as if distributing's debt holders contributed the purchase price of the distributing debt directly to controlled, which distributed the cash and controlled securities to distributing, followed by distributing's distribution of the controlled securities to its debt holders.⁹⁴² In that case, the IRS would seek to ignore the debt holders and treat distributing as transferring the controlled securities directly to the purchasers, rather than to its creditors as section 361 requires.

c. Principal/Agency Issues

Since distributing's debt holders generally will prefer to receive cash instead of controlled securities in repayment, distributing may execute an exchange agreement with an investment bank. The agreement, which should only be negotiated and executed after the bank purchases distributing debt, would

(Apr. 13, 2007); P.L.R. 2006-45-012 (Nov. 10, 2006). The IRS has also accepted less rigorous standards on occasion. *See, e.g.*, P.L.R. 2008-37-027 (Sept. 12, 2008); P.L.R. 2007-18-024 (Feb. 5, 2007) (debt that distributing will retire has been outstanding prior to any initial discussions by distributing's board of directors regarding the distribution); P.L.R. 2007-02-033 (Sept. 25, 2006) (amount of distributing debt retired will not exceed amount of distributing affiliated group debt owed to unrelated parties on day before distributing board of directors authorized distributing to actively pursue the distribution); P.L.R. 2007-01-010 (Sept. 1, 2006) (amount of debt that distributing will retire will not exceed sum of "historic debt" and commercial paper outstanding on distribution date that does not exceed amount of "historic commercial paper" and "refinancing commercial paper"); P.L.R. 2007-16-024 (Dec. 22, 2005) (distributing debt incurred or accrued prior to distribution date in ordinary course of business transactions unrelated to distribution).

⁹⁴¹ I.R.C. § 355(a). *See* Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507, 510 (Feb. 5, 2007) (IRS demands that creditors be "old and cold" for section 361 to apply).

⁹⁴² *See, e.g.*, Robert Willens, *Ruling Illustrates Potential for Shifting Debt Through Spinoff*, Daily Tax Rep. (BNA), at J-1 (Dec. 10, 2007); Robert Willens, *Alltel's Spinoff Model Provides a Blueprint for Others*, 113 Tax Notes 273 (Oct. 16, 2006).

obligate the bank to exchange its distributing debt with distributing for controlled securities, and then sell the controlled securities in the market.⁹⁴³

For advance ruling purposes, the IRS requires that investment banks act as principals for their own accounts in order to qualify as “creditors” for section 361 purposes.⁹⁴⁴ If the investment banks were treated as distributing’s agents, the IRS presumably would treat distributing as selling the controlled securities for cash and then using the cash to repurchase distributing debt.⁹⁴⁵

To ensure that the IRS treats the investment banks as creditors, the investment banks must hold the distributing debt for a minimum amount of time before entering into an exchange agreement with distributing.⁹⁴⁶ During this holding period, the

⁹⁴³ See generally Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts* ¶ 1012.2 (Jan. 2007). See, e.g., P.L.R. 2008-37-027 (Sept. 12, 2008) (distributing will enter into a debt exchange agreement with investment banks no sooner than an undisclosed number of days after investment banks initiate purchase of debt securities in secondary market, acting as principals for their own accounts); P.L.R. 2011-38-021 (Sept. 23, 2011); P.L.R. 2007-01-010 (Jan. 5, 2007); P.L.R. 2006-29-007 (July 21, 2006); P.L.R. 2006-29-001 (July 21, 2006).

⁹⁴⁴ See, e.g., P.L.R. 2006-29-007 (July 21, 2006) (investment bank did not act as distributing’s agent in acquiring distributing debt and exchanging it for controlled securities); T.A.M. 87-35-006 (May 18, 1987) (underwriter that purchased corporate debt, exchanged it for debtor’s stock and then marketed stock to public did not act as debtor’s agent where (i) underwriter acquired debt prior to executing exchange agreement with debtor, (ii) underwriter received economic benefit or detriment from subsequent stock sale, and (iii) stock issuance was not transitory; and, as a result, debtor avoided cancellation of indebtedness income on exchange under former “stock for debt” exception).

⁹⁴⁵ See Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts* ¶ 1012.2 (Jan. 2007); Robert Willens, *Ruling Illustrates Potential for Shifting Debt Through Spinoff*, Daily Tax Rep. (BNA), at J-1 (Dec. 10, 2007); Robert Willens, *Alltel’s Spinoff Model Provides a Blueprint for Others*, 113 Tax Notes 273 (Oct. 16, 2006).

⁹⁴⁶ See, e.g., P.L.R. 2011-32-009 (Aug. 12, 2011) (distributing would enter into a debt exchange agreement with investment banks no

investment banks must be exposed to declines in the value of the distributing debt, although they generally may hedge their

earlier than X days before closing of exchange agreement, and investment banks would act as principals for their own account); P.L.R. 2008-37-027 (Sept. 12, 2008) (distributing will enter into debt exchange agreement with investment banks no sooner than an undisclosed number of days after investment banks initial purchase of debt securities in secondary market, as principals for their own accounts); P.L.R. 2008-10-024 (Mar. 7, 2008) (investment bank will acquire distributing debt at least an undisclosed number of days before debt exchange and will not enter into exchange agreement sooner than an undisclosed number of days after acquiring distributing debt from market and at least an undisclosed number of days prior to debt exchange); P.L.R. 2008-10-018 (Mar. 7, 2008) (same); P.L.R. 2008-10-001 (Mar. 7, 2008) (same); P.L.R. 2008-08-006 (Feb. 22, 2008); (same); P.L.R. 2008-02-009 (Jan. 11, 2008) (investment bank will acquire distributing debt at least 14 days prior to distribution, and will not enter into exchange agreement sooner than 5 days after acquiring distributing debt); P.L.R. 2007-47-012 (Nov. 23, 2007) (investment bank will acquire distributing debt at least an undisclosed number of days before debt exchange occurs and will not enter into exchange agreement sooner than an undisclosed number of days after acquiring distributing debt from market); P.L.R. 2007-32-002 (Aug. 10, 2007) (investment bank will not acquire distributing debt from third parties within an undisclosed number of days of valuation date, and will not enter into exchange agreement sooner than an undisclosed number of days after acquiring the distributing debt from market and at least an undisclosed number of days prior to valuation date); P.L.R. 2007-02-033 (Jan. 12, 2007) (investment bank will acquire distributing debt from secondary market at least an undisclosed number of days before distribution, and will not enter into exchange agreement sooner than an undisclosed number of days after acquiring the distributing debt from secondary market); P.L.R. 2007-01-010 (Jan. 5, 2007) (investment bank will not acquire distributing debt from third parties within 14 days of valuation date, and will enter into exchange agreement at some time during 7 days before distribution); P.L.R. 2006-29-007 (July 21, 2006) (investment bank will acquire distributing debt from marketplace at least 14 days before distribution, and will not enter into exchange agreement until at least 5 days after acquiring debt from marketplace and 9 days before distribution); P.L.R. 2006-29-001 (July 21, 2006) (same).

exposure with a counterparty unrelated to distributing or controlled.⁹⁴⁷

4. Debt for Equity Exchanges

Distributing may also be able to extract value from controlled by transferring up to 20% of the outstanding controlled stock received in the D reorganization to distributing's creditors in exchange for distributing debt (a "debt for equity exchange").⁹⁴⁸

In addition, distributing may be able to provide its creditors with more than 20% of controlled's value by utilizing a high vote/low vote recapitalization structure.⁹⁴⁹ For example, after controlled is recapitalized with high vote stock (5+ votes per share) and low vote stock (1 vote per share) to distributing,⁹⁵⁰ distributing

⁹⁴⁷ See Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507, 509 (Feb. 5, 2007) (discussing comments of Bill Alexander, IRS Associate Chief Counsel (Corporate)).

⁹⁴⁸ I.R.C. § 361(c)(3). Controlled is limited to issuing up to a 20% voting interest in its stock to its creditors because section 355 requires the distribution of controlled stock representing at least section 368(c) control of controlled to distributing's shareholders, and the D reorganization rules require distributing or its shareholders to hold controlled stock representing at least section 368(c) control of controlled immediately after the distribution. See I.R.C. §§ 355(a)(1)(D), 368(a)(1)(D). See, e.g., P.L.R. 2009-44-026 (Oct. 30, 2009); P.L.R. 2008-37-027 (Sept. 12, 2008); P.L.R. 2003-45-050 (Nov. 7, 2003); P.L.R. 2003-44-018 (Aug. 31, 2003); P.L.R. 2003-01-011 (Jan. 3, 2003).

⁹⁴⁹ See P.L.R. 2002-19-025 (May 10, 2002).

⁹⁵⁰ See Rev. Rul. 69-407, 1969-2 C.B. 50 (recapitalization resulted in permanent realignment of voting control). Taxpayers that seek rulings involving a high vote/low vote structure generally represent that they have no intention to alter the high vote/low vote structure after the distribution. See, e.g., P.L.R. 2002-19-025 (May 10, 2002) (distributing represented that none of management, distributing or controlled had any intention to recapitalize or convert high vote/low value shares after distribution). However, the IRS has been loosening its position on reversals of high vote/low vote structures after a distribution. See, e.g., P.L.R. 2008-37-027 (Sept. 12, 2008) (IRS blessed a transaction in which (i) controlled recapitalized its common stock into a high vote/low vote structure, (ii) distributing exchanged substantially all of its controlled common stock for

could distribute the high vote stock, representing at least 80% of controlled's total voting power, to distributing's shareholders, and the low vote stock, representing up to 49.9% of controlled's

controlled high vote stock, and (iii) distributing exchanged controlled's high vote shares for outstanding distributing shares in a section 355 split-off, even though controlled represented that it might convert the high vote/low vote structure back into a single class of stock following the spinoff); P.L.R. 2011-23-030 (Nov. 15, 2010) (IRS approved a high vote/low vote structure where, in order to consummate a split-off, distributing obtained control of controlled by acquiring newly created high vote stock, despite the fact that controlled represented to the IRS that it would potentially unwind the high vote/low vote structure following the split-off). *See also* Amy S. Elliot, *Practitioners Inquire About Stock Recap After Spinoff*, 134 Tax Notes 1039 (Feb. 27, 2012) (IRS Associate Chief Counsel (Corporate) Bill Alexander stated that the step transaction doctrine does not apply in the context of a recapitalization into control, followed by a spinoff, and then a recapitalized out of control, as long as the first two steps would have been permissible absent the third step suggesting that a shareholder vote or other similar event may not be required with respect to the third step); *Ruling on Stock Recap Following Spinoff Isn't Radical, IRS Says*, 2009 TNT 77-4 (Apr. 24, 2009) (IRS Associate Chief Counsel (Corporate) Bill Alexander stating that IRS no longer demands specific representation that taxpayer had no plan or intention to eliminate dual stock structure); Robert Willens, *Dissecting MetLife's Split-Off of RGA*, 35 Inst. Tax Rev. 1411 (Dec. 2008) (discussing Private Letter Ruling 2008-37-027); Thomas F. Wessel, et al., *Tax Strategies for Corporate Acquisitions, Dispositions, Spin Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 781 PLI/TAX 311 (2007) (IRS has permitted taxpayers to integrate two-class stock structure into one-class stock structure as a result of unanticipated circumstances); *Chipotle to Collapse Dual Voting Stock After Split-Off, Without IRS Ruling*, 2009 TNT 204-1 (Oct. 26, 2009) (Chipotle received an opinion of counsel concluding that it could collapse its dual voting structure without having received a favorable private letter ruling). *See, e.g.*, P.L.R. 2004-03-041 (Jan. 16, 2004); P.L.R. 2001-39-011 (Sept. 28, 2001); P.L.R. 2001-25-083 (June 22, 2001); P.L.R. 2001-18-018 (May 4, 2001); P.L.R. 2000-50-017 (Dec. 15, 2000).

value⁹⁵¹ and up to 20% of controlled's voting power, to distributing's creditors.⁹⁵²

In effecting a debt for equity exchange, distributing must ensure that it retires historic distributing debt so that the recipient of controlled stock is treated as a distributing "creditor" for section 361 purposes and complies with the principal/agency issues discussed above in the debt for debt exchange (assuming distributing retains an investment bank to effect the debt for equity exchange).

5. Pre-Distribution Initial Public Offerings of Controlled Stock

As an alternative to a debt for equity exchange, controlled might seek to issue up to 20% of its stock in an initial public offering ("IPO"), or distributing could directly sell up to 20% of the controlled stock that it receives, to the public before a distribution.⁹⁵³ Distributing would then distribute its remaining

⁹⁵¹ The low vote stock must represent no more than 49.9% of controlled's value to satisfy the requirements of sections 355(d) and (e).

⁹⁵² See, e.g., P.L.R. 2002-19-025 (May 10, 2002). Lucent took advantage of the fact that stock may be distributed to security holders in its distribution of Agere Systems to retire a portion of its debt in exchange for Agere Systems stock. See P.L.R. 2002-05-035 (Oct. 31, 2001); P.L.R. 2001-25-011 (June 22, 2001); see generally Robert Willens, *Lucent's Spin Off of Agere Systems Breaks New Ground*, Mergers and Acquisitions (Sept. 2001); Willens, *Lucent Spinoff of Agere Systems*. See also P.L.R. 2010-04-001 (Jan. 29, 2010) (taxpayer's reclassification that caused a vote shift among its shareholders was not part of a plan under section 355(e) because the reclassification constituted an acquisition of controlled stock by reason of holding stock or securities in distributing; accordingly, the reclassification did not affect controlled's stock status as qualified property).

⁹⁵³ See, e.g., T.A.M. 2005-14-019 (Apr. 8, 2005).

Controlled should not recognize any gain on the issuance of its stock to the public in an IPO. See I.R.C. § 1032. Distributing, however, would generally recognize gain on the sale of a portion of its controlled stock to the extent the cash received on the sale exceeds distributing's tax basis in the controlled stock sold in the exchange. See I.R.C. § 1001.

controlled stock, which must represent at least 80% of distributing's total voting power, to distributing's shareholders to satisfy section 355.⁹⁵⁴ After a pre-distribution IPO, controlled could distribute the IPO proceeds to distributing, which could use the proceeds to pay a dividend, redeem stock or repay creditors, or fund other business expenses.⁹⁵⁵

Distributing could extract additional value from controlled by utilizing a high vote/low vote structure before an IPO.⁹⁵⁶ For example, controlled could be recapitalized into high vote stock (5+ votes per share) held by distributing, representing at least 80% of controlled's total voting power, and low vote stock (1 vote per share) to be issued in a pre-distribution IPO, representing up to 49.9% of controlled's value⁹⁵⁷ and up to 20% of its voting power. Controlled could distribute the IPO proceeds to distributing as a dividend, and distributing could use the IPO proceeds to pay a dividend, redeem stock or repay creditors and could also distribute the high vote stock to distributing's shareholders.⁹⁵⁸ The IRS has issued several helpful private rulings respecting the first transaction as an IPO and the second step as a tax-free section 355 distribution.⁹⁵⁹

There is of course some risk that the IRS could seek to reorder the steps of a particular transaction and treat a pre-distribution IPO as a secondary offering of controlled stock by

⁹⁵⁴ I.R.C. § 355(a)(1)(D).

⁹⁵⁵ See, e.g., P.L.R. 2003-27-057 (July 3, 2003); P.L.R. 2001-39-001 (Sept. 28, 2001); P.L.R. 2001-37-036 (Sept. 14, 2001); P.L.R. 2000-20-002 (May 19, 2000).

⁹⁵⁶ See, e.g., Rev. Rul. 69-407, 1969-2 C.B. 50; P.L.R. 2002-19-025 (May 10, 2002).

⁹⁵⁷ The low vote stock must represent no more than 49.9% of controlled's value to ensure compliance with sections 355(d) and (e).

⁹⁵⁸ See, e.g., P.L.R. 2002-05-035 (Oct. 31, 2001); P.L.R. 2001-25-011 (June 22, 2001). See generally Robert Willens, *Lucent's Spin Off of Agere Systems Breaks New Ground*, Mergers and Acquisitions (Sept. 2001); Willens, *Spin Off of Agere Systems*.

⁹⁵⁹ See, e.g., P.L.R. 2005-01-025 (Jan. 7, 2005); P.L.R. 2000-35-001 (Sept. 1, 2000).

distributing instead of a tax-free IPO by controlled.⁹⁶⁰ If recast in this manner, distributing's deemed sale of the controlled stock would result in gain or loss in an amount equal to the difference between distributing's tax basis in the controlled stock deemed sold and the IPO proceeds.⁹⁶¹ In addition, controlled's distribution of the IPO proceeds to distributing may create an ELA to the extent the IPO proceeds exceed distributing's tax basis in its controlled stock,⁹⁶² which distributing would generally recognize upon controlled's deconsolidation from distributing's consolidated group in the distribution.⁹⁶³

6. Sponsored Spinoffs

Alternatively, distributing might effect a "sponsored spinoff" in which (i) distributing would contribute a business to controlled and distribute controlled stock to distributing's shareholders, and (ii) controlled, through a prearranged agreement, would issue up to 49.9% of its stock to an investor (a "sponsor").⁹⁶⁴ Section 355(e) limits the sponsor's purchase to a maximum 49.9% interest in controlled in order to avoid triggering a corporate level tax to distributing. The parties should restrict the sponsor from increasing its interest in controlled above 49.9% for

⁹⁶⁰ See Thomas F. Wessel, et al., *Tax Strategies for Corporate Acquisitions, Dispositions, Spin Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 781 PLI/TAX 311 (2007).

⁹⁶¹ See Thomas F. Wessel, et al., *Tax Strategies for Corporate Acquisitions, Dispositions, Spin Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, 781 PLI/TAX 311 (2007).

⁹⁶² Treas. Reg. §§ 1.1502-19(c)(1)(ii); -32(b)(2)(iv).

⁹⁶³ Treas. Reg. § 1.1502-19(c)(1)(ii).

⁹⁶⁴ See generally Mark Mandel, *Sellers Avoid a Tax Bite with Sponsored Spin Offs*, Mergers & Acquisitions, The Dealmaker's Journal 62 (Apr. 2007); David H. Schnabel & Gary M. Friedman, *Spin Cycles*, Daily Deal (May 21, 2007); Lee A. Sheppard, *NYSBA Considers 'Cash Wreck' in Spinoffs*, 114 Tax Notes 507, 510 (Feb. 5, 2007); Gary Mandel, *The Elusive Sponsored Spin-off* (unpublished Tax Club manuscript, on file with author, May 2012) (positing that sponsored spin-offs make the most sense when (i) sponsor acquires controlled after a section 355 distribution in an all-stock transaction, (ii) distributing is not sensitive to triggering corporate level tax under section 355(e), (iii) sponsor is content with the amount of control it wields over controlled despite acquiring less than 50% of its stock.

at least two years after the distribution to ensure compliance with section 355(e).⁹⁶⁵

In connection with a sponsored spinoff, distributing may cause controlled to borrow from third parties in order to effect a leveraged distribution up to distributing's tax basis in the assets contributed to controlled.⁹⁶⁶ Pursuant to the D reorganization plan of reorganization, distributing can pay a dividend, redeem stock or repay creditors, and controlled can use the sales proceeds it receives from the sponsor to repay the debt it incurs to fund the leveraged distribution to distributing.

Distributing could also consider a "reverse sponsored spinoff" in which distributing would (i) contribute an unwanted business to controlled and distribute the controlled stock to its shareholders, and (ii) sell up to 49.9% of its stock to the sponsor.⁹⁶⁷ To maximize the value that the retained company (in this case, controlled) can extract from the transaction, distributing may borrow cash and contribute the loan proceeds to controlled. Since section 361 would not apply to controlled's use of the cash, controlled could freely use the cash in its own business after the distribution.⁹⁶⁸ As in a sponsored spinoff, distributing will need to comply with section 355(e) by limiting the sponsor's purchase to a maximum 49.9% interest and prohibiting the sponsor from increasing its interest in distributing above this threshold during the two year period after the distribution.⁹⁶⁹

⁹⁶⁵ See Robert Willens, *Alberto-Culver's SEC Filings Indicate Plan for 'Reverse' Spin Off*, 173 Daily Tax Rep. (BNA), at J-1 (Sept. 7, 2006).

⁹⁶⁶ I.R.C. § 361(b)(3).

⁹⁶⁷ See Robert Willens, *Alberto-Culver's SEC Filings Indicate Plan for 'Reverse' Spin Off*, 173 Daily Tax Rep. (BNA), at J-1 (Sept. 7, 2006); Robert Willens, *What's a Reverse Sponsored Spinoff?*, Corporate Dealmaker (Sept.-Oct. 2007) (Alberto-Culver and Marshall & Ilsley have each effected reverse sponsored spinoffs).

⁹⁶⁸ See Robert Willens, *What's a Reverse Sponsored Spinoff?*, Corporate Dealmaker (Sept.-Oct. 2007); Robert Willens, *Alberto-Culver's SEC Filings Indicate Plan for 'Reverse' Spin Off*, 173 Daily Tax Rep. (BNA), at J-1 (Sept. 7, 2006).

⁹⁶⁹ See Robert Willens, *Alberto-Culver's SEC Filings Indicate Plan for 'Reverse' Spin Off*, 173 Daily Tax Rep. (BNA), at J-1 (Sept. 7, 2006).

I. Distributions Involving Disqualified Investment Companies

The 2005 Act enacted section 355(g) to reduce the amount of cash or other investment assets that could be distributed tax-free in a transaction commonly known as a cash rich split-off.⁹⁷⁰ A cash rich split-off typically involves a corporate shareholder that wishes to monetize a substantial block of appreciated stock in the distributing corporation in the most tax-efficient manner possible, and the distributing corporation has a valid business reason to eliminate the shareholder's interest. To effect the transaction, the distributing corporation generally transfers cash or other investment assets (and a small amount of active business assets) to a newly-formed controlled corporation, and distributes the stock of such corporation to the shareholder in complete redemption of its stock in the distributing corporation.⁹⁷¹

⁹⁷⁰ Examples of cash rich split-offs include the Henkel KGaA/The Clorox Company split-off and the Houston Exploration Company/KeySpan split-off. See Robert S. Bernstein, *Henkel's Cash-Rich Split Off From Clorox*, 32 Corp. Tax'n 33, 34 (Jan./Feb. 2005); Robert S. Bernstein, *KeySpan Corp's Cash-Rich Split Off*, 31 Corp. Tax'n 38, 40 (Sept./Oct. 2004). For a general discussion of effecting cash rich split-offs, see Robert Willens, *Dispelling Cash-Rich Split-Off Myths*, 135 Tax Notes 503 (Apr. 23, 2012); Robert Willens, *Ending Entanglements Through a 'Cash-Rich' Split-Off*, 2010 TNT 9-6 (Jan. 14, 2010).

⁹⁷¹ Although the distribution of a large amount of cash or investment assets to a shareholder generally constitutes a device to distribute the earnings and profits of the distributing corporation, a distribution that results in capital gain treatment to the shareholder (such as a redemption that completely terminates a shareholder's interest under section 302(b)(3)) is ordinarily not considered a device. See Treas. Reg. § 1.355-2(d)(5)(iii), (iv). However, the IRS will no longer issue private letter rulings determining whether a transaction is principally used as a device. See Rev. Proc. 2003-48, 2003-2 C.B. 86. In addition, the IRS will not rule on whether the active trade or business requirement of section 355(b) is satisfied when, within a five-year period, a distributing corporation acquired control of a controlled corporation as a result of transferring cash or other liquid or inactive assets to the controlled corporation in a transaction meeting the requirements of section 351(a) or section 368(a)(1)(D). See Rev. Proc. 2007-3, 2007-1 C.B. 108, § 4.01(29). See also Robert Willens, *Even Berkshire Hathaway Not Immune to Charms of 'Cash-Rich' Split-off*, Daily Tax Rep. (BNA), at J-1 (Apr. 10, 2008).

Section 355(g) limits the amount of cash or investment assets that can be distributed in a split-off by disqualifying from section 355 certain distributions made to or by corporations that hold a substantial amount of investment assets and an insignificant amount of active business assets. Section 355(g) provides that section 355 will not apply to a distribution if (i) either the distributing corporation or controlled corporation is a “disqualified investment corporation” immediately after the transaction,⁹⁷² and (ii) any person holds a 50% or greater interest (by vote or value) in any disqualified investment corporation immediately after the transaction, but only if such person did not hold such interest immediately before the transaction.⁹⁷³ A “disqualified investment corporation” is any distributing or controlled corporation if the fair market value of the corporation’s “investment assets” (i), for distributions occurring after May 17, 2007, is at least two-thirds of the fair market value of all the corporation’s assets, or (ii), for distributions occurring by May 17, 2007, is at least three-fourths of the fair market value of the corporation’s total assets.⁹⁷⁴ Thus, section 355(g) generally requires a corporation to have at least 34% of its assets (or 26%, in the case of distributions occurring by May 17, 2007) consist of active business assets for a distribution to qualify under section 355.⁹⁷⁵

For this purpose, “investment assets” generally include (i) cash, (ii) stock or securities, (iii) partnership interests, (iv) any

⁹⁷² For purposes of section 355(g), the term “transaction” includes a series of transactions. See I.R.C. § 355(g)(4).

⁹⁷³ See P.L.R. 2009-05-018 (Oct. 21, 2008) (split-off qualified for tax-free treatment even though distributing was a disqualified investment corporation because same person held at least a 50% interest in distributing immediately before and after the transaction); see also Robert Willens, *Letter Ruling Examines Split-Off Followed by Distribution*, 122 Tax Notes 1174 (Mar. 2, 2009).

⁹⁷⁴ See Robert Willens, *Discovery Communications Will ‘Redeem’ Cox’s Stock*, 115 Tax Notes 867 (May 28, 2007) (transaction satisfied section 355(g) because Newco’s investment assets comprised less than 75% of the value of all of Newco’s assets; transaction closed on May 14, 2007).

⁹⁷⁵ The IRS had historically required 5% of a corporation’s assets to consist of active business assets to receive a favorable private ruling on a spinoff, but withdrew this ruling in 1996. See Rev. Proc. 96-43, 1996-2 C.B. 330.

debt instrument or other evidence of indebtedness, (v) any option, forward or future contract, notional principal contract, or derivative, (vi) foreign currency, or (vii) any similar asset,⁹⁷⁶ and exclude assets that are actively used in a lending, finance, banking, or insurance business, substantially all of the income of which is derived from unrelated parties (within the meaning of sections 267(b) or 707(b)(1)).⁹⁷⁷ Significantly, “investment assets” do not include stocks, securities, debt instruments, options, forward or future contracts, notional principal contracts, or derivatives that are issued by a corporation in which the distributing corporation or controlled corporation, as the case may be, owns, directly or indirectly, at least 20% of the total voting power and 20% of the total value (without taking into account certain preferred stock) of such issuing corporation.⁹⁷⁸ Similarly, a partnership interest (or a debt instrument issued by a partnership) is not treated as an investment asset if one or more of the partnership’s businesses are taken into account for purposes of determining whether the active trade or business requirement of section 355(b) is satisfied.⁹⁷⁹

⁹⁷⁶ See I.R.C. § 355(g)(2)(B)(i).

⁹⁷⁷ See I.R.C. § 355(g)(2)(B)(ii). Similarly, investment assets do not include securities that are marked to market. See I.R.C. § 355(g)(2)(B)(iii).

⁹⁷⁸ See I.R.C. § 355(g)(2)(B)(iv). For purposes of applying this rule, the controlled corporation or distributing corporation will be treated as owning its ratable shares of the 20% controlled corporation’s assets. See I.R.C. § 355(g)(2)(B)(iv)(II). One example of the use of this rule is the split-off that eliminated Liberty Media’s 19% stake in News Corp. See Robert Willens, *Liberty Media and News Corp. Will be Parting Ways*, 114 Tax Notes 697 (Feb. 12, 2007). The NYSBA has recommended that the government determine the ratable share of the corporation’s assets by multiplying the ownership percentage in the subsidiary or partnership by the fair market value of each asset. See NYSBA, *Report on Disqualified Investment Corporations as Defined in Section 355(g)*, reprinted in 2007 TNT 131-39 (July 9, 2007).

⁹⁷⁹ See I.R.C. § 355(g)(2)(B)(v). A corporation must generally perform active and substantial management functions (through its officers and/or employees) with respect to the partnership’s business to rely on such business to satisfy the active trade or business requirement of section 355(b). See, e.g., Rev. Rul. 2002-49, 2002-2 C.B. 288, *amplifying* Rev. Rul. 92-17, 1992-1 C.B. 142. But see Rev. Rul. 2007-42, 2007-2 C.B. 44 (even though the corporation did not directly perform active and substantial management functions for a

Several issues regarding section 355(g) would benefit from governmental guidance, including the proper date for valuing section 355(g) assets, the scope of the investment asset definition, and the interaction with section 355's device requirement.

Congress expressly authorized Treasury to exclude transactions that would not constitute redemptions from section 355(g).⁹⁸⁰ Without this exclusion, a pro rata distribution and separate stock distribution under section 305 could be subject to section 355(g), which would not comport with Congress's intent. Accordingly, the author recommends that Treasury limit section 355(g) to non-pro rata distributions.

Section 355(g) requires corporations to measure whether they are a disqualified investment corporation based on asset values "immediately after the transaction." However, since transactions are typically negotiated and executed based on asset valuations prepared prior to the actual closing date, this test would more closely track the economic basis for a transaction if assets were valued on the signing date rather than the closing date.

Good arguments can be made that cash exchanged for debt instruments and accounts receivable should properly be excluded as investment assets for section 355(g) purposes because they are often used by corporations in their trade or business. Other investment assets that could fairly be disregarded are stock, securities or cash distributed solely to pay creditors or shareholders but not so transferred before the stock distribution, and investment assets used to acquire non-investment assets before or after the distribution.⁹⁸¹ Standard indemnification payments related to post-

partnership, the corporation's one third interest in the partnership was "significant" and thus the corporation was treated as engaged in the partnership's active trade or business); *see also* Robert Willens, *IRS Ruling Clarifies Requirements for Partner Being Treated as Engaged in Active Conduct Partnership's Trade or Business*, 26 Tax Mgmt. Weekly Rep. 1026 (July 23, 2007).

⁹⁸⁰ Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 507(5)(B), 120 Stat. 345, 361 (2006).

⁹⁸¹ The NYSBA has recommended that the government (i) exclude accounts receivable from the definition of "investment assets" to the extent they are offset by accounts payable, (ii) confirm that investment assets that the distributing corporation will transfer to creditors or shareholders as part of the plan of distribution will not be

distribution transactions which could trigger additional tax liability are another good candidate for exclusion from investment asset treatment.

Finally, the potentially duplicative nature of section 355(g) and the device test is a source of confusion for taxpayers. It would be helpful for the government to clarify, consistent with Congressional intent, that a transaction not subject to section 355(g) due to a sufficiently low portion of investment assets is not separately vulnerable to the assertion that the same (acceptable) amount of investment assets constitutes evidence of a device.⁹⁸²

IV. SECTION 367 RULES REGARDING ACQUISITIONS

This section describes the section 367 rules that govern whether and to what extent the tax-free transactions discussed above will be afforded nonrecognition treatment when one or more parties to a transaction are non-U.S. persons.⁹⁸³ The discussion below incorporates the final regulations under section 367(a) and (b) (the “Final Section 367 Regulations”) issued on January 23, 2006.⁹⁸⁴

taken into account for purposes of section 355(g), and (iii) provide that non-investment assets acquired with investment assets will not be treated as investment assets as long as the non-investment assets are related to the business that such corporation conducts. NYSBA, *Report on Disqualified Investment Corporations as Defined in Section 355(g)*, reprinted in 2007 TNT 131-39 (July 9, 2007).

⁹⁸² Rev. Rul. 64-102, 1964-1 C.B. 136 (cash contribution of 54% of the value of controlled stock not device because a taxable transaction would have been a complete redemption resulting in capital gain treatment for shareholders); Rev. Rul. 71-383, 1971-2 C.B. 180 (device not found for cash contribution because taxable distribution would have been a substantially disproportionate redemption entitled to capital gains treatment under section 302(b)(2)). NYSBA, *Report on Disqualified Investment Corporations as Defined in Section 355(g)*, reprinted in 2007 TNT 131-39 (July 9, 2007).

⁹⁸³ The rules under section 367 are complex, and the discussion that follows does not address many of the esoteric issues raised by section 367 and the Treasury Regulations issued thereunder. Some of these issues are discussed in Section V below, which analyzes intragroup restructuring transactions.

⁹⁸⁴ For a comprehensive discussion of the Final Section 367 Regulations, see Joseph Calianno and Jeffrey Olin, *Section 367 Regs.*

A. Overview

Section 367 is the successor to section 112(k) of the Revenue Act of 1932⁹⁸⁵ (the “1932 Act”), which was enacted to address the inability to impose U.S. tax after an appreciated asset escaped the United States’ taxing jurisdiction.⁹⁸⁶ Section 112(k) of the 1932 Act denied nonrecognition treatment on outbound transfers of property that would otherwise qualify for tax-free or nonrecognition treatment under general U.S. tax principles, unless it could be established to the satisfaction of the Commissioner that the exchange or distribution was not in pursuance of a plan having as one of its principal purposes the avoidance of income taxes. In its present form, a much expanded section 367 covers not only outbound transfers of property, but inbound liquidations, foreign-to-foreign transfers and the unique issues associated with cross-border transfers of intangible property rights.

Section 367(a) generally denies nonrecognition treatment when a U.S. person transfers property to a foreign corporation in any of the following transactions: (i) a transfer of property (including stock or securities) to a foreign controlled corporation under section 351; (ii) a transfer of stock or securities of a corporation in exchange for stock or securities of a foreign corporation pursuant to a section 368(a) reorganization; and (iii) a transfer of assets to a foreign corporation in exchange for stock or securities of another foreign corporation in a section 368(a) reorganization. Section 367(e) similarly denies nonrecognition treatment with respect to a distribution of assets (including stock of a controlled subsidiary) by a domestic corporation to a foreign

Relating to Cross Border ‘A’ Reorganizations Finalized,
33 Corporate Tax’n 3 (May/June 2006).

⁹⁸⁵ Pub. L. No. 72-154, 47 Stat. 169.

⁹⁸⁶ The legislative history to the predecessor of section 367 described a situation where a U.S. person transferred an appreciated portfolio of securities to a foreign corporation organized in a tax-advantaged jurisdiction in a nonrecognition transaction in exchange for stock in the foreign transferee corporation. Immediately thereafter the foreign corporation sold the appreciated securities for cash. The sale by the foreign transferee corporation was not subject to tax in the foreign jurisdiction and, under then current law, the U.S. person was not subject to U.S. federal income tax in respect of such gain. *See* H.R. Rep. No. 708, 72nd Cong., 1st Sess. 20 (1932), 1939-1 C.B. 457, 471.

corporation. Transfers of intangible property are not subject to these gain recognition rules; instead, a transfer of intangible property to a foreign corporation is treated as a sale of the intangible property for a stream of payments contingent on the productivity, use or disposition of the intangible property.⁹⁸⁷

The section 367(a) gain recognition rules are subject to two principal exceptions. First, transfers of assets used in an active trade or business outside the United States may be entitled to nonrecognition treatment. Also, certain transfers of stock or securities to a foreign corporation may be entitled to nonrecognition treatment if the U.S. transferor is either a less than 5% shareholder of the transferee foreign corporation or enters into a gain recognition agreement (“GRA”) with the IRS.

Section 367(b) affects the U.S. federal income tax consequences of “inbound” transfers and wholly foreign-to-foreign transactions that fall within the scope of the section 367(b) legislative regulations, which were promulgated to prevent the avoidance of U.S. tax.⁹⁸⁸ Very generally, the purpose of the section 367(b) regulations is twofold: (i) to tax a foreign corporation’s earnings upon a repatriation of those earnings pursuant to nonrecognition transactions, and (ii) to preserve the ability to impose tax on a United States shareholder of a controlled foreign corporation (a “CFC”) under section 1248 upon a subsequent disposition of its CFC stock.

⁹⁸⁷ I.R.C. § 367(d). The Obama Administration has proposed clarifying that the definition of “intangible property” for section 367(d) and other purposes includes workforce-in-place, goodwill and going concern value. The proposal also includes other modifications to section 367(d), as discussed below. *See* DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 90, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. *But see* LMSB-04-0108-001 (Feb. 13, 2008) (IRS stated that, to the extent workforce-in-place can be valued as a distinct asset, it should not be viewed as part of foreign goodwill or going concern value).

⁹⁸⁸ Section 367(b)(2) and the Treasury Regulations thereunder also provide special rules with respect to outbound transfers of stock or securities by a U.S. person to a foreign corporation.

B. Section 367(a) Transfers

Section 367(a) provides that when a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356 or 361, the foreign corporation “shall not be considered a corporation” for purposes of determining the extent to which gain shall be recognized on an exchange.⁹⁸⁹ The accepted meaning of this obscure language is that section 367(a) renders these transactions taxable, unless a specific statutory or regulatory exception applies.

1. Outbound Asset Transfers

A U.S. person transferring appreciated assets to a foreign corporation pursuant to a section 351 exchange or an outbound section 368(a) asset reorganization will generally recognize gain (but not loss) on the exchange under section 367(a). Under section 367(a) gain must also be recognized on indirect or constructive asset transfers by U.S. persons to foreign corporations.⁹⁹⁰ An indirect asset transfer includes both the transfer of a partnership interest by a U.S. person to a foreign corporation⁹⁹¹ and the transfer by a partnership of its assets to a foreign corporation if one or more U.S. persons are partners in the partnership.⁹⁹² Moreover, the IRS has also applied section 367(a)

⁹⁸⁹ I.R.C. § 367(a).

⁹⁹⁰ See Temp. Reg. § 1.367(a)-1T(c)(1).

⁹⁹¹ See Temp. Reg. § 1.367(a)-1T(c)(3)(ii). The transfer of the partnership interest is treated for section 367 purposes as a transfer of the partner’s proportionate share of the partnership’s property. Temp. Reg. § 1.367(a)-1T(c)(3)(ii). The transfer of a limited partnership interest that is regularly traded on an established securities market is treated as if it were a “stock” transfer for purposes of section 367, and the consequences of such transfer are determined under Treasury Regulation section 1.367(a)-3. Temp. Reg. § 1.367(a)-1T(c)(3)(ii)(C); Steven Surdell, Russell Carr and Paul Pencak, *International Acquisitions and Dispositions*, Int’l Tax Journal (Sept. – Oct. 2012) (arguing that the section 367 rules governing transfers of partnership interests apply an aggregate approach for section 367(a) purposes and an entity approach for section 367(b) purposes).

⁹⁹² See Temp. Reg. § 1.367(a)-1T(c)(3)(i). In such case, a U.S. person that is a partner in the partnership is treated for section 367 purposes as having transferred a proportionate share of the partnership’s

to impose tax on sovereign debt-for-equity swaps in which a U.S. corporation enters into an agreement with a foreign government to exchange debt for restricted use foreign currency.⁹⁹³

Although a U.S. target may recognize gain in an outbound C or non-divisive D reorganization, the U.S. target shareholders may receive nonrecognition treatment under Section 354.⁹⁹⁴ This result provides an opportunity for a target with high-basis assets or net operating losses sufficient to offset any built-in gain in its assets to expatriate in a tax-free, or tax efficient, asset reorganization.⁹⁹⁵

a. Active Business Exception

Certain outbound asset transfers are excepted from the general section 367(a) gain recognition rule. For example, a U.S. person's transfer of assets to a foreign corporation is not subject to section 367(a) if the assets will be used by the foreign corporation in the active conduct of a trade or business outside the United States (the "Active Business Exception").⁹⁹⁶ However, as discussed in more detail below, this exception is only available under very limited circumstances. For example, it is not available with respect to certain types of assets ("tainted assets")⁹⁹⁷ and it is limited to transfers pursuant to section 351 and reorganizations involving a transferor U.S. corporation that is controlled by five or fewer U.S. corporations.⁹⁹⁸

property (as determined in accordance with the rules and principles of section 701 through 760). Temp. Reg. § 1.367(a)-1T(c)(3)(ii).

⁹⁹³ See F.S.A. 1999-04-012 (Oct. 27, 1998). *But see G.M. Trading Corp. v. Commissioner*, 121 F.3d 977 (5th Cir. 1997).

⁹⁹⁴ See Treas. Reg. § 1.367(a)-3(a).

⁹⁹⁵ See Samuel Thompson Jr., *Section 367: A 'Wimp' for Inversions and a 'Bully' for Real Cross-Border Acquisitions*, 94 Tax Notes 1505 (Mar. 18, 2002).

⁹⁹⁶ I.R.C. § 367(a)(3).

⁹⁹⁷ I.R.C. § 367(a)(3)(B).

⁹⁹⁸ I.R.C. § 367(a)(5); Temp. Reg. § 1.367(a)-2T.

To qualify for the Active Business Exception, a taxpayer must establish that it satisfies the following requirements:⁹⁹⁹

- the foreign transferee must conduct a business, *i.e.*, a unified group of activities that constitutes an independent economic enterprise carried on for profits (for these purposes, the holding of investments for the foreign corporation's own account does not constitute a business);¹⁰⁰⁰
- the foreign transferee must actively conduct its business, *i.e.*, the officers and employees of the foreign transferee must carry out substantial managerial and operational activities;¹⁰⁰¹
- the foreign transferee's business must be conducted outside the United States, which requires that the management and operation of the business be undertaken, and the transferred assets be located, outside the United States immediately after the transfer;¹⁰⁰² and
- the assets transferred to the foreign transferee must be used or held for use in the foreign transferee's business.¹⁰⁰³ Special rules apply to determine whether transfers of oil and gas

⁹⁹⁹ See Temp. Reg. § 1.367(a)-2T(b)(1).

¹⁰⁰⁰ See Temp. Reg. § 1.367(a)-2T(b)(2).

¹⁰⁰¹ See Temp. Reg. § 1.367(a)-2T(b)(3).

¹⁰⁰² See Temp. Reg. § 1.367(a)-2T(b)(4). As a result of this requirement, the Active Business Exception will not apply to the liquidation of a domestic subsidiary if the assets of the subsidiary are operated as a branch of the foreign transferee in the United States. See I.R.C. § 367(e)(2).

¹⁰⁰³ See Temp. Reg. § 1.367(a)-2T(b)(5). Assets are held for use in the foreign transferee's business if they are (i) held for the principal purpose of promoting the conduct of the business; (ii) acquired and held in the ordinary course of business; or (iii) held in a direct relationship to the business. Temp. Reg. § 1.367(a)-2T(b)(5).

working interests qualify for the Active Business Exception.¹⁰⁰⁴

A separate rule provides that, even if the above-described requirements cannot be satisfied, the Active Business Exception will nonetheless apply to a transfer of assets to a foreign corporation as a result of a local legal requirement or genuine threat of immediate expropriation by a foreign government, provided the transferred property was used prior to the transfer in the foreign country in which the foreign transferee is organized.¹⁰⁰⁵

There are five important limitations to the Active Business Exception. First, the exception does not apply to assets that are transferred back to the transferor as part of the same transaction.¹⁰⁰⁶ For purposes of this test, all transfers within six months of the original transfer will be treated as part of the same transaction, and transfers after six months may also be treated as part of the same transaction under step transaction principles.¹⁰⁰⁷ Second, the Active Business Exception does not apply to asset transfers effected pursuant to reorganizations unless five or fewer domestic corporations control the transferor (within the meaning of section 368(c)), and the U.S. corporate shareholders in the target corporation make appropriate basis adjustments.¹⁰⁰⁸ Thus, for example, the exception does not apply to a transfer of assets by a U.S. corporation to a foreign corporation in a C reorganization if individuals control the U.S. target corporation or a combination of one or more domestic corporations and individuals control the

¹⁰⁰⁴ See Temp. Reg. § 1.367(a)-4T(e).

¹⁰⁰⁵ See Temp. Reg. § 1.367(a)-4T(f).

¹⁰⁰⁶ See Temp. Reg. § 1.367(a)-2T(c).

¹⁰⁰⁷ See Temp. Reg. § 1.367(a)-2T(c)(1). Retransfers pursuant to section 351 or 721 transactions will not violate the retransfer limitation of the Active Business Exception if the transferees use the property in the active conduct of a trade or business outside the United States and certain other requirements are met. Temp. Reg. § 1.367(a)-2T(c)(2).

¹⁰⁰⁸ I.R.C. § 367(a)(5). The legislative history to section 367(a)(5) explains that these shareholders must agree to take a basis in the foreign acquiring corporation stock they receive equal to the lesser of: (i) these shareholders' tax basis in the stock received or (ii) their proportionate share of the basis in the transferor's assets received by the acquirer. See S. Rep. No. 100-445, at 62 (1988).

target. Third, if the transferred assets were used by the transferor in the United States, any recaptured depreciation with respect to the assets must be recognized as ordinary income, even if the Active Business Exception otherwise applies.¹⁰⁰⁹ Fourth, even if the Active Business Exception applies, gain must be recognized with respect to previously deducted foreign branch losses on the incorporation of a foreign branch.¹⁰¹⁰

Finally, a transfer of tainted assets cannot qualify for the Active Business Exception.¹⁰¹¹ Any gain realized on the transfer of tainted assets must be recognized by the transferor under section 367(a). Tainted assets include: (i) inventory;¹⁰¹² (ii) a copyright, literary, musical or artistic composition, a letter or memorandum, if the asset transferred is not a capital asset in the hands of the transferor;¹⁰¹³ (iii) installment obligations, accounts receivable or similar property (unless previously included in income);¹⁰¹⁴ (iv) foreign currency or any asset denominated in foreign currency (subject to certain exceptions);¹⁰¹⁵ (v) leased property, unless either the transferee is the lessee, or the leasing is *de minimis* or the transferor's leasing activities qualify as a business conducted outside the United States and the transferee has need for substantial investment in assets of the type transferred;¹⁰¹⁶

¹⁰⁰⁹ See Temp. Reg. § 1.367(a)-4T(b).

¹⁰¹⁰ I.R.C. § 367(a)(3)(C); Temp. Reg. § 1.367(a)-6T(b)(2).

¹⁰¹¹ I.R.C. § 367(a)(3)(B); Temp. Reg. § 1.367(a)-5T.

¹⁰¹² See Temp. Reg. § 1.367(a)-5T(b)(1).

¹⁰¹³ See Temp. Reg. § 1.367(a)-5T(b)(2).

¹⁰¹⁴ See Temp. Reg. § 1.367(a)-5T(c). In Field Service Advice, the IRS considered the treatment of the transfer of a sales contract pursuant to the reincorporation of a domestic corporation as a foreign corporation. The contract consisted of a prepaid amount and a deferred payment, and the IRS treated the deferred payment as an account receivable by the taxpayer. Therefore, its transfer was subject to tax, and, as a liquid and passive asset, the prepayment was considered "similar property" that was also subject to tax. See F.S.A. 1999-27-006 (Mar. 31, 1999).

¹⁰¹⁵ See Temp. Reg. § 1.367(a)-5T(d).

¹⁰¹⁶ See Temp. Reg. § 1.367(a)-5T(f).

and (vi) intangible property (other than foreign goodwill and going concern value).¹⁰¹⁷

2. Outbound Stock Transfers

In response to concern over “inversion” transactions,¹⁰¹⁸ the government modified the section 367(a) regulations to treat an outbound transfer of stock or securities described in section 351, 354, 356 or 361 by a U.S. person to a foreign corporation (an “Affected Stock Transfer”) as a taxable exchange under section 367(a) unless an exception applies. Any Affected Stock Transfers that are not subject to section 367(a) may be subject to the separate gain recognition rules of section 367(b), as described below. Moreover, the section 367(a) stock transfer rules may also apply to the transfer of an instrument not clearly defined as equity. In such case, if the instrument more closely resembles equity than debt, even the nonrecognition exceptions under section 367(a) discussed below may apply to the transferor.¹⁰¹⁹

As in the case of outbound asset transfers, the section 367(a) stock transfer rules apply to direct as well as indirect transfers of stock or securities to a foreign corporation.¹⁰²⁰ Indirect transfers of stock or securities to a foreign corporation under section 367(a) include:

¹⁰¹⁷ See Temp. Reg. § 1.367(a)-5T(e).

¹⁰¹⁸ An “inversion” transaction is one in which a domestic parent corporation with a foreign subsidiary reorganizes as a foreign parent corporation with a domestic subsidiary, thus liberating the foreign businesses from the reach of U.S. income tax rules, particularly Subpart F. Inversions are discussed in greater detail in Section IV.C. below.

¹⁰¹⁹ In Field Service Advice, the IRS considered the treatment of a disputed security of a foreign subsidiary that the subsidiary exchanged for stock of another foreign subsidiary of the same U.S. parent. The IRS determined that (i) the instrument more closely resembled equity than debt, and (ii) the transaction could qualify for nonrecognition treatment if all other applicable section 367(a) requirements were satisfied, and a GRA was executed. See F.S.A. 1999-29-002 (July 23, 1999).

¹⁰²⁰ See Treas. Reg. § 1.367(a)-3(a).

- an A2D reorganization and an A or G reorganization, in each case, involving a foreign parent corporation;¹⁰²¹
- a reverse subsidiary merger involving a foreign parent corporation;¹⁰²²
- a triangular B reorganization involving a foreign or domestic parent corporation;¹⁰²³
- a triangular C reorganization involving a foreign parent corporation;¹⁰²⁴
- an asset reorganization (other than a triangular C reorganization, an A2D reorganization and an A or G reorganization, or a reverse subsidiary merger, in each case as described above, or a “same-country F reorganization”) that is followed by a transfer of acquired assets to a controlled subsidiary;¹⁰²⁵ and

¹⁰²¹ See Treas. Reg. § 1.367(a)-3(d)(1)(i), (3)(d)(3), Ex. 10.

¹⁰²² See Treas. Reg. § 1.367(a)-3(d)(1)(ii), (3)(d)(3), Ex. 2, 11.

¹⁰²³ See Treas. Reg. § 1.367(a)-3(d)(1)(iii), (3)(d)(3), Ex. 5A. The Final Section 367 Regulations expanded this provision to include triangular reorganizations in which the parent entity is a domestic corporation.

¹⁰²⁴ See Treas. Reg. § 1.367(a)-3(d)(1)(iv), Ex. 5.

¹⁰²⁵ See Treas. Reg. § 1.367(a)-3(d)(1)(v), Exs. 6A, 6B, 6C, 9. More specifically, a “controlled subsidiary” is a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation as part of the same transaction. See Treas. Reg. § 1.367(a)-3(d)(1); *see also* Treas. Reg. § 1.367(a)-3(e)(1)(D)(2) (in the case of a D reorganization followed by a controlled asset transfer, the Final Section 367 Regulations apply this provision retroactively to reorganizations occurring after December 9, 2002 in light of Revenue Ruling 2002-85 and Notice 2002-77). A same-country F reorganization is an F reorganization in which both the acquired and acquiring corporations are foreign corporations created or organized under the laws of the same foreign country. See Treas. Reg. § 1.367(a)-3(d)(1)(v).

- a section 351 transfer of assets to a foreign transferee corporation followed by a transfer of those assets to a second corporation in one or more section 351 exchanges.¹⁰²⁶

Generally, if one of the referenced indirect stock transfers occurs, a U.S. person who exchanges U.S. corporation stock or securities for stock or securities in a foreign corporation is deemed to have transferred U.S. corporation stock or securities to a foreign corporation in a transaction subject to the section 367(a) rules.¹⁰²⁷ These rules may recast an asset reorganization as a so-called indirect stock reorganization, applying certain fictions and ordering rules to allow the section 367(a) rules to function properly. For example, for purposes of determining the corporation with respect to which a GRA is filed, the transferred corporation is generally treated as the acquiring corporation,¹⁰²⁸ except in the case of a triangular B reorganization,¹⁰²⁹ a C reorganization followed by a drop down of acquired assets,¹⁰³⁰ or successive section 351 transfers.¹⁰³¹

The Final Section 367 Regulations coordinate the outbound asset transfer and indirect stock transfer rules with the goal of restricting a U.S. corporation's ability to effect an outbound "inversion" or divisive transaction (the "coordination rule"). An outbound asset reorganization that includes an indirect stock transfer is no longer entitled to a blanket exception from section 367(a) for a foreign acquirer's retransfer of assets to its domestic subsidiary. Instead, the Final Section 367 Regulations create two narrow exceptions to tax where an outbound asset transfer is followed by an inbound asset transfer.

¹⁰²⁶ See Treas. Reg. § 1.367(a)-3(d)(1)(vi).

¹⁰²⁷ If the transferor is deemed to exchange stock or securities of a foreign corporation, the section 367(b) rules may also apply.

¹⁰²⁸ See Treas. Reg. § 1.367(a)-3(d)(2)(ii).

¹⁰²⁹ In such case, the transferred corporation is the acquired corporation. See Treas. Reg. § 1.367(a)-3(d)(2)(ii).

¹⁰³⁰ In such case, the transferred corporation is the transferee corporation. See Treas. Reg. § 1.367(a)-3(d)(2)(ii).

¹⁰³¹ In such case, the transferred corporation is the transferee corporation. See Treas. Reg. § 1.367(a)-3(d)(2)(ii).

One exception applies if (i) U.S. transferors receive 50% or less of the vote and value of the acquirer stock, (ii) U.S. persons that are officers, directors or 5% shareholders of the target together own 50% or less of the vote and value of the acquirer stock immediately after the transaction, (iii) the section 367(a) “active trade or business test” and certain reporting requirements are satisfied, (iv) the basis in the retransferred assets is not increased, (v) the target attaches a “Required Statement under § 1.367(a)-3(d) for Assets Transferred to a Domestic Corporation” to its U.S. federal income tax return for the year of transfer,¹⁰³² and (vi) the transaction does not facilitate a divisive transaction with a principal purpose of U.S. tax avoidance.¹⁰³³ The second exception applies where five or fewer U.S. corporations control the target within the meaning of section 368(c), and there is no increase in the tax basis of the retransferred assets.¹⁰³⁴

In Notice 2008-10,¹⁰³⁵ the government announced its intention to publish regulations modifying the coordination rule to tax certain transactions that it believes are designed to repatriate assets from foreign subsidiaries without gain recognition or a

¹⁰³² See Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B)(1)(ii). This statement requires the target or its successor to certify that, if the foreign acquirer disposes of any stock of its domestic U.S. subsidiary in a gain recognition transaction and a principal purpose of the transfer was avoidance of U.S. federal income tax (even if this purpose is outweighed by other purposes), the domestic acquired corporation will report the gain on its U.S. federal income tax return or amended return. See Treas. Reg. § 1.367-3(d)(2)(vi)(C).

¹⁰³³ See Treas. Reg. § 1.367(a)-2(d)(2)(vi)(C).

¹⁰³⁴ See Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B)(1)(i), (d)(3), Ex. 6B, 9.

¹⁰³⁵ 2008-1 C.B. 277. See generally Patrick Jackman & Philip Tretiak, *Is the ‘Cash D’ the New ‘Killer B’*, 34 Int’l Tax J. 11 (July/Aug. 2008); Kenneth J. Krupsky, *Notice 2008-10: Some Sandwiches Are Tasty and Some Aren’t*, 37 Tax Mgmt. Int’l J. 179 (2008); Philip A. McCarty & Timothy S. Shuman, *Notice 2008-10: The IRS and Treasury Continue Their Assault on Tax-Free Earnings Repatriations*, 37 Tax Mgmt. Int’l J. 163 (2008); Hal Hicks & David J. Sotos, *The Empire Strikes Back (Again) – Killer Bs, Deadly Ds and Code Section 367 As the Death Star Against Repatriation Rebels*, 34 Int’l Tax J. 37 (May/June 2008); *Regs. Would Prevent Repatriation from Foreign Subs*, 19 J. of Int’l Tax’n 8 (Mar. 2008); Michael J. Cornett, *Outbound Asset Transfers*, 34 Int’l Tax J. 23 (Mar./Apr. 2008).

dividend inclusion. The Notice describes an all cash D reorganization in which (i) a U.S. parent's foreign subsidiary acquires all the assets of a U.S. subsidiary for cash, (ii) the U.S. subsidiary distributes the cash to the U.S. parent in liquidation, and (iii) the foreign subsidiary then contributes all the acquired assets to its wholly owned U.S. Newco.¹⁰³⁶ Based on the Notice, the U.S. subsidiary typically has no tax basis in its assets, while the U.S. parent typically has tax basis in both its U.S. subsidiary and foreign subsidiary stock equal to the fair market value of the U.S. target's assets.¹⁰³⁷ According to the Notice, taxpayers take the position that the second exception to the coordination rule precludes the application of sections 367(a) and (d) to the outbound asset transfer because (i) the foreign acquirer contributes the acquired assets to U.S. Newco; and (ii) the U.S. parent would typically agree to reduce its tax basis in its historic foreign subsidiary stock by the amount of built-in gain in the U.S. target's assets.¹⁰³⁸

Notice 2008-10 explains that forthcoming regulations will instead require a downward basis adjustment in the foreign acquirer shares actually received in the outbound asset transfer, and will provide that the asset transfer will be fully taxable if the foreign acquirer does not issue shares in the acquisition.¹⁰³⁹ In addition, the government intends to restrict the exception under the current coordination rule whereby an outbound section 351 asset transfer followed by an inbound section 351 asset transfer is

¹⁰³⁶ See Notice 2008-10, 2008-1 C.B. 277. For a discussion of all cash D reorganizations, see Section I.D.4 above. See also Lowell D. Yoder, *Cash D Reorganizations-Selected International Issues*, 37 Tax Mgmt. Int'l J. 110 (2008).

¹⁰³⁷ See Notice 2008-10, 2008-1 C.B. 277.

¹⁰³⁸ See Notice 2008-10, 2008-1 C.B. 277. While this transaction would also be subject to the indirect stock transfer rules, U.S. parent typically would not recognize any gain on the outbound transfer of its U.S. subsidiary shares in the all cash D reorganization because U.S. parent would typically have a fair market value tax basis in those shares. See Notice 2008-10, 2008-1 C.B. 277; see also I.R.C. § 956(a) (while FA's ownership of U.S. Newco stock would be an investment in United States property under Subpart F rules, there would be no income inclusion due to FA's zero basis in U.S. Newco stock).

¹⁰³⁹ See Notice 2008-10, 2008-1 C.B. 277.

generally excepted from section 367(a) and (d) if no asset basis step-up occurs¹⁰⁴⁰ to transactions that do not also qualify as section 361 reorganizations.¹⁰⁴¹ Accordingly, those transactions would also need to satisfy the basis adjustment rule described immediately above to avoid gain recognition under section 367.¹⁰⁴²

In August, 2008, Treasury and the IRS issued proposed regulations (the “2008 Proposed Section 367(a)(5) Regulations”) permitting a U.S. corporation to elect to avoid section 367(a)(5) corporate level gain recognition on the transfer of assets to a foreign corporation in an otherwise tax-free reorganization.¹⁰⁴³ To make the election under the 2008 Proposed Section 367(a)(5) Regulations: (i) the U.S. transferor must be directly controlled by at least one, and no more than five, domestic corporations (treating all members of an affiliated group as a single corporation) (collectively, the “controlled group”);¹⁰⁴⁴ (ii) the U.S. transferors and all controlled group members must agree to make the

¹⁰⁴⁰ See Treas. Reg. § 1.367(a)-2(d)(2)(vi)(B)(2).

¹⁰⁴¹ See Notice 2008-10, 2008-1 C.B. 277.

¹⁰⁴² See Notice 2008-10, 2008-1 C.B. 277.

¹⁰⁴³ 73 Fed. Reg. 49277 (Aug. 20, 2008). See generally Joseph Calianno, *Detailed Guidance Provided on Application of Section 367(a)(5) in Prop. Regs.*, 36 Corp. Tax’n 3 (May/June 2009); NYSBA, *Report on Proposed Regulations Issued Under Code Sections 367, 1248 and 6038B*, reprinted in 2009 TNT 17-18 (Jan. 28, 2009); Joseph M. Calianno, *Section 367(a)(5) - Proposed Regulations Provide Long-Awaited Guidance*, 20 J. Int’l Tax’n 24 (Mar. 2009); Robert Willens, *IRS Offers Long-Awaited Guidance with Rules Regarding Outbound Reorganizations*, Daily Tax Rep. (BNA), at J-1 (Oct. 15, 2008); *Corporate Reorganizations: IRS Unveils Rules on Domestic-to-Foreign Transfers with Elective Exception to Tax*, Daily Tax Rep. (BNA), at GG-1 (Aug. 20, 2008); Lee A. Sheppard, *IRS Official Reviews International Tax Agenda*, 2011 TNT 144-1 (July 27, 2011) (IRS expects to issue guidance on section 367(a)(5) covering outbound asset reorganizations, including issues relating to minority owners and built-in losses).

¹⁰⁴⁴ Prop. Reg. § 1.367(a)-7(c)(1). The NYSBA has recommended that the IRS (i) consider extending the 2008 Proposed Section 367(a)(5) Regulations to include RICs, REITs, and S corporations, and (ii) expand the definition of controlled group to accommodate indirect corporate ownership through a partnership. See NYSBA, *Report on Proposed Regulations Issued Under Code Sections 367, 1248 and 6038B*, reprinted in 2009 TNT 17-18 (Jan. 28, 2009).

election;¹⁰⁴⁵ (iii) each member of the controlled group must reduce its tax basis in the stock received in the transaction to preserve the controlled member's share of the U.S. transferor "inside gain";¹⁰⁴⁶ and (iv) the U.S. transferor must certify that, if the foreign acquiring corporation disposes of a significant amount of the section 367(a) property received with a principal purpose of avoiding the U.S. tax that would otherwise have been imposed on the sale of the property, the U.S. transferor will file a U.S. tax return for the year of the exchange and report (and pay the tax on) the gain realized but not recognized on the property sale.¹⁰⁴⁷ The 2008 Proposed Section 367(a)(5) Regulations contain an anti-stuffing rule that disregards the acquisition of property otherwise constituting section 367(a) property if acquired by the U.S. transferor with a principal purpose of affecting the determination of aggregate section 367(a) property.¹⁰⁴⁸ The NYSBA has recommended that the final regulations permit a corporate transferor to recognize a portion of its unrecognized gain in an amount equal to the transferor's NOLs, if any, thereby reducing the amount of inside gain that must be preserved through basis adjustments.¹⁰⁴⁹

¹⁰⁴⁵ Prop. Reg. § 1.367(a)-7(c)(5).

¹⁰⁴⁶ Prop. Reg. § 1.367(a)-7(c)(3). Inside gain generally equals the amount by which the aggregate gross fair market value of the "section 367(a) property" transferred by the U.S. transferor in the section 361 exchange exceeds the sum of the aggregate tax bases of such property and a proportionate amount of any liabilities of the U.S. transferor assumed in the exchange or satisfied in the reorganization. *See* Prop. Reg. § 1.367(a)-7(f)(6). "Section 367(a) property" is generally any property other than intangible property. *See* Prop. Reg. § 1.367(a)-7(f)(9)(i).

¹⁰⁴⁷ Prop. Reg. §§ 1.367(a)-7(c)(4); 1.6038B-1(c)(6)(iii). A disposition of a "significant amount" of the section 367(a) property occurs if the foreign acquiring corporation disposes of greater than 40% of the fair market value of section 367(a) property at the time of the exchange. Prop. Reg. § 1.6038B-1(c)(6)(iii)(A).

¹⁰⁴⁸ Prop. Reg. § 1.367(a)-7(f)(9)(ii). For example, the anti-stuffing rule may apply if the U.S. transferor acquires built-in loss property or cash proceeds from indebtedness incurred in connection with the section 367(a) transaction. *See* 73 Fed. Reg. 49277 (Aug. 20, 2008).

¹⁰⁴⁹ *See* NYSBA, *Report on Proposed Regulations Issued Under Code Sections 367, 1248 and 6038B*, reprinted in 2009 TNT 17-18 (Jan. 28, 2009).

The preamble to the 2008 Proposed Section 367(a)(5) Regulations states that the IRS is studying transactions that have the effect of repatriating earnings and profits of foreign corporations without the recognition of gain or dividend inclusion.¹⁰⁵⁰ In particular, the IRS is analyzing whether it is appropriate for the gain limitation rule of section 356(a)(1) to apply in acquisitive asset reorganizations involving foreign acquiring corporations.¹⁰⁵¹

The Obama Administration has proposed repealing the section 356(a)(1) “boot within gain” limitation for reorganizations where the exchange “has the effect of the distribution of a dividend” within the meaning of section 356(a)(2).¹⁰⁵² This proposal could change the treatment of outbound “all cash” D reorganizations where the exchanging shareholder has no built-in gain in the acquired corporation stock.

The Final Section 367 Regulations create a rebuttable presumption that U.S. federal income tax avoidance was a principal purpose for a putative asset reorganization if any stock of the acquirer subsidiary is disposed of within two years after the

¹⁰⁵⁰ 73 Fed. Reg. 49277 (Aug. 20, 2008).

¹⁰⁵¹ Commentators have questioned whether the IRS’s request for comments indicates that the government may view “all cash” D reorganizations with a foreign acquiring corporation as a potential repatriation transaction. See, e.g., Lee A. Sheppard, *IRS Looking for the Next Killer B*, *Official Says*, 2009 TNT 141-3 (July 24, 2009); *IRS’s Request for Comments in Outbound Asset Transfer Regs Designed to Start Dialog*, 2008 TNT 196-4 (Oct. 8, 2008); *Proposed Regs on Outbound Asset Transfers Not Currently Applicable*, *IRS Official Warns*, 2008 TNT 164-2 (Aug. 22, 2008).

¹⁰⁵² See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 133, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. For the purpose of determining the source of earnings and profits supporting a section 356(a)(2) dividend, commentators have recommended treating the dividend as (i) occurring after the reorganization in a separate transaction, or (ii) a separate pre-reorganization dividend first out of the acquiring entity’s earnings and then out of the target’s earnings. See Paul W. Oosterhuis & Daniel M. McCall, *What’s in Order for Assets Crossing the Border?*, 88 Taxes 41 (Mar. 2010).

acquirer subsidiary receives target assets.¹⁰⁵³ If a principal purpose of tax avoidance exists, and the acquirer subsidiary stock is disposed of, gain (but not loss) will be recognized. The amount of gain will be determined as if all retransferred assets were contributed to a new U.S. corporation under section 351, and the stock of such new corporation is sold for cash to a third party at its fair market value.¹⁰⁵⁴

In March, 2013, Treasury and the IRS released a section 367 regulation package that included: (i) the finalization of portions of the 2008 Proposed Section 367(a)(5) Regulations, (ii) the adoption as temporary regulations of portions of the 2008 Proposed Section 367(a)(5) Regulations and (iii) the issuance of new temporary regulations (together, the “2013 Section 367(a)(5) Regulations”).¹⁰⁵⁵ Treasury and the IRS generally maintained the framework set out in the 2008 Proposed Section 367(a)(5) Regulations with a few targeted changes and clarifications.¹⁰⁵⁶

As discussed above, the 2008 Proposed Section 367(a)(5) Regulations provide an exception to section 367(a)(5) if the controlled group members of the U.S. transferor elect, among other things, to reduce their tax basis in the stock received in the transaction to preserve their share of the U.S. transferor’s “inside gain”. The NYSBA recommended that the final regulations permit

¹⁰⁵³ See Treas. Reg. § 1.367(a)-3(d)(2)(vi)(D)(2).

¹⁰⁵⁴ In addition, interest is charged if additional tax is required, based on the rates under section 6621 for the period between the date of the transfer and the date on which the additional tax for that year is paid. See Treas. Reg. § 1.367(a)-3(d)(2)(vi)(E)(2). The foreign acquirer will receive a step-up in the basis of its U.S. subsidiary stock immediately before the sale; however, the U.S. subsidiary’s asset basis will not be increased. See Treas. Reg. § 1.367(a)-3(d)(2)(vi)(E)(1).

¹⁰⁵⁵ T.D. 9614, 2013-17 I.R.B. 947; T.D. 9615, 2013-19 I.R.B.1026; REG-132702-10, 2013-19 I.R.B.1042.

¹⁰⁵⁶ See also David D. Stewart, *Officials Respond to Questions on ‘Imminent’ Outbound Transfer*, 2013 TNT 42-14 (Mar. 4, 2013); Kristen A. Parillo, *Outbound Asset Transfer Reg Package Contains Some Surprises*, 2013 TNT 53-1, (Mar. 19, 2013); Alison Bennett, *IRS Unveils Guidance on Section 367 Exception on Domestic-to-Foreign Transfers*, Daily Tax Rep. (BNA), at GG-1 (Mar. 19, 2013); Amy S. Elliot, *Officials Explain New Outbound Asset Reporting and Stock Transfer Guidance*, 2013 TNT 66-1 (Apr. 8, 2013).

a corporate transferor to recognize a portion of its unrecognized gain in an amount equal to the U.S. transferor's net operating losses, if any, thereby reducing the amount of inside gain that must be preserved through basis adjustments.¹⁰⁵⁷ In the preamble to the 2013 Section 367(a)(5) Regulations, Treasury and the IRS rejected this recommendation, citing the complexity the rule would cause; however, they clarified that a U.S. transferor may utilize any available tax attributes by not electing to apply the elective exception.¹⁰⁵⁸

In addition, the NYSBA previously recommended that the IRS (i) consider extending the 2008 Proposed Section 367(a)(5) Regulations to include RICs, REITs, and S corporations, and (ii) expand the definition of "controlled group" to accommodate indirect corporate ownership through a partnership.¹⁰⁵⁹ In the preamble to the 2013 Section 367(a)(5) Regulations, Treasury and the IRS rejected those recommendations on the basis that corporate-level tax on the "inside gain" would not be appropriately preserved and complexity would be increased if those recommendations were adopted.¹⁰⁶⁰

The preamble to the 2013 Section 367(a)(5) Regulations clarifies that if a U.S. transferor does not have inside gain, *i.e.*, there is no net built-in gain in the U.S. transferor's assets, controlled group members are not required to make stock basis adjustments even if there is an outside stock loss with respect to a controlled group member.¹⁰⁶¹

The 2013 Section 367(a)(5) Regulations also eliminate one of the exceptions applicable to the coordination rule discussed above.¹⁰⁶² The coordination rule provides that, if a U.S. person

¹⁰⁵⁷ See NYSBA, *Report on Proposed Regulations Issued Under Code Sections 367, 1248 and 6038B*, reprinted in 2009 TNT 17-18 (Jan. 28, 2009).

¹⁰⁵⁸ T.D. 9614, 2013-17 I.R.B. 947.

¹⁰⁵⁹ See NYSBA, *Report on Proposed Regulations Issued Under Code Sections 367, 1248 and 6038B*, reprinted in 2009 TNT 17-18 (Jan. 28, 2009).

¹⁰⁶⁰ T.D. 9614, 2013-17 I.R.B. 947.

¹⁰⁶¹ T.D. 9614, 2013-17 I.R.B. 947.

¹⁰⁶² T.D. 9615, 2013-19 I.R.B. 1026.

transfers assets to a foreign corporation in a direct asset transfer that is in connection with an indirect stock transfer, the rules of section 367 apply first to the direct asset transfer and then to the indirect stock transfer. Formerly, an exception to the coordination rule was available in cases in which a foreign acquiring corporation acquired assets from a domestic target corporation in an asset reorganization and subsequently re-transferred the assets to a domestic corporation controlled by the foreign acquiring corporation, provided the requirements under section 367(a)(5) were met. Treasury and the IRS have become aware of transactions involving outbound asset reorganizations that involve the repatriation of earnings and profits of a foreign corporation in which taxpayers take the position that this section 367(a)(5) exception protects against income or gain recognition; accordingly, Treasury and the IRS have eliminated this exception.

There are several exceptions to immediate taxation for stock transfers subject to section 367(a), as discussed below.

a. Exception for Certain Reorganizations & Foreign Stock Transfers

The Treasury Regulations except two types of share exchanges from the section 367(a) stock transfer rules. First, a U.S. person's exchange of stock or securities of a foreign corporation in a recapitalization described in section 368(a)(1)(E) is not subject to section 367(a).¹⁰⁶³ Second, a U.S. person's exchange of stock or securities of a domestic or foreign corporation pursuant to an A, C, D, F or G reorganization that is not treated as an indirect stock transfer under the rules described above is not subject to section 367(a).¹⁰⁶⁴ Thus, for example, if a

¹⁰⁶³ See Treas. Reg. § 1.367(a)-3(a). The Final Section 367 Regulations inserted the phrase "or securities" so that the exception will apply to recapitalizations involving securities as well as stock. See T.D. 9243, 2006-1 C.B. 475; Notice 2005-6, 2005-1 C.B. 448.

¹⁰⁶⁴ See Treas. Reg. § 1.367(a)-3(a), (3)(d)(3), Ex. 16 (shareholder not subject to section 367(a) on exchange of stock in a D reorganization that was not treated as an indirect stock transfer). This exception, by its terms, only applied if the exchanging shareholder received stock of a foreign corporation in the exchange. See T.D. 9243, 2006-1 C.B. 475. The preamble to the Final Section 367 Regulations clarified that this exception was (and is) intended to apply to any section 354 exchange pursuant to an asset reorganization that is not

widely held U.S. corporation reincorporates as a foreign corporation in an F reorganization, the deemed asset transfer by the U.S. corporation to the new foreign corporation would be taxable under section 367(a), but the shareholders' section 354 tax-free exchange of U.S. corporation stock for new foreign corporation stock would be respected.¹⁰⁶⁵ However, if a U.S. person transfers foreign corporation stock in exchange for stock of another foreign corporation in a nonrecognition exchange described in section 351 or 368, and the exchanging shareholder is no longer a section 1248 shareholder after the transfer, or the transferred corporation no longer qualifies as a CFC, the exchanging shareholder must include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges under section 367(b).¹⁰⁶⁶

In addition, a U.S. person transferring stock or securities of a foreign corporation in an Affected Stock Transfer will not be subject to tax under section 367(a) if such U.S. person either (i) owns less than 5% of the total voting power and value of the stock of the transferee foreign corporation immediately after the transaction, or (ii) enters into a GRA with the IRS.¹⁰⁶⁷ As

treated as an indirect stock transfer, including a U.S. person's transfer of foreign target corporation stock for stock of a domestic parent corporation that controls a foreign acquiring subsidiary. *See* T.D. 9243, 2006-1 C.B. 475. The Final Section 367 Regulations include modified language that effectuates this intent.

If, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling parent corporation to a foreign surviving target corporation in an A2E reorganization, the section 361 transfer is not subject to section 367(a) if the controlling parent corporation provides its stock directly to the merging corporation pursuant to the plan of reorganization; however, a section 361 transfer of other property, including stock of the controlling parent corporation provided, for example, by the domestic merging corporation to the foreign surviving target corporation pursuant to such a reorganization, is subject to section 367(a). *See* T.D. 9243, 2006-1 C.B. 475.

¹⁰⁶⁵ *See* Treas. Reg. § 1.367(a)-3(d)(3), Ex. 12.

¹⁰⁶⁶ *See* Treas. Reg. § 1.367(b)-4(b)(1).

¹⁰⁶⁷ *See* Treas. Reg. § 1.367(a)-3(b)(1). Section 367(a)(2) provides that, "except to the extent provided in regulations", section 367(a) does not apply to a transfer of stock or securities of a foreign corporation that is a party to the exchange or a party to the reorganization.

discussed below, however, even if section 367(a) does not apply to an Affected Stock Transfer, a U.S. transferor nonetheless may be required to recognize taxable income in connection with the transaction under section 367(b).¹⁰⁶⁸

b. Exception for Certain U.S. Stock Transfers

Any Affected Stock Transfer of U.S. stock or securities by a U.S. person to a foreign corporation is subject to section 367(a) unless each of the following four conditions are satisfied: (i) an aggregate of no more than 50% of the total voting power and value of the stock of the foreign transferee corporation is received directly, indirectly or constructively, by U.S. transferors in the transaction;¹⁰⁶⁹ (ii) an aggregate of no more than 50% of the total voting power and value of the stock of the foreign transferee corporation is owned directly, indirectly or constructively, immediately after the transaction by U.S. persons (x) who are officers or directors of the domestic transferred corporation, or (y) who owned at least 5% of the total voting power of the stock of the domestic transferred corporation immediately before the transaction;¹⁰⁷⁰ (iii) an active trade or business test (described below) is satisfied;¹⁰⁷¹ and (iv) each U.S. transferor who owns 5% or more of the total voting power and value of the stock of the foreign transferee corporation enters into a GRA with the IRS.¹⁰⁷²

Existing Treasury Regulations under section 367(a)(2) provide no additional exceptions.

¹⁰⁶⁸ See Treas. Reg. § 1.367(a)-3(b)(2).

¹⁰⁶⁹ See Treas. Reg. § 1.367(a)-3(c)(1)(i). For purposes of this test, transferees of stock or securities of a domestic transferred corporation that receive stock of a transferee foreign corporation are presumed to be U.S. persons. Treas. Reg. § 1.367(a)-3(c)(2). This presumption can only be rebutted with respect to a transferor that provides a statement under penalty of perjury representing that it is not a U.S. person and certain additional information. Treas. Reg. § 1.367(a)-3(c)(7).

¹⁰⁷⁰ See Treas. Reg. § 1.367(a)-3(c)(1)(ii).

¹⁰⁷¹ See Treas. Reg. § 1.367(a)-3(c)(1)(iv).

¹⁰⁷² See Treas. Reg. § 1.367(a)-3(c)(1)(iii)(B). A U.S. person who owns less than 5% of the total voting power or value of the stock of the transferee foreign corporation is not required to enter into a GRA to obtain tax-free treatment. Treas. Reg. § 1.367(a)-3(c)(1)(iii)(A). The IRS has informally indicated that the applicable regulations will

Moreover, if 10% or more of the total voting power or value of a domestic corporation is transferred by U.S. persons to a foreign corporation, U.S. persons participating in the stock transfer are entitled to the exception described above only if the transferred domestic corporation discloses certain information with its federal income tax return for the taxable year in which the transaction occurs.¹⁰⁷³

The active trade or business test has three components: (i) the transferee foreign corporation must have engaged in an active trade or business outside the United States for the entire 36-month period preceding the transaction;¹⁰⁷⁴ (ii) the transferors

be amended to confirm that transfers of foreign target stock by 5% U.S. shareholders in exchange for foreign acquirer stock in tax-free asset acquisitions will not be subject to GRAs under Treasury Regulation section 1.367(a)-3(c)(1)(iii)(B).

¹⁰⁷³ See Treas. Reg. § 1.367(a)-3(c)(6)(i).

¹⁰⁷⁴ See Treas. Reg. § 1.367(a)-3(c)(3)(i)(A). This test may be satisfied even if the foreign transferee corporation acquires the requisite 36-month active trade or business, provided that the business assets were not owned by the domestic transferred corporation at any time during the preceding 36-month period and the principal purpose of the acquisition was not to satisfy the active trade or business requirement. Treas. Reg. § 1.367(a)-3(c)(3)(ii)(A). See, e.g., P.L.R. 2011-41-011 (Oct. 14, 2011) (foreign transferee acquired a foreign corporation which has been engaged directly or through one or more qualified subsidiaries or qualified partnerships in the active conduct of a trade or business for 36 months, thereby allowing the transferee to satisfy the active trade or business test). The active trade or business may be carried on directly by the foreign transferee corporation or by a qualified subsidiary or qualified partnership. Treas. Reg. § 1.367(a)-3(c)(3)(i). For these purposes, a qualified subsidiary is a foreign corporation whose stock is at least 80% owned (by total voting power and value) directly or indirectly by the foreign transferee corporation. Treas. Reg. § 1.367(a)-3(c)(5)(vii). A qualified partnership is a partnership in which (i) the transferee foreign corporation has active and substantial management functions as a partner with regard to the partnership business or has a 25% or greater interest in the partnership's capital or profits, and (ii) no U.S. target company or affiliate (as defined in section 1504, but without the exceptions under section 1504(b) and substituting "5%" for "80%" where it appears therein) has held a 5% or greater interest in the partnership's capital or profits at any time during the 36-month period prior to the transfer. Treas. Reg. § 1.367(a)-3(c)(5)(viii).

and the transferee foreign corporation must not intend to substantially dispose of or discontinue such trade or business;¹⁰⁷⁵ and (iii) the substantiality test must be satisfied, *i.e.*, the value of the foreign transferee corporation must equal or exceed the value of the domestic transferred corporation at the time of the transaction.¹⁰⁷⁶

The substantiality test includes an anti-stuffing rule designed to prevent foreign transferee corporations from acquiring assets for the sole purpose of satisfying the test.¹⁰⁷⁷ The anti-stuffing rule excludes certain assets acquired by the transferee during the 36-month period preceding the outbound transfer from the value of the transferee except in limited situations.¹⁰⁷⁸ Specifically, the transferee may not include assets acquired from the U.S. target or its affiliates.¹⁰⁷⁹ In addition, assets which are acquired outside the ordinary course of business are only included if the assets were not acquired for the principal purpose of satisfying the substantiality test, and either (i) the assets (or their proceeds) do not produce and are not held for the production of passive income when outbound transfer of the U.S. target occurs, or (ii) the assets consist of an equity interest in a qualified subsidiary or partnership.¹⁰⁸⁰

Commentators have criticized the anti-stuffing provision for requiring unnecessarily complex analysis, especially in transactions involving corporations of approximately equal size.¹⁰⁸¹ Of particular concern is the blanket exclusion of all

¹⁰⁷⁵ See Treas. Reg. § 1.367(a)-3(c)(3)(i)(B).

¹⁰⁷⁶ See Treas. Reg. § 1.367(a)-3(c)(3)(i)(C).

¹⁰⁷⁷ Treas. Reg. § 1.367(a)-3(c)(3)(i)(C).

¹⁰⁷⁸ Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B).

¹⁰⁷⁹ Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B).

¹⁰⁸⁰ Treas. Reg. § 1.367(a)-3(c)(3)(iii)(B). See C.C.A. 2007-51-024 (Dec. 21, 2007) (anti-stuffing rule took into account majority shareholder's contribution of debt to foreign acquirer's capital but disregarded foreign acquirer's cash from ordinary course sales). See generally Richard W. Bailine, *IRS Must Be Bluffing on Anti-Stuffing*, 35 Corp. Tax'n 28 (Mar./Apr. 2008).

¹⁰⁸¹ For an excellent discussion of this issue, see Robert J. Staffaroni, *Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations*, 52 Tax Law. 523 (1999).

passive assets, which generally applies to all cash and portfolio investments of a corporation, as well as 50% or smaller interests in joint ventures.¹⁰⁸² In addition, the rule imposes upon taxpayers the significant burden of proving a lack of bad intent regarding certain asset acquisitions.

It is worth noting, however, that the anti-stuffing rule, by its terms, does not require domestic corporations that shed assets prior to the transfer to add those assets back when making the determination under the substantiality test. In fact, the preamble to the 1996 regulations indicates that the IRS considers the rule to be a mechanical one.¹⁰⁸³ As a result, the U.S. target could potentially reduce its value for purposes of satisfying the substantiality test by making an asset distribution to its shareholders before the transfer.¹⁰⁸⁴ It is important to note, however, that such a distribution must be structured so as not to violate the substantially all requirement if the transaction were structured as a C, A2D or A2E reorganization.

The target shareholders are generally taxed on such a distribution, unless the distribution satisfies the section 355 requirements. Thus, the U.S. target could potentially satisfy the substantiality test and at the same time avoid a shareholder tax by distributing an unwanted business. However, as a practical matter, structuring an acquisition following a tax-free spinoff that would satisfy both the “anti-Morris Trust” provisions of section 355(e)

¹⁰⁸² Notice 88-22, 1988-1 C.B. 429.

¹⁰⁸³ T.D. 8702, 1997-1 C.B. 92 (“The IRS and Treasury Department are aware that the active trade or business test is *mechanical in nature* and thus, in limited circumstances, a taxpayer may demonstrate an ongoing and substantial trade or business even though it fails to meet the test set forth in the final regulations.”) (emphasis added).

¹⁰⁸⁴ See D. Kevin Dolan, Patrick Jackman, Ronald Dabrowski & Philip Tretiak, *U.S. Taxation of International Mergers, Acquisitions, and Joint Ventures*, at ¶ 9.01[3][b][iv] (2007) (Vodafone/AirTouch merger agreement permitted pre-acquisition distribution to AirTouch’s shareholders to reduce AirTouch’s value if parties could not obtain IRS ruling on substantiality test, which they ultimately received).

and the section 367(a) stock ownership rules is a bit like threading a needle.¹⁰⁸⁵

Perhaps due to the complex and mechanical nature of the rules governing U.S. stock transfers, the IRS was granted regulatory authority to issue private letter rulings confirming that certain transactions qualify for an exception to the general section 367(a) gain recognition rule, and the IRS has in fact issued several such rulings.¹⁰⁸⁶ Such a ruling may be issued if: (i) a taxpayer is in substantial, albeit not technical, compliance with the active trade or business test, or (ii) a taxpayer is unable to qualify for the exception for transfers of U.S. stock or securities due to the application of stock ownership attribution rules.¹⁰⁸⁷ Notably, these rulings have permitted the acquirer to take the value of its passive assets into account in making the substantiality determination, provided they were not acquired in a transaction undertaken “for the purpose” of satisfying the substantiality test.¹⁰⁸⁸

The IRS has also ruled privately that the substantiality test was satisfied in an acquisition by a privately held foreign acquirer that was conditioned upon the receipt of an investment bank’s

¹⁰⁸⁵ See D. Kevin Dolan, *International M&A Update: Tax Strategies for Corporate Acquisitions, Dispositions, Spinoffs, Joint Ventures, Financings, Reorganizations & Restructurings 2000*, Practising Law Institute (Nov. 2, 2000).

¹⁰⁸⁶ See Treas. Reg. § 1.367(a)-3(c)(9).

¹⁰⁸⁷ See Treas. Reg. § 1.367(a)-3(c)(9)(i), (ii). See also P.L.R. 2007-09-054 (Mar. 2, 2007) (acquirer’s market capitalization exceeded target’s for significant amount of time before announcement of merger, and continued to exceed target’s market capitalization after announcement when measured on an outstanding share basis); P.L.R. 99-03-048 (Oct. 21, 1998) (value of acquirer’s stock was greater than U.S. target’s stock during representative pre-merger period); P.L.R. 99-29-039 (Apr. 12, 1999) (AirTouch-Vodafone ruling found substantial compliance despite fact that acquirer’s offer to pay premium drove market value of target stock above market value of acquirer stock); P.L.R. 98-49-014 (Sept. 4, 1998) (Daimler-Chrysler ruling); P.L.R. 97-20-024 (Feb. 12, 1997) (acquirer dominated on the basis of gross operating revenues, assets and employees).

¹⁰⁸⁸ See P.L.R. 2000-20-018 (Feb. 15, 2000); P.L.R. 99-29-039 (Apr. 12, 1999); P.L.R. 99-03-048 (Oct. 12, 1998); P.L.R. 98-49-014 (Sept. 4, 1998).

valuation finding that the fair market value of the foreign acquirer stock in the hands of the original foreign acquirer shareholders was equal to, or greater than, the merger consideration to be received by the U.S. target shareholders.¹⁰⁸⁹ The IRS will not, however, rule on whether the principal purpose of an acquisition was to satisfy the active trade or business test, including the substantiality test.

Finally, in April 2005, the NYSBA issued a report urging the elimination of Treasury Regulation section 1.367(a)-3(c).¹⁰⁹⁰ The report concluded that this provision (i) does not deal directly with the targeted abuse of avoiding corporate (not shareholder) tax, and (ii) did not succeed in any event in preventing corporate expatriations.¹⁰⁹¹ In the preamble accompanying the first two sets of temporary regulations under section 7874 (discussed below), the IRS and the Treasury Department announced that they are considering possible changes to Treasury Regulation section 1.367(a)-3(c) in light of the enactment of section 7874.¹⁰⁹²

c. Effect of Subsequent Transactions on GRAs

A U.S. person executing a GRA is required to recognize gain on an Affected Stock Transfer if the following events (“Triggering Events”) occur during the term of the agreement: (i) the transferee foreign corporation disposes of the transferred stock or securities;¹⁰⁹³ (ii) the transferee foreign corporation

¹⁰⁸⁹ P.L.R. 2000-20-018 (Feb. 15, 2000).

¹⁰⁹⁰ See NYSBA, *Report with Respect to Regs. Section 1.367(a)-3(c)*, reprinted in 2005 TNT 80-14 (Apr. 27, 2005).

¹⁰⁹¹ See NYSBA, *Report with Respect to Regs. Section 1.367(a)-3(c)*, reprinted in 2005 TNT 80-14 (Apr. 27, 2005). In the event the provision is retained, the NYSBA recommended that serious consideration be given to conforming the provision with section 7874 (discussed below) in order to reduce the significant complexity that would otherwise result from different but overlapping rules.

¹⁰⁹² See T.D. 9265, 2006-2 CB. 1; T.D. 9238, 2006-1 C.B. 408. The preamble to the Final Section 367 Regulations also indicated that the government is studying the interaction of Treasury Regulation section 1.367(a)-3(c) and section 7874. See T.D. 9243, 2006-1 C.B. 475.

¹⁰⁹³ See Treas. Reg. § 1.367(a)-8(j)(1). Certain stock transfers qualifying for nonrecognition treatment may not be considered Triggering

disposes of substantially all of the assets of the transferred corporation;¹⁰⁹⁴ (iii) the U.S. transferor in the initial transfer disposes of the transferee foreign corporation stock;¹⁰⁹⁵ (iv) the U.S. transferor that is a member of a consolidated group ceases to be a member of such group or the U.S. transferor becomes a member of a consolidated group;¹⁰⁹⁶ (v) the U.S. person goes out of existence (or dies, in the case of an individual) unless certain exceptions apply;¹⁰⁹⁷ or (vi) the U.S. transferor fails to comply in any material respect with any requirement of the GRA regulations.¹⁰⁹⁸ A U.S. person who has filed a GRA must certify on an annual basis, for five taxable years following the taxable year of the transfer, that no Triggering Events have occurred.¹⁰⁹⁹ If a Triggering Event occurs during the term of the agreement, the U.S. person must file an amended return for the year of the transfer and recognize thereon the gain realized but not recognized on the initial transfer plus interest.¹¹⁰⁰ Alternatively, a U.S. person may elect to recognize the gain realized on the initial transfer in the year of the Triggering Event, together with interest thereon from the year of the transfer.¹¹⁰¹

Events if, in addition to the satisfaction of other requirements, a new GRA is entered into. *See* P.L.R. 2000-15-038 (Jan. 12, 2000) (transaction will not trigger gain recognition under Treasury Regulation section 1.367(a)-3T(g), the predecessor to Treasury Regulation section 1.367(a)-8, if it qualifies as a nonrecognition transaction, a new GRA is entered into, and certain additional requirements are satisfied). Notably, a 2002 private ruling held that a merger of a corporation into an LLC to effect a change in entity classification would be treated as a liquidation into the LLC's parent corporation that would not trigger the merging corporation's existing GRA. *See* P.L.R. 2003-05-017 (Oct. 23, 2002).

¹⁰⁹⁴ *See* Treas. Reg. § 1.367(a)-8(j)(2).

¹⁰⁹⁵ *See* Treas. Reg. § 1.367(a)-8(j)(4).

¹⁰⁹⁶ *See* Treas. Reg. § 1.367(a)-8(j)(5), (6).

¹⁰⁹⁷ *See* Treas. Reg. § 1.367(a)-8(j)(7).

¹⁰⁹⁸ *See* Treas. Reg. § 1.367(a)-8(j)(8).

¹⁰⁹⁹ *See* Treas. Reg. § 1.367(a)-8(g).

¹¹⁰⁰ *See* Treas. Reg. § 1.367(a)-8(c)(1)(i), (iii)(A).

¹¹⁰¹ *See* Treas. Reg. § 1.367(a)-8(c)(1)(iii)(B). This election is made by filing a statement together with the GRA. Treas. Reg. § 1.367(a)-8(c)(2)(vi). The IRS has concluded that a taxpayer lacked reasonable cause for executing a GRA that misstated

In September, 2005, the IRS issued Notice 2005-74,¹¹⁰² which announced that the government would issue new regulations addressing the effect of an asset reorganization involving the acquisition of the assets of the U.S. transferor, the transferee foreign corporation or the transferred corporation on a preexisting GRA and establishing the conditions and requirements that would need to be satisfied for the GRA not to be triggered.¹¹⁰³ On February 5, 2007, the IRS issued proposed and temporary regulations adopting these rules with certain modifications and the inclusion of certain additional provisions (the “Temporary GRA Regulations”).¹¹⁰⁴ The IRS and Treasury finalized the Temporary GRA Regulations, with modifications, in February 2009 (the “Final GRA Regulations”).¹¹⁰⁵ The government has also provided a mechanism for taxpayers to amend their tax returns in order to provide the IRS with a GRA that properly states the fair market value of the transferred stock or securities on the transfer date.¹¹⁰⁶

the value of the transferred property by over \$55 million. *See* F.A.A. 2007-49-01F (Dec. 7, 2007).

¹¹⁰² 2005-2 C.B. 726.

¹¹⁰³ The NYSBA issued a report commenting on the notice and suggesting proposals for the regulations. *See* NYSBA, *Report with Respect to Notice 2005-74*, reprinted in 2006 TNT 97-20 (May 19, 2006).

¹¹⁰⁴ *See* T.D. 9311, 2007-1 C.B. 635. The Temporary GRA Regulations generally applied to GRAs entered into for transactions effected after March 7, 2007. *See* Temp. Reg. § 1.367(a)-8T(h)(1). However, for all open taxable years, taxpayers may apply the Temporary GRA Regulations to preexisting GRAs to the extent of any rules that were not already effective in Treasury Regulation section 1.367(a)-8. *See* Temp. Reg. § 1.367(a)-8T(h)(2).

¹¹⁰⁵ *See* T.D. 9446, 2009-1 C.B. 607. The Final GRA Regulations generally apply to GRAs entered into for transactions effected on or after March 13, 2009. *See* Treas. Reg. § 1.367(a)-8(r)(1)(i). *See also* *Corporate Reorganizations: Final Rules on Gain Recognition Agreements to Contain Broader Approach on Triggering*, Daily Tax Rep. (BNA), at G-12 (Dec. 11, 2008).

¹¹⁰⁶ *See* Directive on Examination Action with Respect to Certain Gain Recognition Agreements, LMSB-4-0510-017 (July 27, 2010). The directive provides relief to, among others, taxpayers who filed a GRA indicating that the fair market value of the transferred stock or securities was “available on request”, an invalid response under the Final GRA Regulations. *See* Lewis J. Greenwald & Joseph Ladocsi,

The discussion below addresses several important aspects of the Final GRA Regulations, noting important differences between the temporary and final regulations.¹¹⁰⁷

i. Subsequent Nonrecognition Transfers

The Temporary GRA Regulations provided specific exceptions for certain dispositions and other events that would otherwise require gain recognition under an existing GRA. These exceptions generally applied to dispositions that would qualify for nonrecognition treatment and required the U.S. transferor to enter into a new GRA with respect to the initial transfer for the remaining term of the existing GRA. The Final GRA Regulations retain the specific exceptions in the Temporary GRA Regulations and add a general exception (the “GRA General Exception”) for any disposition or other event that would otherwise constitute a Triggering Event if (i) the disposition is a nonrecognition transaction, including an exchange described in section 351(b) or 356 (even if all gain is recognized), (ii) a U.S. transferor retains a direct or indirect interest in the transferred stock or securities, and (iii) the transferor enters into a new GRA with respect to the initial transfer.¹¹⁰⁸ The new GRA is generally subject to the same terms

Manna From Heaving: LMSB Provides Important Relief for ‘Available on Request’ GRAs, 22 J. Int’l Tax’n 39 (Jan. 2011). Michael Danilack, the Deputy Commissioner (International) of the IRS Large Business and International Division, has stated that the IRS plans to withdraw this directive in the near future. See Robert Goulder, *IRS to Pull Corrective Gain Recognition Agreements Directive*, 134 Tax Notes 72 (Jan. 2, 2012).

¹¹⁰⁷ See generally Hal Hicks & Daniel McCall, *The Long and Winding (GRA) Road – Final Gain Recognition Agreement Regulations*, 35 Int’l Tax J. 15 (Sept./Oct. 2009); Nardi Bress, Carl Dubert, Tim Anson & Erik Rosenfeld, *What’s New with the GRA Temporary Regs?*, 18 J. Int’l Tax’n 13 (Oct. 2007); Nardi Bress, *The New § 1.367(a)-8T GRA Regulations*, 36 Tax Mgmt. Int’l J. 255 (June 8, 2007); *IRS Unveils Major Regulations Liberalizing Rules on Gain Recognition Agreements*, Daily Tax Rep. (BNA), at G-6 (Feb. 10, 2009).

¹¹⁰⁸ Treas. Reg. § 1.367(a)-8(k)(14). If, as a result of the disposition or other event, a foreign corporation acquired all or part of the transferred stock or securities (or substantially all the assets of the transferred corporation), the GRA General Exception applies only if the U.S. transferor owns at least 5% (applying the attribution rules of section 318) of the total vote and value of the foreign corporation’s

and conditions as the existing GRA, and must also describe the subsequent dispositions that would constitute Triggering Events and include a statement that the U.S. transferor will treat such dispositions as Triggering Events.¹¹⁰⁹

ii. Intercompany Dispositions

The Final GRA Regulations provide an exception for dispositions of transferee foreign corporation stock pursuant to an intercompany transaction not covered by a specific Triggering Event exception in which:¹¹¹⁰ (i) the basis of the transferee foreign corporation stock disposed of in the intercompany transaction does not exceed the sum of (x) the aggregate basis in the transferred stock or securities at the time of the initial transfer, (y) any increases to the basis of the transferred stock or securities by reason of gain recognized by the U.S. transferor in connection with the initial transfer, and (z) any increase to the basis of the transferee foreign corporation stock by reason of income inclusions by the U.S. transferor;¹¹¹¹ and (ii) the annual certification filed with respect to the existing GRA for the taxable year of the intercompany transaction includes a complete description of the intercompany transaction and a schedule illustrating how the basis

outstanding stock immediately after the disposition or other event. Treas. Reg. § 1.367(a)-8(k)(14)(ii). The 5% ownership condition “is intended to limit the application of the general exception in transactions where the U.S. transferor retains a minimal interest in the transferred stock or securities (or substantially all the assets) of the transferred corporation.” T.D. 9446, 2009-1 C.B. 607.

¹¹⁰⁹ Treas. Reg. § 1.367(a)-8(k)(14)(iii). A Triggering Event includes any other disposition or event that is inconsistent with the principles of the Triggering Event exceptions, including an indirect disposition of the transferred stock or securities or substantially all of the transferred corporation’s assets. Treas. Reg. § 1.367(a)-8(k)(14)(iii).

¹¹¹⁰ The Temporary GRA Regulations provided that a complete or partial taxable disposition by the U.S. transferor of the transferee foreign corporation stock received in the initial transfer generally requires the U.S. transferor to recognize gain under the GRA.

¹¹¹¹ Treas. Reg. § 1.367(a)-8(k)(12)(i)(A). To satisfy this requirement, the U.S. transferor can elect to reduce the transferee foreign corporation stock basis, effective immediately before the intercompany transaction. Treas. Reg. § 1.367(a)-8(k)(12)(i)(A).

requirement is satisfied.¹¹¹² If the intercompany transaction exception applies, the U.S. transferor remains subject to the existing GRA in an amount equal to the intercompany item,¹¹¹³ and a subsequent disposition or other event that requires a U.S. transferor to take into account the intercompany item related to the intercompany transaction does not constitute a Triggering Event.¹¹¹⁴ Instead, the GRA terminates without further effect or the amount of gain subject to the GRA is reduced in the case of a partial disposition.¹¹¹⁵

iii. GRA Termination Events

The Final GRA Regulations retain the termination rule in the Temporary GRA Regulations whereby, under certain circumstances, an existing GRA terminates without further effect if the U.S. transferor reacquires the transferred stock or securities, or the U.S. transferor disposes of the transferee foreign corporation stock received in the initial transfer (the “termination rule”).¹¹¹⁶

¹¹¹² Treas. Reg. § 1.367(a)-8(k)(12)(i)(B). The intercompany transaction exception applies only to the extent the intercompany transaction gives rise to an intercompany item, as defined in Treasury Regulation section 1.1502-13(b)(2). If the intercompany item is a gain, the existing GRA must be divided into (i) an agreement that remains with the U.S. transferor equal to the amount of the intercompany item, and (ii) an agreement that moves to the acquiring member in an amount equal to the remaining amount of the existing GRA.

Treas. Reg. § 1.367(a)-8(o)(6). If the intercompany item is a loss, the U.S. transferor remains subject to the entire GRA.

¹¹¹³ Treas. Reg. § 1.367(a)-8(k)(12).

¹¹¹⁴ Treas. Reg. § 1.367(a)-8(o)(6).

¹¹¹⁵ Treas. Reg. § 1.367(a)-8(o)(6).

¹¹¹⁶ See Treas. Reg. § 1.367(a)-8(o); see also T.D. 9311, 2007-1 C.B. 635. One condition to the termination rule is that the basis of the transferred stock or securities in the hands of the U.S. transferor immediately following the acquisition or the basis of the transferee foreign corporation stock disposed of by the U.S. transferor must not exceed the U.S. transferor’s basis in the transferred stock or securities at the time of the initial transfer. While the Temporary GRA Regulations generally permitted the U.S. transferor to reduce the basis of the transferred stock or securities, and further permitted an increase to the basis of other stock or securities in the transferred corporation by a corresponding amount, not to exceed fair market

iv. Liquidation Involving U.S. Transferor

The Final GRA Regulations provide that a U.S. transferor's disposition of foreign transferee corporation stock in a section 332 liquidation will not constitute a Triggering Event if the corporate distributee is a domestic corporation that enters into a new GRA designating the domestic corporate distributee as the U.S. transferor.¹¹¹⁷

v. Asset Reorganization Involving Transferee Foreign Corporation

The Final GRA Regulations provide that, if the transferee foreign corporation stock received in the initial transfer is transferred to a domestic acquiring corporation pursuant to an asset reorganization,¹¹¹⁸ the exchanges will not constitute Triggering Events if the domestic acquiring corporation enters into a new GRA designating the domestic acquiring corporation as the U.S. transferor.¹¹¹⁹ In addition, the Final GRA Regulations provide that transfers of stock or securities to a foreign acquiring corporation pursuant to an asset reorganization will not constitute Triggering Events if the U.S. transferor enters into a new GRA designating the foreign acquiring corporation as the transferee foreign corporation.¹¹²⁰

value, the Final GRA Regulations do not permit the U.S. transferor to increase the basis of other stock or securities of the transferred corporation. *See* T.D. 9446, 2009-1 C.B. 607.

¹¹¹⁷ *See* Treas. Reg. § 1.367(a)-8(k)(2).

¹¹¹⁸ An "asset reorganization" generally is a section 368(a)(1) reorganization involving an asset transfer from one corporation to another pursuant to section 361. *See* Treas. Reg. § 1.367(a)-8(b)(i).

¹¹¹⁹ *See* Treas. Reg. § 1.367(a)-8(k)(6)(i), (q)(2), Exs. 5-6.

¹¹²⁰ *See* Treas. Reg. § 1.367(a)-8(k)(6)(ii), (q)(2), Ex. 7. The Temporary GRA Regulations generally followed Notice 2005-74, which provided that a transferee foreign corporation's transfer of stock or securities of the transferred corporation to a foreign acquiring corporation will be a Triggering Event unless the U.S. transferor, its common parent, or the new common parent corporation, enters into a new GRA, and the U.S. transferor files the new GRA and a notice of the asset reorganization to the IRS with such transferor's next annual certification. *See* Notice 2005-74, § 3.03, 2005-2 C.B. 726.

The Temporary GRA Regulations provided an exception for a transfer of transferee foreign corporation stock by the U.S. transferor to a domestic corporation pursuant to an asset reorganization.¹¹²¹ The Final GRA Regulations do not include a specific exception for these outbound transfers, but the government expects the GRA General Exception to apply to such transfers.¹¹²²

vi. Asset Reorganization Involving Transferred Corporation

The Final GRA Regulations generally treat the disposition of substantially all of the transferred corporation's assets as a Triggering Event.¹¹²³ The Final GRA Regulations define a "disposition" as any transfer that would constitute a disposition for any purpose of the Code, other than the receipt of a property distribution with respect to stock to which section 301 applies (including by reason of section 302(d)).¹¹²⁴ The Final GRA Regulations also generally exempt transfers of substantially all of the transferred corporation's assets in an asset reorganization, provided that the U.S. transferor, enters into a new GRA.¹¹²⁵

The Final GRA Regulations determine whether substantially all of the transferred corporation's assets have been disposed of based on all the facts and circumstances.¹¹²⁶ Case law in this area holds that "[t]he 'substantially all' analysis begins with the fundamental premise that no precise numerical formula exists to determine the proportion of assets that constitute 'substantially all of the assets'."¹¹²⁷ Instead, the cases adopt a facts and circumstances analysis that focuses on the acquisition of operating

¹¹²¹ See T.D. 9311, 2007-1 C.B. 635.

¹¹²² See T.D. 9446, 2009-1 C.B. 607.

¹¹²³ See Treas. Reg. § 1.367(a)-8(j)(2).

¹¹²⁴ See Treas. Reg. § 1.367(a)-8(b)(1)(iii).

¹¹²⁵ See Treas. Reg. § 1.367(a)-8(k)(6)(iii), (q)(2), Ex. 8.

¹¹²⁶ See Treas. Reg. § 1.367(a)-8(b)(1)(x). The Temporary GRA Regulations adopted the interpretation of the substantially all requirement that applies under the C reorganization rules. See T.D. 9311, 2007-1 C.B. 635.

¹¹²⁷ *Viereck v. United States*, 3 Cl. Ct. 745, 753 (1983).

assets.¹¹²⁸ IRS advance ruling guidelines provide a stricter safe harbor under which the substantially all requirement is satisfied only if the acquired target corporation's assets represent at least (i) 90 percent of the fair market value of the net assets, and (ii) 70 percent of the fair market value of the gross assets, held by the target immediately prior to the acquisition (the "90/70 safe harbor").¹¹²⁹ The preamble to the Temporary GRA Regulations expressly states that an asset transfer may constitute a disposition of substantially all of a transferred corporation's assets even if such transfer does not satisfy the 90/70 safe harbor.¹¹³⁰

Subject to the same limitations that apply to transfers of transferred stock and securities, discussed above, transfers by the transferred corporation of substantially all of its assets pursuant to an asset reorganization will not be treated as a Triggering Event.¹¹³¹

vii. Receipt of Boot in Reorganization

The Final GRA Regulations provide that, if gain is recognized upon a disposition of the transferred corporation's stock or securities or substantially all of the transferred corporation's assets where a Triggering Event exception would otherwise apply, the U.S. transferor must recognize gain equal to the gain required to be recognized in connection with the disposition, up to the amount of gain subject to the GRA.¹¹³²

viii. Ordering Rule if Triggering Event Affects Multiple GRAs

The Final GRA Regulations provide an ordering rule to determine the amount of gain recognized under a GRA where a

¹¹²⁸ See, e.g., *Smother's v. United States*, 642 F.2d 894 (5th Cir. 1981) (15% of net assets represented "substantially all" of the assets because all the operating assets were transferred); Rev. Rul. 70-240, 1970-1 C.B. 81 (51% of gross assets represented "substantially all" of the assets because all the operating assets were transferred).

¹¹²⁹ See Rev. Proc. 77-37, 1977-2 C.B. 568, *amplified by* Rev. Proc. 86-42, 1986-2 C.B. 722.

¹¹³⁰ See T.D. 9311, 2007-1 C.B. 635.

¹¹³¹ See Treas. Reg. § 1.367(a)-8(k)(4).

¹¹³² Treas. Reg. § 1.367(a)-8(m).

disposition or other event requires gain to be recognized under multiple GRAs.¹¹³³ The ordering rule adopts a “first-in-time” approach, providing that gain must first be recognized under the GRA that relates to the earliest initial transfer, and so forth until gain has been recognized under each GRA.¹¹³⁴ Gain recognized under a GRA is determined after taking into account any increase in basis of the transferred stock or securities resulting from gain recognized under another GRA relating to an earlier initial transfer.¹¹³⁵

C. Outbound Inversions

Section 367(a), in connection with section 7874 (discussed below), generally denies nonrecognition treatment to so-called “inversion” transactions, *i.e.*, expatriations of the stock or assets of U.S. corporations. Inversions may be effected as stock expatriations or asset expatriations.¹¹³⁶ Depending on their form, inversions are generally taxable to either the shareholders of the expatriating company, the company itself, or both, under current law.¹¹³⁷

The two basic outbound inversion structures employed by U.S. corporations are described below.

¹¹³³ Treas. Reg. § 1.367(a)-8(c)(1)(ii).

¹¹³⁴ Treas. Reg. § 1.367(a)-8(c)(1)(ii).

¹¹³⁵ Treas. Reg. § 1.367(a)-8(c)(1)(ii).

¹¹³⁶ Connecticut-based Stanley Works, Inc. proposed a stock expatriation in which its U.S. parent would become a subsidiary of a Bermuda corporation, although it subsequently abandoned the transaction in the wake of public criticism. Examples of completed stock expatriations include McDermott (Panama), Helen of Troy (Bermuda), Tyco (Bermuda), Everest Reinsurance Holdings (Bermuda), Fruit of the Loom (Cayman Islands), PX Re (Bermuda), TransOcean Sedco Forex (Cayman Islands), Applied Power (Bermuda), Accenture (Bermuda), Foster Wheeler (Bermuda), Ingersoll-Rand (Bermuda), and Cooper Industries (Bermuda).

Although less common, several asset expatriations have also been completed, including White Mountain Insurance Group (Bermuda), Playstar (Antigua), and Xoma (Bermuda).

¹¹³⁷ See generally Office of Tax Policy, Dep’t of Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (May 2002), available at <http://www.treas.gov/press/releases/docs/inversion.pdf>.

1. Stock Inversions

In a typical stock expatriation, the following steps occur:

- A new foreign corporation is formed as a first-tier subsidiary of a U.S. corporation or an existing first-tier foreign subsidiary is selected.
- The foreign subsidiary forms a merger subsidiary as a second-tier subsidiary of the U.S. corporation.
- The U.S. corporation merges with the merger subsidiary in a reverse subsidiary merger, with the U.S. corporation as the surviving entity.
- The outstanding shares of the U.S. corporation are converted into shares of the foreign corporation in the merger.¹¹³⁸

Shareholders of the U.S. corporation will generally recognize taxable gain (but not loss) on the exchange of their shares in the U.S. corporation for shares in the foreign corporation.¹¹³⁹ A limited exception to shareholder gain recognition applies to expatriations in which an existing foreign subsidiary becomes the parent if the following conditions are satisfied: (i) no more than 50% of the vote and value of the foreign corporation stock is received, in the aggregate, by U.S. shareholders of the U.S. corporation,¹¹⁴⁰ (ii) no more than 50% of the vote and value of foreign corporation stock is owned, in the aggregate, by U.S. persons that were officers, directors, or 5% shareholders of the U.S. corporation prior to the merger,¹¹⁴¹ (iii) each U.S. person that is a 5% shareholder of the foreign corporation immediately after the merger enters into a 5-year gain recognition agreement with respect to the U.S. corporation stock it

¹¹³⁸ The foreign corporation's shares in the merger subsidiary are converted into shares of the U.S. corporation in the merger.

¹¹³⁹ I.R.C. § 367(a); Treas. Reg. § 1.367(a)-3.

¹¹⁴⁰ Treas. Reg. § 1.367(a)-3(c)(1)(i).

¹¹⁴¹ Treas. Reg. § 1.367(a)-3(c)(1)(ii)

exchanged,¹¹⁴² and (iv) the foreign corporation was engaged in a substantial non-U.S. active trade or business during the entire 36-month period immediately prior to the merger.¹¹⁴³ The U.S. corporation will not recognize corporate-level taxable gain on the expatriation under current law because, as the survivor of the merger, the U.S. corporation's assets remain subject to U.S. tax.¹¹⁴⁴

2. Asset Inversions

In an outbound asset inversion, a U.S. corporation transfers all of its assets and liabilities to a foreign subsidiary in exchange for the foreign subsidiary's shares and the foreign subsidiary's assumption of the liabilities, and the U.S. corporation makes a liquidating distribution of the foreign subsidiary shares to its shareholders. This outbound asset transfer may be accomplished by merger, or under state law conversion and continuation procedures.

A U.S. corporation generally will be subject to corporate level tax on the built-in gain inherent in its assets at the time of the outbound merger under current law;¹¹⁴⁵ shareholders of the U.S. corporation will generally not recognize taxable gain or loss on their receipt of foreign subsidiary shares.¹¹⁴⁶ The U.S.

¹¹⁴² Treas. Reg. § 1.367(a)-3(c)(1)(iii).

¹¹⁴³ Treas. Reg. § 1.367(a)-3(c)(1)(iv). An active trade or business may include a business acquired by the foreign corporation, other than a business acquired from the U.S. corporation or its 50% affiliates, or a business acquired for the purpose of satisfying the active trade or business test. *See* Treas. Reg. § 1.367(a)-3(c)(3)(ii)(A). The fair market value of the foreign corporation's business must at least equal the fair market value of the U.S. corporation's business. *See* Treas. Reg. § 1.367(a)-3(c)(3)(i)(C) and (iii).

¹¹⁴⁴ The existence of the merger subsidiary is disregarded as the transitory means of transferring the U.S. corporation shares to the foreign corporation. *See* Rev. Rul. 73-427, 1967-2 C.B. 144.

¹¹⁴⁵ I.R.C. § 367(a). A limited exception, which would generally not apply to the standard inversion transaction, permits a U.S. corporation's transfer in a reorganization of certain property for use in an active foreign trade or business if, among other things, 5 or fewer domestic corporations control the transferor. I.R.C. § 367(a)(3)(A) and (a)(5); Temp. Reg. § 1.367(a)-2T.

¹¹⁴⁶ *See* I.R.C. §§ 354, 367(a); Treas. Reg. § 1.367(a)-3(d)(3), Ex. 12.

corporation's tax cost may be mitigated if its assets include stock in CFC subsidiaries, as gain with respect to such stock will be characterized as foreign source dividend income under section 1248 that will make foreign tax credits available.¹¹⁴⁷ If section 7874 does not apply, the foreign corporation is generally not subject to U.S. tax after the expatriation (assuming it engages in no new U.S. business).

3. Anti-Inversion Rules Under Section 7874

Section 7874, which was enacted as part of the 2004 Tax Act to augment the section 367 outbound stock and asset transfer rules, has had a chilling effect on outbound inversions.¹¹⁴⁸ Section 7874 contains two separate rules that apply to different degrees of identity of stock ownership between shareholders of a pre-inversion domestic corporation and the foreign corporation that acquires its assets or stock. These rules are designed to distinguish transactions with a primary tax avoidance motive from those effected to combine U.S. and foreign businesses and acquisitions by foreign parties. Section 7874 generally applies to transactions completed after March 4, 2003.¹¹⁴⁹

¹¹⁴⁷ I.R.C. §§ 902(a) and (b), 1248(a).

¹¹⁴⁸ See generally, Eric Solomon, *Corporate Inversions: A Symptom of Larger Tax System Problems*, 2012 TNT 182-6 (Sept. 17, 2012) (predicting that, although section 7874 has reduced inversion activity, inversions of U.S. corporations will continue through acquisitions of U.S. corporations by foreign corporations or combinations of U.S. corporations with foreign corporations); Willard B. Taylor, *A Comment on Eric Solomon's Article on Corporate Inversions*, 2012 TNT 190-13 (Oct. 1, 2012) (arguing that the core issue with inversions, which has not been sufficiently emphasized, is that inversions reduce U.S. tax liability through earnings stripping transactions); Kimberly S. Blanchard, *Blanchard Adds to the Inconvenient Truth About Corporate Inversions*, 2012 TNT 146-12 (July 25, 2012) (since the enactment of section 7874, tax practitioners have learned to counsel clients focused on non-U.S. markets not to incorporate in the U.S.).

¹¹⁴⁹ I.R.C. § 7874(a)(2)(B), flush language. If a transaction qualifies as an inversion transaction under section 7874, but the foreign corporation had acquired directly or indirectly more than half of the U.S. corporation's properties, on or before March 4, 2003, the transaction will not be treated as an inversion transaction for purposes of section 7874.

a. 80% or Greater Shareholder Overlap

If a U.S. corporation becomes a subsidiary of a foreign corporation, or otherwise transfers substantially all¹¹⁵⁰ of its properties to a foreign corporation pursuant to a plan or a series of related transactions,¹¹⁵¹ the foreign corporation will be treated as a U.S. corporation for all U.S. federal income tax purposes if (i) the former shareholders of the U.S. corporation hold 80% or more of the vote or value of the foreign corporation after the transaction (the “80% test”), and (ii) the business activities of the foreign corporation and its 50% affiliates (together, the “expanded affiliated group”) in the foreign corporation’s country of incorporation are not substantial compared to the total worldwide business activities of the expanded affiliated group (the “foreign business activities test”).¹¹⁵² Treating the new foreign parent as a U.S. corporation would deny the above described benefits of an

The Obama Administration has proposed revising the section 163(j) “earnings stripping rules” to limit the deductibility of interest paid by expatriated entities to related foreign corporations. *See* DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 92-93, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. For expatriated entities, the proposal would eliminate the debt-to-equity safe harbor, would generally reduce the 50% of adjusted taxable income threshold to 25% of adjusted taxable income, and would limit carryforward for disallowed interest to ten years and eliminate the carryforward of excess limitation. *See* DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 92-93, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

¹¹⁵⁰ Although section 7874 does not define “substantially all,” the Conference Report states that the Treasury Secretary will be expected to issue regulations defining substantially all in this context and would not be bound by interpretations of this term in other contexts in the Code. *See* H.R. Rep. No. 108-755, at 346 (2004) (Conf. Rep.).

¹¹⁵¹ A “plan” is deemed to exist if the foreign corporation directly or indirectly acquires substantially all of a domestic corporation’s properties during the 4 year period beginning on the date that is 2 years before the 80% test is satisfied. I.R.C. § 7874(c)(3).

¹¹⁵² I.R.C. § 7874(a)(2)(B), (b).

inversion, although the target shareholders would not recognize any gain.¹¹⁵³

b. Transactions Involving at Least 60% Identity of
Stock Ownership

If, under the same test, the identity of stock ownership after an inversion is at least 60% but less than 80% (the “60% test”), and the new foreign parent expanded affiliated group fails to satisfy the foreign business activities test, the foreign parent will be respected as a foreign corporation for U.S. federal income tax purposes, but any gain the U.S. corporation recognizes in connection with the transaction, except with respect to certain transfers of inventory and similar property, generally cannot be offset by net operating losses for a 10-year period following the transaction.¹¹⁵⁴ These same consequences apply to partnership transactions in which (i) a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership after the acquisition, (ii) at least 60% of the stock of the foreign corporation is owned by former partners of the domestic partnership after the acquisition, and (iii) the foreign corporation’s expanded affiliated group fails to satisfy the foreign business activities test.¹¹⁵⁵ The applicable limitations on gain recognition would apply at the partner level.¹¹⁵⁶

¹¹⁵³ See H.R. Rep. No. 108-755, at 349 (2004) (Conf. Rep.).

¹¹⁵⁴ I.R.C. § 7874(a)(1), (d)(1), (e)(1). Specifically, any corporate level income or gain required to be recognized under section 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation to a related foreign person as part of or after the inversion transaction may not be reduced by any tax attributes (*e.g.*, net operating losses). See H.R. Rep. No. 108-755, at 350 (2004) (Conf. Rep.). Although foreign tax credits may be used, their utility is limited since the inversion gain is treated as U.S. source income. See I.R.C. § 7874(e)(1).

¹¹⁵⁵ See I.R.C. § 7874(a)(2)(A)(i), (B)(ii)(II), (B)(iii).

¹¹⁵⁶ I.R.C. § 7874(e)(2). For a cogent report on various issues involving section 7874, see NYSBA, *Report on Temporary Treasury Regulations Section 1.7874-1T*, reprinted in 2006 TNT 56-32 (Mar. 22, 2006).

c. Additional Statutory Provisions

Section 7874 provides that stock held by a member of the expanded affiliated group will be disregarded when analyzing whether the 80% test or the 60% test is satisfied (the “affiliate-owned stock rule”).¹¹⁵⁷ Further, transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid section 7874 will be disregarded,¹¹⁵⁸ and no provision of law may be construed, by reason of any U.S. treaty obligation, as an exemption from section 7874.¹¹⁵⁹ More generally, the Treasury Secretary has been granted broad authority to prevent the avoidance of section 7874 through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or transactions designed to have persons cease to be (or not become) expanded affiliated group members or related persons,¹¹⁶⁰ and may treat certain non-stock instruments as stock, and stock as not stock, where necessary to carry out the purpose of section 7874.¹¹⁶¹

As discussed below, the government issued final regulations in May 2008 addressing the affiliate-owned stock rule and repropose temporary regulations in June 2009 (the “2009 temporary regulations”) addressing (i) the foreign business

¹¹⁵⁷ I.R.C. § 7874(c)(2)(A). Stock sold in a related public offering will also be disregarded. See I.R.C. § 7874(c)(2)(B).

¹¹⁵⁸ I.R.C. § 7874(c)(4).

¹¹⁵⁹ I.R.C. § 7874(f).

¹¹⁶⁰ I.R.C. § 7874(g).

¹¹⁶¹ I.R.C. § 7874(c)(6). IRS officials have previously acknowledged that the language of section 7874 may extend beyond its intended scope. See *Corporate Inversions: Jobs Act Inversion Crackdown Language Under Scrutiny by Congress, Administration*, Daily Tax Rep. (BNA), at G-15 (Jan. 24, 2005) (then-Deputy Treasury International Tax Counsel Carl Dubert stating that section 7874 is not confined to traditional inversions and may apply to transactions involving foreign owned U.S. companies with more than one owner where the owners contribute the U.S. company’s stock to a foreign holding company); *Beware Corporate Inversion Rules’ Scope, U.S. Tax Officials Warn*, 2005 TNT 14-10 (Jan. 24, 2005) (then-IRS Associate Chief Counsel (International) Hal Hicks stating that section 7874 can “catch” some internal restructurings of foreign multinational corporations with U.S. subsidiaries, depending on subsidiaries’ affiliation with parent).

activities test, (ii) the application of section 7874 to certain partnerships, options and similar interests, (iii) calculation of the 60%/80% foreign corporation ownership threshold (the “by reason of standard”), and (iv) certain transactions that have the purpose of avoiding section 7874.¹¹⁶²

d. 2008 Final Regulations

In May 2008, the Treasury Department issued final Treasury Regulations (the “2008 final regulations”) regarding the application of the affiliate-owned stock rule in determining whether a corporation is subject to section 7874.¹¹⁶³ The preamble to the 2005 temporary regulations explained that Congress intended to accomplish two principal objectives with the affiliate-owned stock rule. First, Congress intended to apply the 60% test and the 80% test to prevent avoidance of section 7874 when it should otherwise properly apply, including situations involving the use of so-called “hook stock.”¹¹⁶⁴ Second, Congress sought to prevent the statute from applying to certain transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly owned domestic subsidiary into a new wholly owned controlled foreign corporation. In the absence of such a rule,

¹¹⁶² See T.D. 9453, 2009-2 C.B. 114. *See generally* *New Rules on Corporate Inversions Seen As Effort to Widen Reach of Section 7874*, Daily Tax Rep. (BNA), at G-5 (June 12, 2009); *IRS Issues Corporate Inversion Guidance Concerning Surrogate Foreign Corporations*, Daily Tax Rep. (BNA), at G-4 (June 11, 2009). The 2009 temporary regulations generally apply to acquisitions completed on or after June 9, 2009. Temp. Reg. § 1.7874-2T(o).

¹¹⁶³ See T.D. 9399, 2008-1 C.B. 1157. *See generally* *Corporate Inversions: IRS Issues Final Rules on Affiliate Stock in Corporate Inversions Under Section 7874*, Daily Tax Rep. (BNA) (May 20, 2008).

¹¹⁶⁴ See T.D. 9238, 2006-1 C.B. 408. “Hook stock” is stock of an acquiring foreign corporation held by an entity that is at least 50 percent owned (by vote or value), directly or indirectly, by such acquiring corporation. *See* Treas. Reg. § 1.7874-1(d). If hook stock were respected as stock of the foreign acquiring corporation, a taxpayer could potentially effect an inversion and take the position that section 7874 did not apply if hook stock accounted for over 40 percent of the value and voting power of the foreign corporation’s stock.

Congress recognized that section 7874 could apply to internal group restructuring transactions involving the transfer of a wholly owned domestic corporation (or its assets) to a wholly owned foreign corporation, without a change in the parent corporation of the group.¹¹⁶⁵

To delineate those situations in which affiliate-owned stock will (and will not) be taken into account in determining the percentage of continuing ownership by former shareholders of the U.S. corporation, the final regulations provide, as a general rule, that affiliate-owned stock is excluded from both the numerator and the denominator of the fraction that determines the stock ownership percentage and whether or not section 7874 applies.¹¹⁶⁶ This rule prevents the use of hook stock (and other similar techniques) to remove an otherwise properly covered transaction from the scope of section 7874.

The final regulations provide limited exceptions to this general rule under which affiliate-owned stock (other than hook stock) will be counted in the denominator (but not the numerator) of the fraction that determines the stock ownership percentage.¹¹⁶⁷ These exceptions (so-called “special rules”) prevent section 7874 from applying to (i) certain transactions occurring as part of an internal group restructuring involving a U.S. entity, and (ii) certain acquisitive business transactions between unrelated parties where the former shareholders or partners of the U.S. entity have a minority interest in the acquired properties after the acquisition.¹¹⁶⁸

¹¹⁶⁵ See T.D. 9238, 2006-1 C.B. 408.

¹¹⁶⁶ See Treas. Reg. § 1.7874-1(b). Commentators argued that the ownership fraction should exclude section 1504(a)(4) preferred stock, noting that it is excluded in determining expanded affiliated group status and arguing that, due to such stock’s debt-like nature, it should not be treated as stock for any purpose of section 7874. The government rejected this argument, pointing out in the preamble to the final regulations that Congress has expressly stated that section 1504(a)(4) preferred stock is not treated as stock in several Code provisions, including certain provisions of section 7874, and specifically decided not to exclude such preferred stock from the ownership fraction. See T.D. 9399, 2008-1 C.B. 1157.

¹¹⁶⁷ Inclusion of affiliate-owned stock solely in the denominator reduces the chance that the 60% test or the 80% test will be satisfied.

¹¹⁶⁸ See T.D. 9399, 2008-1 C.B. 1157.

With respect to internal group restructurings, the special rule applies if the common parent of the expanded affiliated group held, directly or indirectly, at least 80 percent of the stock (by vote and value) or the capital and profits interest, as applicable, of the U.S. entity before the acquisition, and holds at least 80 percent of the stock (by vote and value) of the foreign acquiring corporation after the acquisition.¹¹⁶⁹ In the case of transactions between unrelated parties, the special rule applies to the acquisition of a U.S. entity (or its assets) by a foreign corporation where, after the acquisition, the former shareholders or partners of the U.S. entity own, in the aggregate and directly or indirectly, 50 percent or less of the stock (by vote or value) of any expanded affiliated group member that includes the acquiring foreign corporation.¹¹⁷⁰ The final regulations do not take hook stock into account in determining the ownership percentage of an entity for purposes of determining whether one of the special rules applies or in applying the special rule itself.¹¹⁷¹

e. 2009 Temporary Regulations

In June 2009, the Treasury Department issued temporary regulations principally addressing the foreign business activities test, the application of section 7874 to certain partnerships, options and similar interests, calculation of the 60%/80% foreign corporation ownership threshold, and certain transactions that have the purpose of avoiding section 7874.¹¹⁷²

¹¹⁶⁹ See Treas. Reg. § 1.7874-1(c)(2). The 2005 temporary regulations also required that, after the acquisition, non-members of the expanded affiliated group could not own, by reason of holding stock or a capital or profits interest in the U.S. entity, more than 20 percent of the stock (by vote or value) of the foreign corporation. See Former Temp. Reg. § 1.7874-1T(c)(1). The preamble to the final regulations states that the government agreed with a commentator that the relevant standard should look solely to the stock ownership of the expanded affiliated group's common parent both before and after the acquisition. See T.D. 9399, 2008-1 C.B. 1157.

¹¹⁷⁰ See Treas. Reg. § 1.7874-1(c)(3).

¹¹⁷¹ See Treas. Reg. § 1.7874-1(d).

¹¹⁷² See T.D. 9453, 2009-2 C.B. 114. See generally Philip Tretiak & Patrick Jackman, *Code Sec. 7874: Hotel California for U.S. Companies*, 35 Int'l Tax J. 5 (Nov./Dec. 2009); Jeffrey L. Rubinger & Summer A. LePree, *New Section 7874 Regulations Continue the*

i. Foreign Business Activities Test

Section 7874 does not apply if the expanded affiliated group has business activities in the foreign country in which the acquiring foreign entity was organized that are substantial in comparison to the expanded affiliated group's total business activities (the "Substantial Activities Test").¹¹⁷³

In general, the Substantial Activities Test requires an analysis of all the applicable facts and circumstances.¹¹⁷⁴ The 2009 temporary regulations contain a non-exclusive list of factors to be considered, including the expanded affiliated group's historical presence in the relevant foreign country, its continuous business activities in the foreign country involving property located in such country, performance of services in the foreign country by expanded affiliated group employees, sales of goods to

Service's Attack on Inversion Transactions, 109 J. Tax'n 132 (Sept. 2009).

¹¹⁷³ See I.R.C. § 7874(a)(2)(B)(iii).

¹¹⁷⁴ See Temp. Reg. § 1.7874-2T(g)(1). The 2009 temporary regulations removed a safe harbor and example provided by the 2006 temporary regulations for an expanded affiliated group that has a "substantial and bona fide business presence" in the applicable foreign country. See T.D. 9453, 2009-2 C.B. 114. This safe harbor had three distinct components: (i) the expanded affiliated group employees based in the foreign country must account for at least 10 percent (by headcount and compensation) of the group's employees; (ii) the total value of the group assets located in the foreign country must represent at least 10 percent of the total value of all group assets; and (iii) the group sales made in the foreign country must account for at least 10 percent of total group sales. See Former Temp. Reg. § 1.7874-2T(d)(2). See also NYSBA, *Report on Certain Issues Under Section 7874* (May 3, 2010) (recommending that the 2006 safe harbor be reintroduced and divided into two tests, one for expanded affiliated groups conducting less than 50% of their business activities in the U.S. (measured by both assets and employee compensation) and one for expanded affiliated groups conducting 50% or more of their business activities in the U.S. (measured by either assets or employee compensation)); Amy S. Elliot, *Corporate Inversion Regs May Not Be Forthcoming*, 135 Tax Notes 161 (Apr. 9, 2012) (IRS is still considering whether to reinstate the safe harbor or apply a different mechanical rule).

customers,¹¹⁷⁵ and management activities in the foreign country; ownership of the expanded affiliated group by foreign country residents, and the strategic importance of the business activities in that country.¹¹⁷⁶ The presence or absence of any particular factor is not determinative, and there is no minimum percentage of any factor that must be shown with respect to the foreign country.¹¹⁷⁷ In addition, an expanded affiliated group member that holds at least a 10 percent capital and profits interest in a partnership must take into account its proportionate share of the partnership items, including business activities, employees, assets, income, and sales.¹¹⁷⁸

ii. Application of Section 7874 to Partnerships

According to the preamble to the 2006 temporary regulations, some taxpayers had taken the position that structures involving acquisitions by publicly traded foreign partnerships that result in the same overall tax consequences as structures that Congress intended to be subject to section 7874 are outside the scope of section 7874.¹¹⁷⁹ Section 7874(g) provides broad regulatory authority to apply section 7874 to prevent avoidance of the purposes of the section through the use of noncorporate entities.

Under section 7704, a partnership generally is treated as a corporation if interests in the partnership are traded on an

¹¹⁷⁵ The government has expressed concern that sales (and the performance of services) between expanded affiliated group members can be structured in a manner that does not represent or reflect actual business activities. However, subject to section 7874(c)(4) (which permits the IRS to disregard certain avoidance transfers) and general tax principles, the government believes that in appropriate circumstances, sales (or the performance of services) between expanded affiliated group members may be taken into account. *See* T.D. 9453, 2009-2 C.B. 114.

¹¹⁷⁶ *See* Temp. Reg. § 1.7874-2T(g)(3).

¹¹⁷⁷ *See* Temp. Reg. § 1.7874-2T(g)(2). The 2009 temporary regulations disregard any assets, liabilities or activities in the foreign country that were transferred pursuant to a plan with a principal purpose to avoid section 7874. *See* Temp. Reg. § 1.7874-2T(g)(5).

¹¹⁷⁸ Temp. Reg. § 1.7874-2T(g)(4).

¹¹⁷⁹ *See* T.D. 9265, 2006-2 C.B. 1.

established securities market, or if interests in the partnership are readily tradable on a secondary market or the substantial equivalent.¹¹⁸⁰ However, section 7704(c) provides an exception to corporate treatment where 90 percent or more of such partnership's gross income consists of qualifying income, including dividends from controlled subsidiaries (the "qualifying income exception"). The 2009 temporary regulations define a "publicly traded foreign partnership" for section 7874 purposes as any foreign partnership that, but for the qualifying income exception would be treated as a section 7704 corporation at any time following the partnership's completion of a relevant acquisition pursuant to a plan existing at the time of the acquisition.¹¹⁸¹ A plan is deemed to exist at the time of the acquisition if the foreign partnership would, but for the qualifying income exception, be treated as a corporation under section 7704 at any time during the two-year period following completion of the acquisition.¹¹⁸²

If the foreign partnership is considered a surrogate foreign corporation and the 80% test is satisfied, the foreign partnership will be treated as a domestic corporation for all U.S. tax purposes.¹¹⁸³ By contrast, if only the 60% test is satisfied, the foreign entity will be respected as a foreign partnership for all U.S. tax purposes. However, section 7874(a)(1) (discussed above) will govern the U.S. income tax treatment of the expatriated entity.¹¹⁸⁴ The 2009 temporary regulations clarify that a publicly traded foreign partnership treated as a foreign corporation is treated as a foreign corporation for all purposes of section 7874.¹¹⁸⁵

iii. Options and Similar Interests

For purposes of determining foreign corporation stock ownership, options and interests that are similar to options held by reason of holding domestic corporation stock are treated as

¹¹⁸⁰ See I.R.C. § 7704(b).

¹¹⁸¹ See Temp. Reg. § 1.7874-2T(h)(2).

¹¹⁸² See Temp. Reg. § 1.7874-2T(h)(2).

¹¹⁸³ See I.R.C. § 7874(b). A conversion rule clarifies the U.S. tax consequences of the deemed change from a foreign partnership to a domestic corporation. See Temp. Reg. § 1.7874-2T(h)(6).

¹¹⁸⁴ See Temp. Reg. § 1.7874-2T(h)(4).

¹¹⁸⁵ See Temp. Reg. § 1.7874-2T(h)(3).

exercised.¹¹⁸⁶ More specifically, an option (or similar interest) on a domestic or foreign corporation's stock shall be treated as domestic or foreign corporation stock, respectively, with a value equal to the holder's claim on the equity of the domestic or foreign corporation immediately before the relevant acquisition.¹¹⁸⁷ Options or similar interests should not be taken into account to the extent treating an option or similar interest as stock would duplicate, in whole or in part, a shareholder's claim on the equity of the corporation.¹¹⁸⁸ Similar rules apply to domestic or foreign partnership interests.¹¹⁸⁹ The IRS and Treasury Department have requested comments concerning whether the rules should except certain options, such as publicly traded options or compensatory options.¹¹⁹⁰

iv. Ownership Thresholds – the “By Reason of” Standard

The 2009 temporary regulations clarify that the “by reason of” standard is satisfied if foreign corporation stock is received in exchange for, or with respect to, domestic corporation stock (or a domestic partnership interest).¹¹⁹¹ This includes taxable and nontaxable distributions.¹¹⁹²

If pursuant to the same transaction, foreign corporation stock is received in exchange for, or with respect to, stock of a domestic corporation and other property, the portion of foreign

¹¹⁸⁶ See T.D. 9453, 2009-2 C.B. 114. See NYSBA, *Report on Certain Issues Under Section 7874* (May 3, 2010) (recommending that options generally be ignored for purposes of the ownership test, “subject to an anti-abuse rule that treats certain options as stock,” or alternatively recommending that an “angel list” be created to identify categories of options carved out of the general rule subject to an anti-abuse rule).

¹¹⁸⁷ Temp. Reg. § 1.7874-2T(j)(1), (2).

¹¹⁸⁸ Temp. Reg. § 1.7874-2T(j)(4).

¹¹⁸⁹ See Temp. Reg. § 1.7874-2T(j).

¹¹⁹⁰ See T.D. 9453, 2009-2 C.B. 114.

¹¹⁹¹ Temp. Reg. § 1.7874-2T(f)(1).

¹¹⁹² See T.D. 9453, 2009-2 C.B. 114. The 2009 temporary regulations also clarify that the “by reason of” standard may be satisfied other than through exchanges or distributions.

corporation stock received in exchange for, or with respect to, the domestic corporation stock is determined based on the relative value of the domestic corporation stock compared to the aggregate value of such stock and other property.¹¹⁹³ Subject to section 7874(c)(4) (which permits the IRS to disregard certain avoidance transfers) and general tax principles, the “by reason of” standard is not affected by a relationship between the domestic corporation stock and other property.¹¹⁹⁴

v. Avoidance Transactions

The 2009 temporary regulations address several transactions that the government believes are inconsistent with the congressional purpose underlying section 7874. First, if pursuant to a plan (or series of related transactions), two or more foreign corporations together acquire substantially all of a domestic corporation’s assets, each foreign corporation is treated as completing the acquisition for purposes of determining whether such foreign corporation is a surrogate foreign corporation.¹¹⁹⁵ In addition, the acquisitions by a foreign corporation of more than one domestic corporation pursuant to a plan (or series of related transactions) are treated as a single acquisition and the domestic corporations are treated as a single entity for purposes of determining ownership.¹¹⁹⁶ This rule applies equally to transactions involving multiple corporations, multiple partnerships, or multiple corporations and partnerships.¹¹⁹⁷

Second, the IRS and Treasury Department have become aware of transactions intended to avoid section 7874 by using interests that, although not in form exchangeable or convertible into foreign corporation stock, are structured to represent the substantial equivalent of an equity interest in the foreign corporation.¹¹⁹⁸ To address these transactions, the 2009 temporary regulations provide that, for section 7874 purposes, any interest (including stock or a partnership interest) not otherwise treated as

¹¹⁹³ Temp. Reg. § 1.7874-2T(f)(2); -2T(n), Ex. 8.

¹¹⁹⁴ See T.D. 9453, 2009-2 C.B. 114.

¹¹⁹⁵ Temp. Reg. § 1.7874-2T(d); -2T(n), Exs. 5, 6.

¹¹⁹⁶ Temp. Reg. § 1.7874-2T(e); -2T(n), Ex. 7.

¹¹⁹⁷ Temp. Reg. § 1.7874-2T(e).

¹¹⁹⁸ See T.D. 9453, 2009-2 C.B. 114.

foreign corporation stock shall be treated as foreign corporation stock if (i) the interest entitles the holder to distribution rights that are substantially similar in all material respects to the distribution rights entitled to a foreign corporation shareholder by reason of holding foreign corporation stock,¹¹⁹⁹ and (ii) treating the interest as foreign corporation stock has the effect of treating the foreign corporation as a surrogate foreign corporation.¹²⁰⁰

Finally, the government explained in the preamble to the 2008 final regulations that some taxpayers may take the position that a foreign corporation that acquires substantially all of a domestic corporation's properties in a title 11 or similar case is not a surrogate foreign corporation because the domestic corporation's creditors, which typically receive all of the acquiring foreign corporation's stock issued in the title 11 or similar case, are not the domestic corporation's former shareholders and thus do not acquire or hold their foreign acquiring corporation stock by reason of holding stock in the domestic corporation.¹²⁰¹ Under this interpretation, there often would be little or no continuity of ownership, and, as a result, the foreign corporation would not be a surrogate foreign corporation.¹²⁰² The 2009 temporary regulations clarify that when immediately prior to the first date properties are acquired as part of an acquisition of substantially all of a domestic corporation's properties, such domestic corporation is in a title 11 or similar case, or is insolvent, each domestic corporation creditor is treated as a domestic corporation shareholder for all purposes of section 7874 and any claim by a creditor against the domestic corporation is treated as domestic corporation stock.¹²⁰³ Therefore,

¹¹⁹⁹ Distribution rights include rights to dividend distributions (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest. *See* Temp. Reg. § 1.7874-2T(k)(1)(i).

¹²⁰⁰ Temp. Reg. § 1.7874-2T(k)(1).

¹²⁰¹ *See* T.D. 9399, 2008-1 C.B. 1157.

¹²⁰² *See* T.D. 9399, 2008-1 C.B. 1157.

¹²⁰³ Temp. Reg. § 1.7874-2T(k)(2)(i), (iii); -2T(n), Ex. 19. A domestic corporation creditor treated as a shareholder is treated as a shareholder for all purposes of section 7874, including exceptions to the general section 7874 rule, *i.e.*, internal group restructuring and loss of control, and determining stock held by reason of holding domestic corporation stock. *See* Temp. Reg. § 1.7874-2T(k)(2)(iii),

any foreign corporation stock held by a creditor of the domestic corporation by reason of its claim against the domestic corporation would be considered held by a former domestic corporation shareholder by reason of holding domestic corporation stock.¹²⁰⁴ However, the regulations are clear that foreign corporation stock received by a creditor in exchange for other property is not taken into account in determining former shareholder ownership.¹²⁰⁵ Similar rules apply to creditors of a partnership receiving foreign corporation stock in exchange for their claims.¹²⁰⁶

(f); Treas. Reg. § 1.7874-1(c); *see also* NYSBA, *Report on Certain Issues Under Section 7874* (May 3, 2010) (recommending a more limited rule targeting lenders who acquire debt of a domestic corporation pursuant to a plan to acquire its stock or assets).

¹²⁰⁴ *See* T.D. 9453, 2009-2 C.B. 114.

¹²⁰⁵ *See* T.D. 9453, 2009-2 C.B. 114.

¹²⁰⁶ *See* Temp. Reg. § 1.7874-2T(k)(2)(ii).

f. Notice 2009-78

Notice 2009-78 provides that foreign corporation stock issued in exchange for nonqualified property in a transaction related to the acquisition is not taken into account for purposes of determining the stock ownership percentage.¹²⁰⁷ Nonqualified property is defined as (i) cash or cash equivalents, (ii) “marketable securities” as defined in section 453(f)(2), and (iii) any other property acquired in a transaction with a principal purpose of avoiding section 7874.¹²⁰⁸ For this purpose, marketable securities do not include stock issued by an expanded affiliated group member unless a principal purpose of issuing foreign corporation stock in exchange for such property is the avoidance of section 7874.

¹²⁰⁷ See Notice 2009-78, 2009-2 C.B. 452. See generally Lee A. Sheppard, *Taking the Good with the Bad in the Anti-Inversion Rule*, 2010 TNT 31-2 (Feb. 17, 2010); Robert Willens, *IRS Keeps the Heat on Inversion Transactions*, CFO.com (Sept. 28, 2009), available at <http://www.cfo.com/article.cfm/1444317>; Amy S. Elliott, *Corporate Inversion Regs May Not be Forthcoming*, 2012 TNT 63-5 (Apr. 2, 2012) (the government has not yet decided whether to issue regulations implementing Notice 2009-78); Notice 2009-78 applies to acquisitions completed on or after September 17, 2009.

¹²⁰⁸ See *Application of Anti-Inversion Notice Depends on Facts and Circumstances*, IRS Official Says, 2009 TNT 234-4 (Dec. 9, 2009) (John Merrick, special counsel, IRS Office of Associate Chief Counsel (International) stated that whether the IRS will disregard foreign corporation stock issued in exchange for property other than cash or marketable securities depends on the facts and circumstances). See also NYSBA, *Report on Certain Issues Under Section 7874* (May 3, 2010) (recommending exceptions for “sufficiently large primary issuances” and other situations where the domestic entity’s historical shareholders fail to retain some threshold percentage of their proprietary interest in the entity).

g. 2012 Temporary and Final Regulations

In June 2012, Treasury and the IRS issued temporary regulations that significantly modify the Substantial Activities Test and final regulations that adopt, with some changes, the 2009 temporary regulations relating to other issues.¹²⁰⁹ Subject to a transition rule, the 2012 temporary and final regulations apply to acquisitions completed on or after June 7, 2012.¹²¹⁰

i. Foreign Business Activities Test

As discussed earlier, Section 7874 does not apply if the expanded affiliated group has business activities in the foreign country in which the acquiring foreign entity was organized that are substantial in comparison to the expanded affiliated group's total business activities, *i.e.*, the so-called "Substantial Activities Test".¹²¹¹

In the 2012 temporary regulations, Treasury and the IRS replace the facts and circumstances test of the 2009 temporary regulations with a bright-line rule describing the threshold of activities required for an expanded affiliated group to meet the Substantial Activities Test.¹²¹² The government believes that a bright-line rule would provide more certainty to section 7874.¹²¹³ By contrast, the NYSBA sensibly advocates a general facts and circumstances test, combined with a safe harbor, or, alternatively, a bright-line test, that if failed, would create a rebuttable presumption that the Substantial Activities Test is not met.¹²¹⁴

The 2012 temporary regulations provide that an expanded affiliated group will meet the Substantial Activities Test in the relevant foreign country only if at least 25 percent of the group

¹²⁰⁹ See T.D. 9591, 2012-28 I.R.B. 32.; T.D. 9592, 2012-28 I.R.B. 41.

¹²¹⁰ See Treas. Reg. § 1.7874-2(l); Temp. Reg. § 1.7874-3T(f).

¹²¹¹ See I.R.C. § 7874(a)(2)(B)(iii).

¹²¹² See T.D. 9592, 2012-28 I.R.B. 41.

¹²¹³ See T.D. 9592, 2012-28 I.R.B. 41.

¹²¹⁴ See NYSBA, *Report on Substantial Business Activities Test Under Temporary Section 7874 Regulations*, reprinted in 2012 TNT 225-18 (Nov. 20, 2012).

employees, group assets, and group income are located or derived in the relevant foreign country as described below.¹²¹⁵

The group employees test is satisfied if (i) the number of group employees based in the relevant foreign country is at least 25 percent of the total number of group employees determined on the “applicable date”,¹²¹⁶ and (ii) employee compensation incurred by group employees based in the relevant foreign country is at least 25 percent of the total employee compensation incurred by all group employees determined during a one-year testing period.¹²¹⁷

The group assets test is satisfied if the value of the group assets located in the relevant foreign country is at least 25 percent of the total value of all group assets determined on the “applicable date”.¹²¹⁸ Group assets are generally defined as tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group, including property rented by members of the expanded affiliated group.¹²¹⁹ In order to constitute a group asset rented property must satisfy the other applicable requirements for group assets, including that the rented property is used, or held for use, in the active conduct of a trade or business.¹²²⁰

The group income test is satisfied if the group income derived in the relevant foreign country is at least 25 percent of the

¹²¹⁵ See Temp. Reg. § 1.7874-3T(b).

¹²¹⁶ See Temp. Reg. § 1.7874-3T(b)(1)(i). The 2012 temporary regulations provide that the “applicable date” is either the date on which the acquisition is completed, or the last day of the month immediately preceding the month in which the acquisition is completed. See Temp. Reg. § 1.7874-3T(d)(1)-(2).

¹²¹⁷ See Temp. Reg. § 1.7874-3T(b)(1)(ii).

¹²¹⁸ See Temp. Reg. § 1.7874-3T(b)(2). The 2012 temporary regulations provide that the “applicable date” is either the date on which the acquisition is completed, or the last day of the month immediately preceding the month in which the acquisition is completed. See Temp. Reg. § 1.7874-3T(d)(1)-(2).

¹²¹⁹ See Temp. Reg. § 1.7874-3T(d)(5). The value of rented property is deemed to be eight times the net annual rent paid or accrued with respect to such property.

¹²²⁰ See Temp. Reg. § 1.7874-3T(d)(5).

total group income determined during a one-year testing period.¹²²¹ Group income means the aggregate gross income of members of the expanded affiliated group from transactions occurring in the ordinary course of business with customers that are not related persons.¹²²² Group income is considered to be derived in a foreign country only if the customer is located in such country.¹²²³ The NYSBA notes that situations in which the expanded affiliated group's activities are substantially concentrated in the relevant foreign country but more than 75 percent of the customers are located in other jurisdictions are particularly problematic; as an alternative, the NYSBA proposes that the Substantial Activities Test be met if the expanded affiliated group satisfies the 25 percent threshold for at least two of the three tests, *i.e.*, the group employees, group assets and group income tests, and that the average threshold of all three tests equals or exceeds 25 percent.¹²²⁴

¹²²¹ See Temp. Reg. § 1.7874-3T(b)(3).

¹²²² See Temp. Reg. § 1.7874-3T(d)(7).

¹²²³ See Temp. Reg. § 1.7874-3T(d)(7).

¹²²⁴ See NYSBA, *Report on Substantial Business Activities Test Under Temporary Section 7874 Regulations*, reprinted in 2012 TNT 225-18 (Nov. 20, 2012). In addition, see generally, *New Guidance on Corporate Inversions Raises the Bar Even Higher*, Journal of Taxation (Oct. 2012) (arguing that the 2012 temporary regulations will have the effect of making U.S. companies even more attractive acquisition targets of foreign purchasers since a foreign parent will generally provide more shareholder value from a tax perspective than a U.S. parent); Alison Bennett, *Legislative History Key Factor in Guidance on Corporate Inversions*, 133 Daily Tax Rep. (BNA), at G-4 (July 12, 2012) (Treasury and the IRS closely scrutinized legislative history in developing guidance); Kristen A. Parillo, *Merrick Defends New Substantial Business Activities Test in Anti-Inversion Regs*, 2012 TNT 139-4 (July 23, 2012) (John Merrick, IRS special counsel, noting that one of the hazards of a bright-line test is that there will always be cases that are on the edge but fall short); Jeremiah Coder, *Irrebutable Rule in New Substantial Business Activity Test is Excessive, Practitioners Say*, 2012 TNT 112-4 (June 11, 2012) (Michael DiFronzo of PWC noting that the problem with the 25 percent standard is that many, if not most, multinational companies will fail to meet those thresholds anywhere in the world); Alison Bennett, *Bright-Line Test for Substantial Foreign Business Presence Draws Practitioner Fire*, 114 Daily Tax Rep. (BNA), at G-1 (June 14, 2012) (similar); Amy S. Elliott, *Incidents of Inversions*

ii. Partnership Attribution

The 2009 temporary regulations provide that, for purposes of the Substantial Activities Test, a member of an expanded affiliated group that holds at least a ten-percent capital and profits interest in a partnership is attributed its proportionate share of all items of the partnership.¹²²⁵ However, the 2012 temporary regulations provide that the items of a partnership should be attributed for this purpose only if one or more members of the expanded affiliated group holds, in the aggregate, more than 50 percent (by value) of the interests in the partnership.¹²²⁶ Consistent with the treatment of corporations, all of the items of the partnership are attributed if the 50 percent (by value) ownership requirement is satisfied for this purpose.¹²²⁷

iii. Options and Similar Interests

The 2009 temporary regulations generally provide that, for purposes of section 7874, an option or similar interest with respect to a corporation is treated as stock of the corporation with a value equal to the holder's claim on the equity of the corporation.¹²²⁸ The government did not adopt commentators' suggestions that, subject to an anti-abuse rule, options should be ignored for purposes of section 7874,¹²²⁹ and instead generally retained the claim-on-equity approach in the 2012 final regulations as the approach they believe most properly reflects the economics of the transaction and is not easily manipulated.¹²³⁰

Section 7874 also looks to the voting power of stock,¹²³¹ though the 2009 temporary regulations do not address voting

Debated in Wake of Stricter Anti-Inversion Regs, 2012 TNT 198-1 (Oct. 12, 2012) (similar).

¹²²⁵ See Temp. Reg. § 1.7874-2T(g)(4).

¹²²⁶ See Temp. Reg. § 1.7874-3T(e).

¹²²⁷ See Temp. Reg. § 1.7874-3T(e); T.D. 9592, 2012-28 I.R.B. 41.

¹²²⁸ Temp. Reg. § 1.7874-2T(j)(1), (2).

¹²²⁹ T.D. 9591, 2012-28 I.R.B. 32.

¹²³⁰ T.D. 9591, 2012-28 I.R.B. 32; Treas. Reg. § 1.7874-2(h)(1).

¹²³¹ See, e.g., I.R.C. § 7874(a)(2)(B)(ii) (one of the requirements for a foreign corporation to be treated as a surrogate foreign corporation is that, after the acquisition, at least 60 percent of the stock (by vote or

power with respect to options. The 2012 final regulations provide that, for purposes of determining the voting power of stock under section 7874, an option will be treated as exercised only if a principal purpose of the issuance or acquisition of the option is to avoid treating the foreign corporation as a surrogate foreign corporation.¹²³² In all other cases, options are not taken into account for purposes of determining the voting power of stock under section 7874.¹²³³

iv. Insolvent Entities

The 2009 temporary regulations provide that, if a domestic corporation is in a title 11 or similar case, or the liabilities of the domestic corporation exceed the value of its assets immediately prior to a section 7874 transaction, any claim by a creditor against the domestic corporation is treated as stock of the domestic corporation.¹²³⁴ A similar rule applies with respect to a domestic partnership, or a foreign partnership that owns stock of a domestic corporation.¹²³⁵ The 2012 final regulations generally adopt the approach of the 2009 temporary regulations.¹²³⁶

D. Section 367(b) Transfers¹²³⁷

The section 367(b) regulations override the nonrecognition

value) of the entity is held, in the case of an acquisition relating to a domestic corporation, by former shareholders of the domestic corporation).

¹²³² See Treas. Reg. § 1.7874-2(h)(2).

¹²³³ See Treas. Reg. § 1.7874-2(h)(2).

¹²³⁴ See Temp. Reg. § 1.7874-2T(k)(2)(i).

¹²³⁵ See Temp. Reg. § 1.7874-2T(k)(2)(ii).

¹²³⁶ T.D. 9591, 2012-28 I.R.B. 32.

¹²³⁷ This section describes the consequences of various nonrecognition transactions under the Final Section 367 Regulations issued in January 2006 and the final section 367(b) Treasury Regulations issued in November 2006 (effective Feb. 23, 2000). The tax consequences of these transactions under prior proposed or temporary section 367(b) Treasury Regulations generally are not discussed, and such consequences may differ from those under the final Treasury Regulations in material respects.

provisions of sections 332, 351, 354, 355, 356 and 361 to the extent necessary to prevent the avoidance of U.S. federal income tax by U.S. shareholders on certain inbound and foreign-to-foreign transactions.¹²³⁸ The section 367(b) regulations backstop the section 1248 dividend inclusion rules, which recharacterize gain recognized by U.S. shareholders on certain exchanges of foreign corporation stock as ordinary income to the extent of the foreign corporation's earnings and profits, and provide additional assurance that U.S. shareholders' repatriated foreign earnings and profits from CFCs will be appropriately taxed as ordinary income.

The general application of section 367(b) to inbound and foreign-to-foreign tax-free exchanges that would otherwise facilitate the avoidance of U.S. tax on unrepatriated earnings of foreign corporations¹²³⁹ is subject to two exceptions. Section 367(b) does not apply to transfers with respect to which section 367(a) denies nonrecognition treatment,¹²⁴⁰ or to the acquisition of assets pursuant to a foreign-to-foreign liquidation governed by section 367(e)(2).¹²⁴¹

1. Inbound Liquidations and Asset Reorganizations Involving Foreign Subsidiaries

Upon a tax-free inbound asset acquisition, including an inbound liquidation of a foreign corporation under section 332,¹²⁴² each U.S. shareholder must include in its gross income as a dividend for that year its "all earnings and profits amount" (the "all E&P amount") with respect to the foreign acquired corporation.¹²⁴³

¹²³⁸ T.D. 8862, 2001-1 C.B. 466.

¹²³⁹ See Treas. Reg. § 1.367(b)-1(a).

¹²⁴⁰ Treas. Reg. § 1.367(b)-1(a).

¹²⁴¹ See Treas. Reg. § 1.367(b)-3(a).

¹²⁴² As discussed above, the IRS has confirmed that a liquidation of a subsidiary under section 332 does not result in additional liquidations of lower-tier subsidiaries received by the parent in the liquidation. See C.C.A. 2002-30-026 (Apr. 15, 2002).

¹²⁴³ Treas. Reg. § 1.367(b)-3(b). A modified definition of the all E&P amount applies to inbound section 332 liquidating distributions; section 312(a) and (b) adjustments are not taken into account, other than gain or loss to the liquidating corporation on the distribution to

Any excess foreign taxes under section 904(c) allowable to a foreign acquired corporation will carry over to the U.S. acquiring corporation and may be utilized under section 901 (subject to any applicable limitations).¹²⁴⁴

The starting point for determining the all E&P amount is the “section 1248 amount,”¹²⁴⁵ which is the amount of a foreign corporation’s earnings and profits that would be taxable as ordinary dividend income under section 1248 if the reorganization were instead a taxable sale of stock.¹²⁴⁶ This amount generally equals the lesser of (i) the gain actually recognized by the exchanging U.S. shareholder, and (ii) the foreign corporation’s net positive E&P attributable to the exchanged stock that was accumulated in taxable years after 1962 while the foreign corporation was a CFC and the exchanging shareholder was its U.S. shareholder.

The section 1248 amount is modified as follows to determine the all E&P amount. First, it is increased by the amount of E&P attributable to the exchanged stock that is not included in the section 1248 amount, including (i) earnings before 1963, and (ii) earnings that accumulated while the corporation was not a CFC and/or while the exchanging shareholder¹²⁴⁷ was a shareholder but not a (10%) U.S. shareholder. Second, the section 1248 amount is decreased by (i) earnings of lower-tier subsidiaries,¹²⁴⁸ and (ii) amounts attributable to the holding period of non U.S. persons to the extent such a “person” was not owned (directly or indirectly) by U.S. shareholders when the earnings and profits accumulated.¹²⁴⁹ The regulations also contain rules similar to the

the extent provided in section 312(f)(i). *See* Treas. Reg. § 1.367(b)-3(b)(3)(ii), Ex. 3.

¹²⁴⁴ Treas. Reg. § 1.367(b)-3(d), as corrected by T.D. 8862, 2001-1 C.B. 466.

¹²⁴⁵ *See* Treas. Reg. § 1.367(b)-2(d)(1).

¹²⁴⁶ Treas. Reg. § 1.367(b)-2(c).

¹²⁴⁷ Treas. Reg. § 1.367(b)-2(d)(3).

¹²⁴⁸ Treas. Reg. § 1.367(b)-2(d)(3)(iii).

¹²⁴⁹ *See* Treas. Reg. § 1.367(b)-2(d)(3). Section 1248 requirements that are not related to computing the earnings and profits attributable to a shareholder’s block of stock are not taken into account.

section 1248 rules for allocating the resulting all E&P amount among blocks of stock.¹²⁵⁰

Any deemed dividend required to be included in income in connection with a section 367(b) transaction will be considered paid by the entity whose earnings and profits formed the basis for the dividend.¹²⁵¹ Deemed dividends determined by reference to the earnings and profits of lower-tier foreign subsidiaries will be considered to be paid through any intermediate shareholders, rather than directly to the ultimate recipient.¹²⁵² The regulations also contain detailed basis adjustment rules with respect to such deemed dividends.

For purposes of the section 367(b) regulations (*i.e.*, determination of the deemed dividend amount), the gain realized by an exchanging shareholder is determined before the basis in the stock of the foreign corporation is increased by the amount of the deemed dividend. However, for purposes of determining the amount of gain (if any) recognized on the transaction (*i.e.*, gain recognized under section 356 with respect to boot), the basis in the foreign corporation's stock is increased by the amount of the deemed dividend immediately before the exchanging shareholder receives consideration in exchange for its target stock. The earnings and profits of the "payor corporation" are also reduced by the amount of the deemed dividend before determining whether gain is recognized in excess of the deemed dividend.¹²⁵³ Finally, consistent with the treatment of a deemed dividend as a dividend for all purposes of the Code, an exchanging shareholder receiving a deemed dividend may qualify for a deemed paid foreign tax credit, assuming the requirements of section 902 are met.¹²⁵⁴

The section 367(b) regulations deny nonrecognition treatment to any U.S. persons who do not qualify as U.S. shareholders but whose stock in the foreign acquired corporation is worth more than \$50,000 at the time of the exchange. However, in lieu of a requirement to include the all E&P amount in income

¹²⁵⁰ Treas. Reg. § 1.367(b)-2(d)(3).

¹²⁵¹ Treas. Reg. § 1.367(b)-2(c).

¹²⁵² Treas. Reg. § 1.367(b)-2(e)(2).

¹²⁵³ Treas. Reg. § 1.367(b)-2(e)(3).

¹²⁵⁴ Treas. Reg. § 1.367(b)-2(e)(4), Ex. 1.

(which could be burdensome for smaller shareholders), such exchanging U.S. persons are generally required to recognize any gain realized on the exchange.¹²⁵⁵ Under certain circumstances, however, such a U.S. person may instead elect to include its all E&P amount with respect to the exchanged stock in income as a deemed dividend.¹²⁵⁶ U.S. recipients deciding whether to elect deemed dividend treatment should bear in mind that, as less than 10% shareholders, they would not qualify for a deemed paid foreign tax credit.¹²⁵⁷

In 2006, the Treasury Department issued final regulations addressing the extent to which the tax attributes of the foreign acquired corporation carry over to the U.S. acquiring corporation (the “Final Attribute Carryover Regulations”).¹²⁵⁸ The Final Attribute Carryover Regulations specifically address the carryover of net operating loss and capital loss carryovers, and earnings and profits that are not included in income as part of an all E&P amount (or a deficit in earnings and profits). A net operating loss or capital loss carryover of a foreign acquired corporation may be carried over to a U.S. acquiring corporation only to the extent it is effectively connected with the conduct of a trade or business within the United States (or attributable to a U.S. permanent establishment under an applicable U.S. income tax treaty).¹²⁵⁹ Similarly, earnings and profits (or a deficit in earnings and profits) of a foreign acquired corporation that are not included in income as a deemed dividend under the section 367(b) regulations are eligible to carry over to a U.S. acquiring corporation only to the extent such earnings and profits (or deficit in earnings and profits) are effectively connected with the conduct of a trade or business

¹²⁵⁵ Treas. Reg. § 1.367(b)-3(c)(2), (4).

¹²⁵⁶ Treas. Reg. § 1.367(b)-3(c)(3).

¹²⁵⁷ See Treas. Reg. § 1.367(b)-3(c)(5), Ex. 1(iii).

¹²⁵⁸ See T.D. 9273, 2006-2 C.B. 394. For an excellent analysis of the Final Attribute Carryover Regulations, see Charles S. Markham, Bernard T. Bress, Timothy F. Anson & Carl A. Dubert, *Section 367(b) Final Regulations-Overall Simplification But Controversial Rules Remain*, 18 J. Int’l. Tax’n 20 (2007).

¹²⁵⁹ Treas. Reg. § 1.367(b)-3(e); see also Rev. Rul. 72-421, 1972-2 C.B. 166 (because an NOL is the excess of gross income over deductions, a foreign corporation that has not engaged in a U.S. trade or business cannot have allowable deductions (and thus an NOL) for U.S. tax purposes).

within the United States (or are attributable to a U.S. permanent establishment if an applicable United States income tax treaty applies).¹²⁶⁰

2. Foreign-to-Foreign Reorganizations

a. U.S. Shareholder Status Preserved

Direct and indirect U.S. shareholders of a foreign target corporation will generally be required to include a deemed dividend in income after a foreign-to-foreign reorganization only if and to the extent their section 1248 amounts are not preserved after the reorganization. In July, 2007, the Treasury Department issued final regulations that provide rules for accurately attributing earnings and profits to stock of a foreign corporation that is received in certain tax-free transactions.¹²⁶¹ These regulations addressed concerns by some taxpayers that the prior section 1248 regulations required attribution of an excessive amount of earnings and profits in connection with a tax-free transaction.¹²⁶²

A U.S. shareholder exchanging CFC stock for stock of another CFC in a nonrecognition transaction is generally not required to include its section 1248 amount in income as long as the taxpayer is also a U.S. shareholder of the acquiring CFC.¹²⁶³ A foreign corporate shareholder can also participate in a tax-free stock exchange without including its section 1248 amount in

¹²⁶⁰ Treas. Reg. § 1.367(b)-3(f)(1). One comment regarding the rule in the then-proposed regulations prohibiting the carryover of a deficit in the foreign acquired corporation's E&P asserted that, if the regulations require the inclusion of positive E&P in income as a deemed dividend, they should likewise permit the carryover of an E&P deficit. In the preamble to the Final Attribute Carryover Regulations, the government acknowledged the "asymmetries in the tax treatment of inbound reorganizations", but concluded that the final regulations nonetheless reach the appropriate result. T.D. 9273, 2006-2 C.B. 394. Citing section 362(e), the preamble stated that "the importation of favorable tax attributes has been subject to greater scrutiny in recent years." T.D. 9273, 2006-2 C.B. 394.

¹²⁶¹ See T.D. 9345 (July 30, 2007).

¹²⁶² See 71 Fed. Reg. 31985 (June 2, 2006) (preamble to former proposed regulations).

¹²⁶³ See Treas. Reg. § 1.367(b)-4(b)(1).

income if CFC stock is received in the exchange and each of its U.S. shareholders is also an indirect U.S. shareholder of the foreign acquiring corporation.¹²⁶⁴

Section 367(b) permits nonrecognition treatment for the above-described transactions and does not require that a U.S. shareholder include its section 1248 amount in income because the section 1248 attributes of the foreign transferor corporation stock are preserved and included in calculating the earnings and profits of the foreign transferee corporation in any subsequent exchange.¹²⁶⁵ This inclusion ensures that a U.S. shareholder of a CFC will be subject to the requisite section 1248 dividend income inclusion upon a subsequent sale of the stock received in the exchange. With respect to lower tier transfers among foreign corporations indirectly owned before and after the transaction by the same U.S. shareholder(s), the transferor foreign corporation's section 1248 amount is deferred by excluding it from foreign personal holding company income ("FPHCI") under section 954(c). Thus, the U.S. shareholders of the transferor foreign corporation that receive the deemed dividend are not required to include such amount in income under subpart F.¹²⁶⁶

The Final Attribute Carryover Regulations address the apportionment and carryover of any transferor tax attributes (most notably foreign tax credits) or the adjustment of earnings and profits in connection with a foreign-to-foreign reorganization. The Final Attribute Carryover Regulations divide foreign corporations into "pooling" and "nonpooling" corporations. A "pooling corporation" is a first tier or lower tier foreign corporation with respect to which a U.S. taxpayer owns, directly or indirectly, stock that meets the requirements of section 902(c)(3)(B); *e.g.*, a first tier foreign corporation at least 10 percent of whose voting stock is owned by a U.S. corporation, and a lower tier foreign corporation if a domestic corporation owns (i) at least 10 percent of the first tier foreign corporation's voting stock, and (ii) at least 5 percent of the lower tier foreign corporation's voting stock indirectly through

¹²⁶⁴ See Treas. Reg. § 1.367(b)-4(b)(1).

¹²⁶⁵ Treas. Reg. § 1.367(b)-4(d)(1).

¹²⁶⁶ Treas. Reg. § 1.367(b)-3(b)(3).

foreign corporations connected by 10% voting stock ownership.¹²⁶⁷ A “nonpooling corporation” is any foreign corporation other than a pooling corporation.¹²⁶⁸

Accordingly, the Final Attribute Carryover Regulations provide different rules for transactions depending upon whether the surviving corporation in a foreign-to-foreign reorganization tracks its E&P and foreign income taxes in multi-year pools to determine the foreign tax credits available to its U.S. shareholders with respect to distributions from such corporation.¹²⁶⁹ If the surviving

¹²⁶⁷ Treas. Reg. § 1.367(b)-2(l)(9). The pooling concept is derived from the foreign tax credit rules. In general, a domestic corporation that receives a dividend from a foreign corporation in which it owns at least 10% of the voting stock is treated as paying a proportionate part of the foreign corporation’s post-1986 foreign income taxes. The relevant proportion is the amount of the dividend as a percentage of the foreign corporation’s post-1986 undistributed E&P. *See* I.R.C. § 902.

¹²⁶⁸ Treas. Reg. § 1.367(b)-2(l)(10).

¹²⁶⁹ The pooling and nonpooling concepts represent a change from the proposed regulations, which focused on whether a dividend paid by the applicable foreign corporation received “look-through” treatment under section 904(d); *i.e.*, the character of such dividend generally mirrored the character of income earned by the payor foreign corporation itself. Under prior law, dividends from a CFC as well as dividends from a “noncontrolled Section 902 corporation” under section 904(d)(2)(E) (a so-called a “10/50 corporation”) out of post-2002 E&P received “look-through” treatment. By contrast, dividends paid out of pre-2003 E&P were subject to a single separate limitation for dividends from all 10/50 companies. Accordingly, the proposed regulations contained different rules for a “look-through corporation” or a “non-look-through 10/50 corporation”, and also provided a third set of rules for transactions in which a foreign corporation was neither a “look-through corporation” nor a “non-look-through 10/50 corporation”. In the American Jobs Creation Act of 2004, Congress provided that any (i) dividend paid by a noncontrolled section 902 corporation to a 10% or greater U.S. corporate shareholder received look-through treatment, and (ii) dividend paid to a 10% U.S. corporate shareholder of a CFC, is eligible for look-through treatment even if the relevant E&P relates to pre-CFC periods. These statutory changes effectively obsoleted the concept of a “non-look-through 10/50 corporation,” permitting the Final Attribute Carryover Regulations to distinguish solely

corporation is a pooling corporation, the Final Attribute Carryover Regulations divide the corporation's E&P history into its post-1986 pool and its pre-pooling annual layers.¹²⁷⁰ The "post-1986 pool" consists of the undistributed E&P and related foreign income taxes of the foreign acquiring and target corporations for post-1986 taxable years.¹²⁷¹ The regulations combine the foreign acquirer's amounts in each specific foreign tax credit basket with the foreign target's amounts (if any) for each such basket.¹²⁷² The "pre-pooling annual layers" represent the pre-1987 E&P and foreign income taxes of the foreign acquirer and foreign target corporations.¹²⁷³ The Final Attribute Carryover Regulations permit the carryover of these attributes but require the foreign surviving corporation to maintain the foreign acquirer's and foreign target's respective amounts in separate accounts.¹²⁷⁴

Alternatively, if the foreign surviving corporation is a non-pooling corporation, there is less need to track its E&P history because dividends paid by such corporation do not receive look-through treatment for foreign tax credit basketing purposes and do not carry deemed-paid foreign tax credits. Accordingly, the Final Attribute Carryover Regulations generally carry over pre-1987 E&P and foreign income taxes of the foreign acquirer and foreign target as separate pre-pooling annual layers of the foreign surviving corporation that are not combined.¹²⁷⁵ In addition, the Final Attribute Carryover Regulations treat any post-1986 E&P (and foreign income taxes) of the foreign acquirer and/or the foreign target as separately maintained pre-1987 E&P (and foreign income taxes) of the applicable corporation accumulated immediately prior to the reorganization.¹²⁷⁶

between pooling and nonpooling corporations. *See* T.D. 9273, 2006-2 C.B. 394.

¹²⁷⁰ *See* Treas. Reg. § 1.367(b)-7(c)(1).

¹²⁷¹ *See* Treas. Reg. § 1.367(b)-7(d).

¹²⁷² *See* Treas. Reg. § 1.367(b)-7(d)(1).

¹²⁷³ *See* Treas. Reg. § 1.367(b)-7(e).

¹²⁷⁴ *See* Treas. Reg. § 1.367(b)-7(e)(1).

¹²⁷⁵ *See* Treas. Reg. § 1.367(b)-7(e)(2).

¹²⁷⁶ *See* Treas. Reg. § 1.367(b)-7(e)(2)(i).

The Final Attribute Carryover Regulations also provide specific rules for the carryover of deficits in E&P from one foreign corporation to another (the so called “hovering deficit rule”). The hovering deficit rule is applied when either the foreign acquiring or target corporation has a deficit in one or more subcategories of E&P immediately before a section 381 transaction.¹²⁷⁷ The rule is designed to prevent taxpayers with positive E&P from trafficking in E&P deficits by providing that such a deficit can only offset E&P accumulated by the foreign surviving corporation after a section 381 transaction.¹²⁷⁸ Finally, in response to comments, the Final Attribute Carryover Regulations provide that foreign taxes related to a hovering deficit enter the post-1986 foreign income taxes pool on a pro rata basis as the hovering deficit to which the foreign taxes relate is used to offset post-transaction accumulated E&P.¹²⁷⁹ The government agreed with commentators that this type of pro rata approach more accurately correlates the payment of foreign income taxes with the use of the related hovering deficit than the approach employed by the proposed regulations.¹²⁸⁰

b. U.S. Shareholder Status Not Preserved

U.S. shareholders that exchange stock in a CFC for stock in another foreign corporation but do not become direct or indirect U.S. shareholders of such foreign transferee corporation will

¹²⁷⁷ See Treas. Reg. § 1.367(b)-7(d)(2)(i), (e)(1)(iii)(A), (e)(2)(iii)(A), and (f)(1).

¹²⁷⁸ See T.D. 9273, 2006-2 C.B. 394; Treas. Reg. § 1.367(b)-7(d)(2), (e)(i)(1)(iii), (e)(2)(iii), and (f)(1). The hovering deficit rule does not apply to section 381 transactions which are F reorganizations or where the foreign target corporation or the foreign acquiring corporation is newly created. Treas. Reg. § 1.367(b)-(9)(b). Moreover, a hovering deficit cannot be used to determine current or accumulated earnings and profits of the foreign surviving corporation for purposes of calculating the earnings and profits limitation of section 952(c)(1)(A) and (C), or the amount of the foreign surviving corporation’s Subpart F income under section 952(a). Treas. Reg. § 1.367(b)-7(f)(1)(i).

¹²⁷⁹ See Treas. Reg. § 1.367(b)-7(f)(5).

¹²⁸⁰ See T.D. 9273, 2006-2 C.B. 394. Under the proposed regulations, taxes associated with a hovering deficit were not combined in the surviving corporation’s post-1986 foreign income taxes pool until the entire deficit had been offset against post-transaction accumulated E&P.

generally be subject to tax on the exchange under one of three rules.¹²⁸¹ If a U.S. shareholder exchanges CFC stock for stock in a foreign corporation with respect to which such shareholder is not a U.S. shareholder, or for stock in a foreign corporation that is not a CFC, the U.S. shareholder must include its section 1248 amount¹²⁸² attributable to the exchanged stock as dividend income.¹²⁸³ A U.S. shareholder must also include its section 1248 amount attributable to its exchanged stock as dividend income if (i) immediately before the exchange, the foreign target and acquiring corporations are not members of the same affiliated group, (ii) immediately after the exchange, a U.S. corporation qualifies for a deemed paid foreign tax credit for a distribution received from the foreign acquiring corporation (directly or indirectly) under section 902, and (iii) the exchanging shareholder receives nonparticipating preferred stock or tracking stock.¹²⁸⁴ Finally, a U.S. shareholder must include in income its section 1248 amount attributable to CFC stock exchanged in a recapitalization for certain nonparticipating preferred stock or tracking stock, if the CFC is involved in a stock-for-stock exchange as either the foreign target or the foreign acquiring corporation within two years of the recapitalization and the conditions described in (i) and (ii) above are satisfied.¹²⁸⁵

¹²⁸¹ As discussed in the text below, a U.S. shareholder's exchange of stock in a CFC for stock in a U.S. (rather than foreign) corporation pursuant to a section 332 liquidation or a section 368 asset acquisition is governed by Treasury Regulation section 1.367(b)-3.

¹²⁸² Treas. Reg. § 1.367(b)-2(c).

¹²⁸³ Treas. Reg. § 1.367(b)-4(b)(1). In addition to insuring that U.S. tax will be imposed on the E&P of the distributed company, the IRS has imposed an additional toll charge on certain inversions. After the initial inversion transaction in which the U.S. parent becomes the subsidiary of a foreign corporation, the section 367(b) regulations prevent the former U.S. parent corporation from distributing the stock of any foreign subsidiaries tax-free to the new foreign parent corporation, thus removing them from the U.S. tax net, including the Subpart F rules.

¹²⁸⁴ Treas. Reg. § 1.367(b)-4(b)(2)(i).

¹²⁸⁵ Treas. Reg. § 1.367(b)-4(b)(3).

c. Receipt of U.S. Parent Corporation Stock

The Final Section 367 Regulations add an important exception to the rule that an exchanging shareholder receiving stock of a domestic corporation must include in income the section 1248 amount with respect to its foreign target corporation stock. Under the Final Section 367 Regulations, an exchanging shareholder that receives domestic corporation stock may avoid the section 1248 inclusion, provided that the domestic corporation is a section 1248 shareholder of the acquired corporation (in the case of a triangular B reorganization) or the surviving corporation (in the case of a triangular C Reorganization, an A2D, or an A2E, among other transactions) immediately after the exchange, and such acquired or surviving corporation is a CFC.¹²⁸⁶ Although this exception generally applies only to transactions occurring after January 22, 2006,¹²⁸⁷ taxpayers may apply this exception retroactively to triangular B reorganizations occurring after February 22, 2000 if the statute of limitations has not closed for the taxable year in which such a reorganization occurred, and the

¹²⁸⁶ Treas. Reg. § 1.367(b)-4(b)(1)(ii), (b)(1)(iii), Ex. 3B. *See generally* Lowell D. Yoder, *A Bird's Eye View of § 367's Application to Triangular Reorganizations Involving CFCs*, 36 Tax Mgmt. Int'l J. 525 (Oct. 12, 2007). In the case of asset reorganizations, the Treasury Department enacted this change because the new basis rules in Treasury Regulation section 1.367(a)-13(e) now preserve the section 1248 inclusion attributable to the stock of the foreign acquired corporation or surviving corporation, as the case may be, that is held by the domestic issuing corporation. *See* T.D. 9243, 2006-1 C.B. 475. In the case of triangular B Reorganizations, Treasury Regulation section 1.358-6 similarly preserves the section 1248 inclusion with respect to the acquired corporation. *See* T.D. 9243, 2006-1 C.B. 475.

¹²⁸⁷ *See* T.D. 9243, 2006-1 C.B. 475. The preamble to the Final Section 367 Regulations explains that the exception applies prospectively to other triangular reorganizations because the special basis rules in Treasury Regulation section 1.367(a)-13(e) apply prospectively. The government rejected the suggestion by commentators to permit taxpayers to elect to apply the section 1248 inclusion exception to other triangular reorganizations, concluding that such elections would be too complex and difficult to administer. *See* T.D. 9243, 2006-1 C.B. 475.

taxpayer consistently elects to apply this provision to all such triangular B reorganizations.¹²⁸⁸

d. Application of Section 367(b) to Certain Triangular Reorganizations

In May, 2008, the government issued temporary and final regulations under section 367(b) designed to prevent the tax-free repatriation of earnings from CFCs to U.S. parents in section 368(a) triangular reorganizations (the “2008 Regulations”).¹²⁸⁹ The regulations apply when a foreign parent (“P”), and/or subsidiary (“S”) corporation effect a reorganization in which S acquires P stock in exchange for property to use as consideration in a triangular reorganization.¹²⁹⁰ The regulations are largely consistent with Notices 2006-85 and 2007-48, as discussed below.¹²⁹¹

In September, 2006, the government announced in Notice 2006-85¹²⁹² that it intended to issue regulations under section 367(b) addressing certain triangular reorganizations involving foreign corporations with respect to which S purchases P stock, either directly from P or a related party, to use as merger

¹²⁸⁸ Treas. Reg. § 1.367(b)-6(a)(1).

¹²⁸⁹ See Joseph M. Calianno & Kagney Petersen, *IRS Issues Regs. Addressing “Killer B” and Similar Transactions*, 35 J. Corp. Tax’n 10 (Nov./Dec. 2008); Joseph M. Calianno & Kagney Petersen, *‘Killer B’ The Saga Continues*, 19 J. Int’l Tax’n 34 (Sept. 2008); *IRS Issues Final, Temporary Regs on ‘Killer B’ Transactions*, 2008 TNT 102-6 (May 23, 2008); Lee A. Sheppard, *Killing Off the Killer B*, 116 Tax Notes 92 (July 9, 2007). Cf. T.A.M. 2009-19-032 (Jan. 29, 2009) (section 367(a) applied to Killer B transaction; U.S. parent corporation should have filed GRA in connection with transaction); see also Robert Willens, *Technical Advice on ‘Killer B’ Reorganization Examined*, 2009 TNT 103-14 (May 18, 2009) (discussing Technical Advice Memorandum 2009-19-032).

¹²⁹⁰ See T.D. 9400, 2008-1 C.B. 1139; Treas. Reg. § 1.367(b)-14T.

¹²⁹¹ See *IRS Issues Long-Awaited Regulations Cracking Down on Killer B Transactions*, 101 Daily Tax Rep. (BNA), at GG-1 (May 27, 2008) (quoting IRS Deputy Associate Chief Counsel (International) Mike DiFronzo as stating that the 2008 Regulations are “not in any substantive way different from the notices”).

¹²⁹² 2006-2 C.B. 677.

consideration. The parties typically structured these transactions as triangular B reorganizations, although the transactions could often also be structured as triangular C reorganizations.¹²⁹³ Under prior law, P should have recognized no gain or loss on the issuance of its stock to S, S should have obtained a cost basis in the P shares, and thus should not have recognized any gain in the exchange for T stock (unless the P stock appreciated while held by S).¹²⁹⁴ In addition, the U.S. shareholders of P should not have included any amount in gross income as a result of the transaction if the purchase by S of P stock and subsequent transfer to S1 was completed within the same calendar quarter because the P shares would not have constituted U.S. property held by a CFC (S) at quarter end when the section 956 inclusion was determined.¹²⁹⁵

Notice 2006-85 bifurcated the purchase of P stock and the subsequent reorganization to preclude the tax results described above and treated consideration provided by S to P for the stock as a taxable distribution,¹²⁹⁶ followed by a contribution of the stock

¹²⁹³ See I.R.C. § 1032(a). For example, P (U.S.) owns 100% of S (foreign) and S1 (U.S.). S1 owns 100% of T (foreign). S purchases P stock from P for either cash or a note and S uses the purchased stock in exchange for T stock held by S1 in a putative triangular B reorganization.

¹²⁹⁴ See I.R.C. § 362(b); Treas. Reg. § 1.1032-2(c) (basis equals fair market value of P stock in the hands of S, so no gain on transfer in exchange for unappreciated T stock).

¹²⁹⁵ Section 951(a)(1)(B) requires a U.S. shareholder of a CFC to include in income the amount calculated under section 956. Section 956(a)(1), in turn, requires the U.S. shareholder to include in gross income its share of the amount of U.S. property (P stock) held by the CFC (S) at the end of each quarter.

The government specifically identified the following policy concerns in Notice 2006-85: (i) when P is domestic and S is foreign, the transaction could effectively repatriate foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax; (ii) where P is foreign and S is domestic, the transaction could effectively transfer U.S. earnings of S to its foreign parent without U.S. withholding tax, and (iii) where both P and S are foreign, the transactions may permit CFCs to avoid Subpart F income inclusions to certain U.S. shareholders of P. See Notice 2006-85, § 2, 2006-2 C.B. 677.

¹²⁹⁶ See I.R.C. § 301(c).

by P to S's capital pursuant to the plan of reorganization. As a result of these deemed transactions, P would recognize dividend income to the extent of S's E&P; any excess amount would reduce the basis of P's S or T stock to zero and then produce gain from a deemed sale or exchange of P's stock.¹²⁹⁷ S's E&P would also be adjusted to account for the deemed distribution to P.¹²⁹⁸ Finally, P would recognize dividend treatment, notwithstanding the fact that section 1032 would otherwise provide tax-free treatment.

In May, 2007, the government expanded its then-forthcoming regulatory project to include purchases of P stock by S in the open market or from unrelated third parties for use as merger consideration in Notice 2007-48, which extended Notice 2006-85 by deeming P to receive a distribution from S of the consideration paid to acquire P stock, even if S did not acquire the P stock from either P or a related party.¹²⁹⁹ The government explained in Notice 2007-48 that it would rely on the logic employed in *Bazley v. Commissioner*¹³⁰⁰ and Treasury Regulation section 1.301-1(l)¹³⁰¹ (reflecting the holding in *Bazley*) to issue regulations under section 367(b).¹³⁰²

¹²⁹⁷ See I.R.C. § 301(c)(1)-(3).

¹²⁹⁸ See Notice 2006-85, § 5, 2006-2 C.B. 677.

¹²⁹⁹ See Notice 2007-48, 2007-1 C.B. 1428. See generally Joseph M. Calianno & Kagney Petersen, *Notice 2007-48: A Further Attack on the "Killer B" and Similar Transactions*, 18 J. Int'l Tax'n 18 (Aug. 2007); Robert Willens, *Service Expands Anti-Killer 'B' Campaign to 'Public' Transactions*, Daily Tax Rep. (BNA), at J-1 (June 27, 2007).

¹³⁰⁰ 331 U.S. 737 (1947).

¹³⁰¹ See Treas. Reg. § 1.301-1(l) (a distribution to shareholders with respect to their stock is governed by section 301, even if it occurs at the same time as another transaction, if the distribution is in substance a separate transaction; typical examples include a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having little property). See also P.L.R. 2010-01-002 (Jan. 8, 2010) (distribution to shareholders immediately before reorganization was governed by section 301); P.L.R. 2006-08-018 (Feb. 24, 2006) (distribution to shareholders immediately after reorganization was governed by section 301).

¹³⁰² See Notice 2006-85, § 3, 2006-2 C.B. 677. In *Bazley*, a closely held corporation distributed five new shares of stock and a ten-year callable debenture in exchange for each share of stock previously

Notice 2007-48 would essentially employ the same type of deemed transactions as those described above in Notice 2006-85. Under Notice 2007-48, as a result of the deemed distribution, P will recognize dividend income to the extent of S's E&P, and any excess amount will reduce the basis of P's S or T stock and then produce gain from a deemed sale of P's stock.¹³⁰³ The amount constituting a deemed dividend will be treated as received by P and immediately re-contributed to S, thereby increasing P's basis in S stock by the contributed amount.¹³⁰⁴ S's E&P will be adjusted to reflect the deemed distribution to P. After giving effect to these deemed transactions, S's purchase of P stock will be subject to all other generally applicable rules of the Code, *e.g.*, sections 304, 358 and 368.¹³⁰⁵ As discussed below, taxpayers are likely to view the government's expansive view of its authority to issue the 2008 Regulations as questionable at best.

i. 2008 Regulations

The 2008 Regulations treat S as transferring property to P in a deemed section 301 distribution with a value equal to the amount of cash and the fair market value of any other property transferred by S to acquire the property.¹³⁰⁶ The distribution will constitute a dividend to the extent of S's E&P, and any excess amount will constitute a return of basis or gain from the sale or exchange of property, as applicable.¹³⁰⁷ The 2008 Regulations treat S's deemed distribution to P as a distribution for all purposes of the Code, including sections 312, 881, 897, 902, 959, 1442 and

held. The exchange was pursuant to a plan of reorganization and met the technical requirements for a recapitalization. The Supreme Court held that the sole purpose of the purported recapitalization was to effect the payment of undistributed earnings and treated the distribution of debentures as a dividend even though the distribution occurred at the same time as, and was part of, the purported recapitalization. *See Bazley v. Commissioner*, 331 U.S. 737 (1947).

¹³⁰³ See I.R.C. § 301(c)(1)-(3).

¹³⁰⁴ See Treas. Reg. § 1.367(b)-2(e)(3)(ii).

¹³⁰⁵ See Notice 2007-48, § 2, 2007-1 C.B. 1428.

¹³⁰⁶ See Treas. Reg. § 1.367(b)-14T(b). For this purpose, "property" includes any liabilities immediately re-assumed and any S stocks used to acquire P stock from a person other than P. *See* Treas. Reg. § 1.367(b)-14T(a)(2).

¹³⁰⁷ Treas. Reg. § 1.367(b)-14T(b); *see* I.R.C. § 301(c).

1445.¹³⁰⁸ If S does not purchase P stock from P, P is deemed to immediately re-contribute to S the property previously deemed distributed to P.¹³⁰⁹ This deemed contribution is similarly treated as a capital contribution for all purposes of the Code.¹³¹⁰ P must make appropriate adjustments to its tax basis in S stock to account for the deemed distribution and any deemed contribution.¹³¹¹ The ordering rules in the 2008 Regulations generally require these deemed transactions to be taken into account immediately prior to the related triangular reorganization involving P stock.¹³¹²

The regulations also permit appropriate adjustments if, in connection with a triangular reorganization, the parties engage in a transaction to avoid the rules.¹³¹³ For example, if P contributes to a newly formed S another corporation with positive E&P (S2) to facilitate S's purchase of P stock, or the repayment of S debt incurred to purchase P stock, S's E&P may be deemed to include S2's E&P.¹³¹⁴

The portion of the 2008 Regulations addressing transactions described in (i) Notice 2006-85 generally apply to transactions occurring after September 21, 2006, and (ii) Notice 2007-48 transactions generally apply to transactions occurring after May 30, 2007.¹³¹⁵

¹³⁰⁸ See Treas. Reg. § 1.367(b)-14T(c)(1); T.D. 9400, 2008-1 C.B. 1139.

¹³⁰⁹ See Treas. Reg. § 1.367(b)-14T(b)(3); T.D. 9400, 2008-1 C.B. 1139.

¹³¹⁰ See Treas. Reg. § 1.367(b)-14T(c)(2); T.D. 9400, 2008-1 C.B. 1139.

¹³¹¹ See T.D. 9400, 2008-1 C.B. 1139.

¹³¹² See Treas. Reg. § 1.367(b)-14T(b)(2), (3). If P does not own stock representing section 368(c) control of S when S purchases the P stock, the regulations treat the deemed distribution and, if applicable, the deemed contribution as separate transactions occurring immediately after P acquires control of S. See Treas. Reg. § 1.367(b)-14T(b)(3).

¹³¹³ See Treas. Reg. § 1.367(b)-14T(d).

¹³¹⁴ See T.D. 9400, 2008-1 C.B. 1139.

¹³¹⁵ See Treas. Reg. § 1.367(b)-14T(e)(1), (2). The portion of the regulations permitting appropriate adjustments if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of the regulations is generally effective for transactions occurring after May 30, 2007. See Treas. Reg. § 1.367(b)-14T(e)(3)(i).

ii. Government's Asserted Basis for 2008 Regulations

In the government's view, the transactions subject to the 2008 Regulations raise significant policy concerns under section 367(b), including the repatriation of a CFC's earnings to its parent without the payment of U.S. income tax.¹³¹⁶ As discussed below, however, neither the legislative history to section 367 nor the Supreme Court's decision in *Bazley* and Treasury Regulation section 1.301-1(l), which the government cited in Notice 2006-85, support overriding P's entitlement to tax-free treatment under section 1032 on the use of its stock in triangular reorganizations.¹³¹⁷ In addition, neither the 2008 Regulations, the accompanying preamble, nor Notice 2007-48 provide any authority for the creation of the additional steps necessary to treat a purchase by S of P stock from third parties as a deemed distribution to P.

¹³¹⁶ See T.D. 9400, 2008-1 C.B. 1139; Notice 2006-85, § 2, 2006-2 C.B. 677; see also *IRS Official Previews Upcoming 'Killer B' Regulations*, 2007 TNT 143-9 (July 25, 2007) (quoting IRS Deputy Associate Chief Counsel (International) Mike DiFronzo as stating that then-forthcoming 2008 Regulations would address some of the "most offensive, most replicated" repatriation transactions); *IRS Official Defends Use of Section 367(b) to Tax Offshore Earnings in Killer B Deals*, 108 Daily Tax Rep. (BNA), at G-3 (June 6, 2007) (quoting IRS Deputy Associate Chief Counsel (International) Mike DiFronzo as stating that "[o]ur rules are intended to tax offshore earnings when they're employed in the U.S.").

¹³¹⁷ See generally Benjamin G. Wells & Derek S. Green, *Firm Seeks Withdrawal of Proposed Regs on 'Killer B' Reorganizations Involving Foreign Corporations*, 2008 TNT 169-19 (Aug. 29, 2008) (requesting that IRS withdraw regulations in their entirety or at least narrow regulations to not apply when (i) target corporation is an unrelated corporation, or (ii) acquiring subsidiary is a U.S. corporation); Lowell D. Yoder, *Notice 2007-48: IRS Takes a Shot at Public Triangular Reorganizations*, 33 Int'l Tax J. 3, 4 (Sept.-Oct. 2007) (legal basis for Notice 2007-48's rule is "doubtful", there is "no apparent policy reason supporting the result" and any "special treatment" for the relevant transactions should be handled legislatively); Joseph M. Calianno & Kagney Petersen, *IRS Issues Notices on "Killer B" Transactions: Have the IRS and Treasury Overextended Their Reach?*, 34 J. Corp. Tax'n 11 (Sept./Oct. 2007) (even assuming Treasury has sufficient authority under section 367, it is "questionable" for Treasury to exercise such authority in this context).

This lack of authority is notable because the Tax Court has repeatedly declined to apply the step transaction doctrine where the order and substance of the steps chosen represent a logical and efficient manner of accomplishing non-tax corporate business objectives, and no other series of steps would represent a more logical or efficient manner of accomplishing the same objectives.¹³¹⁸ The government has failed to identify a more logical series of steps, or fewer steps, than the actual purchase on the open market or from an unrelated third-party. Accordingly, this author believes that the 2008 Regulations are of questionable validity.

Section 367 initially vested the IRS with complete discretion by requiring taxpayers to obtain an advance ruling that a transaction lacked tax-avoidance as principal purpose.¹³¹⁹ However, Congress substantially amended the statute in 1976 to eliminate the advance ruling requirement and establish separate rules for outbound transfers of property from the United States, on the one hand, and inbound transfers and foreign-to-foreign transactions, on the other hand.¹³²⁰ Although the statutory aim with respect to the second group of transactions was to preserve the government's ability to tax a CFC's accumulated profits,¹³²¹ the Committee Reports to the 1976 legislation reflect a balancing

¹³¹⁸ See *Esmark v. Commissioner*, 90 T.C. 171 (1988) (court refused to invent new steps to apply step transaction doctrine), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989); *Turner Broad. Sys., Inc. v. Commissioner*, 111 T.C. 315 (1998) (court refused to apply step transaction doctrine where IRS recast did not account for all results of transaction and invented steps that did not occur); *Pabst Brewing Co. v. Commissioner*, 69 T.C.M. (CCH) 2773 (1995) (step transaction doctrine did not apply to treat redemption as a sale because IRS recast invented illogical step).

¹³¹⁹ See H.R. Rep. No. 72-708, at 20 (1932); S. Rep. No. 72-665, at 26-27 (1932). The House and Senate committee reports each state that the pertinent non-recognition provisions, as applied to transactions involving foreign corporations, were to be inoperative "unless prior to the exchange the commissioner is satisfied that the transaction does not have as one of its principal purposes the avoidance of Federal income taxes."

¹³²⁰ I.R.C. § 367(b); see Tax Reform Act of 1976, Pub. L. No. 94-455.

¹³²¹ See H.R. Rep. No. 94-658, at 242 (1976); S. Rep. No. 94-938 (Part II), at 264 (1976).

of policy considerations and conclude that “barriers to justifiable and legitimate business transactions should be avoided.”¹³²²

While Treasury Regulations generally receive deference from courts as long as they “implement the congressional mandate . . . in some reasonable manner,”¹³²³ “a regulation which exceeds its congressionally mandated scope of authority and is ‘plainly inconsistent with the revenue statutes,’ should not be sustained.”¹³²⁴ The forthcoming regulations appear to contradict Congress’s intent in amending section 367 in 1976. Requiring P to recognize dividend income whenever S purchases P stock for use in an acquisitive reorganization effectively once again imposes a toll charge, since a deemed dividend occurs regardless of the presence of a tax avoidance motive. As discussed above, Congress intended to eliminate this requirement in 1976 and allow taxpayers to litigate, if necessary, the question of whether tax avoidance is a purpose of their transaction.¹³²⁵

¹³²² H.R. Rep. No. 94-658, at 241 (1976); S. Rep. No. 94-938 (Part II), at 263 (1976).

¹³²³ *Phillips Petroleum Co. v. Commissioner*, 97 T.C. 30, 34 (1991) (citing *United States v. Correll*, 389 U.S. 299, 307 (1967)).

¹³²⁴ *Phillips Petroleum Co. v. Commissioner*, 97 T.C. 30, 33 (1991) (citing *Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981)).

¹³²⁵ See H.R. Rep. No. 94-658, at 241 (1976); S. Rep. No. 94-938 (Part II), at 263 (1976). The Committee Reports identified four reasons for the amendments to section 367: (i) the advance ruling requirement often resulted in an undue delay for taxpayers attempting to consummate proper business transactions, (ii) a number of cases arose where a foreign corporation was involved in an exchange within the scope of the old section 367 guidelines without the knowledge of the U.S. shareholders, (iii) the IRS required U.S. shareholders to include certain amounts in income as a toll charge even absent a tax avoidance purpose, relying only on the existence of a potential for future tax avoidance, and (iv) the taxpayer was unable to elect a transaction and then litigate the question of whether tax avoidance was one of the principal purposes of the transactions.

Even under prior law, the toll charge approach was questionable; the Second Circuit concluded that Congress did not intend to prevent tax avoidance by requiring “the payment of a substantial tax in every case, even where it was clear that the [transaction] was entirely

The preamble to the 2008 Regulations explains that “Congress granted the Secretary authority to provide regulations necessary or appropriate to prevent the avoidance of Federal income taxes and identified transfers constituting a repatriation of foreign earnings as a type of transfer to be covered in regulations to be promulgated by the Secretary.”¹³²⁶ This grant of discretion appears to be (inappropriately) intended to override the specific statutory provisions of section 1032 that explicitly provide P with tax-free treatment on the receipt of property in exchange for its stock. This approach is particularly surprising in light of the willingness by courts to require compliance with statutory language even if that result contravenes the purpose of Subpart F.¹³²⁷ In sum, it is far from clear that the grant of authority in section 367(b) to issue regulations is broad enough to override the result mandated by the specific statutory language of section 1032.

Moreover, Notice 2006-85 cited *Bazley* and Treasury Regulation section 1.301-1(l) in support of the deemed dividend approach. However, Treasury Regulation section 1.301-1(l), by its terms, is “most likely” to apply to transactions involving only a single operating company. Carried to its logical extreme, Notice 2006-85 would suggest that any bona fide sale of property from a shareholder to its parent corporation can be recast as a dividend and capital contribution. Accordingly, defending the approach set forth in Treasury Regulation section 1.301-1(l) to a subsidiary’s purchase of parent stock before an acquisitive reorganization will no doubt prove challenging for the government.¹³²⁸

innocent of any tax avoidance purposes.” *Gerli & Co., Inc. v. Commissioner*, 668 F.2d 691, 699 (2nd Cir. 1982).

¹³²⁶ See T.D. 9400, 2008-1 C.B. 1139.

¹³²⁷ See *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996) (a partnership was not a related person under the plain meaning of section 954(d) even though that conclusion violates the purpose of Subpart F); *The Limited, Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002) (a taxpayer’s wholly owned subsidiary was “carrying on the banking business” for purposes of a section 956 statutory exception to the requirement that a CFC’s purchase of property in the United States constitutes a taxable investment in U.S. property); see generally Lee A. Sheppard, *Corporate Tax Shelters – The Killer B*, 2000 TNT 94-5 (May 15, 2000).

¹³²⁸ See Hal Hicks & David J. Sotos, *The Empire Strikes Back (Again) – Killer Bs, Deadly Ds and Code Section 367 As the Death Star Against Repatriation Rebels*, 34 Int’l Tax J. 37 (May/June 2008);

iii. Final Regulations

In May 2011, the IRS issued final regulations (the “2011 Regulations”) under section 367 that replace the 2008 Regulations for transactions occurring on or after May 17, 2011.¹³²⁹

The 2011 Regulations closely track the 2008 Regulations, subject to several changes detailed below. The IRS modified the scope of the 2011 Regulations to exclude two types of transactions covered by the 2008 regulations.¹³³⁰ First, the 2011 Regulations do

Robert Willens, *Service Rejects ‘Killer Bees’ Technique for Repatriating Earnings of Foreign Subsidiary But Courts May Reject Move for Lack of Authority*, Daily Tax Rep. (BNA), at J-1 (Oct. 5, 2006). Finally, although unrelated to section 367, the government previously attempted to treat the purchase price paid by a subsidiary for its parent corporation’s stock as a deemed dividend for section 304 purposes. See Rev. Rul. 69-261, 1969-1 C.B. 94. The courts rejected both the argument that the parent received a constructive distribution as well as the government’s technical interpretation of section 304. See *Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977); *Virginia Materials Corp. v. Commissioner*, 67 T.C. 372 (1976); *Webb v. Commissioner*, 67 T.C. 293 (1976). The government has failed to articulate a reason why the courts’ conclusions in these cases should not properly apply to section 367 as well.

¹³²⁹ T.D. 9526, 76 Fed. Reg. 28890 (May 19, 2011). See generally *IRS issues Final ‘Killer B’ Regs*, 2011 TNT 96-1 (May 18, 2011); *IRS Unveils Final Regulations Cracking Down On Tax-Free Repatriation Via Killer B Deals*, Daily Tax Rep. (BNA), at G-2 (May 18, 2011); *Final ‘Killer B’ Regulations Further Expand Likelihood of Gain Recognition by Taxpayers*, 114 J. Tax’n 365 (June 2011).

¹³³⁰ This change was made to address practitioners’ concerns with the priority rule, which generally provides that “if the amount of gain in T stock that would otherwise be recognized under section 367(a)(1) (absent an exception) is less than the adjustment treated as a dividend under the 2008 Regulations, then the 2008 Regulations, and not section 367(a)(1), apply to the triangular reorganization.” Practitioners’ comments suggested that “in some cases it may be more appropriate for the priority rule to take into account the amount of resulting U.S. tax.” The IRS acknowledged the appropriateness of this comment, but did not believe that “it would be administrable to take into account the resulting U.S. tax in all cases, because this could require consideration of numerous tax attributes of various parties.” See T.D. 9526, 76 Fed. Reg. 28890, 28890 (May 19, 2011).

not apply where P and S are foreign corporations and neither P nor S is a controlled foreign corporation immediately before or immediately after a triangular reorganization.¹³³¹ Second, the 2011 Regulations also do not apply where: (i) P is a foreign corporation; (ii) S is a domestic corporation; (iii) P's receipt of a dividend from S would not be subject to U.S. tax under either section 881 or section 882; and (iv) P's stock in S is not a United States real property interest.¹³³²

The IRS expanded the scope of the 2011 Regulations to include cases where S acquires P securities in exchange for property¹³³³ to use to acquire the stock, securities, or property of T in a triangular reorganization in which T shareholders or securityholders treat the P securities as "other property" under section 356(d).¹³³⁴ The IRS also expanded the scope of the 2011 Regulations to cover transactions in which S acquires P stock in exchange for property, in cases where T shareholders or securityholders receive P stock in a section 354 or section 356 exchange.¹³³⁵

The 2011 Regulations also clarify that the P's adjustments to its basis in S stock to account for the deemed distribution and contribution are made based on a deemed distribution or deemed contribution of a notional amount¹³³⁶, and therefore without the

¹³³¹ See Treas. Reg. § 1.367(b)-(10)(a)(2)(i). David D. Stewart, *Treasury Issues Final 'Killer B' Regs*, 131 Tax Notes 781 (May 23, 2011) (noting Joseph Calianno's observation that the IRS considered and then rejected commentary recommending that the regulations not apply to acquisitions of unrelated targets).

¹³³² See Treas. Reg. § 1.367(b)-(10)(a)(2)(ii).

¹³³³ For purposes of these rules, "property" is defined by reference to section 317(a), but also includes (i) a liability assumed by S to acquire the P stock or securities, and (ii) S stock (or any rights to acquire S stock) to the extent such S stock (or rights to acquire S stock) is used by S to acquire P stock or securities from a person other than P. See Treas. Reg. § 1.367(b)-10(a)(3).

¹³³⁴ The IRS justifies this expansion to P securities as raising "the same repatriation concerns as the acquisition of P stock by S for property." See T.D. 9526, 76 Fed. Reg. 28890, 28891 (May 19, 2011).

¹³³⁵ See T.D. 9526, 76 Fed. Reg. 28890, 28891 (May 19, 2011).

¹³³⁶ The notional amount is equal to the sum of money transferred, liabilities assumed, and the fair market value of other property

recognition of any built-in gain or loss on the distribution of such notional amount. In addition, the 2011 Regulations clarify that the adjustments that have the effect of a deemed distribution or deemed contribution do not affect the characterization of the actual transaction as provided under applicable tax provisions.

For example, if S uses appreciated property to acquire P stock from P, the required adjustments based on a deemed distribution and deemed contribution of the notional amount occur in addition to S's tax consequences attributable to its exchange of appreciated property for P stock. Accordingly, S would generally recognize gain under section 311(b) with respect to S's actual exchange of property for P stock, but not with respect to the notional amount.¹³³⁷

Finally, the 2011 Regulations combine the two ordering rules for the deemed transactions from the 2008 Regulations into a single rule that applies regardless of whether S acquires P's stock or securities from P or another party.¹³³⁸

3. Coordination of Sections 367(a) and 367(b)

The Final Section 367 Regulations change the rule in the prior regulations that suspended the application of section 367(b) when section 367(a) required a deemed dividend inclusion under section 1248 for the same transaction.¹³³⁹ Instead, the Final Section 367 Regulations apply section 367(b) (rather than section 367(a)) to such exchanges in cases where the all earnings and profits amount (as determined under Treasury Regulation section 1.367(b)-3)) attributable to the stock of an exchanging

transfers, in exchange for the P stock or securities used to acquire the stock, securities or property of T by S in a triangular reorganization. See T.D. 9526, 76 Fed. Reg. 28890, 28891 (May 19, 2011).

¹³³⁷ See T.D. 9526, 76 Fed. Reg. 28890, 28891 (May 19, 2011).

¹³³⁸ See Treas. Reg. § 1.367(b)-10(b)(3). If P controls S at the time of the P acquisition, the adjustment to P's stock basis is made as if the deemed distribution and deemed contribution, respectively, are separate transactions occurring immediately before the P acquisition and, if P does not control S at the time of the P acquisition, as if the deemed distribution and deemed contribution, respectively, are separate transactions occurring immediately after P acquires control of S, but prior to the triangular reorganization.

¹³³⁹ See Treas. Reg. § 1.367(a)-3(b)(2) (prior to amendment).

shareholder exceeds the gain the shareholder would recognize under section 367(a) by virtue of the indirect stock transfer rules.¹³⁴⁰ In such a case, the shareholder must include in income as a deemed dividend the all earnings and profits amount, without regard to whether the exchanging shareholder files a GRA as required under section 367(a).¹³⁴¹ The IRS and the Treasury Department determined that it was contrary to the policy of section 367(b) to allow a shareholder to effectively elect to be taxed on a lesser amount of gain under section 367(a) simply by failing to file a GRA.¹³⁴²

4. Basis and Holding Period Rules

The Final Section 367 Regulations provide special basis and holding period rules to certain triangular reorganizations, such as triangular C, A2D and A2E reorganizations, involving a foreign target or foreign merger subsidiary that has a section 1248 shareholder. The current basis regulations in Treasury Regulation section 1.358-6 determine the parent's basis in its merger subsidiary after an A2D or triangular C reorganization by treating the parent as directly acquiring the target assets and then transferring the assets to its subsidiary.¹³⁴³ The parent's basis in the target stock after an A2E reorganization equals its merger subsidiary's stock basis immediately before the acquisition, adjusted as if the target were acquired in an A2D or triangular C reorganization (in the manner described in the immediately preceding sentence). The government was concerned that these rules would not preserve the section 1248 amount after a triangular

¹³⁴⁰ See Treas. Reg. §§ 1.367(a)-3(b)(2)(i)(B); 1.367(b)-1(a) (cross referencing the controlling provision under the section 367(a) regulations). The all earnings and profits amount may exceed the section 1248 amount because the all earnings and profits amount is not limited by the U.S. shareholder's gain in the foreign target stock.

¹³⁴¹ See Treas. Reg. § 1.367(a)-3(b)(2)(i)(B).

¹³⁴² See T.D. 9243, 2006-1 C.B. 475.

¹³⁴³ In that situation, the parent would be treated as receiving the assets with a carryover basis, increased by the amount of any gain received by the transferor, subject to the section 362(e) limitations. See I.R.C. § 362(b) and (e); Treas. Reg. § 1.358-6(c). If the transferred assets are subject to liabilities that exceed the asset basis, no adjustment is made to the merger subsidiary's stock when it receives the deemed contribution. See Treas. Reg. § 1.358-6(c)(1)(ii).

reorganization when the target's asset basis does not match its section 1248 shareholders' stock basis.¹³⁴⁴

In response to this concern, the Final Section 367 Regulations determine the stock basis of either the surviving target or merger subsidiary (either, the "surviving corporation") by reference to each section 1248 shareholder's basis in its target stock instead of the target corporation's basis in its assets.¹³⁴⁵ For example, in a triangular C reorganization with a domestic parent corporation, foreign merger subsidiary, and foreign target with a section 1248 shareholder, the section 1248 shareholder's basis and holding period in its target stock will be used to determine the parent's basis in the acquisition subsidiary's stock.¹³⁴⁶ To accomplish this result, the Final Section 367 Regulations establish two bases and holding periods in each share of surviving corporation stock to preserve the relevant section 1248 amounts in the merger subsidiary and/or target stock, such that each share of merger subsidiary stock after an A2D or triangular C reorganization, and each share of target stock after an A2E reorganization, is notionally divided into two shares representing the separate bases and holding periods of the merger subsidiary stock and target stock, respectively, immediately before the merger.¹³⁴⁷

¹³⁴⁴ See T.D. 9243, 2006-1 C.B. 475. By contrast, in the case of an exchange under section 354 (and section 356), the Final Section 367 Regulations simply cross reference the section 358 Treasury Regulations to determine the exchanging shareholder's basis in the stock or securities received in the exchange. See Treas. Reg. § 1.367(b)-13(b). The preamble explained that the section 358 regulations provide a general tracing regime for determining basis that is consistent with the policies and requirements underlying the international provisions of the Code, including section 1248. See T.D. 9243, 2006-1 C.B. 475. Consequently, special rules are needed only for the case of triangular reorganizations.

¹³⁴⁵ See T.D. 9243, 2006-1 C.B. 475.

¹³⁴⁶ These rules also apply when acquirer stock is held by a foreign corporation with a section 1248 shareholder that is also a section 1248 shareholder of the target or merger subsidiary through such foreign corporation. See Treas. Reg. § 1.367(b)-13(c)(1)(A).

¹³⁴⁷ See Treas. Reg. § 1.367(b)-13(c)(2). A *de minimis* exception generally applies when, as is often the case, the merger subsidiary is a shell corporation whose stock basis is less than 1% of the surviving corporation's value. In this case, the basis of the merger subsidiary

In addition, if a section 1248 shareholder holds two or more blocks of stock in the target or merger subsidiary (each share in a block having the same basis and holding period), each share of surviving corporation stock is divided into a separate notional share to account for each block of stock.¹³⁴⁸ Two or more blocks held by a shareholder that is not a section 1248 shareholder are aggregated into one notional share of whichever historical corporation they represent.¹³⁴⁹ If the target and merger subsidiary each have no section 1248 shareholders, the current rules in the section 358 regulations continue to apply.¹³⁵⁰

Finally, special E&P rules apply when shares of surviving corporation stock have divided bases and holding periods. E&P that either a target or merger subsidiary accumulates prior to the reorganization are attributed to the notional share of surviving corporation stock, *i.e.*, target or merger subsidiary, to which the E&P relates.¹³⁵¹ The Final Section 367 Regulations attribute E&P generated after the reorganization to each divided share of stock under the section 1248 rules.¹³⁵²

stock is added to the basis of the surviving corporation stock. *See* Treas. Reg. § 1.367(b)-13(c)(2)(i)(C).

¹³⁴⁸ *See* Treas. Reg. § 1.367(b)-13(c)(2)(ii). These rules also apply when stock is held by a foreign corporation with a section 1248 shareholder that is also a section 1248 shareholder of the target or merger subsidiary through such foreign corporation. *See* Treas. Reg. § 1.367-13(c)(i)(A).

¹³⁴⁹ *See* Treas. Reg. § 1.367(a)-13(d)(1). This rule may be difficult to apply from a practical perspective if there is a widely held portion of the stock. *See, e.g.*, James Fuller, *U.S. Tax Review*, 37 Tax Notes Int'l 501 (Feb. 7, 2005). The preamble to the Final Section 367 Regulations acknowledges the complexity of the divided basis rules, but concludes that the creation of exceptions to the application of the rules would result in significant uncertainty for the IRS without meaningfully reducing administrative complexity. *See* T.D. 9243, 2006-1 C.B. 475.

¹³⁵⁰ *See* Treas. Reg. § 1.367-13(d)(1)(iii).

¹³⁵¹ *See* Treas. Reg. § 1.367-13(d)(2).

¹³⁵² *See* Treas. Reg. § 1.367-13(d)(3).

E. Cross-Border Liquidations – Section 367(e)

1. Outbound Section 332 Liquidations

Outbound liquidations pursuant to section 332 are often taxable transactions, notwithstanding the fact that they are not governed by section 367(a). Under section 367(e)(2), the liquidating U.S. corporation must recognize gain or loss on an outbound liquidation unless one of the following three exceptions applies.¹³⁵³

First, a U.S. liquidating corporation will not recognize gain or loss on the distribution of property that it used in the conduct of a trade or business in the United States if:

- the foreign distributee corporation uses the property in the conduct of a trade or business in the United States immediately after the distribution and throughout the 10-year period beginning on the distribution date;¹³⁵⁴
- the domestic liquidating corporation attaches a statement to its federal income tax return which provides, among other things, a description of the property distributed, the identity of the foreign distributee, a waiver of treaty benefits by the foreign distributee and an extension of the statute of limitations on assessments with respect to the liquidating domestic corporation until the lesser of 3 years after the date on which the property has ceased to be used in a trade or business in the United States or 13 years;¹³⁵⁵ and

¹³⁵³ See Treas. Reg. § 1.367(e)-2(b)(1). Loss in excess of gain from the distribution cannot be recognized. If realized losses exceed recognized losses, the losses shall be recognized on a pro rata basis with respect to the realized loss attributable to each distributed loss asset. Treas. Reg. § 1.367(e)-2(b)(1)(ii)(B). Built-in losses (built-in gains) attributable to property received in a transaction described in section 332 or section 361 during the two-year period prior to the liquidation cannot offset gain (loss) from property not received in the same transaction.

¹³⁵⁴ See Treas. Reg. § 1.367(e)-2(b)(2)(i)(A)(1).

¹³⁵⁵ See Treas. Reg. § 1.367(e)-2(b)(2)(i)(A)(2).

- the foreign distributee attaches to its federal income tax return for the tax year that includes the date of the distribution a copy of the property description contained in the statement filed by the liquidating U.S. corporation.¹³⁵⁶

Second, a U.S. liquidating corporation will not recognize gain or loss on the liquidating distribution of stock constituting a United States real property interest (a “USRPI”)¹³⁵⁷ unless the distributed stock is stock in a former United States real property holding corporation (a “USRPHC”) that would be treated as a USRPI during the preceding 5-year period (or, if shorter, the period during which the stock was held).¹³⁵⁸

Finally, certain U.S. corporations may liquidate 80%-owned subsidiaries without current gain by certifying in an attachment to their federal income tax returns for the year of the distribution that if the foreign distributee corporation disposes of any stock in the 80% U.S. subsidiary corporation in a tax avoidance transaction, the U.S. liquidating corporation will recognize the gain attributable to such stock at the time of the distribution. Any such gain must be reported by the U.S. liquidating corporation (or the foreign distributee corporation on behalf of the liquidating U.S. corporation) on a U.S. federal income tax return (or amended tax return, as the case may be) for the year of the liquidating distribution.¹³⁵⁹ If the liquidating corporation is a USRPHC at the time of the liquidation (or was a USRPHC at any time during the preceding 5-year period), this exception is available only if the U.S. subsidiary constitutes a USRPHC both at the time of the liquidation and immediately thereafter.¹³⁶⁰ For these purposes, a corporation is an 80% owned U.S. subsidiary if (i) the subsidiary is a U.S. corporation, and (ii) the U.S. liquidating corporation owns directly at least 80% of each of the total voting power and the total value of all stock of such corporation.¹³⁶¹

¹³⁵⁶ See Treas. Reg. § 1.367(e)-2(b)(2)(i)(A)(3).

¹³⁵⁷ See Treas. Reg. § 1.367(e)-2(b)(2)(ii).

¹³⁵⁸ See Treas. Reg. § 1.367(e)-2(b)(2)(ii).

¹³⁵⁹ See Treas. Reg. § 1.367(e)-2(b)(2)(iii)(A), (D).

¹³⁶⁰ See Treas. Reg. § 1.367(e)-2(b)(2)(iii)(B).

¹³⁶¹ See Treas. Reg. § 1.367(e)-2(b)(iii)(A)(1)-(3).

2. Foreign Subsidiary Section 332 Liquidations

The liquidation by a foreign corporation of another foreign corporation under section 332 generally will not be taxable under section 367(e)(2).¹³⁶² However, the foreign Subsidiary will recognize gain on the distribution of certain property it used in the conduct of a United States trade or business at the time of the distribution¹³⁶³ unless: (i) the foreign distributee corporation continues to use the property in the conduct of a United States trade or business for the 10-year period beginning on the date of the distribution;¹³⁶⁴ (ii) the foreign distributee corporation is not entitled to the benefits of a comprehensive income tax treaty;¹³⁶⁵ and (iii) the foreign liquidating corporation and the foreign distributee corporation each attach a statement similar to the statement described above for an outbound liquidation to their U.S. federal income tax returns for their taxable years that include the distribution.¹³⁶⁶ A foreign liquidating corporation will also be

¹³⁶² See Treas. Reg. § 1.367(e)-2(c)(1). As noted in the text above, section 367(b) does not apply to a foreign-to-foreign 332(a) liquidation. Treas. Reg. § 1.367(b)-3(a) (section applies only to the acquisition by a domestic corporation of the assets of a foreign corporation).

¹³⁶³ See Treas. Reg. § 1.367(e)-2(c)(2)(i)(A).

¹³⁶⁴ See Treas. Reg. § 1.367(e)-2(c)(2)(i)(B)(1).

¹³⁶⁵ See Treas. Reg. § 1.367(e)-2(c)(2)(i)(B)(2). This second requirement applies only if the foreign liquidating corporation or predecessor corporation was not entitled to benefits under a comprehensive income tax treaty. Treas. Reg. § 1.367(e)-2(c)(2)(i)(B)(2).

¹³⁶⁶ See Treas. Reg. § 1.367(e)-2(c)(2)(i)(B)(3). This is the same statement as described above in the case of the liquidation of a domestic corporation with a trade or business in the United States, except that (i) the foreign corporation distributee is not required to waive the benefits of an income tax treaty unless the foreign liquidating corporation was required to waive its treaty benefits in a prior liquidation or the foreign distributee corporation is entitled to benefits under an income tax treaty to which the foreign liquidating corporation is not entitled; (ii) if the foreign distributee corporation is required to waive treaty benefits, the foreign distributee is only required to waive benefits that were not available to the foreign liquidating corporation prior to liquidation; and (iii) the property description only includes the qualified U.S. trade or business property. Treas. Reg. § 1.367(e)-2(c)(2)(i)(C).

subject to tax on the distribution of property (other than United States real property interests) that was used in a trade or business in the United States at any time within the 10-year period preceding the distribution date and whose disposition would have been subject to section 864(c)(7).¹³⁶⁷

3. Section 367(e) Anti-Abuse Rule

The section 367(e) regulations contain a broad anti-abuse rule intended to preclude tax-free treatment for liquidations the IRS considers abusive. The rule, which is now applicable only to domestic liquidating corporations, would subject the liquidating corporation to gain recognition in an otherwise tax-free liquidation effected for a principal purpose of tax avoidance.¹³⁶⁸ The rule was amended retroactively to exclude liquidating distributions involving foreign corporations after September 6, 1999.¹³⁶⁹

The language of the anti-abuse rule governing outbound liquidations of domestic corporations is purposely broad and applies to any transaction that has “a principal purpose” of tax avoidance.¹³⁷⁰ In the context of this provision, it is important to contrast transactions with “a” principal purpose of tax avoidance with (the generally smaller group of) transactions where “the” primary purpose is tax avoidance – the broad anti-abuse rule includes even those transactions whose tax avoidance purpose is outweighed by other valid business purposes.¹³⁷¹ Commentators had criticized this rule for the uncertainty it provides in international tax planning and the potentially stifling effect it may have on valid business transactions and have speculated that this anti-abuse provision was intended to provide a backdoor method to prevent the use of foreign hybrid branch structures (which typically employ check-the-box elections that trigger deemed liquidations) during the Treasury’s six-year moratorium on its regulation of such structures.¹³⁷²

¹³⁶⁷ See Treas. Reg. § 1.367(e)-2(c)(2)(ii).

¹³⁶⁸ Treas. Reg. § 1.367(e)-2(d).

¹³⁶⁹ See T.D. 9066, 2003-2 C.B. 509.

¹³⁷⁰ Treas. Reg. § 1.367(e)-2(d).

¹³⁷¹ Treas. Reg. § 1.367(e)-2(d).

¹³⁷² See *Coalition Criticizes Final Regs on Distributions to Foreign Shareholders*, 2000 TNT 121-17 (May 22, 2000). Congress’s

Notably, the final regulations issued in July 2003 clarify that the anti-abuse rule is limited to outbound liquidations, but indicate that a tax avoidance purpose may be a “principal” purpose even though it is outweighed by other purposes considered together.¹³⁷³

F. Cross-Border Section 355 Distributions

1. Outbound Section 355 Distributions – Section 367(e)

The tax consequences of an outbound section 355 distribution of stock depend on whether stock of a U.S. or foreign subsidiary is distributed.¹³⁷⁴ A distribution of U.S. subsidiary stock to either U.S. or foreign shareholders is tax-free to both the distributing corporation and its U.S. and foreign shareholders.¹³⁷⁵ By contrast, a section 355 distribution of foreign subsidiary stock is tax-free only to the distributing corporation if and to the extent such stock

required six-year moratorium on regulating the use of foreign hybrid-branch structures, announced on July 9, 1999, effectively nullified Notice 98-35.

¹³⁷³ See Treas. Reg. § 1.367(e)-2(d).

¹³⁷⁴ See generally Philip Tretiak & Patrick Jackman, *Cross-Border Business Combinations*, Int'l Tax J. (Sept. – Oct. 2011).

¹³⁷⁵ Treas. Reg. § 1.367(e)-1(c); see also P.L.R. 2009-22-028 (May 28, 2009) (U.S. corporation's distribution of domestic subsidiary to foreign parent qualifies as tax-free under section 355 and does not trigger section 367(e) gain for the distributing corporation); P.L.R. 1999-46-018 (Nov. 19, 1999) (where the section 367(b) regulations are satisfied, a U.S. corporation's distribution of stock and debentures of its wholly owned domestic subsidiary qualifies as tax-free under section 355 and does not trigger gain for the distributing corporation); Robert Willens, “*Cross-Border Spin Offs Can Be Tax-Free*,” CFO.com (Dec. 14, 2009), available at <http://www.cfo.com/article.cfm/14462517>.

This exception was added in the 1999 final regulations. The former temporary regulations required domestic distributing corporations to file GRAs to avoid tax on most distributions of domestic corporation stock. Some practitioners have called for the IRS and Treasury to cancel existing GRAs entered into under the temporary regulations now that such agreements are not required. See KPMG Comment on Revisions to Existing IRC section 367(e)(1) Regulations (Jan. 20, 2000).

is distributed to “qualified U.S. persons,” *i.e.*, U.S. citizens, residents and corporations.¹³⁷⁶ Moreover, all distributions of U.S. subsidiary stock are presumed to be made to persons who are not qualified U.S. persons; this presumption may be rebutted by certifying the amount of stock or securities distributed to such qualified U.S. persons.¹³⁷⁷ Thus, a U.S. corporation distributing foreign subsidiary stock under section 355 to foreign shareholders will recognize gain (but not loss) on the appreciation in the stock or securities distributed to such shareholders.¹³⁷⁸ Foreign shareholders receiving the stock are not subject to tax under section 367(e).¹³⁷⁹

¹³⁷⁶ Treas. Reg. § 1.367(e)-1(b)(1)(A), (B).

¹³⁷⁷ Treas. Reg. § 1.367(e)-1(d). In the case of less than 5% shareholders of a publicly traded distributing corporation, the presumption may be rebutted by providing and relying on a reasonable analysis of shareholder records and other relevant information, unless it is subsequently determined that fewer distributees are qualified U.S. persons than the analysis demonstrated. Treas. Reg. § 1.367(e)-1(d)(3)(ii).

¹³⁷⁸ I.R.C. § 367(e)(1); Treas. Reg. § 1.367(e)-1(b)(1), (3). The adjusted basis in each unit of each class of stock or securities distributed to a distributee shall equal the distributing corporation’s total adjusted tax basis in all of the units of the respective class of stock or securities divided by the total number of units in such class. I.R.C. § 367(e)(1); Treas. Reg. § 1.367(e)-1(b)(1), (3). Companies sometimes inherit “sandwich” structures (*e.g.* a foreign parent owning a U.S. subsidiary, which owns a CFC) from previous acquisitions and use section 355 distributions to eliminate such structures. *See generally* Jasper L. Cummings, Jr., *Another Domestic Sandwich*, Daily Tax Rep. (BNA), at J-1 (Apr. 23, 2010) (discussing Private Letter Ruling 2010-14-002). *See* P.L.R. 2010-14-002 (Apr. 9, 2010). (taxpayer received a favorable ruling to eliminate a “sandwich” structure without the use of a section 355 distribution by means of a taxable liquidation in order to attempt to recognize losses; ruling is also notable because the taxpayer was not certain whether the subsidiary stock was worthless and, accordingly, received alternative rulings indicating the result depending on the value of the subsidiary stock).

¹³⁷⁹ Treas. Reg. § 1.367(e)-1(d)(4). *But see generally* I.R.C. § 897(e)(1).

2. Inbound Section 355 Distributions – Section 367(b)

The tax consequences of U.S. to U.S. section 355 distributions of foreign subsidiary stock depend on whether the stock is distributed to a U.S. individual or a U.S. corporation.¹³⁸⁰ Under the section 367(b) regulations, distributions to U.S. corporations are tax-free to the distributing corporation.¹³⁸¹ By contrast, the distributing corporation will recognize gain (but not loss) on distributions to U.S. individuals.¹³⁸² Each distributee is presumed to be an individual; a private company may rebut the presumption by identifying the domestic corporate distributees and certifying the amount of stock or securities distributed to such corporations.¹³⁸³ A publicly traded distributing corporation must identify any 5% corporate shareholders and certify the amount of stock distributed to each; with respect to any smaller corporate shareholders, a public distributing corporation must provide a reasonable analysis of the distributees that are U.S. corporations.¹³⁸⁴ If foreign subsidiary stock is distributed to one or more individuals, or if the distributing corporation cannot rebut the presumption that such stock was distributed to individuals, the distributing corporation will recognize gain with respect to the appreciation in value of the stock of securities distributed to individuals (determined at the time of the distribution). Any gain recognized is treated as a section 1248 deemed dividend to the extent of the foreign subsidiary's earnings and profits.¹³⁸⁵

¹³⁸⁰ Treas. Reg. § 1.367(b)-5(b)(1).

¹³⁸¹ Treas. Reg. § 1.367(b)-5(b)(1)(i).

¹³⁸² Treas. Reg. § 1.367(b)-5(b)(1)(ii). *See, e.g.*, P.L.R. 2003-27-054 (July 3, 2003) (spinoff of foreign joint venture tax-free under section 355 except to the extent of section 367(b) income inclusions); P.L.R. 2003-35-008 (Aug. 29, 2003); P.L.R. 2003-35-009 (Aug. 29, 2003); P.L.R. 2003-35-010 (Aug. 29, 2003); P.L.R. 2003-35-011 (Aug. 29, 2003); P.L.R. 2003-35-012 (Aug. 29, 2003); P.L.R. 2003-35-013 (Aug. 29, 2003) (each treating demerger of CFC followed by a pro rata distribution as a section 355 spinoff/D reorganization, subject to gain under section 367(b) rules).

¹³⁸³ Treas. Reg. §§ 1.367(b)-5(b)(3), 1.367(e)-1(d)(2).

¹³⁸⁴ Treas. Reg. § 1.367(e)-1(d)(3).

¹³⁸⁵ Treas. Reg. § 1.367(b)-5(b)(4).

Section 355 distributions involving lower-tier CFC stock are subject to certain basis adjustments and current deemed dividend income inclusions under section 367(b).¹³⁸⁶ Without these adjustments and inclusions, distributions involving a chain of CFCs with disproportionate levels of E&P could reduce a U.S. shareholder's respective share of E&P that would otherwise be subject to tax as a section 1248 dividend on a subsequent sale or exchange. Consequently, under the final section 367(b) regulations, any E&P which would be taxable on disposition of the controlled corporation before the spinoff, and which would have otherwise escaped taxation immediately after the spinoff, must either be reflected as an adjustment to basis or be included in income as a deemed dividend. Different methods are used to determine a distributee's basis adjustment and/or deemed dividend inclusion for pro rata and non-pro rata distributions.

The rules regarding basis adjustments and deemed dividend inclusions utilize the defined terms "predistribution amount" and "postdistribution amount" of E&P. A company's predistribution amount of E&P is determined by computing the total section 1248 amount which would be recognized on a distribution prior to the spin and allocating that amount between the distributing corporation and its controlled subsidiaries after the distribution, and the controlled corporation and its controlled subsidiaries after the distribution, in accordance with their respective amounts of E&P.¹³⁸⁷ The postdistribution amount with respect to either the distributing or controlled corporation is the distributee's section 1248 amount with respect to such stock computed immediately after the distribution.¹³⁸⁸ The postdistribution amount is computed before taking into account the increase in E&P attributable to any income inclusion under section 356(a) or (b) for boot received in the spinoff.¹³⁸⁹

a. Pro Rata Distributions by a CFC

In a pro rata distribution by a CFC, to the extent the distributee's postdistribution amount with respect to either the

¹³⁸⁶ Treas. Reg. § 1.367(b)-5(c), (d).

¹³⁸⁷ Treas. Reg. § 1.367(b)-5(e)(1).

¹³⁸⁸ Treas. Reg. § 1.367(b)-5(e)(2).

¹³⁸⁹ Treas. Reg. § 1.367(b)-5(e)(2).

distributing or controlled corporation is less than the distributee's predistribution amount for that corporation, the distributee's basis in such stock is reduced by the amount of the difference immediately after the distribution.¹³⁹⁰ If this adjustment would reduce the distributee's basis below zero, the distributee is required to include the excess amount in income as a deemed dividend from the attributable corporation.¹³⁹¹ Whenever a distributee is required to reduce its basis in the stock of the distributing or controlled corporation, the distributee also increases its basis in the stock of the other corporation, up to the fair market value of such stock, by the sum of the basis reduction and deemed dividend inclusion.¹³⁹²

b. Non-Pro Rata Distributions by a CFC

In a non-pro rata distribution by a CFC, if the distributee's postdistribution amount with respect to the distributing or controlled corporation is less than the distributee's predistribution amount with respect to that corporation (the "referenced corporation"), the distributee must include the amount of the difference in income as a deemed dividend.¹³⁹³ The deemed dividend is treated as though it were paid by the referenced corporation to the other corporation and then by such other corporation to the shareholder.¹³⁹⁴ Accordingly, if such a deemed dividend inclusion is required, the shareholder increases its basis in the stock of the corporation treated as making the ultimate payment to the shareholder by the amount of the deemed dividend inclusion.¹³⁹⁵ However, this increase in the distributee's basis is subject to two limits: it may not increase the distributee's basis in such stock beyond the fair market value and it may not diminish the distributee's postdistribution amount with respect to such corporation.¹³⁹⁶ If a distributee owns no stock in the distributing or controlled corporation immediately after the distribution, the distributee's postdistribution amount with respect to such

¹³⁹⁰ Treas. Reg. § 1.367(b)-5(c)(2).

¹³⁹¹ Treas. Reg. § 1.367(b)-5(c)(2).

¹³⁹² Treas. Reg. § 1.367(b)-5(c)(4).

¹³⁹³ Treas. Reg. § 1.367(b)-5(d)(3).

¹³⁹⁴ Treas. Reg. § 1.367(b)-2(e)(2).

¹³⁹⁵ Treas. Reg. § 1.367(b)-5(d)(4).

¹³⁹⁶ Treas. Reg. § 1.367(b)-5(d)(4).

corporation is treated as zero for purposes of determining the postdistribution amount in a non-pro rata spinoff.¹³⁹⁷

3. Allocation of E&P and Foreign Income Taxes upon Section 355 Distributions

The 2000 proposed regulations address the allocation and reduction of a distributing corporation's E&P ("pre-spinoff earnings") and foreign income taxes ("pre-spinoff taxes") in connection with foreign spinoffs.¹³⁹⁸ The Final Attribute Carryover Regulations issued in 2006 reserve on the treatment of section 355 transactions involving foreign corporations; the preamble explained that the government believes that cross border section 355 transactions should be addressed separately.¹³⁹⁹

Pre-spinoff earnings of a distributing corporation are allocated between a distributing and newly created controlled corporation in section 355 distributions preceded by D reorganizations (each, a "D/355 distribution") in proportion to the net bases¹⁴⁰⁰ of the assets transferred and retained by the distributing corporation.¹⁴⁰¹ Similarly, the reduction of a distributing corporation's earnings in connection with a section 355 distribution not preceded by a section 368(a)(1)(D) reorganization (a "355 distribution") is essentially determined on the basis of a notional D/355 distribution. More specifically, the distributing corporation's earnings and profits are reduced in connection with a 355 distribution by the same amount required if the distributing corporation had transferred stock of its controlled corporation to a new subsidiary in a section 368(a)(1)(D) reorganization and then immediately distributed the stock of the

¹³⁹⁷ Treas. Reg. § 1.367(b)-5(d)(3).

¹³⁹⁸ Prop. Reg. § 1.367(b)-8(a).

¹³⁹⁹ See T.D. 9273, 2006-2 C.B. 394.

¹⁴⁰⁰ The term "net basis" is defined as the basis of the assets minus liabilities assumed or to which the assets are subject. Prop. Reg. § 1.367(b)-8(b)(1)(iv); Treas. Reg. § 1.312-10(a).

¹⁴⁰¹ Prop. Reg. § 1.367(b)-8(b)(1)(iv). The preamble to the proposed regulations states "[t]his rule reflects the view that net basis is the most accurate measure of the appropriate amount of earnings and profits that should be allocated to the assets transferred by a distributing corporation in the D reorganization." See 65 Fed. Reg. 69182 (Nov. 15, 2000).

new subsidiary in a section 355 distribution.¹⁴⁰² Earnings and profits of the controlled corporation are not adjusted in connection with changes in the pre-spinoff earnings of the distributing corporation.¹⁴⁰³

In a foreign spinoff involving a preexisting controlled corporation, the distributing corporation's pre-spinoff earnings are reduced pursuant to the rules discussed above.¹⁴⁰⁴ More specifically, the distributing corporation's pre-spinoff earnings are subject to the reductions required upon (i) a transfer of assets to the controlled corporation as part of a D reorganization,¹⁴⁰⁵ and (ii) a distribution of the controlled corporation's stock, without taking into account any transfer of assets in a preceding D reorganization.¹⁴⁰⁶ Thus, the controlled corporation's earnings and profits immediately after the distribution will equal the sum of (i) the reduction in the distributing corporation's pre-spinoff earnings attributable to the assets transferred to the controlled corporation as part of a D reorganization, except to the extent such amount is included in income as a deemed dividend pursuant to the transaction or is eligible to be carried over to a domestic controlled corporation as a tax attribute,¹⁴⁰⁷ and (ii) the controlled corporation's earnings and profits immediately before the foreign spinoff.¹⁴⁰⁸

For purposes of applying the allocation and reduction rules described above, pre-spinoff earnings of the distributing corporation include any increase in earnings and profits attributable to gain recognized and income included by the

¹⁴⁰² Prop. Reg. § 1.367(b)-8(b)(1)(ii)(A).

¹⁴⁰³ Prop. Reg. § 1.367(b)-8(b)(ii)(B). The preamble states that the reduction in earnings and profits (and related foreign income taxes) of a distributing corporation disappears unless it is otherwise included in income, such as under Treasury Regulation section 1.367(b)-5. 65 Fed. Reg. 69182 (Nov. 15, 2000).

¹⁴⁰⁴ See Prop. Reg. § 1.367(b)-8(b)(4); 65 Fed. Reg. 69182 (Nov. 15, 2000).

¹⁴⁰⁵ Prop. Reg. § 1.367(b)-8(b)(4)(i)(A).

¹⁴⁰⁶ Prop. Reg. § 1.367(b)-8(b)(4)(i)(B).

¹⁴⁰⁷ Prop. Reg. § 1.367(b)-8(b)(4)(ii)(A).

¹⁴⁰⁸ Prop. Reg. § 1.367(b)-8(b)(4)(ii)(B).

distributing corporation as a result of the spinoff.¹⁴⁰⁹ In calculating the distributing corporation's income, it is important to note that the proposed regulations expand the general gain recognition rules for section 355 distributions; a domestic distributing corporation now recognizes gain (but not loss) on a distribution of stock of a tax-exempt foreign controlled corporation.¹⁴¹⁰

The earnings allocation and reduction rules described above do not apply to any portion of a net deficit in the distributing corporation's pre-spinoff earnings,¹⁴¹¹ although the rules do apply to deficits in statutory groupings of earnings and profits¹⁴¹² if the distributing corporation has overall net positive earnings immediately before the spinoff.¹⁴¹³ Decreases in pre-spinoff earnings of a distributing corporation generally decrease the distributing corporation's statutory groupings of earnings and profits on a pro rata basis, except and then only to the extent, any amount of earnings is included in income as a deemed dividend.¹⁴¹⁴ The proposed regulations would not reduce the distributing corporation's effectively connected earnings and profits or its non-previously taxed accumulated effectively connected earnings and profits.¹⁴¹⁵

These general allocation and reduction rules apply to the following three types of cross-border spinoffs: (i) outbound spinoffs by domestic corporations of foreign controlled corporation stock,¹⁴¹⁶ (ii) inbound spinoffs by foreign corporations of domestic

¹⁴⁰⁹ Prop. Reg. § 1.367(b)-8(b)(1)(v). For example, the distributing corporation may be required to recognize gain under section 367(a) and (e), section 1248(f) or Treasury Regulation section 1.367(b)-5(b).

¹⁴¹⁰ Prop. Reg. § 1.367(b)-5(b)(1)(ii).

¹⁴¹¹ Prop. Reg. § 1.367(b)-8(b)(1)(iii).

¹⁴¹² "Statutory groupings of E&P include post-1986 undistributed earnings, and annual layers of pre-1987 accumulated profits and pre-1987 section 960 E&P. Prop. Reg. § 1.367(b)-8(b)(2).

¹⁴¹³ Prop. Reg. § 1.367(b)-8(b)(1)(iii) and (b)(2).

¹⁴¹⁴ Prop. Reg. § 1.367(b)-8(b)(2).

¹⁴¹⁵ Prop. Reg. § 1.367(b)-8(b)(1)(vi).

¹⁴¹⁶ See Prop. Reg. § 1.367(b)-8(c).

controlled corporation stock,¹⁴¹⁷ and (iii) foreign-to-foreign spinoffs by foreign corporations of foreign controlled corporation stock.¹⁴¹⁸

a. Outbound Section 355 Distributions

Notwithstanding the general rules described above, pre-spinoff earnings of a domestic distributing corporation that are allocated to a foreign controlled corporation are not included in the foreign controlled corporation's post-1986 undistributed earnings, its pre-1987 accumulated profits, or its pre-1987 section 960 E&P.¹⁴¹⁹ Instead, a subsequent distribution by a foreign controlled corporation out of such pre-spinoff earnings will be treated as a U.S. source dividend if a distribution made by the domestic distributing corporation prior to the spinoff would have so qualified.¹⁴²⁰ Accordingly, a foreign controlled corporation's distribution of pre-spinoff earnings may be eligible for a dividends-received deduction and may also be subject to withholding tax if distributed to a foreign person.¹⁴²¹ On a separate note, a distributing corporation's excess foreign taxes are not allocated or reduced in connection with an outbound spinoff.¹⁴²²

b. Inbound Section 355 Distributions

In the case of a foreign corporation's D/355 distribution of a domestic subsidiary, an exchanging shareholder must include in income as a deemed dividend its "all earnings and profits" deemed dividend amount attributable to pre-spinoff earnings allocated to the domestic controlled corporation under the general allocation rules described above. The deemed dividend amount is not reduced by any decrease in pre-spinoff earnings from a deemed dividend pursuant to the spinoff transaction.¹⁴²³

¹⁴¹⁷ See Prop. Reg. § 1.367(b)-8(d).

¹⁴¹⁸ See Prop. Reg. § 1.367(b)-8(e).

¹⁴¹⁹ Prop. Reg. § 1.367(b)-8(c).

¹⁴²⁰ Prop. Reg. § 1.367(b)-8(c).

¹⁴²¹ Prop. Reg. § 1.367(b)-8(c) and (c)(3), Ex. 1.

¹⁴²² Prop. Reg. § 1.367(b)-8(b)(3).

¹⁴²³ Prop. Reg. § 1.367(b)-8(d)(2)(ii).

The section 358 basis rules govern the allocation of a distributee's basis in the foreign distributing and domestic controlled corporation stock; no adjustment is made for the exchanging shareholder's all earnings and profits deemed dividend amount.¹⁴²⁴ An exchanging shareholder's basis in the domestic controlled corporation stock is increased by its allocable share of the all earnings and profits deemed dividend amount.¹⁴²⁵ In the case of a distributing corporation that is a CFC, an exchanging shareholder's basis increase is determined before any basis adjustments required under Treasury Regulation sections 1.367(b)-5(c)(4) and (d)(4).¹⁴²⁶

Pre-spinoff taxes attributable to a foreign distributing corporation's pre-spinoff earnings are not allocated to its domestic controlled corporation.¹⁴²⁷ Instead, consistent with the general allocation rules described above, the foreign distributing corporation must ratably reduce its pre-spinoff taxes corresponding to pre-spinoff earnings reduced or allocated to the domestic controlled corporation.¹⁴²⁸

¹⁴²⁴ Prop. Reg. § 1.367(b)-8(d)(2)(iii)(A).

¹⁴²⁵ Prop. Reg. § 1.367(b)-8(d)(2)(iii)(B).

¹⁴²⁶ Prop. Reg. § 1.367(b)-8(d)(2)(iii)(C). For an example and general discussion about a CFC's distribution of U.S. subsidiary stock to a U.S. corporate parent, see Joseph Calianno & Margaret Hogan, *Spinning Out of a Sandwich Structure—IRS Provides Favorable Code Sec. 355 Rulings*, Int'l Tax J. (May – June 2010) (discussing the practical reasons for avoiding "sandwich structures" where, for example, a U.S. parent owns a CFC, which owns a U.S. controlled entity, and a favorable letter ruling (P.L.R. 2010-010-09) where the CFC distributed a U.S. controlled entity to the CFC's U.S. parent). In particular, the article discusses certain possible tax inefficiencies of a sandwich structure such as U.S. and foreign withholding taxes on distributions through the chain of ownership (subject to possible reduction under a treaty), foreign tax on the receipt of such distributions (subject to possible relief in the foreign jurisdiction), and income inclusions to the U.S. parent of the CFC relating to subpart F income and investments in U.S. property under section 956, the inability for a U.S. entity to take advantage of certain benefits of being a member of the U.S. consolidated group that includes the U.S. parent.

¹⁴²⁷ Prop. Reg. § 1.367(b)-8(d)(3).

¹⁴²⁸ Prop. Reg. § 1.367(b)-8(d)(3).

c. Foreign-to-Foreign Section 355 Distributions

The allocation of a foreign distributing corporation's pre-spinoff earnings to a foreign controlled corporation is determined under the proposed Treasury Regulation section 1.367(b)-7 rules for foreign-to-foreign reorganizations.¹⁴²⁹ Any reduction of a foreign distributing corporation's pre-spinoff taxes attributable to earnings allocated to a foreign controlled corporation or reduced as a result of the spinoff will be ratable; any allocation of distributing corporation pre-spinoff taxes to a foreign controlled corporation will be governed by proposed Treasury Regulation section 1.367(b)-7.¹⁴³⁰ The proposed regulations also provide a special rule pursuant to which a newly created foreign controlled corporation succeeds to its allocable share of the distributing corporation's pre-spinoff earnings and corresponding taxes without regard to the hovering deficit rules in proposed Treasury Regulation section 1.367(b)-7.¹⁴³¹

G. Cross-Border Transfers of Intangible Assets – Section 367(d)

The transfer of an intangible asset by a U.S. person to a foreign corporation in a transaction described in section 351 or 361 is not a transfer subject to section 367(a).¹⁴³² Instead, such a transfer is treated as a taxable transaction under section 367(d) in which the U.S. transferor sold the property for a series of deemed payments that are contingent on the productivity, use or disposition of the property.¹⁴³³ The annual deemed payments must be commensurate with the foreign transferee's income attributable to

¹⁴²⁹ Prop. Reg. § 1.367(b)-8(e)(2).

¹⁴³⁰ Prop. Reg. § 1.367(b)-8(e)(3).

¹⁴³¹ Prop. Reg. § 1.367(b)-8(e)(2)(ii) and (3).

¹⁴³² I.R.C. § 367(d)(1)(A).

¹⁴³³ I.R.C. § 367(d)(1)(B), (2)(A)(i). *See generally* David Buss, David Hryck, Alan Granwell & Jeffrey S. Korenblatt, *Planning for the Development and Transfer of Intangible Property*, 86 Taxes 13 (Aug. 2008) (discussing tax consequences of transferring U.S.-owned intangible property to an intangible property holding company and the development of intangible property); NYSBA, *Report on Section 367(d)*, reprinted in 2010 TNT 198-20 (Oct. 14, 2010) (discussing section 367(d) under current law and making recommendations for regulatory changes).

the intangible asset; accordingly, the payments must be adjusted over time to reflect changes in the income attributable to the intangible asset.¹⁴³⁴

In Notice 2012-39, Treasury and the IRS announced their intention to issue regulations under section 367(d) that would treat boot received by the U.S. transferor in an outbound reorganization as a prepayment of future deemed payments relating to an intangible asset as described above.¹⁴³⁵ Notice 2012-39 will apply to all outbound section 367(d) transfers occurring on or after July 13, 2012.¹⁴³⁶

If the U.S. transferor disposes of the stock received in exchange for a transferred intangible asset, two different rules apply: (i) if the stock of the transferee foreign corporation is sold to an unrelated person, the U.S. transferor is treated as selling the transferred intangible assets and must recognize gain (based on the intangible assets' then current value) on a deemed sale of the

¹⁴³⁴ I.R.C. § 367(d)(2)(A) (flush language).

¹⁴³⁵ See Notice 2012-39, 2012-31 I.R.B. 95. See also PricewaterhouseCoopers, *Firm Comments on Treatment of Boot in Outbound Asset Reorganizations*, 2011 TNT 85-22 (Apr. 29, 2011) (arguing, in a letter to Treasury and the IRS, that the outbound transfer of intangibles to a controlled corporation should be governed by the nonrecognition rule of section 361(b) and should not be treated as a prepayment of a section 367(d) deemed royalty); Lee A. Sheppard, *Intangibles Prepayment Theory Will Apply to Pre-Notice Deals*, 2012 TNT 202-1 (Oct. 18, 2012) (prior to Notice 2012-39, taxpayers had been taking the position that cash distributed as boot in an outbound reorganization was not taxable under section 361(c) and that cash received was subject to the boot-within-gain rule under section 356(a)); David L. Forst and William R. Skinner, *Notices 2012-39 and 2012-15: IRS Use of Section 367 as an Anti-Repatriation Provision*, Journal of Taxation (Jan. 2013) (noting the IRS's approach sometimes entails using parts of section 367 in ways seemingly not contemplated by Congress); Robert Willens, *IRS Moves to Curtail Tax-Free Repatriation of Foreign Earnings*, 2012 TNT 159-3 (Aug. 13, 2012) (suggesting that the IRS through the issuance of Notice 2012-39 intended to curtail the type of transaction executed by Johnson & Johnson in its acquisition of Synthes Inc.); Amy S. Elliott, *ABA Meeting: Outbound Asset Reorg Notice Doesn't Address Definition of Intangibles*, 2012 TNT 181-8 (Sept. 18, 2012) (Notice 2012-39 does not address whether goodwill is an intangible).

¹⁴³⁶ See Notice 2012-39, 2012-31 I.R.B. 95.

intangible assets, and any additional gain recognized on the disposition of the stock is characterized and sourced under general federal income tax principles;¹⁴³⁷ and (ii) if the stock of the transferee foreign corporation is sold to a related U.S. person, the selling U.S. person must recognize any gain on the stock sale, and the deemed payments must continue in the hands of the transferee.¹⁴³⁸

If the transferee foreign corporation disposes of the transferred intangible assets to a party unrelated to the initial U.S. transferor, the initial U.S. transferor must recognize gain (based on the intangible assets' then current value).¹⁴³⁹ If a party related to the initial U.S. transferor acquires the intangible assets from the transferee, the section 367(d) deemed payments continue uninterrupted with respect to the initial U.S. transferor.¹⁴⁴⁰

The deemed payments constitute ordinary income¹⁴⁴¹ and must continue for the lesser of the property's useful life¹⁴⁴² or 20 years.¹⁴⁴³ For U.S. foreign tax credit purposes, the deemed payments are treated as foreign source or U.S. source to the same extent that an actual payment would be considered foreign source or U.S. source under general source of income principles.¹⁴⁴⁴ Special rules permit the foreign transferee corporation to make actual payments of previously taxed deemed royalties or gains from deemed dispositions without further U.S. federal income tax consequences.¹⁴⁴⁵ Finally, a special exception to the rules of section 367(d) applies in the case of: (i) certain transfers of

¹⁴³⁷ See Treas. Reg. § 1.367(d)-1(d)(1). The term "related person" is defined by reference to the rules of sections 267(b) and 707(b)(1), except that "10% or more" is substituted for "more than 50%" each place it appears. Treas. Reg. § 1.367(d)-1(h).

¹⁴³⁸ See Treas. Reg. § 1.367(d)-1(e)(1).

¹⁴³⁹ See Treas. Reg. § 1.367(d)-1(f)(1).

¹⁴⁴⁰ See Treas. Reg. § 1.367(d)-1(f)(3).

¹⁴⁴¹ I.R.C. § 367(d)(2)(C).

¹⁴⁴² I.R.C. § 367(d)(2)(A)(ii)(I).

¹⁴⁴³ See Treas. Reg. § 1.367(d)-1(c)(3).

¹⁴⁴⁴ See I.R.C. §§ 861(a)(4), 862(a)(4).

¹⁴⁴⁵ See Treas. Reg. § 1.367(d)-1(g).

operating intangibles;¹⁴⁴⁶ (ii) transfers compelled by law or threat of expropriation;¹⁴⁴⁷ and (iii) initial transfers to 40/60 joint ventures.¹⁴⁴⁸

The Obama Administration has proposed clarifying that the definition of intangible property for section 367(d) and other purposes includes workforce-in-place, goodwill and going concern value.¹⁴⁴⁹ In addition, the proposal provides that, where multiple intangible properties are transferred, the IRS may value the properties on an aggregate basis where such valuation would achieve a more reliable result. In addition, the proposal would clarify that the IRS may value the property taking into consideration the prices and profits that the controlled taxpayer could have realized by choosing a realistic alternative to the transaction undertaken.¹⁴⁵⁰

¹⁴⁴⁶ See Treas. Reg. §§ 1.367(a)-1(d)(5)(ii), 1.367(d)-1(g)(2)(i).

¹⁴⁴⁷ See Treas. Reg. § 1.367(d)-1(g)(2)(ii).

¹⁴⁴⁸ See Treas. Reg. § 1.367(d)-1(g)(2)(iii).

¹⁴⁴⁹ See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 90, *available at* <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>. *But see* LMSB-04-0108-001 (Feb. 13, 2008) (IRS stated that, to the extent workforce-in-place can be valued as a distinct asset, it should not be viewed as part of foreign goodwill or going concern value).

¹⁴⁵⁰ See NYSBA, *Report on Section 367(d)*, reprinted in 2010 TNT 198-20 (Oct. 14, 2010) (recommending that the IRS and the Treasury (i) retain the statement in the Temporary regulations under Section 367(d) that "foreign goodwill and going concern value" are excluded from the scope of Section 367(d) until legislative intervention establishes otherwise, (ii) clarify a number of technical issues with respect to the current application of Section 367(d), including, the election to treat certain transfers as lump-sum sales, and the relationship between Section 367(d) and certain other Code Sections, and (iii) address certain valuation issues that have arisen in the administration of Section 367(d)). *See also* Lowell D. Yoder, *Disputed Issues with the Application of Code Sec. 367 to Intangibles*, 38 Int'l Tax J. 1 (Jan. – Feb. 2012).

H. Section 367 Notice and Procedural Requirements

1. Section 367(a) Reporting

A transfer of property (other than cash) by a U.S. person to a foreign corporation in a transaction described in section 367(a) must be reported on Form 926¹⁴⁵¹ unless (i) the U.S. transferor is a less than 5% shareholder of the transferee foreign corporation and either the transaction was not taxable or such shareholder properly reported the income from the exchange,¹⁴⁵² or (ii) the U.S. transferor was a 5% or greater shareholder and either entered into a gain recognition agreement or properly reported the income from the exchange.¹⁴⁵³ The information that must be provided on Form 926 includes the transferor's and transferee's names and taxpayer identification numbers, a general description of the relevant transactions, the consideration received and the property transferred, including statements of fair market value and adjusted tax basis, and certain other additional information with respect to intangible property transfers.¹⁴⁵⁴ Form 926 must be filed with the transferor's U.S. tax return for the year of the transfer.¹⁴⁵⁵

If a U.S. transferor fails to comply with the reporting requirements, (i) the properties are not treated as transferred for use in the conduct of a business for purposes of section 367(a);¹⁴⁵⁶ (ii) the transferor will be liable for a penalty equal to 10% of the value of the property transferred¹⁴⁵⁷ (the total penalty is capped at \$100,000, unless the failure to report was due to intentional

¹⁴⁵¹ See Treas. Reg. § 1.6038B-1(b)(1).

¹⁴⁵² See Treas. Reg. § 1.6038B-1(b)(2)(i)(A).

¹⁴⁵³ See Treas. Reg. § 1.6038B-1(b)(2)(i)(B).

¹⁴⁵⁴ See Treas. Reg. § 1.6038B-1(c). See also Prop. Reg. § 1.6038B-1(c)(4)(ii) (requiring additional information to be reported in the case of stock or securities transfers).

¹⁴⁵⁵ See Treas. Reg. § 1.6038B-1(b)(1). Partners, rather than partnerships, must file Form 926; Corporations, trusts and estates also must generally file Form 926. AM 2008-006 (May 30, 2008); see also Joseph Calianno & Michael Cornett, *Code Sec. 367(a) Transfers by Partnerships to Foreign Corporations: Who is the Transferor?*, 34 Int'l Tax J. 17 (Sept./Oct. 2008).

¹⁴⁵⁶ See Treas. Reg. § 1.6038B-1(f)(1).

¹⁴⁵⁷ I.R.C. § 6038B(c)(1).

disregard),¹⁴⁵⁸ and (iii) the period of limitations on assessments of the tax due as a result of the transfer will not run until the report is filed.¹⁴⁵⁹

2. Section 367(b) Reporting

Generally, a taxpayer subject to the section 367(b) regulations must provide notice to the IRS.¹⁴⁶⁰ The notice must describe the section 367(b) transaction and include certain other information, such as the amounts to be included in gross income or added to earnings and profits.¹⁴⁶¹ The taxpayer must file the applicable notice on or before the due date for filing its U.S. tax return (with extensions) for the year in which the section 367(b) transaction occurs.¹⁴⁶²

It is important to note that the scope of this notice requirement has been expanded in connection with the issuance of the 2000 proposed regulations. Proposed amendments to Treasury Regulation section 1.367(b)-1 require notice to be provided both by foreign surviving corporations described in proposed Treasury Regulation section 1.367(b)-7(a)¹⁴⁶³ and distributing and controlled corporations subject to the rules of proposed Treasury Regulation section 1.367(b)-8.¹⁴⁶⁴

V. INTRAGROUP RESTRUCTURINGS

A. Introduction

This section of the outline explores the U.S. federal income tax consequences¹⁴⁶⁵ associated with restructuring transfers that

¹⁴⁵⁸ I.R.C. § 6038B(c)(3).

¹⁴⁵⁹ See Treas. Reg. § 1.6038B-1(f)(1)(iii).

¹⁴⁶⁰ Treas. Reg. § 1.367(b)-1(c)(2).

¹⁴⁶¹ Treas. Reg. § 1.367(b)-1(c)(4).

¹⁴⁶² Treas. Reg. § 1.367(b)-1(c)(3).

¹⁴⁶³ Prop. Reg. § 1.367(b)-1(c)(2)(v).

¹⁴⁶⁴ Prop. Reg. § 1.367(b)-1(c)(2)(vi) and (vii).

¹⁴⁶⁵ The foreign, state, local and provincial tax consequences of such restructuring transfers, while often significant, are beyond the scope of this outline.

multinational corporate groups typically employ to isolate selected businesses in order to sell, exchange or distribute such business (or businesses).¹⁴⁶⁶ The discussion focuses, in particular, on transfers in preparation for tax-free dispositions, *e.g.*, through distributions of the stock of a subsidiary (“SpinCo”) to the shareholders of the U.S. parent of the group (such distribution, a “spinoff”).

Two things in particular are worth noting at the outset. First, there are generally several ways to accomplish restructuring transfers. Second, the number and complexity of transfers required to prepare for a disposition increase geometrically with the number of tiers in a multi-tier corporate group structure. Consequently, collapsing one or more tiers through upstream mergers with and into the group parent (each such merger, an “upstream merger”) as an initial restructuring transaction often dramatically reduces the number of other required transfers.

Typical transfer alternatives include:

- sales within a U.S. consolidated group, *e.g.*, a subsidiary selling part of its assets (including stock of another U.S. subsidiary) to another subsidiary in a different chain of corporations (a “cross-chain sale”) or to its parent (an “upstream sale”);¹⁴⁶⁷
- the distribution by a subsidiary (a “distributor”) of part of its assets (including stock of another subsidiary) to its parent (such transaction, a “distribution”); or
- a merger or stock-for-stock exchange involving two subsidiaries: a “target company” and a

¹⁴⁶⁶ The sections contained under this heading are not analyzed under the proposed regulations that might apply to the transactions discussed if such proposed regulations are enacted in final form.

¹⁴⁶⁷ Typically, assets, including stock of subsidiaries that a U.S. parent receives in an upstream transaction, *e.g.*, pursuant to a sale or a distribution, must in turn be contributed to a departing group member prior to its disposition. If staggered dispositions are in the offing, the departing group member may in turn need to contribute any assets (including stock of affiliates) it receives, but will not retain, to a wholly owned subsidiary that will leave the affiliated group.

“transferee” (each such merger or exchange, a “cross-chain reorganization”).

The issues raised by these alternatives are discussed below in examples involving a fictional group that is headed by a U.S. corporation (the “U.S. parent”) and includes both U.S. and foreign subsidiaries (each, a “USCo” and “ForeignCo”, respectively). The following simplifying assumptions are made with respect to the fictional group:

- the U.S. parent has no 5% shareholders;
- no stock of foreign subsidiaries will be distributed by U.S. companies to foreign shareholders;
- no stock of U.S. subsidiaries will be transferred to foreign subsidiaries;
- unless otherwise specifically provided, the U.S. parent will own 100% of each of its foreign subsidiaries either directly or indirectly through a single, direct foreign subsidiary immediately prior to a transfer;
- all cross-chain reorganizations and other putative tax-free transfers will be effected without boot;
- all cross-chain and upstream sales will be for cash or other full-basis property;
- no intangible property will be separately transferred;
- no income or gain recognized by a foreign subsidiary in connection with a transfer will be effectively connected with a U.S. trade or business of the subsidiary;
- no direct or indirect subsidiaries of the U.S. parent are U.S. real property holding companies, “passive foreign investment companies,” or foreign sales corporations;

- no transferred property will be subject to a basis adjustment under section 362(e); and
- corporations receiving stock in cross-chain reorganizations will not have a binding obligation to distribute such stock.

Consistent with these assumptions, the outline does not address some of the more esoteric issues that may arise in connection with particular restructuring transfers.

B. Integration of Restructuring Transactions and Dispositions

The U.S. tax consequences of transfers prior to dispositions will often depend on whether such transfers and subsequent dispositions are each accorded independent tax significance or are viewed as a single transaction. Under general step transaction principles, restructuring transfers and subsequent dispositions would likely be integrated if the transfers are effected pursuant to a single plan.¹⁴⁶⁸ In general, the IRS is apt to impose integrated transaction treatment on a series of cross-border and domestic transfers not governed by the consolidated return rules, coincidentally producing a larger U.S. tax bill. As illustrated below, the tax consequences of integration differ under the specific statutory rules and regulations that apply to particular transfers.

¹⁴⁶⁸ Cf. Rev. Rul. 98-27, 1998-1 C.B. 1159; Rev. Rul. 98-44, 1998-2 C.B. 315; P.L.R. 2010-37-026 (Sept. 7, 2010) (cross-chain asset sales by a foreign subsidiary to controlled prior to, and in anticipation of, a spinoff were respected as “independent transactions and ... not ... viewed as an integrated part of any other transaction” (see ruling 55)); P.L.R. 2010-32-017 (Aug. 13, 2010) (a drop down of assets followed by (i) successive spinoffs and (ii) a merger of controlled into a newly formed entity were treated as two D reorganizations and a merger); *Step Transaction Applied Post-Spinoff*, 2011 TNT 16-2 (Jan. 25, 2011) (Eric Solomon noting with respect to Private Letter Ruling 2010-32-017 that “What it looks like is the step transaction doctrine is turned off”); *Drop, Spin and Liquidate Ruling*, 2011 TNT 39-5 (Feb. 28, 2011) (when asked whether the Service would entertain a spin and then a liquidation of distribution in light of P.L.R. 2010-32-017, an IRS representative said that “We might just say if you don’t have a split-up, you’re not in [section] 355, you’re really in [section] 332 [or section 368], depending on who’s above the distributing company”).

Moreover, the question of integration is even more complex with respect to transactions among consolidated group members. Even if transactions within a U.S. parent's consolidated group are integrated with a subsequent disposition, they may nonetheless constitute intercompany transactions if the parties to a transfer are members of the consolidated group "immediately after" an intragroup transaction; transactions occurring shortly before and pursuant to a plan that includes a party's deconsolidation generally constitute intercompany transactions. For example, the consolidated return intercompany transaction rules trump section 304 with respect to intragroup cross-chain sales of stock of group members as long as the parties to the sale are members of the consolidated group "immediately after" such sale,¹⁴⁶⁹ which should be the case even if one or more of the parties will deconsolidate pursuant to the same plan.¹⁴⁷⁰ However, there are two exceptions to this general rule. First, the intercompany transaction rules do not apply to transfers of boot in connection with an otherwise tax-free intragroup section 355 distribution or cross-chain reorganization if one or more of the involved group members deconsolidate pursuant to the same "plan or arrangement."¹⁴⁷¹ Second, the gain recognition rules of section 357(c) are applied, rather than the intercompany transaction rules, to tax-free intragroup contributions under section 351 whenever one or more of the parties deconsolidate pursuant to the same "plan or arrangement."¹⁴⁷²

In the absence of specific consolidated return rules to the contrary, the author believes that the IRS may well seek to integrate restructuring transfers with subsequent dispositions. Accordingly, the following sections of this outline focus on analyzing hypothetical transactions on an integrated basis. Where different tax consequences would obtain if the IRS were to accord independent tax significance to a particular transfer and subsequent disposition, those consequences are also noted.

¹⁴⁶⁹ Treas. Reg. § 1.1502-80(b).

¹⁴⁷⁰ See P.L.R. 95-35-048 (June 6, 1995); P.L.R. 92-15-043 (Jan. 14, 1992); P.L.R. 91-37-028 (June 13, 1991).

¹⁴⁷¹ Treas. Reg. § 1.1502-13(f)(3)(i).

¹⁴⁷² Treas. Reg. § 1.1502-80(d).

C. Contributions

The most straightforward restructuring transfers are contributions of stock or assets by upper-tier entities to subsidiaries before a disposition.

1. Within a U.S. Consolidated Group

A contribution within a U.S. consolidated group by a corporation to its direct subsidiary will typically qualify as either a contribution under section 351 or a D reorganization.¹⁴⁷³ In general, the U.S. parent corporation would not recognize any gain on the contribution. Even if the subsidiary assumes liabilities in the contribution, section 357(c), which generally requires a transferor to recognize gain in a section 351 or section 361 exchange to the extent the liabilities assumed exceed the transferor's adjusted tax basis in the contributed property (such excess, "section 357(c) gain"), does not apply to transactions qualifying as both section 351 contributions and acquisitive D reorganizations.¹⁴⁷⁴ However, parent would reduce its tax basis in the subsidiary's stock by the amount of the assumed liabilities, and would have an excess loss account ("ELA") to the extent the assumed liabilities exceeded parent's basis in the subsidiary's stock.¹⁴⁷⁵ The ELA would be triggered (and gain recognition would be required) if the subsidiary were to leave the consolidated group before such ELA is eliminated.¹⁴⁷⁶

Alternatively, if the contribution precedes a divisive D reorganization effected in connection with a section 355 distribution, section 357(c) will apply. Section 357(c) gain should be deferred, however, until the occurrence of a triggering event

¹⁴⁷³ See Section I.I. above for a discussion of Proposed Regulation sections 1.351-1 and 1.368-1, which would curtail the application of section 351 and section 368(a)(1)(D) to insolvent subsidiaries.

¹⁴⁷⁴ Rev. Rul. 2007-8, 2007-1 C.B. 469. In addition, section 357(c) does not apply to transfers within a consolidated group. See Treas. Reg. § 1.1502-80(d)(1). However, this exception does not apply if the transferor or transferee leaves the consolidated group as part of the same plan or arrangement as the relevant transfer. See Treas. Reg. § 1.1502-80(d)(1).

¹⁴⁷⁵ See I.R.C. § 358(d); Treas. Reg. § 1.1502-19(a)(2), and (c)(1)(i).

¹⁴⁷⁶ See Treas. Reg. § 1.1502-19(c)(1)(i).

under the consolidated return rules.¹⁴⁷⁷ A subsidiary's adjusted tax basis in any contributed assets would equal its shareholder's adjusted tax basis in those assets immediately prior to the contribution, increased by the amount of any section 357(c) gain recognized in connection with the contribution.¹⁴⁷⁸

2. Outbound Contributions to Foreign Subsidiaries

a. Transfers of Assets (Other than Target Stock)

Transfers by a U.S. subsidiary of assets other than affiliate stock to one or more foreign subsidiaries should qualify as section 351 contributions that are subject to section 367(a).¹⁴⁷⁹ Under section 367(a), the transferor generally will recognize gain (but not loss) on a transfer of assets (other than affiliate stock), unless the transferred assets consist of certain tangible assets¹⁴⁸⁰ used by the foreign transferee in the active conduct of a trade or business outside the United States (such assets, "Active Business Assets").¹⁴⁸¹

b. Transfers of Foreign Corporation Stock

If a U.S. subsidiary contributes part or all of the stock of a foreign subsidiary (which it may have received in a prior contribution) to one or more of its other wholly owned foreign subsidiaries, each such contribution generally would be both a contribution under section 351 and a B reorganization, and, as

¹⁴⁷⁷ See Treas. Reg. § 1.1502-80(d)(1).

¹⁴⁷⁸ Subsequent contributions of assets to lower-tier U.S. subsidiaries would be taxed in the same manner.

¹⁴⁷⁹ See Section I.I. above for a discussion of Proposed Regulation section 1.351-1, which would curtail the application of section 351 to insolvent subsidiaries.

¹⁴⁸⁰ I.R.C. § 367(a)(3). As discussed in Section IV, Active Business Assets are assets other than inventory, copyrights, installment obligations, accounts receivable, foreign currency or other property denominated in foreign currency, intangible property or, in general, property with respect to which the transferor is a lessor at the time of transfer. I.R.C. § 367(a)(3)(B). Transfers of goodwill are subject to special rules also discussed in Section IV.

¹⁴⁸¹ I.R.C. § 367(a)(3); *see generally* Temp. Reg. § 1.367(a)-2T.

such, would be governed by both section 367(a) and 367(b).¹⁴⁸² In order to avoid immediate gain on the contribution under section 367(a), the U.S. transferor must enter into a GRA certifying that, if the foreign transferee disposes of the contributed stock during the 5-year period beginning in the tax year after the contribution, the U.S. transferor will file an amended U.S. tax return for the tax year in which the contribution occurred and will recognize any gain (and interest attributable to the underpayment of such gain) realized in connection with the contribution in the tax year the contribution occurred, unless the U.S. transferor elects to recognize any such gain (and pay any interest attributable to the underpayment of such gain in the tax year of the initial transfer) in the tax year of such foreign transferee's disposition of the contributed stock.¹⁴⁸³ Under section 367(b), the U.S. transferor

¹⁴⁸² Treas. Reg. §§ 1.367(a)-3(b)(2); 1.367(b)-4(b)(1); *see also* P.L.R. 98-39-014 (June 24, 1998) (foreign-to-foreign reorganization will qualify as both a 351 Transaction and a B Reorganization). Of course, if the foreign acquirer assumes a liability of the U.S. transferor in connection with the stock contribution, the transaction will be treated only as a section 351 transfer. The need to contribute foreign corporation stock to a foreign holding company may arise, for example, in the context of an acquisition of a multinational U.S. company and the desire to realign the foreign subsidiaries under a foreign holding company. Often, this may require a distribution of a foreign subsidiary to a U.S. entity, and a subsequent contribution to the foreign holding company, implicating section 367. *See* Jasper L. Cummings, Jr., *Acquiring and Redistributing a Domestic Multinational*, Daily Tax Rep. (Dec. 8, 2010) (discussing Private Letter Ruling 2010-45-020 where taxpayer achieved a similar result without implicating section 367 by structuring the purchase of the target by acquirer and a wholly-owned subsidiary foreign holding company, followed by a F reorganization of the target and an upstream A reorganization of the target into the acquirer in which foreign corporation stock was distributed to the foreign holding company). Cummings also notes that since the acquirer lent the foreign holding company the cash consideration used in the purchase, future repatriation of foreign earnings could occur (at least in part) without dividend inclusion.

¹⁴⁸³ Treas. Reg. § 1.367(a)-3(b)(1)(ii); Temp. Reg. § 1.367(a)-8T. If the transferor does not make a GRA Election, the extent to which its gain will be characterized as dividend income under section 1248 will be determined by taking into account its E&P as of the date of the contribution. T.D. 8770, 1998-2 C.B. 3. If the transferor makes a GRA Election, however, the extent to which its gain will be

may be required to include in income as a deemed dividend the section 1248 amount attributable to the stock exchanged.¹⁴⁸⁴

Assuming the execution of a GRA and compliance with the notice requirement, a contribution of stock of a foreign subsidiary to a U.S. transferor's other foreign subsidiaries generally would have the following tax consequences: (i) no recognition of gain or loss on the contribution, (ii) the transferor's adjusted tax basis in the newly issued transferee foreign corporation stock will equal the transferor's adjusted tax basis in the contributed stock and (iii) the transferee's adjusted tax basis in the contributed stock will equal the transferor's basis in such stock.¹⁴⁸⁵

D. Upstream Transactions

1. Upstream Mergers and Subsequent Contributions and Sales

Merging subsidiaries upstream before undertaking other restructuring transfers often significantly reduces the number and complexity of other necessary transfers.¹⁴⁸⁶ Even though such

characterized as dividend income under section 1248 will be determined by taking into account its E&P as of the date of the transferee's disposition of the contributed stock. T.D. 8770, 1998-2 C.B. 3.

¹⁴⁸⁴ Treas. Reg. § 1.367(b)-4(b)(1). *See* Section IV.D.2.

¹⁴⁸⁵ This discussion assumes that the foreign acquirer did not assume any U.S. transferor liabilities. If the foreign acquirer did, in fact, assume liabilities in connection with the contribution, the U.S. transferor would recognize any resulting section 357(c) gain, and the parties would make corresponding adjustments to the tax basis of the contributed stock and the transferee foreign corporation's stock held by the U.S. transferor. *See* I.R.C. §§ 358(a), 362(a).

¹⁴⁸⁶ P.L.R. 2009-52-032 (Dec. 24, 2009) (a subsidiary's conversion to a disregarded entity before reincorporating as a corporation treated as an upstream C reorganization followed by a section 368(a)(2)(C) contribution of the remaining assets of the subsidiary to a new corporation, in which the subsidiary was deemed to transfer substantially all of its assets to its parent in exchange for parent voting stock which it immediately distributed to its parent); *See also Overlap Transaction Debate Affecting IRS Thoughts on Regs for F Reorgs*, 2011 TNT 99-2 (May 23, 2011) (Bill Alexander, IRS associate chief counsel (corporate), noting that "a certain amount of

upstream mergers may be followed immediately by contributions, the author believes that the IRS should respect the transfers as separate transactions and should not recharacterize them as a single, integrated transaction, since the subsequent contributions will be consummated in order to facilitate a disposition, rather than to avoid tax, *e.g.*, by converting ordinary income into capital gain.¹⁴⁸⁷ Moreover, even if an upstream merger and subsequent contribution are integrated, those transactions should not also be integrated with a subsequent disposition to create a single taxable asset transfer.¹⁴⁸⁸

If the IRS were to integrate upstream mergers and related, subsequent contributions, a transferor could be treated for U.S. tax purposes as transferring assets (including affiliate stock) directly to the ultimate transferee.¹⁴⁸⁹ Such transfers generally would qualify

shrinkage [of assets] would be tolerated” and that the transaction in the PLR could also be treated as an F reorganization).

¹⁴⁸⁷ The IRS has respected the form of similar transactions consummated in connection with a general plan to better align the businesses of a large conglomerate in preparation for a spinoff. *See* P.L.R. 2002-50-024 (Sept. 4, 2002) (upstream A reorganizations and liquidation followed by contribution of assets); P.L.R. 98-19-040 (Feb. 10, 1998) (respecting form of a series of tax-free stock distributions followed by a tax-free contribution of the distributed stock to a company that was then spun off); P.L.R. 98-02-048 (July 11, 1997) (respecting a series of largely tax-free transactions under sections 332, 355 and 368 designed to separate out one business); P.L.R. 91-32-055 (May 14, 1991) (respecting form of upstream merger of subsidiary with and into parent, parent’s subsequent contribution of certain assets of such liquidated subsidiary to controlled subsidiary and parent’s subsequent distribution of all its controlled stock); *see also Telephone Answering Service Co. v. Commissioner*, 63 T.C. 423 (1974), *aff’d*, 546 F.2d 423 (4th Cir. 1976) (distribution not treated as a complete liquidation).

¹⁴⁸⁸ *See* P.L.R. 91-32-055 (May 14, 1991).

¹⁴⁸⁹ Previously issued consolidated return temporary regulations provide limited elective relief when deferred gain or loss on an intercompany transfer of a group member’s stock is accelerated because the stock basis reflecting the intercompany gain is eliminated in a liquidation qualifying for nonrecognition treatment. *See* T.D. 9458, 2009-2 C.B. 547. If an election is made for a transaction whereby old T liquidates into B, followed by B’s transfer of substantially all of old T’s assets to new T, then old T’s liquidation into B and B’s transfer of substantially all of old T’s assets to new T will be disregarded and

as D reorganizations within the meaning of section 368(a)(1)(D) irrespective of whether the subsequent disposition is also integrated.¹⁴⁹⁰ Any assets retained by the surviving company in the upstream merger (other than qualifying property) would be treated as boot.¹⁴⁹¹

The tax consequences of the receipt of boot under section 356 depend on whether the receipt has the effect of a dividend distribution.¹⁴⁹² That determination depends on whether,

the transaction will be treated as if old T transferred substantially all of its assets to new T in exchange for new T stock in a tax-free reorganization (a “reincorporation transfer”). See Temp. Reg. § 1.1502-13T(f)(5)(ii)(B)(1). The transaction may be treated as a reincorporation transaction only if (i) T is a group member throughout the period beginning on the date of the transfer and ending with the completion of the liquidation, (ii) a direct transfer of T’s assets to new T would qualify as a reorganization, and (iii) the transfer of substantially all of T’s assets to new T is completed within 12 months of filing the consolidated return for the tax year including the liquidation (including extensions). See Temp. Reg. § 1.1502-13T(f)(5)(ii)(A), (B)(1), (B)(2). The temporary regulations generally apply to transactions in which T’s liquidation into B occurred on or after October 25, 2007. See Temp. Reg. § 1.1502-13T(f)(5)(ii)(F).

¹⁴⁹⁰ *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184-185 (1942); *Davant v. Commissioner*, 366 F.2d 874, 882-883 (5th Cir. 1966); Rev. Rul. 76-429, 1976-2 C.B. 97; Rev. Rul. 75-139, 1975-1 C.B. 168; Rev. Rul. 70-240, 1970-1 C.B. 81. See P.L.R. 93-19-017 (Feb. 5, 1993); P.L.R. 89-11-067 (Dec. 22, 1988). Cf. Section I.I. above (discussing Proposed Regulation section 1.368-1, which would curtail the application of section 368(a)(1)(D) to insolvent subsidiaries). See also *Timing of Check-the-Box Election Can be Crucial for ‘D’ Reorganization Treatment*, Daily Tax Rep. (BNA), at J-1 (June 19, 2008) (discussing potential IRS treatment with respect to check-the-box elections made in connection with transactions intended as cross-chain reorganizations).

¹⁴⁹¹ In the case of a divisive D reorganization, if, as is likely, the IRS integrates the constructive restructuring transfer and a subsequent disposition as part of the same plan or arrangement, section 357(c) should apply in lieu of the usual intercompany consolidated return rules governing intercompany transactions. See Treas. Reg. § 1.1502-80(d).

¹⁴⁹² *Clark v. Commissioner*, 489 U.S. 726 (1989). For purposes of determining whether the receipt of boot has the effect of a dividend:

as is likely, a deemed distribution and subsequent disposition are treated as part of a single plan.¹⁴⁹³ If so, the deemed boot distribution would not have the effect of a dividend if, as is likely, the transferor's ownership of the transferee is determined after a subsequent disposition, when the transferor would no longer own any transferee stock. In that case, the transferor would recognize capital gain equal to the lesser of the fair market value of the boot and the amount of gain, if any, realized in connection with the reorganization.¹⁴⁹⁴ The transferee would also be required to recognize gain (but could not recognize any loss) equal to the excess of the fair market value of the deemed distributed boot over the transferee's adjusted tax basis in the boot. Assuming gain recognized by either party is deferred until the occurrence of a subsequent disposition under the consolidated return regulations, the transferor's adjusted tax basis in its transferee stock would be increased by the after-tax amount of its gain.

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- (i) the transferee will be treated as transferring its stock to transferor in exchange for 100% of transferor's target company stock, and then
 - (ii) the transferee will be treated as distributing the boot to the transferor in a notional exchange for an appropriate amount of transferee stock.

¹⁴⁹³ Treas. Reg. § 1.1502-13(f)(3)(ii). If the constructive D reorganization were treated as a separate transaction that is not part of a plan or arrangement that includes a subsequent disposition, the receipt of boot would not be subject to section 356. Instead, under the consolidated return rules, a domestic transferee would be treated as distributing the boot to the transferor in a separate transaction to which the intercompany transaction rules apply. Under those rules the transferor would not recognize income in respect of the deemed distributed boot, and would not be entitled to a dividends-received deduction. Instead, the transferor's adjusted tax basis, if any, in its transferee stock would be reduced (to zero) by the fair market value of the boot, and any excess fair market value would create or increase an excess loss account for the transferor with respect to its transferee stock.

¹⁴⁹⁴ I.R.C. § 356(a)(2). If the deemed distribution is accorded independent tax significance, it should nonetheless have the effect of a dividend because the transferor (by attribution) would own 100% of the transferee's stock immediately after such a distribution. If so, the transferor would recognize ordinary dividend income to the extent that the fair market value of the boot does not exceed the transferor's allocable portion of the transferee's E&P. To the extent such fair market value exceeds the transferee's E&P, the transferor would recognize capital gain.

2. Tax-Free Foreign Subsidiary Liquidations¹⁴⁹⁵

A liquidation of a foreign subsidiary into its U.S. parent that is accorded independent tax significance should qualify for nonrecognition treatment under sections 332 and 337, provided that the foreign subsidiary is treated as a “corporation” for purposes of section 332.¹⁴⁹⁶ The U.S. group parent must include as dividend income the “all earnings and profits amount,” *i.e.*, the net positive earnings and profits, if any, for all prior taxable years, calculated under principles similar to section 1248 and attributable to the U.S. parent’s foreign subsidiary stock, when the merger occurs.¹⁴⁹⁷ The foreign subsidiary will not recognize gain or loss in connection with the upstream merger.¹⁴⁹⁸ The U.S. parent will succeed to the foreign subsidiary’s adjusted tax basis in the assets it receives in connection with the merger. The U.S. parent will receive no basis increase for any dividend income it recognizes with respect to its inclusion of the all E&P amount in income.¹⁴⁹⁹

3. Upstream Sales

An upstream sale of stock or assets will constitute a taxable transaction to which section 304 does not apply, whether between consolidated group members or foreign and U.S. affiliates, and whether or not it is integrated with a subsequent disposition.¹⁵⁰⁰ As a result, the seller generally will recognize gain (or loss) equal

¹⁴⁹⁵ When upstream mergers of foreign subsidiaries are necessary, consideration should be given to effecting constructive mergers under the “check the box” regulations. *See generally* David S. Miller, *The Strange Materialization of the Tax Nothing*, Tax Notes, May 1, 2000, at 685.

¹⁴⁹⁶ I.R.C. §§ 332, 337, 367(b). *See* Section IV.D.1. for a discussion of the relevant regulations.

¹⁴⁹⁷ Treas. Reg. § 1.367(b)-3(b)(3).

¹⁴⁹⁸ I.R.C. § 332.

¹⁴⁹⁹ I.R.C. § 334.

¹⁵⁰⁰ Section 304 does not apply to upstream stock sales irrespective of whether the buyer and seller are consolidated group members. I.R.C. § 304(a); *see* Rev. Rul. 74-605, 1974-2 C.B. 97 (upstream sale not subject to section 304); P.L.R. 2008-12-006 (Dec. 4, 2007) (upstream sales by U.S. subsidiaries of foreign subsidiary stock governed by section 1001; foreign subsidiary’s deemed liquidation through check-the-box election treated as separate transaction).

to the appreciation (or depreciation) in the stock or assets it is selling.¹⁵⁰¹

If a particular upstream sale is integrated with a subsequent disposition, it is not certain whether gain (including any section 1248 deemed dividend income) or loss would be deferred until a subsequent disposition, although IRS private rulings (interpreting the predecessor intercompany regulation) have deferred the recognition of gain or loss in similar situations.¹⁵⁰² If an upstream sale and subsequent disposition are accorded independent tax significance, recognition of any gain (including any section 1248 income) or loss would be deferred until a deconsolidation or other triggering event.

It should be noted that the loss disallowance rules under Treasury Regulation section 1.1502-20 may permanently preclude a seller from taking a deduction in respect of any recognized loss on a sale of affiliate stock.¹⁵⁰³ Section 267(f) generally would not defer the recognition of loss after a subsequent disposition, because such a disposition would cause the parties to cease to be members of the same “controlled group” (within the meaning of section 1563(a), as modified by section 267(f)(1)), and the underlying transferred asset would also leave the “controlled group” (either such event, a “267(f) Event”).¹⁵⁰⁴

¹⁵⁰¹ Treas. Reg. § 1.1502-13(a) (applicable rules for intra-group sales); I.R.C. § 1001.

¹⁵⁰² See generally P.L.R. 95-35-048 (June 6, 1995) (applying prior consolidated return regulations, tax consequences of non-intercompany transaction between group members nonetheless deferred until deconsolidation); P.L.R. 92-15-043 (Jan. 14, 1992) (same); P.L.R. 91-37-028 (June 13, 1991) (same).

¹⁵⁰³ Treas. Reg. § 1.1502-20.

¹⁵⁰⁴ A “controlled group” means one or more chains of corporations connected through stock ownership with a common parent corporation if (i) stock representing at least 50% of the total combined voting power or of the total value of all classes of stock of each corporation, except the common parent, is owned by one or more of the other corporations, and (ii) the common parent owns stock representing at least 50% of either the total combined voting power or the total value of all classes of stock of at least one of the other corporations, excluding stock owned directly by such other corporations. I.R.C. §§ 267(f)(1); 1563(a).

Any gain recognized by a CFC in connection with an actual or constructive upstream sale of certain passive assets should constitute Subpart F income under the CFC rules.¹⁵⁰⁵ However, if a CFC sells a CFC subsidiary's stock, any gain on the sale that is recharacterized as a dividend under section 964(e) may be excluded from Subpart F income to the extent attributable to earnings of the CFC subsidiary that represent neither Subpart F income nor income effectively connected with the conduct of a U.S. trade or business (the "Subpart F Look Through Exception").¹⁵⁰⁶ Unless extended by Congress, the Subpart F Look Through Exception will apply only to taxable years beginning before January 1, 2009.¹⁵⁰⁷

¹⁵⁰⁵ The gain should constitute foreign personal holding company income that is not effectively connected with the conduct of a U.S. trade or business. *See* I.R.C. §§ 954(c) (defining foreign personal holding company income); 952(b) (Subpart F income does not include U.S. source income effectively connected with a trade or business in the United States).

¹⁵⁰⁶ *See* I.R.C. § 954(c)(6)(A); Notice 2007-9, 2007-1 C.B. 401.

Section 964(e) recharacterizes gain recognized by a CFC on the sale of a CFC subsidiary's stock as a dividend to the same extent that it would have been included under section 1248 if the selling CFC were a U.S. person. I.R.C. § 964(e). Gain recognized by a U.S. shareholder selling CFC stock is generally recharacterized as ordinary dividend income to the extent of the E&P attributable to the transferred CFC stock accumulated while the corporation was a CFC, and the U.S. shareholder is entitled to an indirect foreign tax credit for foreign taxes paid or accrued by the CFC with respect to the gain that gives rise to the deemed dividend. *See* I.R.C. § 902; Notice 87-64, 1987-2 C.B. 375. Thus, the amount of any deemed dividend under section 1248 depends on the amount of gain realized in connection with the transaction, and the CFC's E&P (as determined pursuant to sections 1248(c) and (d) and the Treasury Regulations promulgated thereunder) at the time of the transaction. The resulting tax would depend on the amount of any foreign tax credits available to offset the portion of any gain taxable as ordinary income pursuant to section 1248.

¹⁵⁰⁷ *See* I.R.C. § 954(c)(6)(B). The Obama Administration's 2013 budget proposals includes a one-year extension of the Subpart F Look Through Exception. *See* Dept. of Treasury, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 65 and

E. Distributions

1. U.S. Taxable Distributions

The tax consequences of a U.S. subsidiary's taxable distribution of property (including affiliate stock) to a U.S. distributee will depend upon whether the distribution is integrated with a subsequent disposition, and whether the distribution is, in any event, considered an intercompany transaction. It is likely that distributions within a consolidated group will be treated as intercompany transactions under the consolidated return regulations even if general integration principles are applied.

If a particular taxable distribution is integrated, but one of the parties to the distribution continues to be a consolidated group member thereafter, or if the distribution is nonetheless treated as an intercompany transaction, the consolidated return rules will apply. Under such rules, the distributee would not recognize income in respect of any distributed property and would not be entitled to a dividends-received deduction.¹⁵⁰⁸ Instead, the distributee's adjusted tax basis, if any, in its distributor stock would be reduced by the fair market value of the distributed property, and the excess of such fair market value over such adjusted tax basis would create or increase an ELA with respect to the distributee's stock in the distributor.¹⁵⁰⁹ Distributions from a nonconsolidated subsidiary, however, may be eligible for a dividends-received deduction if not integrated with another transaction.¹⁵¹⁰

207, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

¹⁵⁰⁸ Treas. Reg. § 1.1502-13(f)(2). The amount of an in-kind distribution, and the distributee's adjusted tax basis with respect to property acquired in connection with an in-kind distribution, will each equal the fair market value of the distributed property. Treas. Reg. § 1.1502-13(f)(7), Ex. 1(b).

¹⁵⁰⁹ Treas. Reg. §§ 1.1502-13(f)(2); -19(a)(2). Immediately prior to the distributee's disposition of its distributor stock, the distributee generally must include in its gross income the amount of any ELA with respect to its distributor stock. Treas. Reg. § 1.1502-19(a). The elimination of ELAs in connection with intragroup section 355 distributions is discussed in the text below.

¹⁵¹⁰ P.L.R. 2003-35-032 (Aug. 29, 2003) (distribution before section 368(a)(1)(E) recapitalization was eligible for dividends-received deduction because distribution was separate in substance).

Under the consolidated return rules, the distributor would be treated as having sold the distributed property to the distributee for its fair market value (a “Deemed Sale”).¹⁵¹¹ Any gain or loss the distributor recognizes in connection with such a Deemed Sale would be deferred until the occurrence of a triggering event (or, in the case of loss, until a subsequent section 267(f) event). At that time, the distributor would take any such gain or loss into account, and in accordance with the single entity theory regarding members of the consolidated group, the distributee’s adjusted tax basis in its distributor stock would be increased or decreased, as appropriate, by the after-tax amount of such gain or loss.¹⁵¹²

If a particular taxable distribution is integrated with a subsequent disposition that deconsolidates the distributor and distributee, the tax consequences of the distribution will depend on whether the distribution is subject to the consolidated return rules regarding dividends. Even under an integrated analysis, the consolidated return rules may apply to such an intragroup distribution by reason of the look-back “entitlement rule,” which provides that an intragroup distribution is taken into account on the date the distribution is declared, irrespective of whether the relevant parties deconsolidate after such date and before the payment date.¹⁵¹³

If this entitlement rule were to apply (or if the transactions were not integrated), an intragroup distribution would be treated in the same manner as described above even if the parties subsequently deconsolidate. By contrast, if an intragroup distribution were not treated as an intercompany transaction governed by the consolidated return rules, the distributee would recognize ordinary dividend income to the extent the fair market value of the distributed property does not exceed the distributor’s E&P, as increased by any section 311(b) gain recognized on the

¹⁵¹¹ Treas. Reg. § 1.1502-13(f)(2)(iii) and (f)(7), Ex. 1(c).

¹⁵¹² Treas. Reg. §§ 1.1502-13(a); -32(a) and (b)(5), Ex. 1(c). Any gain recognized in connection with a Deemed Sale of CFC stock would be recharacterized as dividend income pursuant to section 1248 to the extent of such CFC’s E&P accumulated while it was a CFC. I.R.C. § 1248(a). Any loss recognized in connection with a Deemed Sale of such stock might be permanently disallowed under Treasury Regulation section 1.1502-20.

¹⁵¹³ Treas. Reg. § 1.1502-13(f)(2)(iv).

distribution. The distribution would then be treated as a return of capital to the extent the fair market value of the distributed property exceeds the distributor's E&P, and finally as gain from the sale or exchange of a capital asset. If appreciated property is distributed, the distributor would immediately recognize gain (but not loss) in an amount equal to the excess, if any, of the property's fair market value over the distributor's adjusted tax basis in the property.¹⁵¹⁴

2. Domestic Section 355 Distributions

a. Tax-Free Distributions of U.S. Subsidiaries

For simplicity, the discussion below assumes that (i) no affiliate stock will be distributed as boot in a section 355 distribution, (ii) controlled corporation stock is distributed pro rata, (iii) no controlled company stock has been acquired in a taxable transaction during the preceding five-year period, and (iv) no controlled company stock is retained.

Where a U.S. corporation distributes stock of a U.S. subsidiary to its U.S. shareholder(s) in a section 355 distribution, the distributee(s) will not recognize gain or loss, except in respect of the receipt of cash or other boot, irrespective of whether such section 355 distribution is integrated with a subsequent disposition of the distributed company.¹⁵¹⁵ The distributee will allocate part of its adjusted tax basis in its distributor stock to the stock it receives in connection with the section 355 distribution in accordance with the relative fair market values of the distributing and distributed company stock at the time of the distribution.¹⁵¹⁶ Similarly, the

¹⁵¹⁴ I.R.C. § 311(b).

¹⁵¹⁵ I.R.C. § 355(a)(1). In connection with a spinoff, the conversion of a debtor subsidiary to an entity disregarded from its parent did not result in a significant modification for purposes of Treas. Reg. § 1.1001-3(e). See P.L.R. 2010-10-015 (Mar. 12, 2010) and Robert Willens, *The Debt Remains the Same*, CFO.com (May 10, 2011) (commenting that "The nature of the debt and the constancy of the debt-holders are what matters in a corporate restructuring. What doesn't matter is that the debt has been shifted among subsidiaries").

¹⁵¹⁶ I.R.C. § 358; Treas. Reg. § 1.358-2(a)(2)(i). See the text below for a further discussion of Treasury Regulations that may be issued under section 358(g). See also C.C.A. 2010-05-051 (Aug. 7, 2008) (concluding that, in a transaction where under a pre-arranged deal, (i)

distributing company generally will not recognize gain or loss as a result of a section 355 distribution (except in respect of the distribution of any boot or as required under the consolidated return regulations), irrespective of whether such section 355 distribution and a subsequent distribution are integrated for U.S. income tax purposes, unless sections 355(e) and (f) apply.¹⁵¹⁷

b. Tax Consequences of Boot in Section 355 Distributions

The taxation of boot distributed in connection with a section 355 distribution will depend on whether the section 355 distribution is integrated with a subsequent disposition and whether the distribution is treated as an intercompany transaction.

If the transactions are integrated, but the distributor and distributee remain consolidated after the disposition, the general consolidated return rules described below will apply. Even if the distributor and distributee deconsolidate as part of a plan that includes the distribution, the general consolidated return rules may nonetheless apply to the distribution as a result of the “entitlement rule,” which deems an intragroup distribution to occur on the date it is declared, even if the parties deconsolidate after the declaration date and before the payment date.¹⁵¹⁸

In the unlikely event that a distribution and disposition are integrated, and the consolidated return rules do not apply to the boot distribution, the distributee would recognize ordinary

controlled was spun off to parent, (ii) controlled issued new shares in an IPO, and (iii) parent then spun off its stock in controlled to parent’s shareholders, (a) the controlled stock received by parent should be valued by reference to the IPO price for purposes of allocating parent’s basis in its distributing stock and (b) a control premium should be applied in determining the fair market value of parent’s controlled stock following the first spinoff even though parent may have been legally obligated to distribute the controlled stock to its shareholders).

If the transferor receives boot in addition to stock or securities, or receives stock or securities of more than one class, the terms of the exchange, if reasonable, determine the allocation of basis. Treas. Reg. § 1.358-2(a)(2)(ii).

¹⁵¹⁷ I.R.C. §§ 355(c), (e), (f); 361(c).

¹⁵¹⁸ Treas. Reg. § 1.1502-13(f)(2)(iv).

dividend income to the extent that the fair market value of the boot does not exceed the distributor's E&P, as increased by any section 311(b) gain recognized on the distribution.¹⁵¹⁹ The distributor would also immediately recognize any built-in gain (but not loss) with respect to the distribution of appreciated boot.¹⁵²⁰

If a section 355 distribution and subsequent disposition are afforded independent tax significance, any distribution would be subject to the consolidated return rules.¹⁵²¹ In that case, the distributee would not recognize income in respect of any distributed boot and would not be entitled to a dividends-received deduction. Instead, its adjusted tax basis, if any, in its distributor stock would be reduced by the fair market value of the distributed boot, and any built-in gain in the boot would create or increase an ELA with respect to the distributee's stock in the distributor. The distributor would be treated as selling the boot to the distributee for its fair market value (such sale, a "Deemed Sale").¹⁵²² Any gain or loss recognized by the distributor in connection with such a Deemed Sale would be deferred until the occurrence of a triggering event (or, in the case of loss, until a subsequent section 267(f) event).¹⁵²³ At that time, the distributor would be required to take such gain or loss into account, and the distributee's adjusted tax basis in its distributor stock would be increased or decreased, as appropriate, by the after-tax amount of such gain or loss.¹⁵²⁴

c. ELA Elimination and Applicable Anti-Abuse Rules

Unless one of two anti-abuse rules (described below) apply, a distributor's ELA with respect to U.S. controlled company stock may be eliminated by distributing the controlled company stock to another consolidated group member in a section 355

¹⁵¹⁹ The distribution would be treated as a return of capital to the extent the fair market value of the boot exceeds the distributor's E&P and then as gain from the sale or exchange of a capital asset. I.R.C. § 356(b).

¹⁵²⁰ Treas. Reg. § 1.1502-13(f)(2)(iii).

¹⁵²¹ Treas. Reg. § 1.1502-13(f)(3)(ii).

¹⁵²² Treas. Reg. § 1.1502-13(f)(2)(iii).

¹⁵²³ I.R.C. § 267(f); Treas. Reg. § 1.1502-13(d)(3), Ex. 1.

¹⁵²⁴ Treas. Reg. § 1.1502-32(b).

distribution.¹⁵²⁵ These two anti-abuse rules overlap in scope; therefore, a transaction may be considered abusive under either one or both of the rules.

The first anti-abuse rule provides that if a corporation takes an action with the principal purpose of avoiding the effect of the rules of Treasury Regulation section 1.1502-19 (regarding the maintenance and taxation of ELAs) or any other provision of the consolidated return regulations, adjustments will be made as necessary to carry out the purposes of Treasury Regulation section 1.1502-19.¹⁵²⁶

A second anti-abuse rule is contained in the legislative history with respect to newly enacted section 358(g). It states that Congress expects the Secretary to issue Treasury Regulations under section 358(g) that will prevent, among other things, an elimination of an ELA with respect to controlled company stock upon consummation of a distribution that qualifies as a section 355 distribution.¹⁵²⁷ Such Treasury Regulations, when issued, are

¹⁵²⁵ See Treas. Reg. § 1.1502-19(g), Ex. 3. An ELA with respect to a distributee's stock in the distributing company cannot be similarly eliminated. Rather, any such ELA is allocated between the distributee's stock in each of the distributor and the distributed controlled company based on their relative fair market values as of the distribution date. I.R.C. § 358; Treas. Reg. § 1.358-2.

¹⁵²⁶ Treas. Reg. § 1.1502-19(e); *see, e.g.*, Treas. Reg. § 1.1502-19(g), Ex. 6 (ELA anti-abuse rule applied where subsidiary ceased all substantial operations with respect to its assets but maintained ownership of such assets with a principal purpose of avoiding recapture of its parent's ELA with respect to the subsidiary stock); T.A.M. 2005-49-007 (Dec. 9, 2005) (distinguishing above example and concluding that taxpayer did not act with a principal purpose of avoiding "worthlessness" trigger under ELA regulations by retaining more than an insubstantial amount of assets); F.S.A. 2000-22-006 (Dec. 9, 1999) (applying ELA anti-abuse rule to section 355 distribution where a principal purpose of transaction was to avoid ELA recapture).

¹⁵²⁷ The 1997 Blue Book also states that the regulations under section 358(g) should provide basis adjustment rules that address taxpayer attempts to utilize section 355 distributions to extract significant amounts of asset value and basis without creation of an ELA. The Blue Book notes that distributors have been incurring debt and contributing the proceeds thereof to a controlled company to be

expected to apply prospectively, except in abusive situations.¹⁵²⁸ There is, of course, no guidance as to what types of situations will be treated as abusive for purposes of section 358(g).¹⁵²⁹ The author believes that until regulations are issued, some transactions (for example, transactions not covered by Treasury Regulation section 1.1502-19(e)) should be viewed as non-abusive, since a narrow exception for abusive transactions could largely moot the prospective effective date of the section 358(g) regulations.

d. U.S.-to-U.S. Distributions of Foreign Subsidiary Stock

When a U.S. subsidiary distributes stock of a foreign subsidiary to a U.S. distributee in an otherwise tax-free section 355 distribution, special consideration must also be given to the effect of sections 1248(f)(1) and 367(b).¹⁵³⁰ Section 367(b) permits the tax-free distribution by a U.S. corporation of its foreign subsidiary stock to a domestic corporation, but not to individuals.¹⁵³¹ In the case of individual distributees, the section 367(b) regulations

distributed pursuant to a section 355 distribution. As a result of such debt incurrence and contribution, the distributor's value decreases, while the controlled company's value increases (in each case by the amount of the borrowing). The Blue Book considers this to be an abusive transaction, because no ELA is created in the distributor stock in connection with such a structure, even though the amount of the borrowing may exceed the distributee's aggregate adjusted tax basis in its distributor stock. 1997 Blue Book, at 204.

¹⁵²⁸ 1997 Blue Book, at 206.

¹⁵²⁹ Commentators have suggested that certain "aggressive transactions" involving the incurrence of debt immediately prior to a spinoff will be considered abusive. Such transactions would include, for example, a spinoff in which all the gain inherent in controlled company stock and the distributor's stock prior to the spinoff was not preserved after the spinoff by reason of the application of the basis allocation rules under section 358. See Mark J. Silverman, Andrew J. Weinstein & Lisa M. Zarlenga, *Spinoffs – The New Anti-Morris Trust and Intragroup Spin Provisions*, 98 TNT 12-61 (Jan. 20, 1998); Richard L. Reinhold, *How Tax-Free Spinoffs Got to be Taxable*, 1999 TNT 44-103 (Mar. 8, 1998).

¹⁵³⁰ See Section IV.F.2.

¹⁵³¹ Treas. Reg. § 1.367(b)-5(b)(1)(i), (ii).

subject the distributing corporation to gain, but not loss, on the distribution.¹⁵³²

At the time of the spinoff, each distributee is presumed to be an individual and thus subject to gain recognition on the transaction; this presumption may be rebutted under the section 367(e) identification principles.¹⁵³³ A privately held corporation may rebut the presumption that the distributee is an individual by identifying each domestic corporate distributee and certifying the amount of stock or securities distributed to such corporations.¹⁵³⁴ Publicly traded distributing corporations may overcome the presumption by identifying any 5% corporate shareholders and certifying the amount of stock distributed to each; additionally they must rely on and provide a reasonable analysis of shareholder records or other relevant information with respect to any non-5% shareholders.¹⁵³⁵

If one or more distributees are individuals, or the distributing corporation fails to rebut the presumption of individual distributees, the distributing corporation must recognize gain on the distribution equal to the excess of the fair market value of the stock or securities distributed to such individuals (determined at the time of distribution) over the distributing corporation's adjusted basis in the stock or securities distributed to such distributees.¹⁵³⁶

Section 1248(f)(1) recharacterizes any gain realized by a U.S. corporation that distributes CFC stock in an otherwise tax-free section 355 distribution as taxable dividend income to the extent of the CFC's E&P.¹⁵³⁷ Notice 87-64 provides, however, that Treasury Regulations will be promulgated under section 1248(f)(2) that may (but need not) limit the application of section 1248(f)(1) to those section 355 distributions in which (i) the distributee CFC is no longer a CFC after the distribution, or (ii) one or more of the distributees of the CFC stock are not U.S.

¹⁵³² Treas. Reg. § 1.367(b)-5(b)(1)(ii).

¹⁵³³ Treas. Reg. § 1.367(b)-5(b)(3).

¹⁵³⁴ Treas. Reg. § 1.367(e)-1(d)(2).

¹⁵³⁵ Treas. Reg. § 1.367(e)-1(d)(3).

¹⁵³⁶ Treas. Reg. §§ 1.367(e)-1(b)(3); 1.367(b)-5(b)(2).

¹⁵³⁷ I.R.C. § 1248(f)(1).

shareholders (within the meaning of section 951(b)) after the distribution.¹⁵³⁸ Such regulations, if and when issued, will apply retroactively as of September 21, 1987, and will provide that, if an inclusion of income under section 1248(f)(1) is prevented, the CFC's E&P shall be allocated so that the amount of dividend income recognized pursuant to section 1248 upon a subsequent disposition of the CFC stock will include the CFC's E&P as of the date of the section 355 distribution. Appropriate adjustments will also be made to the distributee's adjusted tax basis and holding period with respect to distributed CFC stock to the extent necessary to achieve this result.¹⁵³⁹

IRS ruling practice has incorporated the principles of Notice 87-64.¹⁵⁴⁰ For example, in one private ruling, the IRS stayed the application of section 1248(f)(1), which would otherwise have required a dividend inclusion, where the distributee reduced its basis in the CFC's stock, and extended its holding period.¹⁵⁴¹ Under the tax basis reduction rule applied in the private rulings, a distributee's adjusted tax basis in any distributed CFC stock will equal the lesser of the distributee's adjusted tax basis in such stock

¹⁵³⁸ Notice 87-64, 1987-2 C.B. 375. Whether a U.S. parent would be considered a U.S. shareholder of a CFC after a section 355 distribution would depend on whether such section 355 distribution and subsequent disposition are integrated. Under an integration analysis, U.S. parent would not be a U.S. shareholder of any CFC subsequently transferred to a departing affiliate because U.S. parent would own no stock of that company after its disposition. It is unclear whether gain must therefore be recognized in such a case under Notice 87-64 even though the section 1248 amount could be preserved in the stock of the company that is disposed of after the disposition.

If a section 355 distribution were afforded independent tax significance, however, a U.S. parent would likely be considered a U.S. shareholder of any CFC transferred to a company that is disposed of after an intragroup section 355 distribution because the U.S. parent would be attributed ownership of 100% of any such CFC's stock after the distribution and prior to the disposition.

¹⁵³⁹ Notice 87-64, 1987-2 C.B. 375.

¹⁵⁴⁰ *See, e.g.*, P.L.R. 95-42-013 (July 20, 1995); P.L.R. 94-05-020 (Nov. 8, 1993); P.L.R. 90-45-031 (Aug. 14, 1990); P.L.R. 90-11-054 (Dec. 22, 1989).

¹⁵⁴¹ P.L.R. 95-42-013 (July 20, 1995).

as determined under section 358 and the distributor's adjusted tax basis in the CFC stock immediately prior to the distribution. Under the holding period extension rule applied in the private rulings, a distributee's holding period with respect to any distributed CFC stock will be the greater of the distributee's holding period with respect to its distributor stock and the distributor's pre-distribution holding period with respect to the CFC stock.¹⁵⁴² Because the IRS is not bound to follow Notice 87-64 or any private rulings consistent therewith, and section 1248(f)(1) by its terms triggers dividend income in connection with any U.S. shareholder's distribution of CFC stock,¹⁵⁴³ U.S. shareholders engaging in transactions that are potentially subject to section 1248 may wish to obtain an IRS private ruling on this point.

In August, 2008, the IRS issued proposed regulations under section 1248(f) (the "Proposed Section 1248 Regulations") providing that a domestic distributing corporation that is a section 1248 shareholder of a foreign corporation generally must include the section 1248 amount attributable to the distributed stock as a dividend when it distributes such foreign corporation stock in a section 337, 361, or 355 transaction.¹⁵⁴⁴ The Proposed Section 1248 Regulations provide elective exceptions for section 355 and 361 distributions.¹⁵⁴⁵

i. Section 355 Distributions

The Proposed Section 1248 Regulations provide that a 1248 shareholder that elects not to include its section 1248 amount may be required to make the following adjustments: (i) solely for section 1248 purposes, immediately following the distribution, the

¹⁵⁴² See, e.g., P.L.R. 95-42-013 (July 20, 1995); P.L.R. 94-05-020 (Nov. 8, 1993); P.L.R. 90-45-031 (Aug. 14, 1990); P.L.R. 90-11-054 (Dec. 22, 1989).

¹⁵⁴³ Any dividend income recognized under section 1248(f)(1) would likely be deferred until the occurrence of a triggering event. See Notice 87-64, 1987-2 C.B. 375.

¹⁵⁴⁴ 73 Fed. Reg. 49277 (Aug. 20, 2008); Prop. Reg. § 1.1248(f)-1(b). The Proposed Section 1248 Regulations become effective 30 days after their publication as final regulations. Prop. Reg. § 1.1248(f)-3(b).

¹⁵⁴⁵ Prop. Reg. § 1.1248(f)-(2)(b), (c).

section 1248 shareholder's holding period in the stock received in the distribution will equal the domestic distributing corporation's holding period at the time of the distribution,¹⁵⁴⁶ and (ii) if the shareholder's section 1248 amount for the foreign corporation stock exceeds the section 1248 shareholder's post-distribution amount attributable to such stock at the time of the distribution (the "excess amount"), the shareholder must reduce its stock basis by the excess amount.¹⁵⁴⁷

ii. Distributions Pursuant to a Plan of Reorganization

A 1248 shareholder that elects not to include its section 1248 amount for a distribution pursuant to a plan of reorganization may be required to make the following adjustments: (i) each share of foreign corporation stock received by the section 1248 shareholder is divided into portions attributable to each block of foreign acquired corporation stock transferred by the domestic distributing corporation with respect to which the distributing corporation was a section 1248 shareholder at the time of the exchange, and to all other property it transferred in the exchange,¹⁵⁴⁸ and (ii) the section 1248 shareholder's basis in such portion is reduced by the excess, if any, of the section 1248(f) amount attributable to a portion of a share (or whole share, if no division is required) of foreign distributed corporation stock received in the distribution over the section 1248 shareholder's post-distribution amount attributable to such portion (or whole share) (the "excess amount").¹⁵⁴⁹

¹⁵⁴⁶ Prop. Reg. § 1.1248(f)-2(b)(2).

¹⁵⁴⁷ Prop. Reg. § 1.1248(f)-2(b)(3). To apply the exception, the domestic distributing corporation and the section 1248 shareholders must (i) enter into a written agreement on or before the domestic distributing corporation's tax return due date for the taxable year of the section 355 distribution; and (ii) include a statement with its tax return for the taxable year of the distribution reporting any required adjustments to stock basis or holding period and confirming that the election has been made. Prop. Reg. § 1.1248(f)-2(b)(1).

¹⁵⁴⁸ Prop. Reg. § 1.1248(f)-2(c)(2).

¹⁵⁴⁹ Prop. Reg. § 1.1248(f)-2(c)(3). To apply the exception, the domestic distributing corporation and the section 1248 shareholders must (i) enter into a written agreement on or before the due date (including extensions) of the domestic distributing corporation's tax return for

3. Inbound Distributions

a. Inbound Taxable Distributions

The tax consequences of a foreign company's distribution of property to a U.S. distributee depend upon whether the distribution qualifies as a section 355 distribution. If a distribution does not so qualify, irrespective of whether the distribution is integrated with a subsequent disposition, the distributee will recognize ordinary dividend income to the extent the fair market value of the distributed property does not exceed the distributor's E&P, as increased by any section 311(b) gain recognized on the distribution.¹⁵⁵⁰ The amount of such dividend income will be reduced by the amount of any previously taxed income, *i.e.*, undistributed E&P of the distributor previously included in the distributee's income pursuant to section 951.¹⁵⁵¹ The distributee generally will not be entitled to claim the dividends-received deduction generally available to corporate holders of stock in a domestic corporation;¹⁵⁵² instead, the U.S. distributee will be treated as having paid an allocable portion of the foreign taxes imposed on the E&P out of which any dividend is paid.¹⁵⁵³ Subject to any section 904(d) limitations, the distributee may claim

the taxable year of the distribution; and (ii) include a statement with its tax return for the taxable year of the distribution reporting any required adjustments to stock basis or the amount of earnings and profits attributable to the stock received for purposes of section 1248 and confirming that the election has been made.
Prop. Reg. § 1.1248(f)-2(c)(1).

¹⁵⁵⁰ I.R.C. §§ 301(c)(1), 311(b).

¹⁵⁵¹ Any distributions out of the distributor's E&P would first be treated as distributions of previously taxed income ("PTI"), *i.e.*, undistributed E&P that the U.S. shareholder has previously included in income pursuant to section 951, which would not be subject to tax as dividends. I.R.C. § 959(c), (d). In August, 2006, the government issued proposed regulations addressing the PTI rules. 71 Fed. Reg. 51155 (Aug. 29, 2006). *See generally* Gregg D. Lemein, Stewart R. Lipeles & John D. McDonald, *Subpart F's New Previously Taxed Income Regulations Provide Additional Clarity in Complex Situations—Part II*, 85 Taxes 9 (Sept. 2007).

¹⁵⁵² I.R.C. §§ 243(a), 245.

¹⁵⁵³ I.R.C. § 902.

a corresponding foreign tax credit for such deemed-paid foreign taxes.¹⁵⁵⁴

The distribution will be treated as a return of capital to the extent the fair market value of the distributed property exceeds the distributor's current and accumulated E&P (increased by any section 311(b) gain recognized on the distribution) and then as gain from the sale or exchange of a capital asset.¹⁵⁵⁵ If appreciated property is distributed, the distributor will recognize gain on a deemed sale of the distributed property to the distributee at fair market value.¹⁵⁵⁶ Any such gain generally will constitute Subpart F income to the distributee.

b. Inbound Section 355 Distributions

A foreign company's distribution of foreign subsidiary stock to a U.S. corporate shareholder in a section 355 distribution will be treated as an inbound transfer that is subject to the 367(b) Rules.¹⁵⁵⁷ Under those rules, neither the distributor nor the

¹⁵⁵⁴ I.R.C. § 904(d).

¹⁵⁵⁵ I.R.C. § 301(c).

¹⁵⁵⁶ I.R.C. § 311(b). If the fair market value of such property is less than the distributor's adjusted tax basis therein, however, the distributor will not be entitled to recognize any loss on the deemed sale.

¹⁵⁵⁷ See I.R.C. § 367(b); Treas. Reg. § 1.367(b)-5(c), (d); *see also* discussion in Section IV.F.2. For an example and general discussion about a foreign corporation's distribution of *U.S. subsidiary stock* to a U.S. corporate parent, see Joseph Calianno & Margaret Hogan, *Spinning Out of a Sandwich Structure—IRS Provides Favorable Code Sec. 355 Rulings*, Int'l Tax J. (May – June 2010) (discussing the practical reasons for avoiding “sandwich structures” where, for example, a U.S. parent owns a CFC, which owns a U.S. controlled entity, and a favorable letter ruling (P.L.R. 2010-010-09) in which the CFC distributed a U.S. controlled entity to the CFC's U.S. parent). In particular, the article discusses possible tax inefficiencies of a sandwich structure, including U.S. and foreign withholding taxes on distributions through the chain of ownership (subject to possible reduction under a treaty), foreign tax on the receipt of such distributions (subject to possible relief in the foreign jurisdiction), and income inclusions to the U.S. parent of the CFC relating to subpart F income and investments in U.S. property under section 956, and the inability for a U.S. entity to take advantage of certain benefits of being a member of the U.S. consolidated group that

distributee will recognize gain or loss for U.S. tax purposes, irrespective of whether a particular section 355 distribution and subsequent disposition are integrated, as long as the distributor and the controlled company are each treated as corporations for purposes of section 355¹⁵⁵⁸ and any amount of E&P that would be taxable upon a disposition of the controlled corporation prior to the spinoff, and would otherwise escape taxation in a disposition immediately after the spinoff, must either be reflected through a basis adjustment or included in income as a deemed dividend under section 1248.

If a foreign corporation distributes stock of its foreign subsidiary pro rata to its shareholders, the distributees must include any diminution reflected between their predistribution and postdistribution amount,¹⁵⁵⁹ with respect to either the distributing corporation or the controlled corporation, as a reduction in basis with respect to that corporation.¹⁵⁶⁰ To the extent that such adjustment would reduce the distributee's basis in an affected corporation below zero, the distributee must recognize the excess amount in current income as a deemed dividend.¹⁵⁶¹ In addition, if any such reduction is made by the distributee to the basis in its distributing or controlled corporation stock, the distributee must also increase its basis in the stock of the other corporation, up to the fair market value of such stock, by the sum of the basis reduction and any deemed dividend inclusion.¹⁵⁶²

If the distribution of a foreign corporation's subsidiary is made non-pro rata to its shareholders, any diminution reflected between the distributee's predistribution and postdistribution amount with respect to either the distributing or controlled

includes the U.S. parent. For a ruling on an intragroup inbound section 355 distribution, see Private Letter Ruling 2010-16-044 (Apr. 23, 2010).

¹⁵⁵⁸ I.R.C. § 367(b)(1).

¹⁵⁵⁹ The "predistribution amount" and "postdistribution amount" generally correspond to the E&P of the distributing and controlled corporation that would be included in income under section 1248 upon a notional disposition immediately before and after the spinoff, respectively. See Section IV.F.2., *supra*.

¹⁵⁶⁰ Treas. Reg. § 1.367(b)-5(c)(2).

¹⁵⁶¹ Treas. Reg. § 1.367(b)-5(c)(2).

¹⁵⁶² Treas. Reg. § 1.367(b)-5(c)(4).

corporation (the “referenced corporation”) must be reflected in the distributee’s income as a deemed dividend.¹⁵⁶³ This deemed dividend is treated as paid by the referenced corporation to the other corporation, and then in turn paid to the distributee.¹⁵⁶⁴ As a result, if such deemed dividend inclusion is required, the distributee increases its basis in the stock of the corporation treated as having made the ultimate payment by the amount of the deemed dividend,¹⁵⁶⁵ subject to two caveats: (i) the adjustment may not increase the stock beyond its fair market value, and (ii) the adjustment may not diminish the distributee’s postdistribution amount with respect to such corporation.¹⁵⁶⁶ Finally, if the distributee owns no stock in either the distributing or controlled corporation immediately after the spinoff, the distributee’s postdistribution amount in such corporation is treated as zero for purposes of determining the extent of any distributee deemed dividend inclusion.¹⁵⁶⁷

4. Foreign-to-Foreign Distributions

a. Foreign Taxable Distributions

If a foreign subsidiary distributes assets (including affiliate stock) to a foreign shareholder in a distribution that is not a section 355 distribution, the foreign distributee will recognize ordinary dividend income to the extent that the fair market value of the distributed property does not exceed the distributor’s E&P, as increased by the amount of any section 311(b) gain the distributor recognizes. This result would obtain without regard to whether a particular foreign-to-foreign distribution is integrated with a subsequent disposition.¹⁵⁶⁸ The amount of such dividend income will be reduced by the amount of any PTI.¹⁵⁶⁹

¹⁵⁶³ Treas. Reg. § 1.367(b)-5(d)(3).

¹⁵⁶⁴ Treas. Reg. § 1.367(b)-5(e)(2).

¹⁵⁶⁵ Treas. Reg. § 1.367(b)-5(d)(4).

¹⁵⁶⁶ Treas. Reg. § 1.367(b)-5(d)(4).

¹⁵⁶⁷ Treas. Reg. § 1.367(b)-5(d)(3).

¹⁵⁶⁸ I.R.C. § 301(c)(1).

¹⁵⁶⁹ I.R.C. § 959(d).

If the fair market value of the distributed property exceeds the distributor's E&P, the distribution is treated as a return of capital to the extent of the distributee's adjusted tax basis in its distributor stock and then as gain from the sale or exchange of a capital asset.¹⁵⁷⁰ If appreciated property is distributed, the distributor will recognize gain in an amount equal to the excess of the fair market value of the property over its adjusted tax basis in the property.¹⁵⁷¹ Any such dividend income or gain generally will constitute Subpart F income to the U.S. parent corporation, subject to the potential application of the Subpart F Look Through Exception or the exception for certain dividends where the parent and subsidiary CFCs are organized in the same foreign country.¹⁵⁷² Unless extended by Congress, the Subpart F Look Through Exception will apply only to taxable years beginning before January 1, 2009.¹⁵⁷³

b. Foreign-to-Foreign Section 355 Distributions

Under the section 367(b) regulations, whether a foreign-to-foreign section 355 distribution and subsequent disposition are each afforded independent tax significance or integrated, the parties would not be subject to tax, except for a possible dividend inclusion.¹⁵⁷⁴ The basis adjustments required do not depend on whether the new shareholders are subject to section 1248, which is a welcome change whenever it is unclear

¹⁵⁷⁰ The distributee will not be entitled to claim the dividends-received deduction generally available with respect to distributions by domestic corporations. I.R.C. § 243(a).

¹⁵⁷¹ I.R.C. § 311(b).

¹⁵⁷² See I.R.C. § 954(c)(3), (6).

¹⁵⁷³ See I.R.C. § 954(c)(6)(B). The Obama Administration's 2013 budget proposals include a one-year extension of the Subpart F Look Through Exception. See Dept. of Treasury, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 65 and 207, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

¹⁵⁷⁴ See P.L.R. 98-24-034 (Mar. 13, 1998) (foreign-to-foreign section 355 distribution of controlled company stock was subject to section 367(b); ruling did not state when U.S. shareholder status should be measured).

whether the IRS would integrate a particular distribution and a subsequent disposition.

The applicable section 367(b) regulations subject the parties to a foreign-to-foreign section 355 distribution to certain basis adjustments, and require deemed dividend inclusions with respect to any domestic shareholders. A pro rata foreign-to-foreign distribution generally has the same tax consequences as the distribution of a lower-tier foreign subsidiary to a domestic shareholder; each foreign distributee must determine the extent of any basis adjustment or dividend inclusion by comparing its predistribution and postdistribution amounts in both the distributing and controlled corporation.¹⁵⁷⁵ If the distributee's postdistribution amount with respect to either the distributing or controlled corporation is less than its predistribution amount, the distributee must reduce its basis in such corporation's stock by the amount of the difference.¹⁵⁷⁶ To the extent such reduction would exceed the distributee's basis in such stock, the distributee must include the excess amount in income as a deemed dividend.¹⁵⁷⁷ In connection with any required reduction in its basis in either the distributing or controlled corporation stock, the distributee must make a corresponding increase in its basis in the stock of the other corporation, up to the fair market value of such other stock, by the sum of the basis reduction and deemed dividend inclusion.¹⁵⁷⁸

Non-pro rata foreign-to-foreign distributions also require the foreign distributee to make a comparison of the predistribution and postdistribution amounts in both the distributing and controlled corporations. The distributee must include a deemed dividend in income to the extent that the distributee's postdistribution amount in either the distributing or controlled corporation (the "referenced corporation") is less than its predistribution amount.¹⁵⁷⁹ This dividend is treated as if it were paid by the referenced corporation to the other corporation, and then by such other corporation to the distributee.¹⁵⁸⁰ As a result, any required deemed dividend is

¹⁵⁷⁵ Treas. Reg. § 1.367(b)-5(c)(2).

¹⁵⁷⁶ Treas. Reg. § 1.367(b)-5(c)(2).

¹⁵⁷⁷ Treas. Reg. § 1.367(b)-5(c)(2).

¹⁵⁷⁸ Treas. Reg. § 1.367(b)-5(c)(4).

¹⁵⁷⁹ Treas. Reg. § 1.367(b)-5(d)(3).

¹⁵⁸⁰ Treas. Reg. § 1.367(b)-2(e)(2).

accompanied by a basis increase in the distributee's stock of the corporation treated as making the ultimate payment of the dividend to the shareholder.¹⁵⁸¹ However, this rule is subject to two limitations: (i) the distributee's basis in such stock may not be increased beyond the stock's fair market value and (ii) the increase may not diminish the distributee's postdistribution amount with respect to such corporation.¹⁵⁸² If a distributee owns no stock in the distributing or controlled corporation immediately after the distribution, the distributee is treated as having a zero postdistribution amount.¹⁵⁸³

As a final note, because section 1248 may continue to apply after either a pro rata or non-pro rata distribution of a CFC's subsidiary,¹⁵⁸⁴ the section 367(b) regulations specifically exempt from the foreign personal holding company income provisions of Subpart F any deemed dividend required to be included in a foreign corporation's income by virtue of either a pro rata or non-pro rata distribution of a foreign corporation's subsidiary.¹⁵⁸⁵

F. Cross-Chain Transactions

An intragroup cross-chain reorganization that involves a transfer of stock in actual or constructive exchange for transferee stock may constitute both a section 351 transaction and/or a B reorganization.¹⁵⁸⁶ Cross-chain reorganizations are typically used to transfer one or several line(s) of business assets (including

¹⁵⁸¹ Treas. Reg. § 1.367(b)-5(d)(4).

¹⁵⁸² Treas. Reg. § 1.367(b)-5(d)(4).

¹⁵⁸³ Treas. Reg. § 1.367(b)-5(d)(3).

¹⁵⁸⁴ See T.D. 8862, 2001-1 C.B. 300.

¹⁵⁸⁵ Treas. Reg. § 1.367(b)-5(f).

¹⁵⁸⁶ Cross-chain reorganizations that qualify as B reorganizations are not subject to section 304. *Deficit Reduction Act of 1984*, Pub. L. No. 98-369, H.R. 4170, 98th Cong., at 1002 (Dec. 31, 1984). ("Thus, where the reorganization provisions apply, including those governing the treatment of exchanges by shareholders pursuant to a reorganization, the rules of section 304(a) providing treatment as a stock redemption would not apply.")

stock of target companies engaged in any such businesses) to one or more corporations that will leave the consolidated group.¹⁵⁸⁷

As discussed more fully below, cross-chain reorganizations generally do not produce more favorable U.S. tax results than the other transfer alternatives, and may in some cases produce less favorable results. Thus, cross-chain reorganizations should generally be employed only where they would produce a compelling corporate or foreign tax benefit that could not otherwise be obtained.¹⁵⁸⁸

1. Section 351 Transaction and B Reorganization Requirements¹⁵⁸⁹

a. Section 351 Transactions

As discussed in more detail below, a cross-chain reorganization will qualify as a section 351 transaction if (i) affiliate stock is transferred solely in exchange for transferee stock (or for boot, as permitted under section 351(b)), and (ii) immediately after such exchange the transferor of such stock owns at least 80% of the transferee's voting stock and at least 80%

¹⁵⁸⁷ Although less common, cross-chain reorganizations might also be used to transfer a group of specific assets to a company's parent before the company leaves the group. The analysis described below would apply equally to any such cross-chain reorganization.

¹⁵⁸⁸ On December 29, 2009, the IRS released temporary anti-abuse regulations that prevent the use of controlled corporate intermediaries to circumvent the application of section 304. *See* T.D. 9477, 2010-1 C.B. 385; Temp. Reg. § 1.304-4T. The temporary regulations generally provide that where a principal purpose of creating, organizing or funding a corporate intermediary is to avoid the application of section 304, (i) the corporation that controls an acquiring corporate intermediary will be treated as the acquiring corporation and (ii) the corporation that is controlled by an issuing corporate intermediary will be treated as the issuing corporation. *See* Temp. Reg. § 1.304-4T(a), (b)(1)-(2). Tax practitioners should fear these anti-abuse provisions when structuring proposed cross-chain transactions, particularly in the cross-border context. *See* T.D. 9477, 2010-1 C.B. 385.

¹⁵⁸⁹ *See* Sections I and II of this outline for a discussion of the specific requirements for section 351 transactions and B reorganizations.

of the remaining transferee stock (such stock ownership requirement, the “Control Test”).¹⁵⁹⁰

Whether a transferor’s ownership of transferee stock satisfies the Control Test will depend on whether such ownership is measured immediately after the cross-chain reorganization and whether, based on the relative values of the assets transferred to and previously held by the transferee, the target company would be deemed to receive stock sufficient to directly satisfy the Control Test or, if not, whether the transferor would be attributed sufficient ownership of transferee stock under the consolidated return rules to permit indirect satisfaction of the Control Test.

The IRS should properly measure the transferor’s ownership of transferee stock for purposes of the Control Test immediately after the cross-chain reorganization.¹⁵⁹¹ Even in that case, however, a transferor may not receive enough transferee stock in the exchange to directly satisfy the Control Test. For example, if the two parties are of equal size, the transferor would be treated only as receiving 50% of the transferee’s stock. Thus, the Control Test would only be directly satisfied when a large target company is transferred to a small transferee. As a result, many cross-chain reorganizations would satisfy the Control Test only by attribution of transferee stock owned by other U.S. parent affiliates, and attribution is permitted only under the consolidated return rules, which treat transferors as owning any transferee stock owned by other consolidated group members (the “consolidated group control rule”).¹⁵⁹² Moreover, transferee stock held by a company that will deconsolidate may not be attributed to a transferor under the consolidated group control rule if the IRS

¹⁵⁹⁰ I.R.C. § 351(a). See generally Robert Willens, *Analyzing the ‘Control Immediately After’ Requirement*, 2009 TNT 156-10 (July 23, 2009) (concluding that the IRS generally looks to the substance of a transaction rather than its form in determining whether the Control Test is satisfied). See Section I.I. above for a discussion of Proposed Regulation section 1.351-1, which would curtail the application of section 351 to insolvent subsidiaries.

¹⁵⁹¹ *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), aff’d *per curiam*, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976). Cf. Rev. Rul. 56-100, 1956-1 C.B. 624; Rev. Rul. 54-96, 1954-1 C.B. 111.

¹⁵⁹² Treas. Reg. § 1.1502-34.

applies the Control Test after a subsequent disposition, since such entities would no longer be consolidated group members at that time.

It may be possible to structure transactions to include a contribution of stock or assets by the parent of a transferee, *e.g.*, a U.S. parent, to the relevant transferee in order to satisfy the Control Test. A transferee's corporate shareholder (the "transferee parent") would also be treated as a transferor because it contributes stock or assets to the transferee in actual or constructive exchange for additional transferee stock in connection with a cross-chain reorganization, and so both the transferor's and transferee parent's stock in the transferee will count for purposes of the Control Test.¹⁵⁹³

b. B Reorganizations

A cross-chain reorganization will generally qualify as a B Reorganization if (i) the transferee acquires affiliate stock solely in exchange for transferee voting stock, and (ii) immediately after such exchange, the transferee's ownership of the acquired stock satisfies the Control Test.¹⁵⁹⁴ In the case of a B Reorganization, the transferee's ownership of such stock immediately after the reorganization will satisfy the Control Test irrespective of whether the B Reorganization is integrated with a subsequent disposition.¹⁵⁹⁵

2. Post-Reorganization Stock Transfers

All transferee stock received in a cross-chain reorganization must be held by the appropriate subgroup member prior to a disposition to prevent cross-ownership thereafter.¹⁵⁹⁶ To

¹⁵⁹³ I.R.C. § 351(a).

¹⁵⁹⁴ I.R.C. § 368(a)(1)(B). *See* Section I.I. above for a discussion of Proposed Regulation section 1.368-1, which would curtail the application of section 368(a)(1)(B) to insolvent subsidiaries.

¹⁵⁹⁵ The transferee's ownership of stock generally will satisfy the Control Test even if it contributes some or all of the target stock to one of its subsidiaries. Treas. Reg. § 1.368-2(k)(l).

¹⁵⁹⁶ It is possible to eliminate cross-ownership after an intragroup transfer, although pre-transfer restructuring is preferable. *See, e.g.*, P.L.R. 95-10-070 (Dec. 15, 1994) (downstream contribution of stock

achieve this result, any transferee stock actually or constructively received by a transferor must often be (actually or constructively) distributed up the transferor's chain of corporations to the parent of the group, and then contributed to a subsidiary in another chain of corporations prior to a subsequent disposition.

A transferor distributing transferee stock generally will recognize the built-in gain in such transferee stock (which gain would likely be deferred until a subsequent deconsolidation or disposition of assets),¹⁵⁹⁷ and generally the distributee will either recognize dividend income, or its adjusted tax basis in its transferor stock will be reduced (if the consolidated return rules apply). The transferee will take a carryover tax basis in the stock it acquires in connection with a cross-chain reorganization and therefore will likely recognize gain for U.S. tax purposes on a subsequent disposition of such appreciated stock. The distribution and/or contribution of transferee stock will not cause a cross-chain reorganization to fail to satisfy the general continuity of interest requirement for reorganizations.¹⁵⁹⁸

received in an intragroup reorganization does not affect tax-free treatment of the reorganization); P.L.R. 90-24-056 (same) (Mar. 20, 1990); P.L.R. 89-30-066 (same) (May 4, 1989); Rev. Rul. 84-30, 1984-1 C.B. 114 (post reorganization push-up of acquired stock does not jeopardize tax-free treatment of reorganization); P.L.R. 92-29-026 (Apr. 21, 1992) (reorganization treatment when stock treated as distributed up two tiers and contributed down one tier); P.L.R. 87-05-062 (Oct. 23, 1996) (C reorganization achieved where stock received was distributed up two tiers and dropped down into corporation that was a shareholder of the acquirer). In the context of foreign intragroup reorganizations, the cross-ownership problem is exacerbated by the consequences of section 367.

¹⁵⁹⁷ I.R.C. § 311(b). In the case of a U.S. subsidiary's distribution of foreign transferee stock, any such gain may be taxed as ordinary dividend income pursuant to section 1248 to the extent of the foreign transferee's E&P accumulated while it was a CFC. I.R.C. § 1248(a).

¹⁵⁹⁸ See Treas. Reg. § 1.368-1(b), (e); P.L.R. 91-02-012 (Oct. 10, 1990) (continuity satisfied notwithstanding distribution of acquirer stock up two corporate tiers and down another corporate tier); P.L.R. 89-11-067 (Dec. 22, 1988) (continuity satisfied notwithstanding distribution of acquirer stock up one tier and down three tiers); P.L.R. 89-39-056 (July 7, 1989) (continuity satisfied notwithstanding that merger was followed by successive distributions of acquirer stock to shareholders of target's shareholder). See also P.L.R. 2009-28-001 (July 10, 2009) (cross

Finally, there is a general question as to whether the IRS would integrate post-reorganization stock transfers with a cross-chain reorganization to recast the reorganization as either a different type of tax-free reorganization or as a series of taxable transfers. The author believes that a given cross-chain reorganization should be recast, if at all, as a single taxable stock or asset transfer.

3. U.S. Cross-Chain Sales and Reorganizations

a. U.S. Cross-Chain Asset Sales

A cross-chain asset sale between U.S. subsidiaries is a taxable transaction¹⁵⁹⁹ in which the seller generally will recognize gain or loss in an amount equal to the difference between (i) the seller's adjusted tax basis in the assets (other than affiliate stock) sold, and (ii) the fair market value of any property or cash received in exchange therefor. If a cross-chain asset sale and a subsequent disposition are each afforded independent tax significance, any gain recognition within a consolidated group will be deferred until the occurrence of a triggering event. Any such loss will be deferred until the later to occur of a consolidated return triggering event or a 267(f) Event.¹⁶⁰⁰ Even if a particular cross-chain asset sale and subsequent disposition are integrated, it is likely that any gain on the sale would be deferred until the occurrence of a triggering event.¹⁶⁰¹

chain merger of one subsidiary to another for stock of surviving subsidiary, followed by drop down of such stock to a third subsidiary that prior to the transaction owned the surviving subsidiary, treated as an A reorganization); McDermott Will & Emery Newsletter, *IRS Issues Significant Private Letter Ruling Approving Tax-Free Merger*, available at

http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/2cf5c182-54d2-41f3-9419-a8a00a6ffc88.cfm (July 22, 2009) (noting that P.L.R. 2009-28-001 represents a roadmap for achieving tax-free treatment while avoiding cross-ownership and involved recontributions by former target shareholders of stock received in a reorganization).

¹⁵⁹⁹ Section 304 does not apply to sales of assets other than affiliate stock irrespective of integration.

¹⁶⁰⁰ I.R.C. § 267(f).

¹⁶⁰¹ See P.L.R. 95-35-048 (June 6, 1995) (applying prior consolidated return regulations, tax consequences of non-intercompany

b. U.S. Cross-Chain Stock Sales

i. Integrated Transaction Treatment¹⁶⁰²

If the parties to an intragroup cross-chain sale involving affiliate stock (a “cross-chain stock sale”) are not treated as consolidated group members immediately after such a sale, section 304 would likely apply to the sale.¹⁶⁰³ In that case, the buyer would be treated as redeeming the seller’s affiliate stock in exchange for the property or cash paid by the buyer in connection with the sale. Such a deemed redemption would be treated as either a dividend or a sale or exchange, depending on the seller’s ownership of the affiliate before and after the deemed redemption. The redemption would be treated as a sale or exchange if the buyer and seller deconsolidate as a result of a subsequent disposition and the seller’s ownership is tested after the disposition, which would have completely terminated the seller’s direct and indirect ownership of the affiliate.¹⁶⁰⁴ In such a case, the seller would recognize gain or loss in an amount equal to the difference between (i) such seller’s adjusted tax basis in the affiliate stock sold, and (ii) the fair market value of any property or cash received in exchange therefor.

transaction between group members nonetheless deferred until deconsolidation); P.L.R. 92-15-043 (Jan. 14, 1992) (same); P.L.R. 91-37-028 (June 13, 1991) (same).

¹⁶⁰² The tax consequences discussed in this section are unlikely to obtain; the analysis is nevertheless presented first to maintain consistent organization.

¹⁶⁰³ See *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52, 59 (1989) (holding that a corporation (“C”) was in control of brother-sister corporations even though C’s parent was under a binding commitment to sell C to an unrelated party; sale of C broke the constructive control that C had through attribution of its parent’s stock interest in the cross-chain corporations); P.L.R. 89-21-065 (Feb. 28, 1989) (as supplemented by P.L.R. 89-35-028 (June 5, 1989)).

¹⁶⁰⁴ In the case of a foreign affiliate any such gain would be recharacterized as dividend income pursuant to section 1248 to the extent of such company’s E&P accumulated while the company was a CFC. I.R.C. § 1248(a).

ii. Separate Transaction Treatment

A cross-chain stock sale between consolidated group members will constitute a taxable transaction that is not subject to section 304 if the parties are treated as consolidated group members immediately after the sale.¹⁶⁰⁵ This would be the case if a cross-chain stock sale and subsequent disposition are each afforded independent tax significance, and even if the transactions are integrated for purposes other than the consolidated return regulations.¹⁶⁰⁶ If section 304 does not apply, the selling affiliate would recognize gain (including section 1248 income, if any, on sales of stock of foreign subsidiaries)¹⁶⁰⁷ or loss in an amount equal to the difference between (i) such seller's adjusted tax basis in the affiliate stock and (ii) the fair market value of any property or cash received in exchange therefor.¹⁶⁰⁸ Recognition of any such gain or loss generally would be deferred until the occurrence of a triggering event (or, in the case of loss, a subsequent section 267(f) event).¹⁶⁰⁹ Moreover, where U.S. affiliate stock is the subject of a cross-chain sale, the consolidated return loss disallowance rules may permanently prevent the Seller from taking a deduction in respect of recognized loss on the disposition of stock of a U.S. consolidated group member.¹⁶¹⁰

¹⁶⁰⁵ Treas. Reg. § 1.1502-80(b).

¹⁶⁰⁶ I.R.C. § 304(b)(4); Treas. Reg. § 1.1502-80(b).

¹⁶⁰⁷ Treas. Reg. § 1.1502-13(c)(7)(ii), Ex. 1, 5(a)-(c) (setting forth rules for determining the amount of gain that will be treated as a dividend pursuant to section 1248(a) upon the occurrence of a triggering event). *See also* Notice 87-64, 1987-2 C.B. 375 (“in situations in which gain . . . is recognized under the rules of Subchapter C but . . . is deferred under the consolidated return rules, section 1248(a) will apply at such time as the deferral of gain ends”); Rev. Rul. 87-96, 1987-2 C.B. 209 (interpreting Treasury Regulation section 1.1502-14, the predecessor to current Treasury Regulation section 1.1502-13).

¹⁶⁰⁸ I.R.C. § 1001.

¹⁶⁰⁹ Treas. Reg. § 1.1502-13(a).

¹⁶¹⁰ Treas. Reg. § 1.1502-20.

c. U.S. Cross-Chain Reorganizations

i. U.S. Target Companies

In general, if a consolidated group member's transfer of a group member's stock to another group member otherwise qualifies as a 351 Transaction and/or a B reorganization, the parties will not recognize gain or loss, except, as discussed below, in the case of section 357(c) gain. This result would obtain irrespective of whether such a cross-chain reorganization is integrated with a subsequent disposition.¹⁶¹¹ The tax consequences of recognizing section 357(c) gain will depend on whether a particular domestic cross-chain reorganization is integrated with a subsequent disposition, and, if so, whether the consolidated return intercompany transaction rules apply. Even in that case, the transferor may be required to include any section 357 gain in income only upon a deconsolidation or other triggering event.¹⁶¹²

By contrast, the consolidated return rules would apply if a particular 351 Transaction is afforded independent tax significance unless the 351 Transaction and a subsequent disposition were treated as part of a plan or arrangement that includes the 351 Transaction. If the consolidated return rules apply, section 357(c) would not apply, and therefore no section 357(c) gain (or deemed dividend income under section 1248) would be recognized.¹⁶¹³ Instead, the transferor's adjusted tax basis in its transferee stock would be reduced by the amount of the section 357(c) gain, and to the extent such gain exceeds the transferor's adjusted tax basis in the transferee's stock, an excess loss account would be created.

ii. Foreign Target Companies

If a consolidated group member's transfer of foreign affiliate stock to another consolidated group member otherwise qualifies as a section 351 transaction and/or a B Reorganization,

¹⁶¹¹ I.R.C. §§ 354, 357(c), 361, 368.

¹⁶¹² See P.L.R. 95-35-048 (June 6, 1995) (applying prior consolidated return regulations, tax consequences of non-intercompany transaction between group members nonetheless deferred until deconsolidation); P.L.R. 92-15-043 (Jan. 14, 1992) (same); P.L.R. 91-37-028 (June 13, 1991) (same).

¹⁶¹³ Treas. Reg. § 1.1502-80(d).

the parties will not recognize gain or loss (except, in the case of a section 351 transaction, to the extent of any section 357(c) gain) in connection with the transaction.¹⁶¹⁴ Any section 357(c) gain may be recharacterized as ordinary dividend income under section 1248 to the extent of the foreign target's E&P that accumulated while it was a CFC.¹⁶¹⁵ The transferor generally will be entitled, subject to applicable limitations, to a foreign tax credit for any taxes paid by the affiliate with respect to E&P that is taxable as a dividend under section 1248.¹⁶¹⁶

4. Inbound Cross-Chain Sales and Reorganizations

a. Inbound Cross-Chain Asset Sales

A foreign subsidiary's sale of assets (other than affiliate stock) to a U.S. subsidiary will constitute a taxable transaction in all cases. The seller will recognize gain or loss in an amount equal to the difference between (i) the fair market value of any property and cash received in connection with the cross-chain sale, and (ii) the seller's adjusted tax basis in the assets underlying such transaction.¹⁶¹⁷ Gain recognized on a foreign subsidiary's sale of

¹⁶¹⁴ I.R.C. §§ 351, 357(c), 358, 362.

¹⁶¹⁵ I.R.C. § 1248(a).

¹⁶¹⁶ I.R.C. §§ 902, 1248(a); Treas. Reg. § 1.1248-1(d).

In technical advice, the IRS concluded that, in order to properly determine the amount of a U.S. parent's gain on the sale of stock of its CFC under section 1248, the E&P of the CFC must be reduced by both pre-sale and post-sale distributions by the CFC. Thus, where the CFC made a distribution in the year of its sale to a U.S. seller and also to the acquiring corporation, the E&P of the CFC was reduced by the total amount of both distributions. The amount of the deemed dividend was treated as creating PTI, which was in turn treated as distributed to the buyer in the transaction. The deemed dividend did not entitle the parent to claim a deemed paid foreign tax credit for taxes paid by the CFC with respect to which the parent had previously received such credits in connection with dividends. T.A.M. 1999-06-035 (June 26, 1998).

¹⁶¹⁷ I.R.C. § 1001. In P.L.R. 2010-37-026 (Sept. 7, 2010) (cross-chain asset sales by a foreign subsidiary to controlled prior to, and in anticipation of, a spinoff were respected as "independent transactions and ... not ... viewed as an integrated part of any other transaction" (see ruling 55)).

certain passive assets generally will constitute Subpart F income to the U.S. parent.¹⁶¹⁸

b. Inbound Cross-Chain Stock Sales

Different tax consequences will obtain for a foreign subsidiary's sale of foreign affiliate stock to a U.S. buyer for cash, depending on whether the cross-chain stock sale is integrated with a subsequent disposition under general step transaction principles.

i. Integrated Transaction Treatment

If an inbound cross-chain stock sale is integrated with a subsequent disposition, section 304 would likely apply to the sale,¹⁶¹⁹ and the U.S. buyer, therefore, would be treated as redeeming the foreign seller's stock in exchange for the cash.¹⁶²⁰ In determining whether such a deemed redemption would be treated as a dividend or as a sale or exchange, the foreign seller's interest in the affiliate before and after the deemed redemption would be compared, and the deemed redemption would be treated as a sale or exchange only if it (i) is not "essentially equivalent to a dividend"; (ii) is "substantially disproportionate" with respect to the seller; or (iii) completely terminates the seller's interest in the affiliate.¹⁶²¹ If the seller's stock ownership is measured after a subsequent disposition, the deemed redemption would completely terminate the seller's ownership of the affiliate.¹⁶²² As a result, the deemed redemption would be treated as a sale or exchange in which the foreign seller would recognize gain or loss equal to the difference between its adjusted tax basis in the affiliate stock underlying the cross-chain stock sale, and the cash it receives in the exchange. Any such gain generally will constitute Subpart F income to the U.S. parent.

¹⁶¹⁸ See I.R.C. § 954(c).

¹⁶¹⁹ See *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52, 59 (1989).

¹⁶²⁰ I.R.C. § 304(a).

¹⁶²¹ I.R.C. § 302(a), (b).

¹⁶²² I.R.C. § 302(b)(2).

ii. Separate Transaction Treatment

If an inbound sale of affiliate stock is afforded independent tax significance, section 304 would treat a U.S. buyer as redeeming its notional foreign seller stock in exchange for the cash received.¹⁶²³ As discussed above, in determining whether such a deemed redemption would be treated as a dividend or a sale or exchange, the foreign seller's interest in the affiliate before and after such deemed redemption would be compared.¹⁶²⁴

Section 318 would attribute ownership of 100% of the affiliate stock to the seller after the sale, and the deemed redemption would therefore constitute a dividend rather than a sale or exchange.¹⁶²⁵ As a result, the foreign seller would be deemed to transfer the affiliate stock to the U.S. buyer in exchange for notional buyer stock ("Buyer Stock") in a transaction to which section 351 applies (the "Deemed Contribution"),¹⁶²⁶ and the buyer would then be deemed to redeem the notional Buyer Stock from the seller in exchange for the cash (the "Deemed Redemption").¹⁶²⁷

a) Deemed Contribution

The Deemed Contribution is a tax-free inbound transfer of the stock by the affiliate foreign seller to the U.S. buyer.¹⁶²⁸ Under section 351, the seller's adjusted tax basis in the notionally issued Buyer Stock, and the U.S. buyer's adjusted tax basis in the deemed contributed affiliate stock, will each equal the seller's adjusted tax basis in the deemed contributed affiliate stock.¹⁶²⁹

b) Deemed Redemption

The Deemed Redemption would be treated as a dividend distribution to the foreign seller to the extent of, first, the U.S. buyer's current and accumulated E&P, and then the affiliate

¹⁶²³ I.R.C. § 304(a).

¹⁶²⁴ I.R.C. § 302(b).

¹⁶²⁵ I.R.C. § 302(b).

¹⁶²⁶ I.R.C. § 304(a).

¹⁶²⁷ I.R.C. § 304(a).

¹⁶²⁸ I.R.C. § 351(a).

¹⁶²⁹ I.R.C. §§ 351, 358, 362.

company's E&P.¹⁶³⁰ The gross amount of the cash would be subject to U.S. withholding tax (except as otherwise provided in applicable treaties) to the extent it is deemed distributed out of the U.S. buyer's E&P.¹⁶³¹ Any dividend income to the foreign seller generally will constitute Subpart F income to the U.S. parent, subject to the potential application of the Subpart F Look Through Exception.¹⁶³² Unless extended by Congress, the Subpart F Look Through Exception will apply only to taxable years beginning before January 1, 2009.¹⁶³³

c. Inbound Cross-Chain Reorganizations

The tax consequences of a cross-chain reorganization in which a foreign corporation transfers foreign affiliate stock to a U.S. corporation in exchange for its stock in a section 351 transaction that also qualifies as a B Reorganization will depend on whether the U.S. transferee and the foreign transferor are members of the same affiliated group (as defined in section 1504(a), without application of the exclusion regarding foreign corporations) after the reorganization.¹⁶³⁴ If the transferee and the transferor are not

¹⁶³⁰ I.R.C. § 304(b)(2). Different rules would apply to the dividend distribution if the combined E&P of the target company and the buyer did not equal or exceed the fair market value of the boot. I.R.C. § 301(c)(2), (3). Such a Deemed Redemption nonetheless would constitute a dividend, for the same reasons discussed in the text above.

¹⁶³¹ The foreign seller would be entitled to claim a refund with respect to any amount withheld that was not distributed out of the U.S. buyer's E&P.

¹⁶³² See I.R.C. § 954(c)(6)(A); Notice 2007-9, 2007-1 C.B. 401.

¹⁶³³ See I.R.C. § 954(c)(6)(B). The Obama Administration's 2013 budget proposals includes a one-year extension of the Subpart F Look Through Exception. See Dept. of Treasury, DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (Feb. 13, 2012), at 65 and 207, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>.

¹⁶³⁴ As discussed in the text below, in many cases, inbound stock reorganizations may fail to satisfy the Control Test, and so would not qualify as section 351 transactions, except in cases where the fair market value of the target company is significantly greater than that of the transferee.

treated as members of the same affiliated group (because they will not have a common corporate parent after a subsequent disposition), the parties will not recognize gain or loss in the transaction if the foreign transferor's E&P is increased by the section 1248(c)(2) amount, but the U.S. shareholders will be required to include in income as a deemed dividend the all E&P amount with respect to their stock in the foreign corporation.

If a particular inbound stock reorganization is afforded independent tax significance such that the transferee and the transferor are treated as members of the same affiliated group immediately thereafter, section 1248 attribute carryover rules may apply.

5. Outbound Cross-Chain Sales and Reorganizations

Cross-chain sales are typically used to transfer assets, including foreign affiliate stock, to or from a direct or indirect U.S. subsidiary that will be retained, to a direct or indirect foreign subsidiary that will be disposed of.¹⁶³⁵

a. Outbound Cross-Chain Asset Sales

A cross-chain asset sale in which a U.S. corporation sells assets (other than affiliate stock) to a foreign corporation will constitute a taxable transaction to which section 304 does not apply in all cases.¹⁶³⁶ As a result, the U.S. corporation will recognize gain or loss in an amount equal to the difference between its adjusted tax basis in the assets (other than stock) underlying such cross-chain sale and the fair market value of any property or cash received in exchange therefor. Any recognized loss generally will be deferred until the occurrence of a section 267(f) event.¹⁶³⁷

¹⁶³⁵ For a general discussion of concerns, see *Complex Out-From-Under Transaction 'Particularly Obnoxious'*, Daily Tax Rep. (BNA), at G-3 (Nov. 18, 2011).

¹⁶³⁶ I.R.C. § 267(f).

¹⁶³⁷ I.R.C. § 1001.

b. Outbound Cross-Chain Stock Sales

i. Integrated Transaction Treatment

As discussed above, section 304 would likely apply to a cross-chain sale that is integrated.¹⁶³⁸ In that case, the foreign buyer would be treated as redeeming the U.S. seller's affiliate stock in exchange for the boot. The U.S. seller's interest in the affiliate before and after such deemed redemption would be compared in determining whether such deemed redemption would be treated as a dividend or a sale or exchange of the affiliate stock. The deemed redemption would constitute a sale or exchange, rather than a dividend, if the seller's ownership of the affiliate is determined after a subsequent disposition (at which point the seller's ownership of the affiliate would have been completely terminated).¹⁶³⁹ As a result, the U.S. seller would recognize gain or loss in an amount equal to the appreciation or depreciation in the affiliate stock being sold.¹⁶⁴⁰

ii. Separate Transaction Treatment

If a cross-chain stock sale is afforded independent tax significance, section 304 would apply because the U.S. parent will continue to control both the buyer and seller immediately after the cross-chain stock sale. In that case, the foreign buyer would be treated as redeeming the U.S. seller's affiliate stock in exchange for the boot. As discussed above, the U.S. seller's interest in the affiliate before and after such redemption would be compared. Under the applicable section 318 attribution rules, the deemed redemption would not constitute a sale or exchange, because the seller would be attributed continued ownership of 100% of the affiliate stock after the sale.¹⁶⁴¹ As a result, the deemed redemption would be treated as a dividend and the affiliate stock would be treated as transferred to the foreign buyer in exchange for

¹⁶³⁸ *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52, 58 (1989).

¹⁶³⁹ I.R.C. § 302(b)(3).

¹⁶⁴⁰ If section 304 does not apply to a particular cross-chain stock sale, a U.S. seller would nonetheless recognize the same amount of gain or loss under section 1001, and the sale would produce the same Subpart F consequences.

¹⁶⁴¹ I.R.C. § 302(b).

additional Buyer Stock in a Deemed Contribution. The buyer would then be treated as redeeming such notionally issued Buyer Stock from the seller in exchange for the boot in a Deemed Redemption.¹⁶⁴²

a) Deemed Contribution

In 2006, the Treasury Department released final Treasury Regulations that render section 367(a) and (b) inapplicable to deemed section 351 exchanges in section 304(a)(1) transactions.¹⁶⁴³ Thus, the Deemed Contribution would not constitute an outbound transfer of the foreign affiliate stock by the U.S. seller to the foreign buyer and thus would not be subject to section 367(a) or section 367(b). The seller's adjusted tax basis in the deemed issued Buyer Stock and the buyer's adjusted tax basis in the deemed contributed affiliate stock would each equal the seller's pre-sale adjusted tax basis in its affiliate stock.¹⁶⁴⁴

In February of 2009, the Treasury Department issued temporary regulations tightening these rules.¹⁶⁴⁵ The temporary

¹⁶⁴² I.R.C. § 304(a)(1).

¹⁶⁴³ See Treas. Reg. §§ 1.367(a)-3(a); 1.367(b)-4(a). According to the preamble to these regulations, the government concluded that (i) its interests are protected, and the policies underlying section 367(a) and (b) are preserved, without applying section 367, since the income recognized in a section 304 transaction generally will equal or exceed the transferor's inherent gain in the stock of the issuing corporation that is transferred in the Deemed Contribution, and (ii) excepting Deemed Contributions from the application of section 367(a) and (b) will create greater certainty and simplicity for section 304 transactions and avoid the over-inclusion of income that could result when both section 367 and section 304 apply to such transactions. See T.D. 9250, 2006-1 C.B. 588.

¹⁶⁴⁴ I.R.C. § 351.

¹⁶⁴⁵ T.D. 9444, 2009-1 C.B. 603; Temp. Reg. § 1.367(a)-9T(a). See generally Joseph M. Calianno, Brad Rode & Tracy Watkins, *A Basis Issue – IRS Revises Section 367 Regulations to Address Section 304(a)(1) Transactions*, 20 J. Int'l Tax'n 29 (Nov. 2009); *Corporate Reorganizations: IRS Tightens Regime on Stock Transfers to Foreign Firms for Repatriation Deals*, Daily Tax Rep. (BNA), at G-3 (Feb. 11, 2009); *Treasury, IRS Release Regs on Cross-Border Stock Transfers*, 2009 TNT 26-2 (Feb. 11, 2009).

regulations generally require a U.S. person to recognize gain under section 367(a) if the distribution received by the U.S. person reduces the basis of foreign acquiring corporation stock held by the U.S. person, other than stock deemed issued to the U.S. person in the deemed section 351 exchange.¹⁶⁴⁶ The gain recognized equals the gain realized by the U.S. person with respect to the transferred stock in the deemed section 351 exchange over the distribution amount received by the U.S. person in redemption of the foreign acquiring corporation stock that is treated as a dividend.¹⁶⁴⁷ The temporary regulations apply to transfers or distributions occurring after February 11, 2009.¹⁶⁴⁸

On February 10, 2012, the IRS issued Notice 2012-15, which proposes to reverse the current regulations and apply section 367(a) and (b), and the corresponding regulations and exceptions, to deemed section 351 exchanges that are part of a section 304 transaction.¹⁶⁴⁹ The notice confirms that, under section 367(a), a U.S. person who transfers stock of a domestic or foreign corporation to a foreign corporation may be able to avoid immediate recognition of the gain otherwise applicable to an outbound section 304 transaction by entering into a GRA, provided that the transferor satisfies Treasury Regulation section 1.367(a)-8. However, under section 367(b) and the accompanying regulations, the exchanging shareholder in a deemed section 351 exchange

Regulations also finalized a portion of the February 2009 temporary regulations, unrelated to gain recognition under 367(a). *See* 77 Fed. Reg. 24380 (Apr. 24, 2012).

¹⁶⁴⁶ *See* Temp. Reg. § 1.367(a)-9T(b).

¹⁶⁴⁷ *See* Temp. Reg. § 1.367(a)-9T(b).

¹⁶⁴⁸ Temp. Reg. § 1.367(a)-9T(f).

¹⁶⁴⁹ Notice 2012-15, 2012-9 I.R.B. 424. *See generally* David D. Stewart, *IRS Reverses Approach to Cross-Border Stock Transfers*, 134 Tax Notes 941 (Feb. 20, 2012); Amy S. Elliot & David D. Stewart, *ABA Section of Taxation Meeting: IRS Calls Outbound Stock Transfer Notice 'Justified'*, 135 Tax Notes 988 (May 21, 2012). For criticism of the proposed regulations, *see, e.g.*, Lewis J. Greenwald & Christopher M. Flanagan, *The IRS Should Quickly Back Away From Notice 2012-15*, 66 Tax Notes Int'l 341 (Apr. 23, 2012). The exceptions described in Treasury Regulation section 1.367(a)-3(b)(1) and (c)(1), if applicable, are included in the list of corresponding exceptions.

generally must include in income as a deemed dividend the section 1248 amount attributable to the foreign stock, if the section 1248 status of the exchanging shareholder or the CFC is not preserved immediately following the exchange.¹⁶⁵⁰ The notice provides that the government will issue proposed regulations that will apply to section 304 transactions occurring after February 9, 2012. For section 304 transactions occurring before the proposed regulations are issued, but after February 9, 2012, the IRS will not challenge reasonable interpretations of the application of section 367(a) and (b) to deemed section 351 exchanges, including reasonable interpretations of the GRA regulations as they apply to deemed 351 transactions.¹⁶⁵¹

b) Deemed Redemption

The Deemed Redemption would be treated as a distribution of property to which section 301 applies, because the seller would be attributed ownership of all the buyer stock immediately after the Deemed Redemption.¹⁶⁵² Thus, the seller's receipt of the cash would be treated as a dividend to the extent of the buyer's E&P

¹⁶⁵⁰ Treas. Reg. § 1.367(b)-4.

¹⁶⁵¹ Notice 2012-15, 2012-9 I.R.B. 424; *see also* NYSBA, Report on Notice 2012-15: Cross-Border Stock Sales Subject to Sections 304 and 367, reprinted in 2012 TNT 29-21 (July 9, 2012) (making recommendations to fix instances of double taxation resulting from Notice 2012-15); David D. Stewart, *ABA Meeting: Officials Offer Explanations on Recent Cross-Border Guidance*, 2012 TNT 93-13 (May 14, 2012) (discussing the possibility that the IRS could issue guidance permitting an increase in the basis of target stock to the extent the distribution comes from the earnings and profits of target to prevent double taxation); James P. Fuller and Adam S. Halpern, *New Rules for Code Sec. 304/Code Sec. 367 Overlap Transactions: The IRS Comes Full Circle with Notice 2012-15*, Int'l Tax Journal (May – Jun 2012) (so long as the basis recovery rules remain unsettled, the amendments announced in Notice 2012-15 seemingly continue to allow taxpayers to choose the more tax-favorable of alternative basis positions in cross-border section 304 transactions); Sean Mullaney, *New Guidance for Cross-Border Stock Transfers*, 2012 TNT 75-6 (Apr. 18, 2012) (placing Notice 2012-15 within the historical perspective of the section 367 regulations).

¹⁶⁵² I.R.C. §§ 301; 302(b); 318.

and then to the extent of the affiliate company's E&P.¹⁶⁵³ Cash in excess of such E&P would be treated first as a return of capital (to the extent of the Seller's adjusted tax basis in the Buyer Stock), and then as capital gain.

If and to the extent the cash is treated as distributed out of the foreign buyer's or foreign affiliate's E&P, the seller generally would be entitled to a corresponding indirect foreign tax credit under section 902, and if Buyer Stock possessing at least 10% of the buyer's total combined voting power is deemed issued to the seller in connection with the Deemed Contribution, the seller can avail itself of the look-through rules of Treasury Regulation section 1.904-5(c)(4).¹⁶⁵⁴ In general, this test should be satisfied in cases where the buyer has only voting stock outstanding, except perhaps when the relative size of the buyer greatly exceeds that of the affiliate company.

Even if the buyer is not deemed to issue Buyer Stock possessing the requisite voting power, the seller should nevertheless be entitled to a foreign tax credit and the benefit of the look-through rules based on the constructive ownership theory discussed in Revenue Ruling 92-86. The legislative history and statements of the Joint Committee on Taxation connected to the Internal Revenue Service Restructuring and Reform Act of 1998, which amended section 304(b)(5) and added section 304(b)(6),¹⁶⁵⁵ confirm that the 1997 Act was not intended to affect the continuing validity of Revenue Ruling 92-86.¹⁶⁵⁶

¹⁶⁵³ The domestic seller generally will not be able to reduce such dividend income by the amount of PTI with respect to other U.S. shareholders of the foreign buyer. I.R.C. §§ 304(b)(5); 959(a); 1248(d).

¹⁶⁵⁴ I.R.C. §§ 304(a)(1); 902; Rev. Rul. 92-86, 1992-2 C.B. 199.

¹⁶⁵⁵ Pub. L. No. 105-206, Internal Revenue Service Restructuring and Reform Act of 1998, § 6010(d)(1), (2).

¹⁶⁵⁶ See *Finance Committee Report Explanation of Titles V and VII of Internal Revenue Service Restructuring And Reform Act Of 1998*, 98 TNT 78-16 (Apr. 23, 1998) ("The 1997 Act amendments to section 304, including the modifications under this provision, are not intended to change the foreign tax credit results reached in Rev. Rul. 92-86 and 91-5."); Joint Committee on Tax'n, Description of Senate Finance Committee Chairman's Mark of Tax Technical Provisions, JCX-18-98 (Mar. 26, 1998) (same); Joint Committee on Tax'n,

c. Outbound Cross-Chain Reorganization

The tax consequences of an outbound cross-chain reorganization in which a U.S. shareholder exchanges foreign subsidiary stock for foreign stock in a transaction that qualifies as a section 351 transaction and/or a B Reorganization will depend upon whether the IRS integrates the outbound stock reorganization with a subsequent disposition.¹⁶⁵⁷

i. Integrated Transaction Treatment

If the IRS employs an integration analysis, it is unclear whether the U.S. transferor is currently required to recognize any income or gain as a result of the transaction. If the foreign target is a CFC as to which the transferor is a U.S. shareholder, the tax consequences will depend on whether the transferor is a U.S. shareholder of the foreign transferee after the transaction. This, in turn, would depend on whether U.S. shareholder status is tested immediately after the outbound stock reorganization, or after a subsequent disposition.

If U.S. shareholder status is tested immediately after an outbound stock reorganization, the transferor would not recognize any gain or income as a result of the transaction and it need not include the all E&P amount in its income if the transferor enters into a GRA.¹⁶⁵⁸ By contrast, if U.S. shareholder status is tested after a subsequent disposition, adverse tax consequences may

Explanation of 1998 Tax Legislation, JCS-6-98 (Nov. 24, 1998) (same).

Notwithstanding the foregoing, some uncertainties may remain after the 1997 and 1998 amendments to section 304. For example, the IRS should clarify that satisfaction of the 10% voting stock requirement for the section 902 credit depends on both the Buyer Stock deemed issued and redeemed in the transaction and on stock deemed owned pursuant to the constructive ownership principles of Revenue Ruling 92-86.

¹⁶⁵⁷ The IRS has indicated that it is currently examining such cross-chain reorganizations when followed by a liquidation of the target to determine whether D or F reorganization characterization is appropriate and whether the transactions should be integrated. *See IRS to 'Clarify Scope' of Section 367 in Intragroup Context, DeNovio Says*, 2004 TNT 116-9 (June 15, 2004).

¹⁶⁵⁸ Treas. Reg. §§ 1.367(a)-3(b); 1.367(b)-4(b).

obtain. In particular, because the transferor would no longer be a U.S. shareholder of the transferee, in addition to entering into a GRA the shareholder would also be required to recognize as dividend income the section 1248 amount with respect to the target stock.¹⁶⁵⁹ However, under applicable Treasury Regulations, U.S. shareholder status should be tested taking into account only the outbound stock reorganization, and so the U.S. transferor should not be required to recognize its section 1248 amount.¹⁶⁶⁰

ii. Separate Transaction Treatment

If a particular outbound stock reorganization is afforded independent tax significance, the transferor's tax treatment would be the same as that described in the section above regarding "Integrated Transaction Treatment" where U.S. shareholder status is tested taking into account only the outbound stock reorganization.

6. Foreign-to-Foreign Cross-Chain Sales and Reorganizations

a. Foreign-to-Foreign Cross-Chain Asset Sales

A foreign seller's sale of assets (other than affiliate stock) to a foreign buyer will constitute a taxable transaction to which section 304 does not apply. The foreign seller will recognize gain or loss in an amount equal to the difference between its adjusted tax basis in the assets underlying the sale and the fair market value of any property or cash received in exchange therefor.¹⁶⁶¹ Although a foreign seller not engaged in a U.S. trade or business generally would not be subject to U.S. tax on gain recognized, any gain not attributable to the sale of operating assets may constitute Subpart F income with respect to its U.S. parent.¹⁶⁶²

¹⁶⁵⁹ Treas. Reg. § 1.367(b)-4(b).

¹⁶⁶⁰ Treas. Reg. § 1.367(b)-4(b)(1)(B)(1) (referring to a transferor's receipt of transferor stock).

¹⁶⁶¹ I.R.C. § 1001.

¹⁶⁶² I.R.C. §§ 267(f); 964.

b. Foreign-to-Foreign Cross-Chain Stock Sales

Whether section 304 applies to a foreign corporation's sale of affiliate stock to a foreign buyer for cash will depend on whether a cross-chain stock sale is integrated with a subsequent disposition.

i. Integrated Transaction Treatment

As discussed above, section 304 would likely apply to a cross-chain stock sale that is integrated with a subsequent disposition.¹⁶⁶³ In that case, the foreign buyer would be treated as redeeming the foreign seller's affiliate stock in exchange for the boot. In determining whether such a deemed redemption would be treated as a dividend or a sale or exchange, the foreign seller's interest in the affiliate before and after the deemed redemption would be compared. The redemption would be treated as a sale or exchange, rather than a dividend, under an integrated analysis, if the seller's ownership of the target affiliate's stock would be completely terminated by a subsequent disposition. As a result, the foreign seller would recognize gain or loss in an amount equal to the difference between its adjusted tax basis in the affiliate stock underlying the sale, and the fair market value of the boot received in exchange therefor.¹⁶⁶⁴ Any gain recognized by the foreign seller will generally constitute Subpart F income with respect to its U.S. parent.

ii. Separate Transaction Treatment

Where a foreign corporation sells affiliate stock to a foreign buyer for cash in a cross-chain stock sale, section 304 would apply if the sale is afforded independent significance. In that case, the foreign buyer would be treated as redeeming the foreign seller's target stock in exchange for the cash.¹⁶⁶⁵ As discussed above, in determining whether such a deemed redemption would constitute a dividend or a sale or exchange of the target stock, the foreign

¹⁶⁶³ *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52, 59 (1989).

¹⁶⁶⁴ If section 304 did not apply to a particular cross-chain sale, the Seller would nevertheless recognize the same amount of gain or loss under section 1001, and the same Subpart F consequences would apply.

¹⁶⁶⁵ I.R.C. § 304(a)(1).

seller's interest in the target company before and after such redemption would be compared. The seller would typically be attributed continued ownership of 100% of the target stock after the sale under section 318, and, consequently, the deemed redemption would be treated as a dividend. As a result, the affiliate stock would be treated as transferred to the foreign buyer in a Deemed Contribution, and the buyer would then be treated as redeeming such notionally issued Buyer Stock for the cash in a Deemed Redemption.¹⁶⁶⁶

a) Deemed Contribution

Under recently finalized Treasury Regulations, the Deemed Contribution will not be subject to section 367(b).¹⁶⁶⁷ The seller's adjusted tax basis in the notionally issued Buyer Stock and the buyer's adjusted tax basis in the deemed contributed affiliate stock will each equal the seller's adjusted tax basis in the contributed stock.¹⁶⁶⁸

b) Deemed Redemption

The Deemed Redemption will be a section 301 distribution of property,¹⁶⁶⁹ which means that the boot will be treated as a dividend to the extent of the buyer's E&P and then of the affiliate's E&P.¹⁶⁷⁰ The dividend will constitute Subpart F income to the U.S. parent, unless the Subpart F Look Through Exception or another exemption from Subpart F applies.

c. Foreign-to-Foreign Cross-Chain Reorganizations

The tax consequences of a foreign subsidiary's transfer of foreign corporation stock to another foreign affiliate of the same U.S. parent that otherwise qualifies as a section 351 transaction or

¹⁶⁶⁶ I.R.C. § 304(a).

¹⁶⁶⁷ See Treas. Reg. § 1.367(b)-4(a).

¹⁶⁶⁸ I.R.C. § 351.

¹⁶⁶⁹ I.R.C. § 302(d).

¹⁶⁷⁰ I.R.C. § 304(b)(2). Different rules apply to dividend distributions if the combined E&P of the target company and the acquiring company are less than the fair market value of the boot.
I.R.C. § 302(c)(2), (3).

a B Reorganization (a “foreign-to-foreign stock reorganization”) will depend upon whether the U.S. parent will be considered a U.S. shareholder of the foreign transferee corporation after the reorganization under section 367(b). If the U.S. parent is not considered a U.S. shareholder (because ownership is tested after a disposition when it would own no foreign transferee stock), then the U.S. shareholder must include as dividend income the section 1248 amount attributable to the stock exchanged.¹⁶⁷¹

If a particular foreign-to-foreign stock reorganization and disposition are each afforded independent tax significance, and the U.S. parent is therefore treated as a U.S. shareholder of the foreign transferee for purposes of section 367(b) through attributed ownership of 100% of the stock of the foreign transferee immediately after the reorganization, none of the parties to such a reorganization will recognize gain or loss and the U.S. parent will not be required to include in income the section 1248 amount. However, such amount will be included in income shortly thereafter upon the subsequent disposition of the stock,¹⁶⁷² and such gain may be recharacterized as dividend income pursuant to section 1248 when the U.S. parent subsequently disposes of its transferee stock in a transaction to which section 1248(a) or section 1248(f) applies.¹⁶⁷³

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¹⁶⁷¹ Treas. Reg. § 1.367(b)-4(b).

¹⁶⁷² I.R.C. § 1248(a); Treas. Reg. § 1.367(b)-4(d).

¹⁶⁷³ I.R.C. § 1248(a).