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New York State Bar Association Tax Section

Report on Final Regulations on Reorganizations under Section 368(a)(1)(F)

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Contents

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This Report[1] of the New York State Bar Association Tax Section provides comments on final regulations (the "**Final Regulations**") published by the U.S. Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**Service**") on September 21, 2015, regarding the qualification of a transaction as a corporate reorganization under Section 368(a)(1)(F) of the Internal Revenue Code of 1986, as amended (the "**Code**").[2] The Final Regulations represent an attempt by the Service and Treasury to ensure that a reorganization purporting to qualify under that section involves only one continuing corporation and is not an acquisitive or divisive transaction.

This report is divided into three parts. Part I contains a general summary of our recommendations. Part II presents a brief summary of reorganizations under Section 368(a)(1)(F) and a general description of the Final Regulations. Part III sets out our comments and recommendations regarding the Final Regulations.

I. SUMMARY OF RECOMMENDATIONS

The Final Regulations present a carefully crafted and thoughtful framework that defines the scope of an F reorganization and addresses a number of the issues that arise in what many might think of as straightforward transactions. This Report does not seek fundamental changes to the approach set out in the Final Regulations, nor does it suggest eliminating any of the six requirements set out in the Final Regulations (or adding additional requirements). However, there are a few situations, described below, in which the rules of the Final Regulations introduce

[1] The principal author of this Report is Peter A. Furci, with substantial assistance from Samuel M. Duncan and Lena Smith. Significant contributions were made by William Alexander, Timothy Devetski, Andrew Herman, Stephen Land, Mark Lubin, Michael Schler, Eric Sloan, Karen Sowell and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Reorganizations Under Section 368(a)(1)(F), T.D. 9739, 80 Fed. Reg. 56,904 (Sep. 21, 2015). Unless otherwise indicated, all references herein to "Section" or "§" refer to the Code. References to the Treasury Regulations are to those in effect as of the date of this Report.

some uncertainty as compared to prior law, and thus the application of the Final Regulations to those situations, particularly with respect to the first recommendation noted below, could helpfully be clarified through the issuance of published guidance.

The Final Regulations prescribe six requirements for F reorganizations, which are tested over a time period (sometimes referred to as the "bubble") that commences when the transferor corporation begins to transfer assets to the resulting corporation, and ends when the transferor corporation liquidates and the stock of the resulting corporation is distributed to the former owners of the transferor corporation. The most important aspect of the Final Regulations, on which F reorganization status frequently turns, is exactly where the "bubble" begins and ends. As this Report will discuss, many of the issues raised turn on determining the steps that are or are not included in the "bubble," and in some cases, turn on the form of the transaction at issue. Many of our recommendations go to this issue.

We believe that the Final Regulations are intended to provide taxpayers with both flexibility and certainty in structuring "mere change" transactions. We believe that our recommendations are consistent with the intended operation of the Final Regulations, but we highlight areas where the intent could be made clearer. Specifically, this Report recommends that Treasury and the Service consider issuing guidance clarifying the following points:

1. That the *de minimis* exceptions to the Final Regulations look to all the relevant facts and circumstances, including legal or regulatory requirements, and that issuances of stock or contributions of assets in order to facilitate a resulting corporation's organization (or otherwise in connection with the organization) or maintain its legal existence will be presumed to be *de minimis* as long as they do not exceed 1% of the resulting corporation's shares outstanding or assets (by value) immediately after the potential F reorganization.

2. That in a "drop and check" transaction pursuant to an integrated plan, the potential F reorganization begins when the stock of the transferor corporation is contributed to the resulting corporation.

3. That the prohibition in the Final Regulations on a resulting corporation holding tax attributes only looks to U.S. federal income tax attributes, and that tax attributes are not considered "property" for purposes of the Final Regulations. As an alternative, the guidance could provide that tax attributes only include attributes arising from prior business activities of the resulting corporation.

4. That the step transaction doctrine will only be applied to integrate steps occurring outside the "bubble" in a manner that disqualifies the transaction from F reorganization treatment where the resulting integrated transaction is a tax-free reorganization described in the "overlap" rule of Treas. Reg. §1.368-2(m)(3)(iv).

5. That an insolvent corporation can successfully undergo an F reorganization under the Final Regulations.

6. That the overlap rule of the Final Regulations takes precedence over the distribution non-integration rule.

7. To what extent, if any, Revenue Rulings 61-156 and 68-349, which deal with stock issuances to non-historic owners, remain valid in light of the Final Regulations.

8. That a transferor corporation should retain its EIN for relevant purposes if it becomes disregarded in a "drop and check" F reorganization.

II. OVERVIEW OF SECTION 368(A)(1)(F) AND THE FINAL REGULATIONS

A. Section 368(a)(1)(F)

Section 368 defines a set of tax-free reorganizations that serve as exceptions to the general rule that gain or loss must be recognized upon the sale or exchange of property.[3] This includes a "mere change in identity, form, or place of organization of one corporation, however effected" ("**F reorganizations**").[4] F reorganizations were included in the original definition of corporate reorganizations in the Revenue Act of 1921 with language almost identical to that used in the current Code.[5] F reorganizations are single-entity reorganizations and generally include straightforward corporate changes, such as reincorporating in a new jurisdiction. Over time, questions have arisen regarding the requirements of an F reorganization and, in particular, what other changes are allowed to occur either before, during or after a "mere change." Prior to proposed and Final Regulations, these questions were answered either by the courts or in Revenue Rulings.[6]

On August 12, 2004, the Treasury Department and the Service published proposed regulations containing requirements for F reorganizations and requested comments from the

[3] §§ 368, 1001.

[4] § 368(a)(1)(F).

[5] *See* Pub. L. 67-98 (1921) § 202(c)(3) (defining a reorganization to include a "mere change in identity, form, or place of organization of a corporation, (however effected)"). The only differences are replacing "a" with "one" and removing parentheses from "however effected". This does not quite tell the full story: the Revenue Act of 1924 deleted "of a corporation"; and, 58 years later, "of one corporation" was added by the Tax Equity and Fiscal Responsibility Act of 1982. *See* Pub. L. 68-176 (1924); Pub. L. 97-248 (1982).

[6] *See*, *e.g.*, Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942); Rev. Rul. 96-29, 1996-1 C.B. 50 (obsoleted by the Final Regulations); Rev. Rul. 66-284, 1966-2 C.B. 115 (obsoleted by the Final Regulations).

public (the "**2004 Proposed Regulations**").[7] The 2004 Proposed Regulations provided that if a corporate enterprise underwent a reorganization and met four requirements, the resulting corporation would be treated as the equivalent of the transferor corporation. The 2004 Proposed Regulations also proposed to eliminate for F reorganizations the continuity of business enterprise and the continuity of interest requirements, which are generally applicable to reorganizations under Section 368(a)(1). Under the 2004 Proposed Regulations, a transaction resulted in a "mere change" only if:

- All of the stock of the resulting corporation, including stock issued before the transfer, was issued in respect of stock of the transferring corporation;
- There was no change in the ownership of the corporation in the transaction, except a change that had no effect other than that of a redemption of less than all the shares of the corporation;
- The transferring corporation completely liquidated in the transaction; and
- The resulting corporation did not hold any property or have any tax attributes (including those specified in Section 381(c)) immediately before the transfer.

A portion of the 2004 Proposed Regulations was adopted on February 25, 2005 (the "**2005 Regulations**").[8] The 2005 Regulations did not adopt the four requirements of the 2004 Proposed Regulations, but provided that the continuity of business enterprise and continuity of interest requirements do not apply to reorganizations under Section 368(a)(1)(F). The 2005 Regulations noted that Treasury and the Service would continue to study the other issues addressed in the 2004 Proposed Regulations.

B. The Final Regulations

The Final Regulations generally adopt the balance of the 2004 Proposed Regulations, setting out six requirements that must be satisfied for a transaction involving an actual or deemed transfer of property from one corporation (a "**transferor corporation**") to another corporation (a "**resulting corporation**") to qualify as a "mere change." The Final Regulations add two requirements in addition to the four requirements set out in the 2004 Proposed Regulations, namely that the resulting corporation must be the only acquiring corporation and that the

[7] Notice of Proposed Rulemaking, Reorganizations Under Section 368(a)(1)(E) or (F), REG-10688904, 69 Fed. Reg. 49,836 (Aug. 12, 2004).

[8] Reorganizations Under Section 368(a)(1)(E) and Section 368(a)(1)(F), T.D. 9182, 70 Fed. Reg. 9219 (Feb. 25, 2005).

transferor corporation must be the only acquired corporation.[9] The Final Regulations are based on the premise that a resulting corporation in an F reorganization is functionally equivalent to the predecessor corporation in all significant respects.[10]

First, the Final Regulations require that immediately after a potential F reorganization, all the stock of the resulting corporation must be distributed (or deemed distributed) in exchange for the stock of the transferor corporation.[11] Unlike the 2004 Proposed Regulations, the Final Regulations focus on the distribution of stock of, rather than the issuance of stock by, the resulting corporation. This reflects a determination by Treasury and the Service that a focus on distributions "better matches" the transactions occurring in an F reorganization.[12] A *de minimis* amount of stock may be distributed by the resulting corporation, other than in respect of stock of the transferor corporation, to either facilitate its organization or maintain its legal existence.

Second, the Final Regulations require that the same person or persons must own all of the stock of the transferor corporation at the beginning of the potential F reorganization and all of the stock of the resulting corporation at the end of the potential F reorganization.[13] The Final Regulations do, however, allow some changes in ownership resulting from recapitalizations, redemptions or distributions.[14] Allowing these ownership changes reflects a determination by the Treasury and the Service that is it acceptable to have certain transactions occur simultaneously with an F reorganization, provided that a single corporation could effect such a transaction without undergoing an F reorganization.[15]

Third, the Final Regulations provide that the resulting corporation may not hold any property or have any tax attributes immediately before the potential F reorganization.[16] The resulting corporation may, however, hold (i) a *de minimis* amount of assets to facilitate its organization or maintain its legal existence, (ii) tax attributes related to holding these assets or (iii) the proceeds of borrowings undertaken in connection with the potential F reorganization.

9 As discussed in the Preamble to the Final Regulations (hereinafter the "**Preamble**"), these new requirements were added in light of comments on the 2004 Proposed Regulations relating to "overlap transactions," where a potential F reorganization could also qualify under another nonrecognition provision. Preamble to Final Regulations, Reorganizations Under Section 368(a)(1)(F), T.D. 9739, 80 Fed. Reg. 56,904, 56,908 (Sep. 21, 2015); *see also* N.Y. ST. BA. ASS'N TAX SEC., *Report on Characterizing "Overlap" Transactions under Subchapter C* (Report No. 1229, Jan. 6, 2011).

10 Preamble, at 56,905–06.

11 Treas. Reg. § 1.368-2(m)(1)(i).

12 Preamble, at 56,908.

13 Treas. Reg. § 1.368-2(m)(1)(ii).

14 Treas. Reg. § 1.368-2(m)(1)(ii).

15 Preamble, at 56,908.

16 Treas. Reg. § 1.368-2(m)(1)(iii).

Fourth, the transferor corporation must completely liquidate for U.S. federal income tax purposes in the F reorganization.[17] The transferor corporation is not, however, required to dissolve under applicable law, and it may retain a *de minimis* amount of assets for the purpose of preserving its legal existence.[18] The third and fourth requirements are intended to preserve the policy that an F reorganization can involve only one corporation.[19]

The final two requirements are intended to ensure that an F reorganization is neither an acquisitive nor a divisive transaction. Under the fifth requirement, after the potential F reorganization, no corporation other than the resulting corporation may hold property held by the transferor corporation immediately before the potential F reorganization. This limitation applies only if the other corporation would, as a result of holding that property, succeed and take into account certain tax attributes of the transferor corporation described in Section 381(c).[20] Under the sixth requirement, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation immediately after the potential F reorganization if the resulting corporation would, as a result of holding that property, succeed and take into account certain tax attributes of the other corporation described in Section 381(c).[21]

The Final Regulations also provide an overlap rule in cases where a potential F reorganization may also qualify as a reorganization under another provision of Section 368(a)(1). In general, a potential F reorganization will qualify only under Section 368(a)(1)(F), unless (i) the potential F reorganization (or a step thereof) qualifies as a reorganization or part of a reorganization under another provision of Section 368(a)(1) and (ii) a corporation in control (within the meaning of Section 368(c)) of the resulting corporation is a party to that other reorganization within the meaning of Section 368(b)). In these cases, the potential F reorganization will not qualify as a reorganization under Section 368(a)(1)(F).[22]

The Final Regulations also address how to apply these six requirements and the overlap rule to complex transactions. The approach taken by the Final Regulations can be described as a "reorganization in a bubble," looking to the transaction steps that constitute a "potential F reorganization" and testing those steps against the six requirements. Under the Final Regulations, a potential F reorganization begins when the transferor corporation begins to

17 We believe that the question as to whether the transferor corporation has completely liquidated for U.S. federal income tax purposes should be determined with respect to the existing body of law dealing with corporate liquidations. *See e.g.* Rev. Rul. 61-191, 1961-2 C.B. 251.

18 Treas. Reg. § 1.368-2(m)(1)(iii).

19 Preamble, at 56,909.

20 Treas. Reg. § 1.368-2(m)(1)(iv); Treas. Reg. § 1.368-2(m)(1)(v).

21 Treas. Reg. § 1.368-2(m)(1)(iv); Treas. Reg. § 1.368-2(m)(1)(v).

22 Treas. Reg. § 1.368-2(m)(3)(iv).

transfer assets to the resulting corporation and ends upon the liquidation of the transferor corporation and the corresponding distribution of resulting corporation stock.[23]

III. RECOMMENDATIONS AND COMMENTS

A. Clarifying the *De Minimis* Exceptions

Under the Final Regulations, all of the stock of the resulting corporation must be distributed (or deemed distributed) immediately after a potential F reorganization in exchange for stock of the transferor corporation.[24] This reflects a determination by Treasury and the Service that a transaction which shifts the ownership of interests in a corporation does not qualify as an F reorganization because it is more than a "mere change."[25] Similarly, the resulting corporation may not hold any property or have any tax attributes, including those attributes identified in Section 381(c), immediately before the potential F reorganization.[26] The Final Regulations go on to permit *de minimis* deviations from these requirements to either facilitate the resulting corporation's organization or maintain its legal existence, acknowledging that practical considerations or compliance with statutory requirements may be inconsistent with strictly satisfying the these requirements under the Final Regulations.[27] The Preamble notes that these *de minimis* exceptions are designed to permit reincorporation in a jurisdiction that requires minimum capitalization, two or more initial shareholders or the ownership of shares by directors.[28]

Although the Final Regulations require that these *de minimis* exceptions can only be used to facilitate the resulting corporation's organization or maintain its legal existence, they do not provide any guidance as to the scope of the exceptions. Absent such guidance, we believe that taxpayers may be hesitant to rely on these valuable exceptions when they are needed, and we believe that any such guidance can be tailored to protect the policy goals underlying the Final Regulations while providing taxpayers with the necessary certainty of treatment.

For example, a stated purpose for the *de minimis* exceptions is to allow compliance with minimum capitalization requirements. This may, however, be more complicated than it appears.

[23] Treas. Reg. § 1.368-2(m)(1).

[24] Treas. Reg. § 1.368-2(m)(1)(i).

[25] Preamble, at 56,908.

[26] Treas. Reg. § 1.368-2(m)(1)(iii).

[27] As noted in Part II.B. above, the Final Regulations also provide that the Resulting Corporation may hold the proceeds of borrowings undertaken in connection with a potential F reorganization. Treas. Reg. § 1.368-2(m)(1)(iii).

[28] Preamble, at 56,908.

First, each jurisdiction will have its own standard for minimum capitalization, and these standards may vary widely.[29] Practitioners may be concerned that assets that are unquestionably required to incorporate in that jurisdiction are not clearly *de minimis*. Similarly, a jurisdiction's minimum capitalization requirement may be defined in light of all the applicable facts and circumstances, rather than providing a "bright line" minimum, raising the concern of a challenge over whether pre-F reorganization assets are necessary to facilitate organization or maintain legal existence.[30] In addition, for non-tax reasons it may be desirable to effect a potential F reorganization by transferring a disregarded entity that, in addition to owning the stock of the transferor corporation, has a small amount of other assets or liabilities. Finally, the Final Regulations do not clearly state whether minimum capital requirements under regulatory or licensing requirements (where the license or regulatory authorization is necessary to permit the resulting corporation to acquire the assets of the transferor corporation) are also within the scope of "facilitating the organization" of a corporation.

We recommend that Treasury and the Service issue guidance clarifying that these *de minimis* exceptions will be evaluated based on all the relevant facts and circumstances (including applicable law and practice), and that issuances of stock or contributions of assets in order to facilitate the resulting corporation's organization (or in connection with the organization) or maintain its legal existence will be presumed to be *de minimis* as long as they do not exceed 1% of the resulting corporation's shares outstanding or assets (by value) immediately after the potential F reorganization.[31] Further, we suggest that the guidance provide that any issuance of stock or contribution of assets, if necessary to satisfy either legal or regulatory requirements for a corporation's organization, should not violate the requirements of the Final Regulations (whether or not in excess of 1%). Any other rule would force a reincorporating entity to choose between compliance with local law and having the reincorporation qualify as an F reorganization. Finally, we suggest that the guidance consider providing that certain inchoate assets of the resulting

[29] It is also possible that a jurisdiction will set different minimum capital requirements for different types of entities or for entities set up for specific purposes.

[30] In addition, we expect that many jurisdictions allow minimum capitalization requirements to be satisfied with assets (rather than just cash), and there are often good business reasons to use assets to do so. When assets are used in lieu of cash, it may well be necessary to leave a margin to ensure the requirement will be met in light of changes in values.

[31] The Final Regulations contain an example where a resulting corporation issues 1% of its stock to facilitate its organization and such issuance is considered *de minimis*. Treas. Reg. § 1.368-2(m)(4), Ex. 3. We chose 1% primarily based on the amount permitted in Example 3. Additionally, the Service historically permitted a *de minimis* change in shareholder ownership in connection with an F reorganization in an amount of less than 1%. *See* Rev. Rul. 66-284, 1966-2 C.B. 115 (obsoleted by the Final Regulations). We believe that 1% is high enough to give comfort under reasonable circumstances, but low enough to protect the policy goals behind the requirements of the Final Regulations.

corporation not arising from prior business activities and not capable of ready valuation (such as a stock exchange listing) be excluded for purposes of determining compliance with the Final Regulations.

B. "Drop and Check" Transactions

The Final Regulations provide that the same person or persons must own all of the stock of the transferor corporation immediately before a potential F reorganization and all of the stock of the resulting corporation immediately after the F reorganization.[32] A very literal reading of this requirement could disqualify a so-called "drop and check" transaction, in which all of the stock of the transferor corporation is contributed to the resulting corporation and the transferor corporation liquidates or is deemed to liquidate.[33] Specifically, if the "bubble" begins after the contribution of transferor corporation stock, then the resulting corporation technically owns the transferor corporation immediately before the potential F reorganization, and the resulting corporation's shareholders own the resulting corporation immediately after, so the second requirement is not satisfied.[34] Further, the Final Regulations' statement that step transaction principles "may also treat" such a transaction as a transfer of property from the transferor corporation to the resulting corporation, followed by a distribution of the stock of the resulting corporation, could be read to suggest that this issue is, at least in some way, in doubt.[35]

In contrast, the Final Regulations include an example of a "drop and check" transaction where it is quite clear that the transaction qualifies as an F reorganization.[36] Further, the Preamble's discussion of when the "bubble" begins specifically discusses the deemed asset transfer from the transferor corporation to the resulting corporation in a "drop and check" transaction.[37] Although we believe that Example 5 of the Final Regulations makes clear that Treasury and the Service intend for "drop and check" transactions pursuant to an integrated plan

[32] Treas. Reg. § 1.368-2(m)(1) (ii).

[33] We note that the treatment of a stock transfer, followed by a liquidation of the transferred corporation as part of the same plan, can vary depending on the steps of the overall transaction. *Compare* Rev. Rul. 67-274, 1967-2 C.B. 141 (which disregards the stock transfer) *with* Rev. Rul. 2015-9, I.R.B. 2015-21 (which does not).

[34] For example, pursuant to an election under Treas. Reg. § 301.7701-3(c)(1), as described in Treas. Reg. § 301.7701-3(g)(1)(iii).

[35] Treas. Reg. § 1.368-2(m)(1).

[36] Treas. Reg. § 1.368-2(m)(4), Example 5.

[37] "Another example of such a deemed asset transfer would include the deemed transfer of the Transferor Corporation's assets to the Resulting Corporation in a so-called 'drop-and-check' transaction in which a newly formed Resulting Corporation acquires the stock of a Transferor Corporation from its shareholders and, as part of the plan, the Transferor Corporation liquidates into the Resulting Corporation." Preamble, at 56,908.

to qualify as F reorganizations, we recommend that Treasury and the Service consider issuing guidance clarifying that in these "drop and check" transactions the potential F reorganization begins when the stock of the transferor corporation is contributed to the resulting corporation (*i.e.*, at the first step that, after the application of the step transaction doctrine, is treated as an asset transfer).[38] Treasury and the Service could also consider providing broader guidance to clarify that in any step transaction that is treated for tax purposes as an asset transfer, the potential F reorganization begins with the first step that is combined. For example, this would include transactions where a transferor corporation liquidates into an individual shareholder, followed by a subsequent drop of the transferor corporation's property to a resulting corporation.

C. Tax Attributes

The Final Regulations require that the resulting corporation not hold any property or have any tax attributes, including those attributes identified in Section 381(c), immediately before a potential F reorganization.[39] The resulting corporation may, however, have certain tax attributes related to holding assets that qualify under the *de minimis* exception discussed above. The Final Regulations do not define "tax attributes" for purposes of this rule. As a result, a transaction that would otherwise qualify as an F reorganization could fail if some other jurisdiction's law assigns or grants some tax attributes to the resulting corporation and such tax attributes were taken into account under the Final Regulations. Further, an overly expansive reading of the term "attributes" would materially increase the compliance burden associated with an F reorganization, as it would require legal analysis in each jurisdiction that could possibly treat the resulting corporation as owning tax attributes under applicable law.

We therefore recommend that Treasury and the Service issue clarifying guidance that this requirement only looks to U.S. federal income tax attributes and is not violated if some other jurisdiction treats the resulting corporation as having tax attributes before the proposed F reorganization. This is in part a practical clarification, ensuring that the requirement set out in Treas. Reg. § 1.368-2(m)(1)(iii) will not be interpreted in a manner that requires extensive analysis in

[38] This result does depend on the sequence of events; *i.e.* the transferor corporation must be contributed down before liquidating in order to avoid implicating the overlap rule if the shareholder is a corporation. One way that this could arise is if the transferor corporation elects to be disregarded without being mindful of the timing of the deemed liquidation. Under the Treasury Regulations, an entity that elects to be disregarded is deemed to liquidate at the end of the day *before* the election is effective. Treas. Reg. § 301.7701-3(c)(3)(i). In order to ensure the desired sequence of events, and to avoid the overlap rules, it appears that the check-the-box election must have an effective date *after* the date that the transferor corporation's stock is contributed to the resulting corporation. Similar timing issues appear to apply where the transferor corporation becomes a disregarded entity pursuant to a state law conversion statute. Rev. Rul. 2009-15, 2009-1 C.B. 1035 (situation 2); Rev. Rul. 2004-59, I.R.B. 2004-24.

[39] Treas. Reg. § 1.368-2(m)(1)(iii).

any number of jurisdictions (including merely determining the possible jurisdictions at issue). Further, a broad reading of this requirement (possibly consistent with its language), that it is violated if the resulting corporation has any tax attribute in any jurisdiction before the beginning of a potential F reorganization, leads to the counter-intuitive conclusion that a transaction's qualification as an F reorganization may turn on the tax laws of an entirely unrelated jurisdiction.

We believe that our proposed clarification is consistent with the purpose of Treas. Reg. § 1.368-2(m)(1)(iii) and the tax policy underlying that purpose. The regulation does not need to look to tax attributes other than U.S. federal income tax attributes to accomplish its stated goal. As discussed in the Preamble, this requirement is needed because an F reorganization permits the continuation of the taxable year and loss carrybacks from the resulting corporation to the transferor corporation (and so F reorganizations should not involve a resulting corporation with preexisting activities or tax attributes).[40] We agree with that concern. However, it is solely a concern because U.S. federal income tax law permits the resulting corporation to continue the transferor's tax year and to carry losses back to the transferor corporation, and the concern does not arise under any jurisdiction's tax law unless that jurisdiction applies U.S. federal income tax law by reference.[41] We also believe that Treasury and the Service should clarify that tax attributes should not impact the other requirements under the Final Regulations, *i.e.*, that any tax attributes are not considered property for purposes of Treas. Reg. § 1.368-2(m)(1)(iii). Under this proposed clarification, net operating losses arising under local law would not be considered property for purposes of Treas. Reg. § 1.368-2(m)(1)(iii).[42]

An alternative (and more limited, but still valuable) clarification would be to confirm that "tax attributes" and "property" do not include items that do not arise from the resulting corporation's business activities before the start of a potential F reorganization, such as its qualification under a particular tax treaty or a special tax regime or incentive that it is eligible for as a result of its jurisdiction of incorporation. If incidents of a corporation's ownership, choice of jurisdiction, entity classification in that jurisdiction and similar matters that do not relate to its past activities are considered tax attributes, Treas. Reg. § 1.368-2(m)(1)(iii) could disqualify transactions involving a newly-created resulting corporation.

40 *See also* H.R. Rep. No. 97-760, 97th Cong., 2d Sess. (Conf. Rep.), at 540–41 (1982).

41 For example, if a U.K. entity is the transferor corporation in a "drop and check" F reorganization, its election to be disregarded for U.S. federal income tax purposes is not relevant to its U.K. tax treatment: for U.K. tax purposes, the transferor remains in existence as a separate taxable entity.

42 We believe this is consistent with prior rulings by the Service, in which the Service has treated payments from one corporation in a consolidated group to another corporation in the same consolidated group for use of the second corporation's tax losses as a capital contribution and not as an exchange for value. *See* Rev. Rul. 73-605, 1973-2 C.B. 109; GCM 39367 (1985) (stating that "the surrender of a tax loss by one corporation to another is not considered for United States tax purposes to be a transfer of value").

D. Step Transaction Doctrine

The step transaction doctrine is a judicially created doctrine which integrates into a single transaction nominally separate steps that, in substance, are part of a larger, interdependent transaction. The step transaction doctrine has often been invoked by the Service to recharacterize transactions purporting to qualify as tax-free reorganizations as taxable transactions.[43] On the other hand, the doctrine has also been used to recast steps that would otherwise constitute a taxable transaction into a tax-free reorganization by combining them with later steps.[44]

Traditionally, the Service has not applied the step transaction doctrine to disqualify a transaction from F reorganization treatment, even where the steps constituting the F reorganization were part of a larger transaction that involved, for example, a combination with another company or the issuance of shares to new shareholders.[45] Consistent with this historic approach, the Final Regulations provide that the step transaction doctrine will only apply to F reorganizations in a very specific way; the "bubble" is in fact quite well protected. Specifically, "related events that precede or follow [a] potential F reorganization generally will not cause a reorganization to fail to qualify as [an F reorganization]."[46] The Final Regulations thus appear to protect the steps in the "bubble" from being integrated with a step outside the "bubble" that would result in the overall transaction being recast.

Example 6 of the Final Regulations illustrates this concept. In Example 6, P owns all of the stock of S1, a State A corporation, and wants to change S1's place of incorporation to State B by merging S1 into a newly-created State B corporation, S2. Immediately after the merger, P sells all of its stock in S2 to an unrelated party. The Final Regulations provide that the subsequent sale is disregarded in determining whether the merger of S1 into S2 qualifies as an F reorganization. Similarly, PLR 201611015 demonstrates the breadth of the Final Regulations' defense of the "bubble."[47] The ruling describes a transaction in which (i) Oldco forms Holdco A, (ii) Holdco A forms Merger Sub, (iii) Merger Sub merges into Oldco, with Oldco surviving, (iv) Oldco shareholders receive Holdco A Stock, (v) Oldco converts into a limited liability company (LLC) treated as a disregarded entity, (vi) LLC distributes stock of a subsidiary to Holdco A, (vii) Holdco A forms Holdco B and contributes all its interest in LLC to Holdco B, and (viii) LLC re-converts into a state law corporation. The potential F reorganization in steps (i)–(v) is a form of "drop and check" transaction; however, in the same overall integrated transaction the "checked" Oldco is reincorporated and is, at the end of the transaction, a

43 Gregory v. Helvering, 293 U.S. 465 (1935); Rev. Rul. 2008-25, 2008-1 C.B. 986.

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

45 Rev. Rul. 96-29, 1996-1 C.B. 50; Rev. Rul. 79-250, 1979-2 C.B. 156; Rev. Rul. 69-516, 1969-2 C.B. 56.

46 Treas. Reg. § 1.368-2(m)(3)(ii).

47 PLR 201611015 (Mar. 11, 2016).

corporation for U.S. federal income tax purposes. Nevertheless, the Service concluded that the reincorporation did not preclude the potential F reorganization from qualifying as such.

Example 13 of the Final Regulations appears to illustrate an exception to the general non-application of the step transaction doctrine when the steps meeting the requirements of an F reorganization are also integral steps in another reorganization. In Example 13, X owns all the stock of T, and P acquires all the stock of T in exchange for $50 cash and P voting stock worth $50. Immediately thereafter and as part of the same plan, P forms S as a wholly-owned subsidiary and T is merged into S. Although the merger of T into S would appear to qualify as an F reorganization in a "bubble," the step transaction doctrine applies in the Example to treat the transaction as a statutory merger of T into S in exchange for cash and P's voting stock and P's momentary ownership of T stock is disregarded. The example goes on to conclude that since the transaction as recast qualifies as an asset reorganization of a type that trumps F reorganization treatment under the overlap rule, the transaction will not qualify as an F reorganization.

The Final Regulations indicate that the step transaction doctrine will "generally" not apply to events that precede or occur subsequent to a qualifying F reorganization. Our recommendation is premised on the belief that the use of the word "generally" in the Final Regulations was intended to reference the overlap rule, and thus that the only situation in which a step outside the "bubble" is integrated with the steps inside the "bubble" in a manner that disqualifies a potential F reorganization that would otherwise so qualify is when both (i) a step of the potential F reorganization is an integral part of the alternative characterization of the transaction (*i.e.*, the recast transaction would not qualify as a tax-free reorganization absent the steps that are a part of the potential F reorganization) and (ii) the recast transaction qualifies as a tax-free reorganization of a type that trumps F reorganization treatment under the overlap rule (as was the case in Example 13). If the Treasury and Service intend for step transaction principles to apply in circumstances not implicating the overlap rule to ultimately prevent a transaction from qualifying as an F reorganization, we recommend that the Treasury and Service clarify the circumstances in which the step transaction principles might apply.[48]

E. F Reorganizations of Insolvent Companies

Although we do not believe that this is the intent, the Final Regulations may be literally interpreted to prohibit an F reorganization of an insolvent company. Specifically, all the stock of the resulting corporation must be distributed (or deemed distributed) in exchange for the stock of

48 It would also be helpful for guidance to clarify that nothing in the Final Regulations implies that the steps in the potential F reorganization are ignored or disregarded for the purpose of characterizing another transaction just because such steps occur in a "bubble." For example, the steps in the "bubble" would not be ignored for purposes of determining whether the continuity of business enterprise requirement is satisfied for another reorganization under Section 368(a)(1).

the transferor corporation. If the transferor corporation is insolvent, there is some doubt as to whether the distribution of resulting corporation stock is, in substance, in exchange for stock if that stock has no value.

The policy behind permitting F reorganizations, that "mere changes" should not be subject to the tax consequences resulting from the recognition of gain or loss, does not turn on the solvency (or lack thereof) of the transferor corporation. Further, a mere change is not in substance an economic exchange, and so it should be sufficient for the transaction to satisfy this requirement in form, *i.e.*, that the stock of the resulting corporation is transferred in exchange for the stock of the transferor corporation without regard to whether that exchange has economic substance.[49]

Our recommendation is also consistent with Treasury and the Service's proposed approach in the broader reorganization context. On March 10, 2005, Treasury and the Service announced proposed regulations governing corporate formations, reorganizations and liquidations of insolvent corporations (the "**No Net Value Regulations**"). The No Net Value Regulations provide that a transaction must involve an exchange or distribution of property with a net value in order to qualify for nonrecognition treatment under Sections 351, 332 or 368.

The impetus behind the No Net Value Regulations stems from the continuity of interest requirement that is generally applicable to reorganizations under Section 368(a)(1). Continuity of interest requires that "a substantial part of the value of the proprietary interests in the target corporation be preserved in [a] reorganization."[50] Shareholders generally hold the proprietary interests in a corporation; however, where a transferor corporation is insolvent, it can be argued that any stock that the shareholders exchange in a reorganization is worthless, and therefore shareholders cannot obtain a proprietary interest in a transferee corporation.[51] Thus, the No Net Value Regulations provide that for potential reorganizations to qualify under Section 368 there must be both a surrender and receipt of net value. This requirement is met in an asset reorganization, if, for example, the fair market value of the property transferred by a transferor corporation to an acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of any money and the fair market value of any property received by the target corporation.

[49] The policy behind allowing tax-free F reorganizations is that this exchange does not have, in the colloquial sense, economic substance; it is a mere change that does not affect the exposure of the owners of the transferor corporation to the benefits and burdens of their investment. *See* Preamble, at 56,905; *see also* PLR 201326006 (Apr. 1, 2013); PLR 201108025 (Nov. 23, 2010).

[50] Treas. Reg. § 1.368-1(e)(1).

[51] *See* Norman Scott, Inc. v. Comm'r, 48 T.C. 598 (1967).

The No Net Value Regulations provide that the net value requirement does not apply to reorganizations under Section 368(a)(1)(F).[52] F reorganizations are not subject to the continuity of business enterprise and continuity of interest requirements in the first place: it is not necessary to apply those restrictions to the F reorganization context to protect the policy goals that drive the structure of the reorganization provisions.[53] As a result, Treasury and the Service concluded that it was not necessary to impose the No Net Value requirement, which protects similar policy concerns, to F reorganizations. Hence, Treasury and the Service should clarify that the Final Regulations permit an insolvent corporation to change its identity, form or place of organization in a tax-free transaction.

F. Significant Distributions in F Reorganizations

The Final Regulations provide that distributions made by the transferor corporation during a potential F reorganization are treated as unrelated and separate transactions, "whether or not connected in a formal sense."[54] We believe this is a good and helpful rule that in many cases allows a transaction to qualify as an F reorganization where it might otherwise be recast. On its face, this is a flat rule: distributions are never integrated with the steps of a potential F reorganization. However, it would be valuable to clarify exactly how it interacts with the remainder of the Final Regulations (*i.e.* where a potential recharacterization would disqualify the potential F reorganization). In addition, there are situations where it may be appropriate to qualify this rule, for example if a distribution is sufficient to implicate the overlap rule (if the transaction would also qualify as an asset reorganization under Section 368(a)(1)(C)). We recommend that Treasury and the Service issue guidance clarifying the application of this rule under these facts. We further recommend that Treasury and the Service clarify that the distribution non-integration rule applies regardless of whether the distribution is liquidating or non-liquidating—that the purpose of this rule does not require it to be limited to transactions that are in form non-liquidating distributions. These issues are best illustrated with an example:

> *Example 1.* Corporation T (formed in State X) is 100% owned by Corporation P. T owns assets with a value of $130 and has liabilities of $30. In an integrated transaction, P forms R, a new State Y Corporation, T distributes a dividend of $40 to P, and then T merges into R with R surviving.

Under the Final Regulations, we believe that this transaction should qualify as an F reorganization as a result of the distribution non-integration rule: a distribution should simply not be

52 Prop. Treas. Reg. 1.368-1(b)(1).

53 Preamble to the Notice of Proposed Rulemaking Transactions Involving the Transfer of No Net Value (Correction), REG-163314-03, 70 Fed. Reg. 20,315 (Apr. 19, 2005).

54 Treas. Reg. § 1.368-2(m)(3)(iii).

integrated with a potential F reorganization. Treas. Reg. § 1.368-2(m)(3)(iii) appears to have a meaningful impact in this case, as the transaction could be recharacterized as a liquidation pursuant to Section 332 of the Code in which Corporation T liquidated into its 80% parent, distributing cash and the stock of Corporation R (to which Corporation T had contributed the remainder of its assets). However, the recast transaction would violate Treas. Reg. § 1.368-2(m)(1)(v), that there must be a single acquiring corporation, as P, if treated as the distributee in a Section 332 liquidation, would succeed to items of the transferor corporation described in Section 381(c). We believe that in this case, F reorganization treatment is the correct result, and shows the importance of the distribution non-integration rule.[55]

Example 2. Same facts as Example 1, except T forms R, contributes $90 of its assets and assigns all of its liabilities to R, and then liquidates.

In this example, the distribution is a part of one of the steps of the potential F reorganization (and not just a part of the same integrated transaction as the potential F reorganization). We believe that the result in Example 1 is equally appropriate in Example 2 (for the reasons described above), and so the distribution non-integration rule should apply to the liquidating distribution of $40 in Example 2.[56] However, there may be some ambiguity as the distribution is not in any way separate from the potential F reorganization, and there is some discussion in the Preamble which puts this result in doubt.[57] Specifically, the Preamble notes that

[55] If Treasury and the Service issue guidance clarifying this point, it would be helpful for that guidance to also cover this base case, to confirm that the distribution non-integration rule applies to prevent recharacterization of a potential F reorganization (except under the facts we describe below).

[56] Among other reasons, this is just an issue of form: if the rule applies to non-liquidating distributions but not to liquidating distributions, taxpayers will simply restructure their transactions to gain the benefit of the distribution non-integration rule.

[57] "For example, assume that corporation P owns all of the stock of corporation T, and T operates two separate businesses, Business 1 (worth $297) and Business 2 (worth $3). Further assume that T merges into newly formed corporation R, and that, pursuant to the merger agreement, P receives Business 1 and all of R's stock in exchange for surrendering all of the T stock, and R receives Business 2. Under the 2004 Proposed Regulations, the transaction could have qualified as an F reorganization, with T as the Transferor Corporation and R as the Resulting Corporation, because the only change in ownership is a redemption of less than all of the T shares. However, because T transfers 99 percent of its historic business assets (Business 1) to P in exchange for all of T's stock, the transaction might also qualify as a complete liquidation under sections 332 and 337 or an upstream reorganization under section 368(a)(1)(C) of T into P. This overlap—with two potential acquiring corporations—would present unintended complexities. For example, as discussed above, there would be uncertainty as to which corporation should succeed to T's tax attributes.

"Accordingly, notwithstanding the overall flexibility provided with respect to transactions occurring contemporaneously with a Mere Change, the Final Regulations provide that a Mere Change cannot accommodate transactions that occur at the same time as the potential F reorganization if those other recharacterizing a potential F reorganization as a Section 332 liquidation would disqualify its treatment. The discussion in the Preamble, however, is focused on the situation in which almost all of the assets of the transferor corporation are distributed (and not contributed to the resulting corporation).[58] As a result, we further request that Treasury and the Service issue guidance confirming that the distribution non-integration rule applies regardless of whether the distribution in question is in form non-liquidating (as in Example 1) or liquidating (as in Example 2). Further, in the F reorganization context, and in light of Treasury and the Service's express conclusion that distributions should not be integrated with a mere change, we think it is important to clarify when (if at all) a potential F reorganization can be characterized as a Section 332 liquidation. We believe that a distribution should be integrated with a potential F reorganization if and only if it is a distribution of substantially all of the assets of the transferor corporation to a single corporate distributee that is not the resulting corporation.

> *Example 3.* Same facts as Example 2, except T contributes $35 of assets and assigns $30 of liabilities to R.

In Example 3, the transaction can now be recharacterized as an acquisitive stock-for asset reorganization under Section 368(a)(1)(C) if the distribution is integrated with the remainder of the transaction. The key difference is that P has acquired substantially all of the assets of T. We believe that it would be appropriate to limit the distribution non-integration rule where the transferor corporation distributes substantially all of its assets to a single corporate distributee. Using this rule, the following transaction would qualify as an F reorganization:

> *Example 4.* Corporation S3 (formed in State X) is 50% owned by Corporation S1 and 50% owned by Corporation S2, which in turn are each 100% owned by Corporation P. S3 owns assets with a value of $100. S3 forms R, a new State Y Corporation, contributes $2 of its assets to R, and then liquidates.

Although the quantum of assets distributed in Example 4 may initially give one some pause, the absence of a single corporate distribute that could be viewed as another acquiring corporation means that the facts presented appear to be solidly within the Final Regulations' definition of a qualifying F reorganization.

transactions could result in a corporation other than the Resulting Corporation acquiring the tax attributes of the Transferor Corporation." Preamble, at 56,909.

58 Under existing law and guidance, a liquidation-reincorporation transaction as described above may well not qualify under Section 332 in the first place. However, we believe that Treasury and the Service did not intend to require a detailed liquidation-reincorporation analysis for any prospective F reorganization that also includes a distribution.

G. Clarifications Requested Regarding Revenue Rulings 61-156 and 68-349

Revenue Rulings 61-156[59] and 68-349[60] appear to be inconsistent with the Final Regulations. In Revenue Ruling 61-156, a corporation sold substantially all of its assets to a newly formed corporation in exchange for cash, long-term notes and 45% of the new corporation's stock. The new corporation then sold 55% of its outstanding stock to the public, following which the original selling corporation liquidated. In Revenue Ruling 68-349, corporation *Y* transferred all of its assets subject to all of its liabilities to a newly formed corporation *X*, in exchange for voting stock of *X*. *Y* then distributed *X*'s voting stock to its shareholders in liquidation. At the same time, individual *A* transferred to *X* appreciated property (which *Y* wanted to use in its business) and received *X* voting stock in exchange. In both rulings, the resulting corporation issued stock to transferors of cash or assets that were not historic owners of the transferor corporation during the pendency of the "bubble." However, these rulings have not been revoked. We request that Treasury and the Service clarify to what extent, if any, these rulings remain valid in light of the Final Regulations.

H. EIN Issues

The final regulations seek comments regarding how to assign or reassign employer identification numbers ("**EINs**") in an F reorganization, including in cases in which the transferor corporation remains in existence as a disregarded entity. The Service's position, as stated in Revenue Ruling 73-526, is that the resulting corporation in an F reorganization should generally use the EIN of the transferor corporation, and in circumstances in which the transferor corporation liquidates (in reality as well as for U.S. federal income tax purposes) this result seems entirely appropriate. However, more complex fact patterns arise where the transferor corporation remains in legal existence as a disregarded entity of the resulting corporation and continues to engage in transactions where an EIN may be required. For example, Revenue Ruling 2008-18 addressed an F reorganization of an S corporation where the transferor corporation became a qualified subchapter S subsidiary ("**QSub**") of the resulting corporation. The Service held that the resulting corporation needed to obtain a new EIN and that the QSub would continue to use its historic EIN for employment and excise tax purposes.

Revenue Ruling 2008-18 is based on Treas. Reg. § 301.6109-1(h) and (i), which provides that an entity that becomes disregarded from its owner or elects to be treated as a QSub is generally required to use its parent's EIN for all tax purposes, except as otherwise provided. However, these entities appear to conceptually "retain" their old EIN, and to be required to use that number where the treasury regulations require an entity to use its own EIN even though it is

[59] 1961-2 C.B. 62.

[60] 1968-2 C.B. 143.

otherwise disregarded.[61] Further, when a disregarded entity becomes regarded, or a QSub ceases to be so treated, if it previously had an EIN (as described in the preceding sentence), it must use that EIN.[62] We believe this is the appropriate result in the F reorganization context as well—that a transferor corporation should retain its EIN for relevant purposes if it becomes disregarded in a "drop and check" F reorganization.[63]

61 For example, for purposes of employment tax or excise tax returns. Treas. Reg. § 301.7701-2(c)(2)(iv); Treas. Reg. § 1.1361-4(a)(8).

62 For example, in PLR 201611015, discussed above, the "old" entity is, at the end of the transaction, reincorporated as a regarded entity. PLR 201611015 (Mar. 11, 2016). Under our proposed approach, it would retain its historic EIN and its successor would be required to request a new EIN.

63 This treatment can be contrasted with the treatment of EINs in the partnership merger context. If two or more partnerships merge or consolidate into one partnership, the resulting partnership is treated as a continuation of the merging or consolidating partnership, the members of which own an interest of more than 50% in the capital and profits of the resulting partnership. In these circumstances the resulting partnership will use the EIN of the continuing partnership. Treas. Reg. § 1.708-1(c)(2). To the extent the continuing partnership becomes a disregarded entity of the resulting partnership, there appears to be at least the potential for some conflict between this rule and Treas. Reg. § 301.6109-1(h).