

REPORT #859

TAX SECTION

New York State Bar Association

859 Letter on Rev. Rul. 95-69

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December 5, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
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Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
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Washington, D.C. 20224

Dear Secretary Samuels and Commissioner
Richardson:

On September 29, 1995, the Internal Revenue Service (the "Service") issued Revenue Ruling 95 69, I.R.B. 1995-424. The ruling holds that a partnership's nonliquidating distribution of stock received in a reorganization under section 368 of the Internal Revenue Code to its partners in accordance with their partnership interests does not affect satisfaction of the continuity of proprietary interest requirement of Treas. Reg. §1.368-1(b). We believe that the ruling reaches the correct result and clarifies an issue often confronted by practitioners advising parties to reorganization transactions.

There are a number of difficult issues that require resolution in the reorganization area. These include, for example, the general scope of the continuity of interest requirement in

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light of the Seagram case¹ However, the issuance of a series of rulings, like Revenue Ruling 95-69, that clarify more modest reorganization issues would be very helpful to taxpayers and their advisors.

In that light, we suggest that rulings be issued on the following subjects:

1. Drop-down of assets to subsidiaries. The Groman and Bashford cases² continue to raise issues concerning "remote" continuity of interest where assets of a target corporation are transferred to corporations owned, in whole or in part, by the acquiring corporation. Section 368(a)(2)(C), which was enacted in response to Groman-Bashford. Permits post-reorganization drop-downs, but does not expressly apply to drop-downs to a corporation indirectly "controlled" by the acquiring corporation. Nonetheless, the Service allowed a drop-down of assets to a second-tier subsidiary following a (C) reorganization in Revenue Ruling 64-73, 1964-1 C.B. (Part 1) 142, and a number of private letter rulings have also permitted multi-tier asset drop-downs (see e.g., PLRs 9519052 (Feb. 15, 1995) and 9151036 (Sept. 25, 1991)). These rulings raise the question whether remote asset continuity has continuing relevance to post-reorganization drop-downs. Indeed, the Service appears to have taken a broad view of the Congressional response to Groman-Bashford. recognizing that Revenue Ruling 64-73 reaches its conclusion "despite the lack of specific statutory authority." See G.C.M. 39100 (Dec. 21, 1983).

If the Service believes that remote asset continuity is no longer relevant in determining whether a transaction qualifies as a reorganization, a ruling to that effect would be helpful. Even if that is the case, the postreorganization drop-down of assets could still disqualify a reorganization. For example, if, pursuant to the plan of reorganization, the acquiring corporation transferred the assets of the

¹ J.E. Seagram Corp. v. Commissioner. 104 T.C. No. 4 (1995).

² Groman v. Commissioner. 302 U.S. 82 (1937); Bashford v. Commissioner. 302 U.S. 454 (1938).

target corporation to another corporation in which it owned only 20% of the stock, both continuity of interest and continuity of business enterprise would, presumably, be violated.

If, on the other hand, the Service believes that relief from remote asset continuity should apply only to drop-downs to corporations controlled, directly or indirectly, by the acquiring corporation, a ruling that expands on Revenue Ruling 64-73 should be issued permitting the acquiring corporation to drop down the assets of the target following the reorganization through an unlimited number of tiers of indirectly controlled subsidiaries. The test of the ruling should be whether the acquiring corporation indirectly meets the control test of section 368(c). Thus, for example, a drop-down, first, to an 80%-owned subsidiary of the acquiring corporation, followed by a dropdown to that subsidiary's 100%-owned subsidiary would qualify³. In light of the uncertain reach of the remote continuity doctrine, the ruling might leave unresolved the tax consequences where the acquiring corporation's indirect interest in the transferred assets falls below the control required by section 368(c).

2. Drop-down of stock to subsidiaries. The rulings discussed in paragraph 1 above should also apply to the drop-down of stock acquired in a (B) reorganization. The Service has issued private letter rulings holding that multi-tier drop-downs following a (B) reorganization are permitted. See PLRs 8614019 (Dec. 31, 1985) and 8012094 (Dec. 28, 1979). Likewise, the multitier drop-down of the stock of the surviving corporation in a reverse subsidiary merger under section 368(a)(2)(E) should also be covered. See Treas. Reg. §1.368-2(j)(4) which, with reference to section 368(a)(2)(C), permits the postreorganization drop-down of the stock of the surviving corporation.

The ruling should also extend to the post-reorganization dropdown of stock of the surviving

³ Presumably, each drop-down would be governed by section 351, not the reorganization provisions, since the transferee would not be a "party to the reorganization" under section 368(b).

corporation in a forward subsidiary reorganization under section 368(a)(2)(D). Under section 368(a)(2)(D), the issue presented is whether the controlling corporation is "in control" of the surviving corporation in the merger if there is a post-reorganization drop-down of its stock. While not expressly covered by section 368(a)(2)(C) or the regulations, the Service has privately ruled that the drop-down is permitted by analogy to Treas. Reg. §1.368-2(j)(4). See e.g., PLR 9117069 (Nov. 2, 1990).

3. Drop-down of assets to partnerships. The Service has taken the position that a pre- or post-reorganization drop-down of assets of the target corporation to a partnership may violate the continuity of interest and continuity of business enterprise requirements. See G.C.M. 39150 (Oct. 10, 1982) and G.C.M. 35117 (Nov. 15, 1972). The rationale for this position is that, unlike transfers to corporate subsidiaries which are governed by section 368(a)(2)(C), there is no statutory provision overriding Groman-Bashford in connection with the transfer of assets to a partnership.

We believe that this position should be reviewed in light of Revenue Ruling 95-69 and the general trend in favor of treating partnerships as an aggregate of them" partners. In the case of a transfer of assets to a partnership, we recommend that continuity of interest and business enterprise be tested as if the acquiring corporation directly owned a portion of the assets of the partnership corresponding to its partnership interest.

If the Service is unwilling to issue a ruling of this breadth, we recommend that it issue a ruling analogous to the ruling proposed in paragraph 1 above concerning drop-downs to corporations indirectly controlled by the acquiring corporation. The ruling could hold that continuity of interest and business enterprise are not violated where the capital and profits interests in the transferee partnership are at least 80%-owned, directly or indirectly, by the acquiring corporation and the acquiring corporation is a general partner (or, in the case of a limited liability company, a managing member).

4. Contribution of acquiring corporation stock to a partnership. Applying the aggregate theory of partnerships, a contribution of stock by former target shareholders to a partnership that does not vary the partners' interests in the stock should not affect continuity of interest. For example, if A, B and C each contribute an equal number of shares of stock of the acquiring corporation to a partnership in which they are each one-third partners, satisfaction of continuity of interest should not be affected.

If, however, the contribution of the stock of the acquiring corporation to the partnership results in a shift in the contributors' indirect ownership of the stock, continuity may be affected, but, we believe, only to the extent of the shift.⁴ Thus, if, in the above example, D contributes cash for a 50% interest in the partnership, the continuing ownership of A, B and C in the acquiring corporation stock would be reduced by half.

⁴ Similarly, we assume that, under Revenue Ruling 95-69, a distribution of acquiring corporation stock that was not in accordance with the partners' interests in the partnership would affect continuity only to the extent of the shift in ownership.

5. Distribution in complete liquidation of a partnership. Revenue Ruling 95-69 deals with a nonliquidating distribution of acquiring corporation stock. We assume that the same result would apply in a complete liquidation of the partnership. It would be useful if Revenue Ruling 95-69 was modified to so provide, although we recognize that the Service may believe that Revenue Ruling 76-528, 1976-2 C.B. 103 (dealing with continuity of interest in a section 355 transaction) already states that position.

6. Continuity of interest in reorganizations under section 368(a)(2)(E). Section 368(a)(2)(E) requires that, in a reverse subsidiary merger, former shareholders of the target corporation exchange for voting stock of the controlling corporation, stock constituting control (i.e., 80%) of the target corporation. Thus, as in a (B) reorganization, the statute imposes an initial continuity threshold measured by the consideration received from the controlling corporation.

If shareholders of the target corporation dispose of stock received in the merger pursuant to a prearranged plan, but not to the controlling corporation, general principles of continuity of interest should then apply. Thus, for example, if the shareholders sell 30% of their stock either before or after the reorganization, the reorganization should maintain its qualification under section 368(a)(2)(E) despite the fact that the shareholders could not have received that high a percentage of nonstock consideration directly from the controlling corporation in the merger.

We believe that this analysis is correct even though section 368(a)(2)(E), unlike section 368(a)(1)(B), requires the "former" shareholders of the target to exchange control of the target for voting stock of the controlling corporation. The proposed ruling is also consistent with the representation that was required for a ruling on the qualification of a transaction as a reorganization under section 368(a)(2)(E). Rev. Proc. 86-42, 1986-2 C.B. 722, Sec. 7.03 (Representation 2 - 50% continuity).

We would be pleased to assist you in preparing rulings on these issues.

Very truly yours,

Carolyn Joy Lee

Chair

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