New York State Bar Association

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NYSBA

July 24, 1997

Honorable Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3120
Washington, DC 20220

Michael P. Dolan, Esq.
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Dolan:

I am pleased to enclose a Report prepared by the Committee on Reorganizations of the Tax Section of the New York State Bar Association commenting on the Proposed Amendments to Treasury Regulations §1.368-1(b),(d),(f) and -2(f) (the "Proposed Regulations"). The Proposed Regulations restrict the scope of the so-called continuity of business enterprise ("COBE") and "remote continuity" doctrines that might prevent corporate reorganization transactions intended to be tax-free from qualifying under Section 368 of the Internal Revenue Code of 1986 (the "Code") where the acquiring corporation transfers acquired stock or assets to other members of the acquiring group. The Committee welcomes the Proposed Regulations and urges their prompt adoption in final form.

The Committee considered the Proposed Regulations together with additional Proposed Regulations issued on December 20, 1996 that would significantly limit the so-called "continuity of shareholder interest" doctrine ("COSI") in tax-free reorganizations, and assumes the Proposed COSI Regulations will be adopted in substantially the form in which they were proposed.

The Report addresses the issues as to which the Internal Revenue Service invited comment in its Preamble to the Proposed Regulations, as well as commenting on other aspects of the Proposed Regulations. Specifically, the Report recommends (i) the adoption of a definition of a "qualified group" based on Code section 1504(a) (without the carve-outs enumerated in Code section 1504(b)); (ii) that the Service either clarify that the remote continuity doctrine does not apply to "D", "E" and "F" reorganizations or, should the Service come to a different conclusion, extend the Proposed Regulations to cover non-divisive "D" reorganizations, but not divisive "D" reorganizations; (iii) that the Service further clarify the rules regarding transfers to partnerships and adopt a regulatory safe harbor for the definitions of a "significant partnership" interest and the "active management" test; (iv) that the rules should expressly permit transfers to tiered partnerships or successive transfers to partnerships if all other requirements are satisfied; (v) that the Service later address separately any concerns as to the application of Code section 381 to determine which qualified group member inherits target corporation tax attributes; (vi) that the Service not expand the scope of "triangular" reorganizations at this juncture; and (vii) that the Service clarify that current law as to "cause to be directed" transactions is not affected by the Proposed Regulations. Finally, the Report suggests that the Proposed Regulations be finalized promptly with a prospective effective date but recommends that the Service reconsider the proposal to continue to apply the old rules to transactions that close after the effective date but pursuant to a binding written agreement entered into before that date.

Please let us know if we can be of further assistance in finalizing the proposed regulations.

Very truly yours,

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Report of the New York State Bar Association (Tax Section) on the Proposed Regulations Addressing The Remote Continuity and Continuity of Business Enterprise Doctrines

This Report[1] of the Committee on Reorganizations of the Tax Section of the New York State Bar Association comments on proposed regulations issued on January 3, 1997 that substantially revise the so-called "Remote Continuity of Interest" ("Remote Continuity") and "Continuity of Business Enterprise" ("COBE") doctrines as set forth in Treasury Regulations §1.368-1(b),(d), (f) and -2(f) (the "Proposed Regulations"). The Proposed Regulations eliminate certain restraints on post-reorganization stock or asset transfers that impede ordinary corporate reorganization transactions intended to be tax-free under section 368.[1] Given contemporary corporate structures, the Remote Continuity and COBE doctrines have often been traps for the unwary when corporations have sought to redeploy assets efficiently to one or more group members.

The Proposed Regulations were considered by the Committee together with additional Proposed Regulations under Treas. Reg. §1.368-1 and -2 issued on December 20, 1996, that redefine the Service's position as to the continuity of shareholder interest ("COSI") required to maintain qualification of a transaction as a tax-free reorganization within the meaning of section 368. In this Report, the Committee assumes the Proposed COSI Regulations will be adopted in substantially the form proposed. The COSI doctrine and the Remote Continuity and COBE doctrines derive from one root concern, namely, that a reorganization be a mere modification of shareholder interest in an ongoing corporate business. The COSI doctrine requires that selling shareholders receive a sufficient equity interest in the transferee corporation. The Remote Continuity and COBE doctrines ensure that the equity interest issued to the selling shareholders is in an entity that itself retains an adequate interest in the transferred stock or assets, so that equity interests issued to satisfy the COSI requirement in fact represent a continuing interest in the transferred property.

The substantial restriction in the Proposed COSI Regulations on the Service's previous application of the COSI rules logically lead to a limitation of the scope of Remote Continuity and COBE doctrines. Taken together, the two regulation projects will base tax-free reorganization treatment principally on the statutory terms of section 368 and lessen dramatically

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1/ The principal drafters of this report were Dale Ponikvar, Andrew Walker and Gayle Sered. Helpful comments were received from Robert Jacobs, Richard Loengard, Jr., Eric Solomon and Lewis Steinberg. Additional Members of the Committee who participated in the preparation of this report were Steve Goldbaum, Bertram Kessler, Annaliese Kambour, Aliza Levine, Jay Milkes, Robert Rothman, and Linda Swartz.

2/ All references are to sections of the Internal Revenue Code of 1986 (the "Code").

the emphasis on the Service's prior, expansive interpretation of the judicially-created continuity doctrines.

The Committee welcomes this development because it will provide taxpayers, the Service and the Courts greater certainty in determining when a transaction qualifies as a tax-free reorganization. Given the Service's expanded no-rulings policy as to most "plain vanilla" reorganizations, it is now more important that taxpayers have a set of reorganization rules that are as clear as possible in their meaning.

The COSI doctrine as properly interpreted, we think, in the Proposed COSI Regulations, focuses upon the nature of the consideration issued and conformity of the transaction structure adopted with the express terms of Section 368(a). The Proposed COSI Regulations substantially eliminate the subjective elements of taxpayer purpose and intent that have previously accompanied that doctrine. The Proposed Regulations appropriately will also eliminate, in cases to which they apply, a subjective analysis of a transferee corporation's intention towards the disposition or use of assets or stock it acquires in a reorganization. The Proposed Regulations will dramatically reduce acquirer concern about deploying acquired stock or assets in the most business efficient manner within the acquirer group. The Service generally will also be relieved of the administrative burden of attempting to determine whether post-reorganization transactions should be "integrated" with a reorganization and disqualify its tax-free status.

The Proposed Regulations represent a significant advance in the Service's approach to these issues, for which it is to be commended. We urge the prompt finalization of the Proposed Regulations and encourage the Service to consider our recommendations in the areas as to which the Service has asked for comments.

Summary of Responses to Requested Comments.

1. Definition of "Qualified Group".

The Report suggests a definition of "qualified group" be adopted that more closely reflects the realities of business control of subsidiary entities than does section 368(c). We recommend adoption of a definition based on section 1504(a) (without the carve-outs enumerated in section 1504(b)). At a minimum, the Service has adequate authority under section 1502 to draft regulations to permit transfers within a group filing consolidated returns, regardless of whether members of the group are "controlled" within the meaning of section 368(c).

2. Extension of Proposed Regulations to "D" and "F" Reorganizations.

The extent to which Remote Continuity has continuing vitality is questionable and the application of this and the COBE doctrine to "D" and "F" reorganizations (and recapitalization "E" reorganizations) is particularly questionable. The Committee recommends the Service either clarify that these doctrines do not apply to "D", "E" and "F" reorganizations or, should the Service have a different view, extend the Proposed Regulations to cover non-divisive "D" and "F" reorganizations but not divisive "D" reorganizations.

3. Transfers to Partnerships

The Report recommends that the rules regarding transfers to partnerships be clarified as they are somewhat difficult to understand as currently drafted. While the Committee generally supports a "facts and circumstances" approach, additional guidance regarding when a partnership interest is "significant" and the application of the "active management" test also would be helpful and should include a regulatory safe-harbor. The rules should expressly permit transfers to tiered partnerships or successive transfers to partnerships if the requirements are otherwise satisfied.

4. Miscellaneous Issues

a. Section 381.

It may be unclear from the current section 381 Regulations which corporation in a Qualified Group will inherit the target corporation's tax attributes following post-reorganization transfers under the Proposed Regulations. The uncertainty, however, is present under current law and inherent in the distinction drawn under section 381 between transfers under section 351 and other tax-free transfers. The Committee therefore believes any concerns regarding the application of section 381 should be addressed as part of a separate project.

b. Scope of Triangular Reorganizations.

The Committee concurs with the decision of the Proposed Regulations' drafters not to expand the scope of triangular reorganizations at this juncture to include, for example, an acquisition of T stock or assets in exchange for stock of the acquiring corporation's "grandparent."

c. Cause to be Directed Transactions

Current law treats transfers of the target corporation's stock or assets directly to the acquirer's direct or indirect subsidiary as a transfer to the acquirer followed by a dropdown transaction if the transfer is directed by the acquirer and the acquirer has dominion and control over the transferred assets. When finalized, the Proposed Regulations should clarify that they are not intended to affect the treatment of such transactions under current law.

d. Revenue Ruling 70-107.

Revenue Ruling 70-107 may treat as boot transfers of liabilities accompanying asset transfers that appear to meet the requirements of the Proposed Regulations in certain "C" reorganizations. The Committee supports overruling Revenue Ruling 70-107 and believes the Proposed Regulations offer an opportunity to do so.

5. Effective Date

As considering retroactive application may delay finalization of the regulations, the Committee suggests the regulations be finalized promptly with a prospective effective date. However, the Service should reconsider the portion of the effective date provision that would make the old rules applicable to transactions that close after the effective date pursuant to a binding written agreement entered into before that date.

Detailed Comments.

1. Origins of Remote Continuity.

The genesis of the "remote continuity of interest" doctrine is generally considered to be two Supreme Court cases, <u>Groman v. Commissioner</u>, 302 U.S. 82 (1937) and

Helvering v. Bashford, 302 U.S. 454 (1938). The holding in both cases, however, is considerably narrower than, and often contrary to, the principles for which they have come to stand; namely, that a transfer by an acquiring corporation of assets acquired in a reorganization to a subsidiary, or the use by a subsidiary of stock of a higher-tier corporation to acquire the assets or stock of the target cannot satisfy the continuity of interest requirement absent a special statutory dispensation.

In Groman, a parent corporation formed a subsidiary which acquired all of the stock of a target corporation, which target the subsidiary promptly liquidated. In the reorganization, the target shareholders received cash, parent preferred stock and subsidiary preferred stock. The government argued successfully that the parent stock was "boot" because the parent was not a "party" to the reorganization and the Court held in its favor. The government conceded, however, that the transaction qualified as a reorganization.

The frequently cited "remote continuity" analysis is found in the final paragraph of the Groman opinion, in which the Court responded to the taxpayer's argument that the subsidiary should be disregarded as a mere *alter ego* of the parent. It was in rejecting this *alter ego* argument that the Court briefly discussed the relationship between the target shareholders and target assets that is required in a reorganization. This paragraph of the opinion addresses a narrow question -- whether parent stock may be deemed to be subsidiary stock by disregarding the separate corporate forms. The Court held that it could not. Having held already that the subsidiary was the acquiring "party," however, this analysis arguably was dictum. Also notable is the fact that the term "remote continuity" is nowhere to be found and indeed there is no express discussion of "remoteness" at all.

In Bashford, the acquiring parent formed a subsidiary and contributed to it cash and shares of the parent's common and preferred stock. Stock of three unrelated corporations was then transferred to the subsidiary by target shareholders and the target corporations were liquidated into the subsidiary.[3/] The subsidiary issued cash, its own common

[3/] The Court's opinion implies the stock (or assets) may have been acquired directly by the parent and retransferred immediately to the subsidiary pursuant to the plan of reorganization, which is somewhat misleading. In fact, the target stock was acquired by promoters of the subsidiary who were agents engaged by the parent to conduct negotiations and secure agreement without disclosing the parent company's identity. As agents of the parent, arguably the parent acquired the stock, which presumably was the point raised by the taxpayer. For tax purposes, however, these promoters were merely conduits and the Court viewed the stock as having been transferred directly to the subsidiary. In any event, the transaction was not, as suggested in the preamble, an acquisition of assets by the parent and dropdown of the assets to stock, and common and preferred stock of the parent to the target shareholders. Immediately thereafter, the parent owned all of the subsidiary's preferred stock and 57 percent of its common stock. See Commissioner v. Bashford, 87 F.2d 827 (3d Cir. 1937). Following its Groman decision, the Court held that the parent's activities did not make it a party to the reorganization and its stock, accordingly, was held to be boot. The Court did, as in Groman, treat the transaction as a tax-free reorganization with boot.

Both cases involved complicated and unusual facts far removed from the type of triangular reorganization that Congress subsequently approved in sections 368(a)(2)(C), (D) and (E). In today's terms, the transactions were designed to qualify as triangular "B" reorganizations or, perhaps, "C" reorganizations.[4] Both transactions involved "bifurcated" consideration -- *i.e.*, stock of both the parent and subsidiary was issued. Today this mix of split consideration would disqualify both transactions from tax free reorganization status if executed as a forward triangular merger, and, if executed as a reverse triangular merger, at least cause parent company stock to be taxed as boot. See section 368(a)(2)(D) (prohibiting use of any acquiring subsidiary stock and section 368(a)(2)(E) (requiring that at least "control" of target be paid for with "controlling" corporation voting stock). Indeed, the acquiring subsidiary in Bashford would not even be part of the "qualified group" under the proposed COBE regulations because the parent owned only 57 percent of its common stock.

Subsequent Congressional enactment of sections 368(a)(2)(D) and (E), blessing triangular reorganizations with no or little-split consideration, should be viewed as an attempt to confine these cases to their proper facts. As with other judicial doctrines in the reorganization area, "remote continuity" is largely a creation of the government and certain lower courts, which have pushed the rationale of a single, cryptic reference to "continuity" in Groman to its limits. Indeed, the premise of the original "remote continuity" doctrine as generally articulated (but never by the Court) has been flawed from its inception. If the assets of a corporation acquired in a merger transaction are dropped down to a wholly-owned subsidiary, the doctrine held continuity was lost because an additional corporate shell now separated the acquired corporation's assets from its former shareholders. Yet, an acquisition can qualify as a

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the subsidiary as the consideration was issued directly by the acquiring subsidiary which had been capitalized with the necessary parent stock. See generally Bashford v. Commissioner, 33 B.T.A. 10 (1935).

[4] The prompt liquidation of the acquired targets into the acquiring subsidiary probably would be treated as asset- rather than stock transfers. See Rev. Rul. 67-274, 1967-2 C.B. 141.

tax free reorganization under section 368(a)(1)(B) even though in every such case the acquired corporation's shareholders are separated by the acquisition from the acquired corporation's assets by an additional corporate shell. Congress' addition of section 368(a)(2)(C) does not eliminate this flaw in the popular elaboration of the remote continuity doctrine, because it continues to allow assets to be more remote from the shareholders of the acquired corporation after a "B" reorganization than after an "A", "C" or "G" reorganization.

Thus, the Remote Continuity doctrine has evolved haphazardly from an expansive (and arguably misguided) reading of the fountainhead cases. Congress has repeatedly attempted to limit the application of the doctrine.[5/] Unfortunately, it has done so by providing statutory relief for specific types of reorganizations then in vogue. Subsequent developments in the sophistication and complexity of corporate transactions inevitably have rendered this statutory relief incomplete. Precisely because the doctrine is so nebulous, however, it is difficult to see how Congress could have approached the problem differently, short of enacting an express statutory disavowal of the doctrine in all its forms whenever it might apply. The intent, to overrule the doctrine, however, was clear. <u>See</u> Rev. Rul. 64-73, 1964-1 C.B. 142 and supporting GCM 30887 (Supp.) (arguing that section 368(a)(2)(C) was a "nonexclusive Congressional renunciation" of Remote Continuity principles).

2. *Qualified Group Definition.*

The Proposed Regulations generally permit transfers or successive transfers of target corporation's assets or stock to other members of the "qualified group" without disqualifying the reorganization for failing to satisfy continuity of interest.[6/] A Qualified Group

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5/ Congress enacted section 368(a)(2)(C) in 1954 in an attempt to limit the Remote Continuity doctrine. S. Rep. No. 1622, 83d Cong., 2d Sess. 51 (1954). Then, in 1964, Congress added parenthetical language to section 368(a)(2)(B) to permit triangular "B" reorganizations and dropdowns of stock following "B" reorganizations. S. Rep. No. 830, 88th Cong., 2d Sess. 82 (1964). Congress acted yet again in 1968, enacting section 368(a)(2)(D) to permit forward triangular mergers. S. Rep. No. 1653, 90th Cong., 2d Sess. 3 (1968). Finally, in 1971, Congress enacted section 368(a)(2)(E) permitting reverse triangular mergers. S. Rep. No. 1533, 91st Cong., 2d Sess. 1 (1970). Thus, over the past fifty years, Congress has repeatedly clarified that the Remote Continuity doctrine should not limit legitimate business reorganizations.

6/ The Proposed Regulations generally provide that reorganization status is not affected by a "transfer" of assets to members of the Qualified Group or, in appropriate circumstances, to a partnership. The examples suggest the type of transfer contemplated by the Proposed Regulations is a tax-free contribution to a corporation or partnership under section 351 or section 721. It is not clear whether a permissible transfer could take the form of a taxable rather than a tax-free intercompany transfer. This issue may arise, is defined as one or more chains of corporations connected through stock ownership with the issuing corporation (*i.e.*, the parent corporation) if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

The definition of a Qualified Group is similar to the definitions of an "affiliated group" under section 1504(a) and a "controlled group" under section 1563(a), but defines "control" by reference to section 368(c). The Proposed Regulations request comments on whether the definition of a qualified group should be determined under another provision of the Code.

There appears to be no particular tax policy reason to base the definition of a Qualified Group on section 368(c). The section 368(c) definition presumably was selected because of a possible concern that an alternative definition would exceed the Service's statutory authority. Section 368(c) admittedly is the definition of control in various section 368 provisions, including in particular section 368(a)(2)(C). However, the authority of the Service to promulgate these regulations is not derived narrowly from section 368(a)(2)(C) or related sections.[1/] The Committee therefore believes the Treasury Department has authority to adopt an alternative definition of "qualified group."

The Proposed Regulations are intended to reflect the business reality that assets may be redeployed by an acquiring corporation among corporations under its operational

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for example, if the transfer is to a foreign corporation or partnership as that transfer may be taxable under section 367 or 1491. The Proposed Regulations appear to draw no distinction in defining a Qualified Group between transfers to domestic and foreign entities and the Committee does not believe the residence of the transferee should affect the status of the domestic reorganization. Accordingly, that a transfer may be taxable in whole or in part under section 367 or section 1491 should not be relevant under the Proposed Regulations. Any alternative "qualified group" definition should include foreign entities.

[2/] As discussed above, narrowly defined statutory relief for transactions described in sections 368(a)(2)(C), (D) and (E) has unfortunately (but inevitably) lent support, by negative inference, to the continuing vitality of the Remote Continuity doctrine. The Service itself, however, has long recognized that this is an erroneous reading of these provisions, which are non-exclusive renunciations of the doctrine. See Rev. Rul. 64-73, supra. The limitations on permissible transfers in the Proposed Regulations should be viewed as an affirmative exercise of administrative authority to interpret the COBE doctrine rather than a vestige of the Remote Continuity doctrine.

control following a reorganization. The definition of a Qualified Group should be no narrower than necessary to ensure effective operational control and ownership of the target assets by the acquiring corporation.

Where an affiliated group's ownership and capital structure is simple, the differences between section 368(c) and other controlled group definitions may be unimportant. More complex structures may produce different treatment under alternative definitions. Thus, the existence of cross-ownership may prevent an affiliated group member from qualifying as part of a Qualified Group.[1/] Similarly, the existence of classes of nonvoting stock held by minority shareholders could also prevent a member from qualifying.[1/] Consequently, transfers of target assets to members of an affiliated or consolidated group could nevertheless threaten the tax-free status of a reorganization in some circumstances.

Because corporate groups generally operate based on consolidation for financial accounting and tax return purposes, the section 368(c) Qualified Group definition may be counter-intuitive. Thus, there is a significant risk of technical "foot-faults" by taxpayers. The control definition should be revised to minimize the risk of these inadvertent errors. Were the definition of a Qualified Group based on the affiliated group definition of section 1504, the definition would better conform to the operational unit, as understood by taxpayers. There are,

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8/ Assume, for example, issuing corporation, P, owns all of the stock of S1 and S2, which each own 50 percent of the stock of X. S1, S2 and X join with P in filing a consolidated return. The corporations qualify as an affiliated group because the stock ownership of group members is aggregated. *See* I.R.C. §1504(a)(1)(B)(ii) (stock must be owned by "one or more" of the includible corporations). Thus, the ownership of S1 and S2 in X is aggregated and the group owns 100% of X. Following an otherwise qualifying reorganization, P transfers the target's assets through S1 and S2 to X, which happens to be incorporated in the same state as the target. Despite the fact that this is an intercompany transaction between members of a consolidated group, the transfer will threaten the tax-free status of the reorganization. Neither S1 nor S2 owns 80 percent of X. There generally is no attribution for purposes of section 368(c). Rev. Rul. 56-613, 1956-2 C.B. 212. *See* Prop. Reg. §1.368-1(d)(5)(iii) (stock meeting the requirements of section 368(c) in each of the corporations must be owned *directly* by *one* of the other corporations). It is doubtful whether Treas. Reg. §1.1502-34 applies for this purpose. Therefore, X is not a member of P's Qualified Group.

9/ Section 1504 ignores "vanilla" preferred stock-- generally, nonparticipating, nonvoting, nonconvertible stock that is limited and preferred as to dividends. I.R.C. §1504(a)(4). By contrast, section 368(c) requires ownership of 80 percent of the voting and nonvoting stock of a corporation. The Service has interpreted this rule to mean ownership of 80 percent of *each* class of nonvoting stock. *See* Rev. Rul. 59-259, 1959-2 C.B. 115. Thus, affiliated group members that have any classes of nonvoting stock outstanding owned more than 20 percent by minority shareholders will not be members of the Qualified Group, even if these classes of stock are of insignificant value.

however, disadvantages to adopting the section 1504 definition. In particular, section 1504(b) excludes entities such as insurance companies and foreign corporations that should be covered by the "qualified group" definition. Thus, if a section 1504 definition is adopted it should be based on section 1504(a) without regard to the carve-outs of section 1504(b).

The Committee believes the Qualified Group definition should be revised to conform generally to the parent-subsidiary controlled group definition of section 1504(a) (without regard to section 1504(b)).[10] If the Treasury Department concludes it is generally constrained by its statutory authority to use the section 368(c) definition of control, the Proposed Regulations will still represent a considerable improvement over current law in the vast majority of cases. The regulations may reach anomalous results, however, in the minority of situations involving complex ownership structures. At a minimum, we believe the Service has statutory authority under section 1502 to broaden the Qualified Group definition to include assets transfers within a group filing a consolidated return whether or not the transferee is part of the Qualified Group as defined in the Proposed Regulations.

3. *Extension of the Proposed Regulations to "D" and "F" Reorganizations.*

The Proposed Regulations do not apply to "D" and "F" reorganizations or transactions under section 355. The Preamble requests comments on whether they should. The Preamble suggests the decision not to extend the Proposed Regulations to "D" and "F" reorganizations was based on the fact that section 368(a)(2)(C) does not apply to these types of reorganizations. This assumes, however, that section 368(a)(2)(C) and related sections are a narrow statutory exception to a Remote Continuity doctrine that is otherwise generally applicable. The Committee does not believe section 368(a)(2)(C) is the source of authority for the Proposed Regulations and questions, therefore, whether the omission of "D", "E" and "F" reorganizations from section 368(a)(2)(C) is relevant. As discussed above, the vitality of the

[10] The adoption of a section 1504(a) "control" test may permit transfers to first-tier subsidiaries to qualify under either the regulations or section 368(a)(2)(C). Presumably, the regulations cannot prevent qualification under section 368(a)(2)(C) if the statutory requirements are met. For example, assume an acquirer's subsidiary has two classes of stock, one of which has high vote and low value and is owned by acquirer and the other; with low vote and high value; is owned predominately by unrelated persons. Acquirer may own more than 80 percent of the combined voting power but less than 80 percent of the value of the subsidiary. Such a subsidiary might be controlled within the meaning of section 368(c) but not within the meaning of section 1504(a). Nevertheless, the transfer of target assets to the subsidiary generally should qualify as tax-free. This discontinuity between section 1504(a) and section 368(c) standards, however, would only arise in unusual cases, and therefore is unlikely to create a material risk of abuse.

Remote Continuity doctrine is, at best, questionable.

The extent to which this doctrine and the COBE doctrine apply to "D" and "F" reorganizations, in particular, is unclear. For example, the regulations under section 368 state that continuity of shareholder interest is not separately required in a "D" reorganization.[11/] There is similar uncertainty regarding the application of the continuity of business enterprise test to "D" reorganizations.[12/]

The *Groman-Bashford* doctrine applied originally to those forms of reorganization that were the direct subject of the Supreme Court holdings in those cases, namely, reorganizations under the predecessor sections to section 368(a)(1)(B), and (C). The Committee does not believe a Remote Continuity or COBE doctrine can be said to have been established as to "D", "E", "F" or "G" reorganizations. The 1954, 1964 and 1968 amendments to section 368 effectively repealed the *Groman-Bashford* doctrine, providing explicit statutory approval for remote continuity in "A", "B", "C" and "G" reorganizations. That section 368(a)(2)(c) is silent as to the "D", "E" and "F" reorganizations does not indicate a Congressional intention to create an even stricter Remote Continuity doctrine for those forms of reorganizations. *Cf.* Rev. Rul. 64-73, 1964-1 C.B. 142.[13/]

11/ *See* Treas. Reg. §1.368-1(b) (the requisites of a reorganization include "except as provided in section 368(a)(1)(D)," continuity of interest by the historic owners). Perhaps this reference was originally intended to be limited to divisive "D" reorganizations, although it fails to draw this fairly obvious distinction. Moreover, since continuity of shareholder interest expressly is required under the section 355 regulations, this reading is somewhat problematic.

12/ *See, e.g., Rose v. United States*, 640 F.2d 1030 (9th Cir. 1981) (business continuity need not be satisfied in a liquidation-reincorporation transaction for reorganization treatment to apply).

13/ Section 368(a)(2)(A) provides that, when a transaction is described in both section 368(a)(1)(C) and section 368(a)(1)(D), it must be treated as a "D" reorganization. In 1986, Congress inserted the parenthetical phrase "other than for purposes of section 368(a)(2)(C)." While the provision is hardly a model of clarity, Congress apparently did not intend asset dropdowns to disqualify a reorganization. As with its other efforts to prevent transfers from disqualifying tax-free reorganizations, Congress may however have lent support by negative inference to the notion that an asset transfer could disqualify a "D" reorganization. If that were the case, arguably there would be no overlap with section 368(a)(2)(C) to be resolved in the first instance thus rendering the 1996 amendment's language meaningless. It is an accepted rule of statutory construction that ambiguous language should not be construed to be meaning less where alternative readings are meaningful. Alternatively, therefore, the 1996 amendment should be viewed as Congressional recognition that the Service *might* seek to apply the Remote Continuity to a non-divisive "D" reorganization and an expression of Congress's desire that

In non-divisive "D" reorganizations, a corporation must transfer "substantially all" of its assets to a corporation that it (or its shareholders) "controls." "Control" has the meaning given that term by Section 304(c), which generally defines it as the ownership of stock possessing at least 50 percent of the combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock. In determining control, section 304(c)(3) applies the constructive ownership rules of section 318(a).[14] The definition of control was broadened by Congress, solely for non-divisive "D" reorganizations, to ensure that transfers of assets among corporations subject to effective economic control of the same group of shareholders are treated as tax-free reorganizations.[15]

Because non-divisive "D" reorganizations are necessarily among "related" parties, there is no policy reason to apply the judicial doctrines of continuity of interest and business enterprise that apply in other reorganizations.[16] Indeed, strict application of these doctrines would permit taxpayers to avoid reorganization treatment, which is what section 368(a)(2)(H) was intended to prevent. The broad "controlled group" notion implicit in the definition of section 368(a)(2)(H), therefore, should trump the more restrictive "control" requirement of 368(c) on which the "qualified group" definition in the Proposed Regulations is currently based.

It is equally questionable whether Remote Continuity and COBE apply in divisive "D" reorganizations. Section 355 and the regulations apply a separate and distinct continuity regime. Shareholder continuity of interest is required by Treas. Reg. §1.355-2(c)(1); however, this test differs from the continuity of proprietary interest required in most non-divisive

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the doctrine not be applied.

14/ The section 368(a)(2)(H) definition of control differs markedly from the definition of control under section 368(c), on which the "qualified group" definition in the Proposed Regulations is based -- (1) it applies a 50 percent, rather than an 80 percent threshold; (2) it may be satisfied by ownership of this quantum of vote or value of the transferee corporation; and (3) it may be met based on attribution, whereas no attribution principles apply for purposes of section 368(c). *See* Rev. Rul. 56-613, 1956-2 C.B. 212.

15/ Because "D" reorganizations historically have served as a weapon against abusive liquidation-reincorporation transactions, the statutory definition of "D" reorganizations is broad and judicial interpretation of the statutory requirements has generally been flexible.

16/ The Service's attempts to synthesize the continuity requirement with the broad control requirement have been strained. *See, e.g.*, PLR 9111055 (Dec. 19, 1990) (applying family attribution principles to treat the continuity requirement as satisfied in a purported "D" reorganization).

reorganizations.[1/] Section 355(d) forces the distributing corporation to recognize gain if the spin-off shifts a "50-percent interest" to a less than 5-year shareholder or shareholders. In addition, section 355(b) and Treas. Reg. §1.355-3(b) establish a stringent active business requirement test that supersedes the historic business continuity and asset continuity tests of Treas. Reg. §1.368-1(d).

If the elaborate and restrictive section 355 statutory and regulatory requirements are satisfied, there should be no need for a taxpayer also to meet nebulous, judicially-created doctrines such as "remote continuity" and "continuity of business enterprise" under section 368(a)(1)(D). Indeed, application of the Remote Continuity doctrine to divisive "D" reorganizations is inherently inconsistent with the *Morris Trust* doctrine.[1/] Under this case law and the Service's own rulings, a distributing corporation can spin-off a controlled corporation and, pursuant to a plan, the distributing corporation can merge into an unrelated corporation, in which the distributing corporation's shareholders have a less than 80-percent "controlling" interest.[1/] Transfer of all of the distributing corporation's stock or assets (as to which shareholders are required to retain "continuity of interest" under section 355) presumably would violate Remote Continuity if it applied.[1/] Under these authorities, therefore, the doctrine cannot

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17/ Continuity is required on the part of those persons who "directly or indirectly" were shareholders of the corporation. Reg. §1.355-2(c). This "directly or indirectly" language is inherently inconsistent with remote continuity principles that require a direct nexus between the historic target shareholders and the transferred assets. *Cf.* Rev. Rul. 62-138, 1962-2 C.B. 95. Thus, as discussed below, remote continuity principles have generally been ignored in section 355 transactions. *See, e.g., Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

18/ *See Commissioner v. Morris Trust, supra* n.14.

19/ Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Proc 96-30 at Appendix A. Stock of the distributing corporation also can be acquired in a "B" reorganization. The form of merger is restricted to "A" and "B" reorganizations because of the "substantially all" requirement that applies in other reorganizations. *See Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937).

20/ Importantly, at issue is not satisfaction of continuity in the subsequent reorganization but satisfaction of continuity in the initial divisive reorganization. Shareholders are required to retain continuity in the distributing corporation under the regulations. See Reg. §1.355-2(c). Yet in a *Morris Trust* transaction they immediately exchange their stock in the distributing corporation for an interest in another corporation. The Remote Continuity doctrine suggests precisely that the transfer of stock or assets to a different corporation, *however closely related*, destroys continuity. Thus the Remote Continuity issue would be present even on the facts of *Morris Trust*, where shareholders took back more than 50 percent of the acquirer's stock. Nevertheless, the court held that the divisive transaction qualified as a tax-free.

be applicable to a divisive "D" reorganization.[21]

While it may be desirable to clarify that these doctrines do not apply to divisive "D" reorganizations, applying the Proposed Regulations as currently drafted to divisive reorganizations is not the way to achieve this. The Proposed Regulations limit permissible asset transfers to "controlled" corporations. The merger of a distributing corporation into an acquirer in which shareholders of the distributing corporation receive less than an 80 percent interest would be a transfer of assets to a corporation outside the "qualified group". Thus, if applied to *Morris Trust* transactions, the regulations would effectively overrule this court and Service sanctioned doctrine. While we recognize that legislation has been proposed by the Administration (and certain members of Congress) effectively to repeal the *Morris Trust* doctrine, these proposals have not yet been enacted and should not in any event affect the application of the COBE doctrine in divisive "D" reorganizations.

Consequently, we recommend the Service clarify that the Proposed Regulations do not apply to "D" reorganizations, because the Remote Continuity and COBE requirements are not applicable to these reorganizations. If the Service disagrees that these doctrines do not apply under current law, however, it should extend the relief under the Proposed Regulations to non-divisive "D" reorganizations. The Proposed Regulations, as currently drafted, should not be extended to divisive reorganizations in any event, because they would implicitly conflict with long-standing Treasury policy as reflected in the *Morris Trust* doctrine.

The Proposed Regulations also do not apply to "F" reorganizations, which like "D" reorganizations, are not subject to section 368(a)(2)(C). As discussed above, we question whether the remote continuity doctrine has continuing vitality or applies to "F" and "D" reorganizations. Thus, where an "F" reorganization otherwise qualifies, it should not be disqualified by reason of a transfer of assets to a lower-tier entity. In any event, an "F" Reorganization generally will not be combined with a subsequent transaction under the step transaction doctrine.[22] If the Service has a different view on the application of the Remote

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21/ The same issue may arise in successive acquisitive reorganizations pursuant to a plan.

22/ *See* Rev. Rul. 96-29, 1996-24 I.R.B. 5 modifying Rev. Rul. 79-250, 1979-2 C.B. 156. Rev. Rul. 96-29 describes two situations. In the first, a corporation merged into a corporation newly organized in the new state of choice and converted its shares to shares of the new corporation. The new corporation immediately sold shares of its stock to the public and redeemed all the outstanding shares of nonvoting preferred. The second situation involved a manufacturing corporation that was owned by two individuals and

Continuity doctrine to "F" reorganizations, however, the Proposed Regulations should certainly be extended to "F" reorganizations.

4. Transfers To Partnerships.

a. Summary of New Rules

Under the current COBE regulations, the acquiring corporation must either (i) continue the target corporation's historic business (or, where target corporation has more than one line of business, a significant historic line of business) ("Business Continuity") or (ii) use a "significant portion" of target corporation's historic business assets in *a* business ("Asset Continuity"). Satisfaction of these tests depends on the facts and circumstances of a particular transaction. Examples suggest, however, that a line of business constituting one-third of the total value of businesses conducted is "significant" and perhaps, by extension, that one-third of the historic operating assets is a significant portion of the historic assets.[1/] Transfer of the target's historic business assets to a partnership raises difficult issues as to how these rules should be applied to the indirect ownership of assets, or indirect conduct of a business, through a partnership.

The Proposed Regulations provide guidelines for applying the Business and Asset Continuity tests of the current regulations when assets are transferred to a partnership. These guidelines generally adopt an "aggregate" approach to partnerships. The Proposed Regulations address how a partnership business or assets are to be attributed to the transferring corporate partner for purposes of satisfying the current Business or Asset Continuity tests.

For purposes of the Business Continuity test, a corporate partner will be deemed to conduct a target's historic business (conducted primarily through a partnership)

(..continued)
that conducted business through several subsidiaries. This corporation entered into an agreement under which an unrelated target merged into one of its subsidiaries. Shareholders of the target corporation received newly issued preferred shares from the manufacturing corporation for their target shares. To change its place of organization, the manufacturing corporation merged into a newly organized corporation in another state. Shareholders in the manufacturing corporation surrendered their common and preferred shares for identical common and preferred shares in the newly-organized corporation. Rev. Rul. 96-29 specifically precludes stepping together a change of stock ownership with a formally separate reincorporation, implicitly relying on the fact that the reincorporation itself does not result in the change of stock ownership.

[23/] See Treas. Reg. §1.368-1(d)(5), Example 1.

if it (i) performs active and substantial management functions as a partner with regard to the business or (ii) holds a "significant" interest in the partnership.[24] Although the Proposed Regulations state this provision in the disjunctive -- i.e., one test appears to be based solely on corporate partner *activities*, the other on corporate partner *ownership* -- Example 8 seems to indicate that corporate level managerial functions must be coupled with some minimum interest in the partnership.[25] If so, at a minimum we believe this requirement should be explicitly stated (even if the minimum percentage interest will depend on all the facts and circumstances).[26]

For purposes of the Asset Continuity test, the corporate partner will be deemed to own a portion of the underlying partnership assets based on its "interest" in the

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[24] In effect, the first test permits some partial attribution of the underlying partnership business. Presumably, if sufficient functions of the historic business are conducted at the corporate partner level without regard to the partnership's activities, the Business Continuity test could be satisfied under current law. Where the historic business is primarily conducted by the partnership using its employees and assets, the corporate partner is deemed to conduct that business if the corporate partner's own officers and employees supervise and direct these activities and provide sufficient managerial direction. Cf. Rev. Rul. 92-17, 1992-1 C.B. 142. The second test will simply attribute the underlying business to a corporate partner whose interest is sufficiently significant. Cf. Rev. Ruls. 85-197 and 85-198, 1985-2 C.B. 120. The fact that either of these tests is met will not obviate the need to determine under the current regulations whether the partnerships activities rise to the level of conducting the target's historic business. For example, if the partnership were to continue to conduct only one of the target's three historic lines of business, it would still be necessary to show that this line of business is "significant" under the current regulations. Similarly, the fact that the corporate partner has a "significant interest" in a partnership conducting the business conducted most recently by the target will be unavailing if that business is not the target's "historic" business under the current rules.

[25] Example 8 indicates that active and substantial management functions coupled with a 20 percent interest satisfies the continuity of business enterprise requirement. Presumably, the inclusion of the fact that the partner owned a 20 percent interest is not accidental. See also Treasury Official Says Retroactive Election For COSI and COBE Regs Unlikely, 97 Tax Notes Today 91-31 Document 97-12944 (reporting remarks of Associate Tax Legislative Counsel Rooney apparently confirming that this 20 percent interest may be a requirement).

[26] The current statement in Prop. Reg. §1.368-1(d)(5)(v)(C), that satisfaction of these tests alone is not enough, is cryptic and ambiguous. It could be interpreted as requiring some continuing *ownership* of underlying partnership assets. However, since it applies equally to the "significant interest" test, it could more plausibly be read to clarify that the business conducted by the partnership must meet the Business Continuity test in its own right. For example, if the partnership continues only one historic line of business that line must be "significant" under the current rules. Thus taxpayers reading the current language could quite reasonably assume that no minimum interest is required and that a one percent general partnership interest coupled with substantial management functions at the corporate partner level suffices.

partnership. Thus, for example, if the historic business assets are transferred to and held by a partnership in which the transferor has a 33 percent interest, the corporate transferor will be treated as owning 33 percent of the historic assets for purposes of the Asset Continuity test. Asset Continuity requires more than mere ownership, however. It requires that the historic assets be *used in a business*, albeit a business different than the target's historic business. The Proposed Regulations therefore state that the corporate partner will be deemed to be engaged in "a PRS" partnership business if it meets either of the tests applicable to Business Continuity with respect to the partnership.[1/]

In effect, one or the other of the "active and substantial management" or "significant interest" tests must be met to satisfy not only Business Continuity but also Asset Continuity.[1/] Asset Continuity will therefore be relevant only if the underlying business conducted by the partnership is not the target's historic business. In that event, the partner will be deemed to own its proportionate share of the historic assets owned by the partnership. This proportionate share must itself constitute a "significant portion" of the historic assets under the current regulations.[1/]

b. Nature of partnership interest.

27/ This requirement assumes the partner could not use indirectly owned assets in its *own* business. For example, acquirer may acquire target's hotel business and simply contribute all of the historic land and buildings to a partnership in which it is a 80 percent partner. If it leases the buildings from the partnership and uses them as part of its own hotel business, COBE should be satisfied even though there may be no underlying partnership-level "PRS business" to be attributed to the corporate partner.

28/ It is unclear why the "active and substantial management" test will ever be relevant for purposes of Asset Continuity. If the partner has a "significant" (more than 33 percent) interest, it will be deemed to be engaged in a partnership business and will also own a "significant portion" of the underlying historic assets. Where it owns a less than "significant" interest (and must rely on active and substantial management to be engaged in a partnership business) its proportionate interest in the underlying historic assets is unlikely to be a "significant portion" as required by the current regulations, unless the word "significant" means different things in different places in the COBE regulations.

29/ Presumably, ownership of a significant interest in the partnership does not guarantee satisfaction of COBE because the partnership may not continue the target's historic business and may itself dispose of a portion of the historic assets. A significant interest in less than all the historic assets may or may not be a "significant portion" in the aggregate. Similarly, for example, if an acquiring corporation disposed of two of three equal size target businesses, the Committee would not consider a one third interest in a partnership which conducts the one remaining business to be sufficient to satisfy the requirements.

As discussed above, the application of the Proposed continuity of business enterprise regulations where assets are transferred to a partnership generally will require a determination of the corporate transferor's "interest" in the partnership. The Proposed Regulations do not explain how the magnitude of an interest in a partnership should be determined, but stress in the Preamble that this is a facts and circumstances determination. The transfer of assets acquired in a reorganization to a partnership should occur most often in the context of the formation of an operating joint venture. The interest received in a venture frequently will not involve complex special allocations of partnership items. As drafted, therefore, the Proposed Regulations should provide adequate guidance in most business situations in which the issue will arise.

Because of the flexibility offered by Subchapter K, however, there are likely to be numerous arrangements that involve more complex allocations that will make determination of the corporate partner's "interest" more difficult. A corporate partner may, for example, receive a proportionate interest in profits and losses that differs from its capital interest, a "carried interest," a proportionate interest in profits that differs from its proportionate share of losses in a given year, or an interest that includes special allocations of partnership items that could have the effect of shifting economic consequences of ownership of the assets away from or to the contributing partner.

Definitive rules for quantifying a corporate partner's partnership interest in this context are likely to be inordinately complex. The Committee therefore generally supports the facts and circumstances approach of the Proposed Regulations.[1] Without a well-defined expression of the policy goals behind the continuity of business enterprise requirement, however, it may not be possible to determine which facts and what circumstances are significant, making it difficult or impossible to predict whether an interest in the partnership is "significant," or what portion of the underlying assets should be treated as owned by a partner.

As the goal of the Proposed Regulations presumably is to minimize uncertainty in this area, we believe it would be helpful at least to provide certainty as to the magnitude of interest that is sufficient in cases not involving "exotic" partnership interests. The Committee therefore recommends the Proposed Regulations establish an express regulatory safe

[30] The approach is consistent with the approach in similar situations elsewhere in the regulations. *See, e.g.*, Treas. Reg. § 1.367(a)-1T(c)(3)(ii) (defining a partner's "proportionate share" of partnership assets by reference to the rules and principles of sections 701 through 761).

harbor indicating that a 33 and one-third or greater interest in both profits and capital will be deemed to be "significant" but that lesser percentages or more complex interests may be significant depending on all the facts and circumstances.

c. *Active management by corporate partner.*

The Proposed Regulations provide that COBE may be satisfied if the corporate partner "has active and substantial management functions as a partner" with respect to the partnership business. The regulations provide no guidance regarding what constitutes "active and substantial" management functions. Example 8 suggests these functions include (1) decision-making regarding significant business decisions, and (2) regular participation in the overall supervision, direction and control of employees. The Preamble suggests that this test was derived from that set forth in Revenue Ruling 92-17.[31/]

The Committee believes additional guidance regarding the types of activities constituting "active and substantial" management functions would be helpful. As it may be difficult to define "active and substantial" management, the guidance could take the form of further examples.

As discussed above, the regulations should clarify the relationship between the test and the cryptic language in Prop. Reg. Section 1.368-1(d)(5)(v)(C) to the effect that satisfaction of the test, alone, is not sufficient. If a minimum partnership interest is required in addition to "active and substantial" management, this should be spelled out clearly in the regulations and not merely implied by Example 8 and the general "facts and circumstances" approach of the regulation.

Further, as the "active and substantial management" test is irrelevant if the partner also owns a more than 33 percent interest in the partnership,[32/] adopting a minimum 20 percent interest requirement would limit the relevance of the "active management" test to situations where the partner owned between 20 and 33 percent of the partnership. The Committee considers this unnecessarily restrictive and believes that a lower percentage interest combined with more significant corporate-level activity could also meet the test. We recommend instead that the 20 percent interest be adopted as a regulatory safe- harbor threshold.

31/ 1992-1 C.B. 142.

32/ The test would be irrelevant because the interest would be "significant" and would meet the Business Continuity or Asset Continuity test without regard to the corporate partner's managerial activities.

Thus, the regulations should specify that a 20 percent interest in profits and capital combined with "active and substantial management" will meet the Business Continuity test.[1/]

d. Indirectly owned partnerships.

The proposed regulations do not address whether the target assets may be transferred to a lower-tier partnership. The regulations discuss the corporate partner's "interest" without specifying whether this interest must be direct. For certain tests -- such as the "active and substantial management" test -- a direct/indirect interest distinction should be irrelevant. For other tests that look to the corporate partner's interest in the partnership, however, the distinction may be important. The examples should deal with transfers to indirectly owned partnerships.

The Committee believes transfers to lower-tier partnerships should be permitted if the transaction otherwise meets the Proposed Regulation requirements and there are valid non-tax reasons for transferring assets to a tiered partnership. Permitting multiple transfers is consistent with the "aggregate" approach of the regulations, which ignore the separate entity status of partnerships.[1/] The relevant question is whether the corporate partner has retained a sufficient economic interest in the underlying assets. Because the Proposed Regulations adopt a facts and circumstances test, rather than a bright line threshold, in measuring interests in the partnership, the rules should apply to an indirect interest without the need for modification in most circumstances. The final regulations should clarify that the corporate partner's interest may be direct or indirect, provided it otherwise satisfies the requirements of the regulations.

To the extent a particular threshold (such as a 33 percent interest) is created by the Proposed Regulation for an interest to be significant, a corporate partner should

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[33/] Example 8, should therefore state that satisfaction of COBE is based on satisfaction of this safe-harbor (along with active and substantial management functions) but that ownership of a lower percentage interest in the partnership might also satisfy the test based on all the facts and circumstances including the degree and extent of managerial activity at the corporate partner level.

[34/] The Service's objection in earlier pronouncements to contributions of target assets to partnerships was that a partnership cannot be a "party to the reorganization." The Service reasoned that a partnership that receives all of the target assets as part of the plan of reorganization, must be treated under the step transaction doctrine as the direct transferee. *See, e.g.*, G.C.M. 35117 (Nov. 15, 1972); and G.C.M. 39150 (Mar. 1, 1984). The Proposed Regulations resolve this issue by adopting an aggregate theory of partnerships and treating the underlying assets as owned by the partners.

be treated as having satisfied this threshold based on its indirect interest in the partnership that ultimately receives the assets. A contrary rule would be inconsistent with the aggregate approach to partnerships adopted in the Proposed Regulations.[35]

The proposed regulations do not address situations where interests in a partnership are owned by more than one member of a Qualified Group. Given the general principle that sufficient control of the assets exists with respect to any member of the Qualified Group, and given the aggregate theory of partnerships adopted in the Proposed Regulations, it would seem appropriate to examine the nature and extent of the partnership interests held by the Qualified Group as a whole. Accordingly, for purposes of determining the corporate transferor's interest in the transferee partnership, the Committee believes that interests held by all members of the Qualified Group in the transferee partnership should be aggregated and attributed to the corporate transferor.

35/ The Committee recognizes there are circumstances in which this aggregate approach may be difficult to reconcile with the definition of a Qualified Group, which adopts a strict entity approach. For example, assume there are successive transfers of assets to 80%-owned subsidiaries, culminating in a transfer to a partnership in which the group's corporate partner has a 34 percent interest. Because there is no attribution for purpose of the section 368(c) test for control, a Qualified Group is determined by reference to the interest of the corporation at each respective level in the chain of ownership. Accordingly, by permitting transfers within a Qualified Group without limitation, the Proposed Regulations may permit successive transfers that significantly dilute the acquiring corporation's interest in the transferred assets. Although the economic interest of the acquiring corporation in the underlying partnership assets may be lower than would be acceptable under a pure aggregate approach, the dilution of the acquirer's interest in the assets is of a type permitted by the regulations. Accordingly, the significance of the "interest" should be tested without regard to dilution resulting from the structure of the corporate Qualified Group. That is, the actual corporate partner's interest, rather than the common parent's interest, should be measured.

e. *Transfers of stock to partnerships.*

The preamble to the proposed regulations states that they do not permit the transfer of stock (as opposed to assets) to a partnership if the Code imposes a "control" requirement.[1/]

We believe the Proposed Regulations reflect a decision not to recharacterize a transaction where there is no abuse of the reorganization provisions and the transaction is consistent with business realities. This approach avoids the troubling application of "substance over form" principles to reorder the formal steps in a transaction in a way that causes it to fail a technical statutory requirement. We see no reason why the same logic should not apply when stock is transferred to a partnership.

The application of a "control" requirement does, however, raise difficult issues. Thus, if the fiction of legal personality is ignored, the corporate transferor of stock within the Qualified Group will retain control in the sense that it may effectively direct how the stock is voted. This may not be the case when stock is transferred to a partnership even if the "proportionate interest" of the transferor is significant. For example, the corporate partner that holds a 95 percent limited partnership interest in a partnership may divest itself of voting control by transferring stock to the partnership, if operational control is exercised by the general partner and governed by the partnership agreement. Therefore, while the continued distinction between stock and asset transfers exalts form over substance and may ultimately need to be addressed, we concur with the Service's decision not to address these issues now in the interest of finalizing the regulations expeditiously.

[36/] Of the statutory descriptions of the various forms of reorganization, a number have a "control" requirement. For example, a "B" reorganizations is described as a transaction in which the acquirer acquires the target corporation solely for voting stock and has control of the target immediately after the acquisition; an "(a)(2)(D)" reorganization is described as a transaction in which the target assets are acquired in exchange for stock of a corporation which is in "control" of the acquiring corporation. As for most other purposes of section 368, control is defined in section 368(c) (primarily by reference to voting power).

The issue whether control requirements are satisfied when stock of a "controlled" corporation is immediately transferred to another entity has been considered in a number of different contexts. For example, under section 351 it may be unclear whether assets have been transferred to a corporation that the transferors control immediately thereafter if as part of the same plan, the stock of that corporation is disposed of. Generally, unless there is a *binding commitment* to make the transfer, the control requirement is satisfied. *See American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948); *Intermountain Lumber Co.*, 65 T.C. 1025 (1976).

5. *Miscellaneous Issues.*

a. *Application of Section 381.*

The Proposed Regulations request comments on whether the regulations under section 381 will need to be revised to reflect the proposed changes.

Section 381 was enacted to resolve uncertainties under prior law regarding the carryover of tax attributes to the acquiring corporation in a reorganization.[1/] It generally provides that in "A," "C," non-divisive "D," "E" and "F" reorganizations, the acquiring corporation succeeds to the target's tax attributes and items enumerated in section 381(c). Although section 381 applies to transfers of assets that occur as part of a reorganization under section 368, section 381 currently does not apply to transfers of assets under section 351.

The regulations under section 381 already address the treatment of triangular reorganizations in detail, providing that there may only be one "acquiring corporation" for purposes of section 381 -- that is, only one corporation will be entitled (or required) to inherit the transferor's tax attributes and items.[1/] In general, the acquiring corporation will be (1) a corporation that ultimately acquires all of the assets of the transferor in the reorganization or (2) if no single corporation acquires all of the assets, the corporation that initially acquires the assets.[1/]

To the extent all of the assets are transferred to a third- or lower-tier entity, however, the treatment of the transaction under section 381 may be unclear. Section 381 contemplates that the assets are transferred "as part of the reorganization." As discussed below, the Proposed Regulations merely clarify that an otherwise qualifying reorganization will not be disqualified by asset- or stock transfers under the remote continuity or COBE doctrines, but do not otherwise alter the reorganization rules. (For example, they do not change the rule

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37/ *See, e.g., New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

38/ Treas. Reg. §1.381(a)-1(b)(2).

39/ Thus, in a fairly simple triangular merger, the acquiring corporation generally is the entity that receives all of the operating business assets of the transferor. However, where assets are divided among the initial acquirer and its subsidiaries, the initial acquirer is deemed to inherit the transferor's attributes. In that case, section 381 does not apply to the asset transfers to the various subsidiaries which, for example, are not required to adopt the target corporation's inventory accounting method. Treas. Reg. §1.381(a)-1(b)(3).

against issuing "grandfather" stock). Thus, the transfer to a third- or lower-tier entity may be a separate transaction under section 351 rather than an integral part of the reorganization and the assets will not be acquired as "part of" the reorganization. In these circumstances, the initial acquirer may inherit the target attributes. Similarly, if the operating assets are transferred to a partnership, the initial acquirer rather than the entity that actually holds the target's operating assets may inherit the target's attributes.[40/] Thus, corporate attributes may be separated from the associated operating assets.

It could be argued that the section 381 regulations should be revised to reflect the ability of the corporate acquirer to transfer substantially all of the target's assets to a partnership or corporation under the Proposed Regulations. However, the discontinuity under section 381 between reorganizations under section 368 and asset transfers under section 351 or section 721 is inherent in the existing rules. *See, e.g.*, Rev. Rul. 64-73, *supra.* We believe that any policy concerns should be addressed as part of a separate project, rather than as part of the finalization of the Proposed Regulations.

[40/] Cf. Treas. Reg. §1.381(a)-1(b)(3)(ii).

b. Proposed regulations limited to continuity.

The Proposed Regulations limit their scope to continuity of proprietary interest and continuity of business enterprise issues, stating that they do not otherwise change current law, for example, by permitting the direct issuance of "grandfather" stock in a reorganization. As a policy matter, continuing the distinction between asset dropdowns and triangular reorganizations involving grandfather stock (and between asset and stock dropdowns, discussed above) elevates form over substance. Conforming this treatment may, however, raise issues that go beyond remote continuity and business continuity -- in particular, this will raise issues regarding the statutory authority for such a reorganization requirement. While the Committee believes these issues will ultimately have to be addressed, it concurs with the Service's decision to focus on common business transactions that most frequently present problems that do not raise these more difficult issues.

c. Cause to be directed transactions.

The Committee supports the Service's long-standing position that a transfer of target assets made directly to a lower-tier entity at the acquirer's direction is treated as an acquisition of the assets by the acquirer and dropdown to the lower-tier entity if the acquirer has "dominion and control" of the assets (so-called "Cause to be Directed" transactions). See Rev. Rul. 70-224, 1970-1 C.B. 79, Rev. Rul. 64-73, 1964-1 (Part 1) C.B. 142, and GCM 30887 (Supp.) (in which Rev. Rul. 64-73 was considered).

In Rev. Rul. 70-224, the Service ruled that a transaction qualified as a reorganization within the meaning of section 368(a)(1)(C) and section 368(a)(2)(C) when the acquiring corporation caused the assets of target corporation to be transferred directly to a corporation controlled by acquiring, rather than being transferred through the acquiring corporation to the controlled corporation. In reaching this conclusion, the Service explained that, as of the effective time of the reorganization, the acquiring corporation had "dominion and control" of target corporation's assets, and therefore the acquiring corporation was deemed to have received the target corporation's assets and transferred them to its controlled corporation.

In Rev. Rul. 64-73, the Service ruled that a transaction qualified as a reorganization within the meaning of section 368(a)(1)(C) where the acquiring corporation caused some of the assets of target corporation to be transferred directly from target corporation to a wholly-owned subsidiary of a corporation controlled by the acquiring corporation. According to GCM 30887 (Supp.), the Service reached the conclusion in Rev. Rul. 64-73 by recharacterizing the transaction as if two separate steps were executed: (1) acquiring corporation acquired "substantially all" of target corporation's assets, as required by section 368(a)(1)(C) and (2) acquiring corporation transferred target corporation's assets to a wholly-owned subsidiary of a corporation controlled by the acquiring corporation in a series of transactions governed by section 351. The Service did not require the transaction to be analyzed under the control requirements of section 368(a)(2)(C) because the Service viewed section 368(a)(2)(C) as "a *nonexclusive* Congressional renunciation of the *Groman-Bashford* doctrine in C reorganizations." (Emphasis added).

The Committee believes that taxpayers should not be compelled formally to transfer target corporation stock or assets through each of the acquiring corporation and its intervening subsidiaries under state law to qualify the transaction as a reorganization. In some cases, regulatory restrictions will preclude this form; in others, this will generate multiple levels of state transfer taxes and unnecessary fees from recording (and rerecording) title of the transferred target stock or assets. Cause to be Directed Transactions avoid these problems without violating the letter or spirit of the Proposed Regulation. Favorable treatment for federal tax purposes under the regulations should not be conditioned on the acquirer's willingness to absorb duplicative state taxes.

The Committee concurs in the Service's conclusion that a partnership should be treated as an aggregate of its partners, and not as an entity separate from its partners, in analyzing a transaction with respect to continuity of interest. The analysis of Cause to be Directed Transactions should be the same regardless of whether the ultimate transferee entity is a subsidiary corporation or a partnership to which stock or assets are permitted to be transferred under the Proposed Regulations.[1/] Federal tax treatment generally does not, and should not, turn on state law formalities regarding the transfer of title but on dominion and control over the transferred assets.

The Committee asks that when the Proposed Regulations are finalized, they clarify, in the preamble or otherwise, that they are not intended to alter or affect the treatment of Cause to be Directed Transactions under current law.

[41/] Cf. PLR 9106037 (ruling that a section 351 exchange occurred where corporate transferor transferred assets, at the direction of corporate acquirer, to a trust, which was 99.9% beneficially owned by a partnership).

d. *Definition of acquiring corporation.*

In the context of "C" reorganizations, it may be unclear whether the "solely for voting stock" requirement has been met if liabilities of the target are assumed by a corporation other than the nominal acquirer.[1/] Section 368(a)(1)(C), which requires that the exchange be "solely for voting stock," provides that the assumption of liabilities by the *acquiring* corporation does not cause this requirement not to be met. The Service, however, has adopted the position that there may be only one acquiring corporation for this purpose. Accordingly, when target assets subject to liabilities are divided within the group, that division arguably may disqualify the entire reorganization.[1/]

As this issue does not directly involve remote continuity of interest or business enterprise it is arguably beyond the scope of the Proposed Regulations. As discussed above, the Committee generally supports the Service's decision to limit the scope of the regulations in the interests of providing guidance as expeditiously as possible. On the other hand, this particular problem is closely related to the types of issues presented by triangular reorganizations.[1/] As the Service has itself recognized, the rationale in Revenue Ruling 70-107 is questionable and there appears to be no tax policy reason for the position adopted by the Service.[1/] Notwithstanding the caveats in the Preamble, the permissive approach of the Proposed

[42/] Early case law held that the assumption of liabilities in a reorganization was boot -- *i.e.*, equivalent to cash. *See U.S. v. Hendler*, 303 U.S. 564 (1938). Congress generally addressed this issue from the perspective of the target and its shareholders in section 357.

[43/] *See* Rev. Rul. 70-107, 1970-1 C.B. 78. In that ruling, the parent in a triangular reorganization assumed part of the target's debts. The Service held that the subsidiary was the acquiring corporation and therefore debts assumed by the parent were boot for purposes of the "solely for voting stock" rule. This rule does not apply, however, in other types of reorganizations that lack this statutory language of section 368(a)(1)(C). *See* Rev. Rul. 73-257, 1973-1 C.B. 189 (no boot, provided corporation assuming the debt is a party to the reorganization). In Rev. Rul. 70-224, 1970-1 C.B. 74, the Service held that directing all of the assets to be transferred to a subsidiary did not prevent the parent from being the acquiring corporation. Therefore, its assumption of part of the debt did not invalidate the transaction, which was treated as a merger into the parent followed by a separate section 351 transfer of substantially all the assets to a subsidiary. The Service has itself suggested that Rev. Rul. 70-107 was wrongly decided and should be revoked. See G.C.M. 39102 (Dec. 21, 1983).

[44/] In effect, this issue goes to the ability to transfer liabilities (as opposed to assets) within the group. While distinct as a theoretical matter, as a business matter it may be impossible to transfer assets separately from associated liabilities.

[45/] *See* G.C.M. 39102, *supra*.

Regulations may mislead taxpayers into assuming that asset transfers will not threaten reorganizations that otherwise qualify. This creates a real risk of technical foot-faults by taxpayers if the transferred assets are subject to liabilities. Therefore, the Committee urges the Treasury Department to clarify this issue as part of, or in conjunction with, the finalization of the Proposed Regulations.

6. *Effective Date*

The Committee has considered whether the regulations should be effective retroactively for transactions completed on or after the date of proposal. As the regulations merely adopt a more restrained government application of a judicially-created doctrine, it is arguably appropriate to apply this interpretation to earlier transactions that might otherwise have been adversely affected by the doctrine. Transactions may, however, have been structured and priced on the assumption that they would (or would not) be tax free.

The Committee believes that retroactive relief is less important than prompt finalization of the regulations. Therefore, the Committee recommends that the regulations be finalized promptly with their current prospective effective date. If the Proposed Regulations are finalized with a prospective effective date, however, the Service should reconsider the portion of the effective date rule that would apply the old rules to transactions occurring after the effective date pursuant to a binding written agreement entered into before that date. We believe most taxpayers will prefer to be governed by the new rules; the "binding agreement" rule will merely put pressure on practitioners and the Service to resolve issues such as whether a modification to or contingency in the agreement excludes the agreement from this rule. Therefore, the "binding agreement" provision either should be eliminated and the new rules applied to all transactions closing after the effective date or parties with the power to cancel contracts should be given the right to elect the application of the new rules.

Conclusion

While there are a few areas in which they might be modified, overall, the Proposed Regulations represent a significant improvement over the Service's previous approach to these issues. The Committee commends the Service for adopting a clear, administrable set of rules founded on the statutory language of section 368 and consonant with modern business realities. Sharply reduced reliance on arcane doctrines like Remote Continuity can only improve the transparency and efficient administration of the tax system.

\# 909

New York State Bar Association

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NYSBA

August 7, 1997

TO: Executive Committee

FROM: Richard O. Loengard, Jr.

Enclosed is a revised version of a report sent to you on July 24th on the proposed regulations relating to continuity of business enterprise and "remote continuity" doctrines. We now realize that in converting this report between software systems, the footnotes in the text, but not at the bottom of the page, lost their numbering. In addition, in one or two cases, the text stopped in the middle of the page and then began again on the next page.

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Report of the New York State Bar Association (Tax Section)on the Proposed Regulations Addressing The Remote Continuity and Continuity of Business Enterprise Doctrines

This Report[1] of the Committee on Reorganizations of the Tax Section of the New York State Bar Association comments on proposed regulations issued on January 3, 1997 that substantially revise the so-called "Remote Continuity of Interest" ("Remote Continuity") and "Continuity of Business Enterprise" ("COBE") doctrines as set forth in Treasury Regulations §1.368-1(b),(d), (f) and -2(f) (the "Proposed Regulations"). The Proposed Regulations eliminate certain restraints on post-reorganization stock or asset transfers that impede ordinary corporate reorganization transactions intended to be tax-free under section 368.[2] Given contemporary corporate structures, the Remote Continuity and COBE doctrines have often been traps for the unwary when corporations have sought to redeploy assets efficiently to one or more group members.

The Proposed Regulations were considered by the Committee together with additional Proposed Regulations under Treas. Reg. §1.368-1 and -2 issued on December 20, 1996, that redefine the Service's position as to the continuity of shareholder interest ("COSI") required to maintain qualification of a transaction as a tax-free reorganization within the meaning of section 368. In this Report, the Committee assumes the Proposed COSI Regulations will be adopted in substantially the form proposed. The COSI doctrine and the Remote Continuity and COBE doctrines derive from one root concern, namely, that a reorganization be a mere modification of shareholder interest in an ongoing corporate business. The COSI doctrine requires that selling shareholders receive a sufficient equity interest in the

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[1] The principal drafters of this report were Dale Ponikvar, Andrew Walker and Gayle Sered. Helpful comments were received from Robert Jacobs, Richard Loengard, Jr., Eric Solomon and Lewis Steinberg. Additional Members of the Committee who participated in the preparation of this report were Steve Goldbaum, Bertram Kessler, Annaliese Kambour, Aliza Levine, Jay Milkes, Robert Rothman, and Linda Swartz.

[2] All references are to sections of the Internal Revenue Code of 1986 (the "Code").

transferee corporation. The Remote Continuity and COBE doctrines ensure that the equity interest issued to the selling shareholders is in an entity that itself retains an adequate interest in the transferred stock or assets, so that equity interests issued to satisfy the COSI requirement in fact represent a continuing interest in the transferred property.

The substantial restriction in the Proposed COSI Regulations on the Service's previous application of the COSI rules logically lead to a limitation of the scope of Remote Continuity and COBE doctrines. Taken together, the two regulation projects will base tax-free reorganization treatment principally on the statutory terms of section 368 and lessen dramatically the emphasis on the Service's prior, expansive interpretation of the judicially-created continuity doctrines.

The Committee welcomes this development because it will provide taxpayers, the Service and the Courts greater certainty in determining when a transaction qualifies as a tax-free reorganization. Given the Service's expanded no-rulings policy as to most "plain vanilla" reorganizations, it is now more important that taxpayers have a set of reorganization rules that are as clear as possible in their meaning.

The COSI doctrine as properly interpreted, we think, in the Proposed COSI Regulations, focuses upon the nature of the consideration issued and conformity of the transaction structure adopted with the express terms of Section 368(a). The Proposed COSI Regulations substantially eliminate the subjective elements of taxpayer purpose and intent that have previously accompanied that doctrine. The Proposed Regulations appropriately will also eliminate, in cases to which they apply, a subjective analysis of a transferee corporation's intention towards the disposition or use of assets or stock it acquires in a reorganization. The Proposed Regulations will dramatically reduce acquirer concern about deploying acquired stock or assets in the most business efficient manner within the acquirer group. The Service generally will also be relieved of the administrative burden of attempting to determine whether post-reorganization transactions should be "integrated" with a reorganization and disqualify its tax-free status.

The Proposed Regulations represent a significant advance in the Service's approach to these issues, for which it is to be commended. We urge the prompt finalization of the Proposed Regulations and encourage the Service to consider our recommendations in the areas as to which the Service has asked for comments.

Summary of Responses to Requested Comments.

1. Definition of "Qualified Group".

The Report suggests a definition of "qualified group" be adopted that more closely reflects the realities of business control of subsidiary entities than does section 368(c). We recommend adoption of a definition based on section 1504(a) (without the carve-outs enumerated in section 1504(b)). At a minimum, the Service has adequate authority under section 1502 to draft regulations to permit transfers within a group filing consolidated returns, regardless of whether members of the group are "controlled" within the meaning of section 368(c).

2. Extension of Proposed Regulations to "D" and "F" Reorganizations.

The extent to which Remote Continuity has continuing vitality is questionable and the application of this and the COBE doctrine to "D" and "F" reorganizations (and recapitalization "E" reorganizations) is particularly questionable. The Committee recommends the Service either clarify that these doctrines do not apply to "D", "E" and "F" reorganizations or, should the Service have a different view, extend the Proposed Regulations to cover non-divisive "D" and "F" reorganizations but not divisive "D" reorganizations.

3. *Transfers to Partnerships*

The Report recommends that the rules regarding transfers to partnerships be clarified as they are somewhat difficult to understand as currently drafted. While the Committee generally supports a "facts and circumstances" approach, additional guidance regarding when a partnership interest is "significant" and the application of the "active management" test also would be helpful and should include a regulatory safe-harbor. The rules should expressly permit transfers to tiered partnerships or successive transfers to partnerships if the requirements are otherwise satisfied.

4. *Miscellaneous Issues*

a. *Section 381.*

It may be unclear from the current section 381 Regulations which corporation in a Qualified Group will inherit the target corporation's tax attributes following post-reorganization transfers under the Proposed Regulations. The uncertainty, however, is present under current law and inherent in the distinction drawn under section 381 between transfers under section 351 and other tax-free transfers. The Committee therefore believes any concerns regarding the application of section 381 should be addressed as part of a separate project.

b. *Scope of Triangular Reorganizations.*

The Committee concurs with the decision of the Proposed Regulations' drafters not to expand the scope of triangular reorganizations at this juncture to include, for example, an acquisition of T stock or assets in exchange for stock of the acquiring corporation's "grandparent."

c. Cause to be Directed Transactions

Current law treats transfers of the target corporation's stock or assets directly to the acquirer's direct or indirect subsidiary as a transfer to the acquirer followed by a dropdown transaction if the transfer is directed by the acquirer and the acquirer has dominion and control over the transferred assets. When finalized, the Proposed Regulations should clarify that they are not intended to affect the treatment of such transactions under current law.

d. Revenue Ruling 70-107.

Revenue Ruling 70-107 may treat as boot transfers of liabilities accompanying asset transfers that appear to meet the requirements of the Proposed Regulations in certain "C" reorganizations. The Committee supports overruling Revenue Ruling 70-107 and believes the Proposed Regulations offer an opportunity to do so.

5. Effective Date

As considering retroactive application may delay finalization of the regulations, the Committee suggests the regulations be finalized promptly with a prospective effective date. However, the Service should reconsider the portion of the effective date provision that would make the old rules applicable to transactions that close after the effective date pursuant to a binding written agreement entered into before that date.

Detailed Comments.

1. *Origins of Remote Continuity.*

The genesis of the "remote continuity of interest" doctrine is generally considered to be two Supreme Court cases, Groman v. Commissioner, 302 U.S. 82 (1937) and Helvering v. Bashford, 302 U.S. 454 (1938). The holding in both cases, however, is considerably narrower than, and often contrary to, the principles for which they have come to stand; namely, that a transfer by an acquiring corporation of assets acquired in a reorganization to a subsidiary, or the use by a subsidiary of stock of a higher-tier corporation to acquire the assets or stock of the target cannot satisfy the continuity of interest requirement absent a special statutory dispensation.

In Groman, a parent corporation formed a subsidiary which acquired all of the stock of a target corporation, which target the subsidiary promptly liquidated. In the reorganization, the target shareholders received cash, parent preferred stock and subsidiary preferred stock. The government argued successfully that the parent stock was "boot" because the parent was not a "party" to the reorganization and the Court held in its favor. The government conceded, however, that the transaction qualified as a reorganization.

The frequently cited "remote continuity" analysis is found in the final paragraph of the Groman opinion, in which the Court responded to the taxpayer's argument that the subsidiary should be disregarded as a mere *alter ego* of the parent. It was in rejecting this *alter ego* argument that the Court briefly discussed the relationship between the target shareholders and target assets that is required in a reorganization. This paragraph of the opinion addresses a narrow question -- whether parent stock may be deemed to be subsidiary stock by disregarding the separate corporate forms. The Court held that it could not.

Having held already that the subsidiary was the acquiring "party," however, this analysis arguably was dictum. Also notable is the fact that the term "remote continuity" is nowhere to be found and indeed there is no express discussion of "remoteness" at all.

In Bashford, the acquiring parent formed a subsidiary and contributed to it cash and shares of the parent's common and preferred stock. Stock of three unrelated corporations was then transferred to the subsidiary by target shareholders and the target corporations were liquidated into the subsidiary.[3] The subsidiary issued cash, its own common stock, and common and preferred stock of the parent to the target shareholders. Immediately thereafter, the parent owned all of the subsidiary's preferred stock and 57 percent of its common stock. See Commissioner v. Bashford, 87 F.2d 827 (3d Cir. 1937). Following its Groman decision, the Court held that the parent's activities did not make it a party to the reorganization and its stock, accordingly, was held to be boot. The Court did, as in Groman, treat the transaction as a tax-free reorganization with boot.

Both cases involved complicated and unusual facts far removed from the type of triangular reorganization that Congress

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[3] The Court's opinion implies the stock (or assets) may have been acquired directly by the parent and retransferred immediately to the subsidiary pursuant to the plan of reorganization, which is somewhat misleading. In fact, the target stock was acquired by promoters of the subsidiary who were agents engaged by the parent to conduct negotiations and secure agreement without disclosing the parent company's identity. As agents of the parent, arguably the parent acquired the stock, which presumably was the point raised by the taxpayer. For tax purposes, however, these promoters were merely conduits and the Court viewed the stock as having been transferred directly to the subsidiary. In any event, the transaction was not, as suggested in the preamble, an acquisition of assets by the parent and dropdown of the assets to the subsidiary as the consideration was issued directly by the acquiring subsidiary which had been capitalized with the necessary parent stock. See generally Bashford v. Commissioner, 33 B.T.A. 10 (1935).

subsequently approved in sections 368(a)(2)(C), (D) and (E). In today's terms, the transactions were designed to qualify as triangular "B" reorganizations or, perhaps, "C" reorganizations.[4] Both transactions involved "bifurcated" consideration -- *i.e.*, stock of both the parent and subsidiary was issued.[5] Today this mix of split consideration would disqualify both transactions from tax free reorganization status if executed as a forward triangular merger, and, if executed as a reverse triangular merger, at least cause parent company stock to be taxed as boot. See section 368(a)(2)(D) (prohibiting use of any acquiring subsidiary stock and section 368(a)(2)(E) (requiring that at least "control" of target be paid for with "controlling" corporation voting stock). Indeed, the acquiring subsidiary in Bashford would not even be part of the "qualified group" under the proposed COBE regulations because the parent owned only 57 percent of its common stock.

Subsequent Congressional enactment of sections 368(a)(2)(D) and (E), blessing triangular reorganizations with no or little-split consideration, should be viewed as an attempt to confine these cases to their proper facts. As with other judicial doctrines in the reorganization area, "remote continuity" is largely a creation of the government and certain lower courts, which have pushed the rationale of a single, cryptic reference to "continuity" in Groman to its limits. Indeed, the premise of the original "remote continuity" doctrine as generally articulated (but never by the Court) has been flawed from its inception. If the assets of a corporation acquired in a merger transaction are dropped down to a wholly-owned subsidiary, the doctrine held continuity was lost because an additional corporate shell now separated the acquired corporation's assets from its former shareholders. Yet, an acquisition can qualify as a tax free reorganization under section 368(a)(1)(B) even though

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[4] The prompt liquidation of the acquired targets into the acquiring subsidiary probably would be treated as asset- rather than stock transfers. See Rev. Rul. 67-274, 1967-2 C.B. 141.

in every such case the acquired corporation's shareholders are separated by the acquisition from the acquired corporation's assets by an additional corporate shell. Congress' addition of section 368(a)(2)(C) does not eliminate this flaw in the popular elaboration of the remote continuity doctrine, because it continues to allow assets to be more remote from the shareholders of the acquired corporation after a "B" reorganization than after an "A", "C" or "G" reorganization.

Thus, the Remote Continuity doctrine has evolved haphazardly from an expansive (and arguably misguided) reading of the fountainhead cases. Congress has repeatedly attempted to limit the application of the doctrine.[5] Unfortunately, it has done so by providing statutory relief for specific types of reorganizations then in vogue. Subsequent developments in the sophistication and complexity of corporate transactions inevitably have rendered this statutory relief incomplete. Precisely because the doctrine is so nebulous, however, it is difficult to see how Congress could have approached the problem differently, short of enacting an express statutory disavowal of the doctrine in all its forms whenever it might apply. The intent, to overrule the doctrine, however, was clear. <u>See</u> Rev. Rul. 64-73, 1964-1 C.B. 142 and supporting GCM 30887 (Supp.) (arguing that section 368(a)(2)(C) was a "nonexclusive Congressional renunciation" of Remote Continuity principles).

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5 Congress enacted section 368(a)(2)(C) in 1954 in an attempt to limit the Remote Continuity doctrine. S. Rep. No. 1622, 83d Cong., 2d Sess. 51 (1954). Then, in 1964, Congress added parenthetical language to section 368(a)(2)(B) to permit triangular "B" reorganizations and dropdowns of stock following "B" reorganizations. S. Rep. No. 830, 88th Cong., 2d Sess. 82 (1964). Congress acted yet again in 1968, enacting section 368(a)(2)(D) to permit forward triangular mergers. S. Rep. No. 1653, 90th Cong., 2d Sess. 3 (1968). Finally, in 1971, Congress enacted section 368(a)(2)(E) permitting reverse triangular mergers. S. Rep. No. 1533, 91st Cong., 2d Sess. 1 (1970). Thus, over the past fifty years, Congress has repeatedly clarified that the Remote Continuity doctrine should not limit legitimate business reorganizations.

2. *Qualified Group Definition.*

The Proposed Regulations generally permit transfers or successive transfers of target corporation's assets or stock to other members of the "qualified group" without disqualifying the reorganization for failing to satisfy continuity of interest.[6] A Qualified Group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation (*i.e.*, the parent corporation) if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

The definition of a Qualified Group is similar to the definitions of an "affiliated group" under section 1504(a) and a "controlled group" under section 1563(a), but defines "control" by reference to section 368(c). The Proposed Regulations request comments on whether the definition of a qualified group should be determined under another provision of the Code.

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[6] The Proposed Regulations generally provide that reorganization status is not affected by a "transfer" of assets to members of the Qualified Group or, in appropriate circumstances, to a partnership. The examples suggest the type of transfer contemplated by the Proposed Regulations is a tax-free contribution to a corporation or partnership under section 351 or section 721. It is not clear whether a permissible transfer could take the form of a taxable rather than a tax-free intercompany transfer. This issue may arise, for example, if the transfer is to a foreign corporation or partnership as that transfer may be taxable under section 367 or 1491. The Proposed Regulations appear to draw no distinction in defining a Qualified Group between transfers to domestic and foreign entities and the Committee does not believe the residence of the transferee should affect the status of the domestic reorganization. Accordingly, that a transfer may be taxable in whole or in part under section 367 or section 1491 should not be relevant under the Proposed Regulations. Any alternative "qualified group" definition should include foreign entities.

There appears to be no particular tax policy reason to base the definition of a Qualified Group on section 368(c). The section 368(c) definition presumably was selected because of a possible concern that an alternative definition would exceed the Service's statutory authority. Section 368(c) admittedly is the definition of control in various section 368 provisions, including in particular section 368(a)(2)(C). However, the authority of the Service to promulgate these regulations is not derived narrowly from section 368(a)(2)(C) or related sections.[7] The Committee therefore believes the Treasury Department has authority to adopt an alternative definition of "qualified group."

The Proposed Regulations are intended to reflect the business reality that assets may be redeployed by an acquiring corporation among corporations under its operational control following a reorganization. The definition of a Qualified Group should be no narrower than necessary to ensure effective operational control and ownership of the target assets by the acquiring corporation.

Where an affiliated group's ownership and capital structure is simple, the differences between section 368(c) and other controlled group definitions may be unimportant. More complex structures may produce different treatment under alternative definitions. Thus, the existence of cross-ownership

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[7] As discussed above, narrowly defined statutory relief for transactions described in sections 368(a)(2)(C), (D) and (E) has unfortunately (but inevitably) lent support, by negative inference, to the continuing vitality of the Remote Continuity doctrine. The Service itself, however, has long recognized that this is an erroneous reading of these provisions, which are non-exclusive renunciations of the doctrine. <u>See</u> Rev. Rul. 64-73, <u>supra</u>. The limitations on permissible transfers in the Proposed Regulations should be viewed as an affirmative exercise of administrative authority to interpret the COBE doctrine rather than a vestige of the Remote Continuity doctrine.

may prevent an affiliated group member from qualifying as part of a Qualified Group.[8] Similarly, the existence of classes of nonvoting stock held by minority shareholders could also prevent a member from qualifying.[9] Consequently, transfers of target assets to members of an affiliated or consolidated group could nevertheless threaten the tax-free status of a reorganization in some circumstances.

Because corporate groups generally operate based on consolidation for financial accounting and tax return purposes, the section 368(c) Qualified Group definition may be counter-intuitive. Thus, there is a significant risk of technical "foot-

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[8] Assume, for example, issuing corporation, P, owns all of the stock of S1 and S2, which each own 50 percent of the stock of X. S1, S2 and X join with P in filing a consolidated return. The corporations qualify as an affiliated group because the stock ownership of group members is aggregated. *See* I.R.C. §1504(a)(1)(B)(ii) (stock must be owned by "one or more" of the includible corporations). Thus, the ownership of S1 and S2 in X is aggregated and the group owns 100% of X. Following an otherwise qualifying reorganization, P transfers the target's assets through S1 and S2 to X, which happens to be incorporated in the same state as the target. Despite the fact that this is an intercompany transaction between members of a consolidated group, the transfer will threaten the tax-free status of the reorganization. Neither S1 nor S2 owns 80 percent of X. There generally is no attribution for purposes of section 368(c). Rev. Rul. 56-613, 1956-2 C.B. 212. *See* Prop. Reg. §1.368-1(d)(5)(iii) (stock meeting the requirements of section 368(c) in each of the corporations must be owned *directly* by *one* of the other corporations). It is doubtful whether Treas. Reg. §1.1502-34 applies for this purpose. Therefore, X is not a member of P's Qualified Group.

[9] Section 1504 ignores "vanilla" preferred stock-- generally, nonparticipating, nonvoting, nonconvertible stock that is limited and preferred as to dividends. I.R.C. §1504(a)(4). By contrast, section 368(c) requires ownership of 80 percent of the voting and nonvoting stock of a corporation. The Service has interpreted this rule to mean ownership of 80 percent of *each* class of nonvoting stock. *See* Rev. Rul. 59-259, 1959-2 C.B. 115. Thus, affiliated group members that have any classes of nonvoting stock outstanding owned more than 20 percent by minority shareholders will not be members of the Qualified Group, even if these classes of stock are of insignificant value.

faults" by taxpayers. The control definition should be revised to minimize the risk of these inadvertent errors. Were the definition of a Qualified Group based on the affiliated group definition of section 1504, the definition would better conform to the operational unit, as understood by taxpayers. There are, however, disadvantages to adopting the section 1504 definition. In particular, section 1504(b) excludes entities such as insurance companies and foreign corporations that should be covered by the "qualified group" definition. Thus, if a section 1504 definition is adopted it should be based on section 1504(a) without regard to the carve-outs of section 1504(b).

The Committee believes the Qualified Group definition should be revised to conform generally to the parent-subsidiary controlled group definition of section 1504(a) (without regard to section 1504(b)).[10] If the Treasury Department concludes it is generally constrained by its statutory authority to use the section 368(c) definition of control, the Proposed Regulations will still represent a considerable improvement over current law in the vast majority of cases. The regulations may reach anomalous results, however, in the minority of situations involving complex ownership structures. At a minimum, we believe the Service has statutory authority under section 1502 to broaden

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[10] The adoption of a section 1504(a) "control" test may permit transfers to first-tier subsidiaries to qualify under either the regulations or section 368(a)(2)(C). Presumably, the regulations cannot prevent qualification under section 368(a)(2)(C) if the statutory requirements are met. For example, assume an acquirer's subsidiary has two classes of stock, one of which has high vote and low value and is owned by acquirer and the other; with low vote and high value; is owned predominately by unrelated persons. Acquirer may own more than 80 percent of the combined voting power but less than 80 percent of the value of the subsidiary. Such a subsidiary might be controlled within the meaning of section 368(c) but not within the meaning of section 1504(a). Nevertheless, the transfer of target assets to the subsidiary generally should qualify as tax-free. This discontinuity between section 1504(a) and section 368(c) standards, however, would only arise in unusual cases, and therefore is unlikely to create a material risk of abuse.

the Qualified Group definition to include assets transfers within a group filing a consolidated return whether or not the transferee is part of the Qualified Group as defined in the Proposed Regulations.

3. *Extension of the Proposed Regulations to "D" and "F" Reorganizations.*

The Proposed Regulations do not apply to "D" and "F" reorganizations or transactions under section 355. The Preamble requests comments on whether they should. The Preamble suggests the decision not to extend the Proposed Regulations to "D" and "F" reorganizations was based on the fact that section 368(a)(2)(C) does not apply to these types of reorganizations. This assumes, however, that section 368(a)(2)(C) and related sections are a narrow statutory exception to a Remote Continuity doctrine that is otherwise generally applicable. The Committee does not believe section 368(a)(2)(C) is the source of authority for the Proposed Regulations and questions, therefore, whether the omission of "D", "E" and "F" reorganizations from section 368(a)(2)(C) is relevant. As discussed above, the vitality of the Remote Continuity doctrine is, at best, questionable.

The extent to which this doctrine and the COBE doctrine apply to "D" and "F" reorganizations, in particular, is unclear. For example, the regulations under section 368 state that continuity of shareholder interest is not separately required in a "D" reorganization.[11] There is similar uncertainty regarding the application of the continuity of business

[11] *See* Treas. Reg. §1.368-1(b) (the requisites of a reorganization include "except as provided in section 368(a)(1)(D)," continuity of interest by the historic owners). Perhaps this reference was originally intended to be limited to divisive "D" reorganizations, although it fails to draw this fairly obvious distinction. Moreover, since continuity of shareholder interest expressly is required under the section 355 regulations, this reading is somewhat problematic.

enterprise test to "D" reorganizations.[12]

The *Groman-Bashford* doctrine applied originally to those forms of reorganization that were the direct subject of the Supreme Court holdings in those cases, namely, reorganizations under the predecessor sections to section 368(a)(1)(B), and (C). The Committee does not believe a Remote Continuity or COBE doctrine can be said to have been established as to "D", "E", "F" or "G" reorganizations. The 1954, 1964 and 1968 amendments to section 368 effectively repealed the *Groman-Bashford* doctrine, providing explicit statutory approval for remote continuity in "A", "B", "C" and "G" reorganizations. That section 368(a)(2)(c) is silent as to the "D", "E" and "F" reorganizations does not indicate a Congressional intention to create an even stricter Remote Continuity doctrine for those forms of reorganizations. *Cf.* Rev. Rul. 64-73, 1964-1 C.B. 142.[13]

In non-divisive "D" reorganizations, a corporation must transfer "substantially all" of its assets to a corporation that

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12 *See, e.g., Rose v. United States*, 640 F.2d 1030 (9th Cir. 1981) (business continuity need not be satisfied in a liquidation-reincorporation transaction for reorganization treatment to apply).

13 Section 368(a)(2)(A) provides that, when a transaction is described in both section 368(a)(1)(C) and section 368(a)(1)(D), it must be treated as a "D" reorganization. In 1986, Congress inserted the parenthetical phrase "other than for purposes of section 368(a)(2)(C)." While the provision is hardly a model of clarity, Congress apparently did not intend asset dropdowns to disqualify a reorganization. As with its other efforts to prevent transfers from disqualifying tax-free reorganizations, Congress may however have lent support by negative inference to the notion that an asset transfer could disqualify a "D" reorganization. If that were the case, arguably there would be no overlap with section 368(a)(2)(C) to be resolved in the first instance thus rendering the 1996 amendment's language meaningless. It is an accepted rule of statutory construction that ambiguous language should not be construed to be meaning less where alternative readings are meaningful. Alternatively, therefore, the 1996 amendment should be viewed as Congressional recognition that the Service *might* seek to apply the Remote Continuity to a non-divisive "D" reorganization and an expression of Congress's desire that the doctrine not be applied.

it (or its shareholders) "controls." "Control" has the meaning given that term by Section 304(c), which generally defines it as the ownership of stock possessing at least 50 percent of the combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock. In determining control, section 304(c)(3) applies the constructive ownership rules of section 318(a).[14] The definition of control was broadened by Congress, solely for non-divisive "D" reorganizations, to ensure that transfers of assets among corporations subject to effective economic control of the same group of shareholders are treated as tax-free reorganizations.[15]

Because non-divisive "D" reorganizations are necessarily among "related" parties, there is no policy reason to apply the judicial doctrines of continuity of interest and business enterprise that apply in other reorganizations.[16] Indeed, strict application of these doctrines would permit taxpayers to avoid reorganization treatment, which is what section 368(a)(2)(H) was intended to prevent. The broad "controlled group" notion implicit in the definition of section 368(a)(2)(H), therefore, should trump the more restrictive

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14 The section 368(a)(2)(H) definition of control differs markedly from the definition of control under section 368(c), on which the "qualified group" definition in the Proposed Regulations is based -- (1) it applies a 50 percent, rather than an 80 percent threshold; (2) it may be satisfied by ownership of this quantum of vote or value of the transferee corporation; and (3) it may be met based on attribution, whereas no attribution principles apply for purposes of section 368(c). *See* Rev. Rul. 56-613, 1956-2 C.B. 212.

15 Because "D" reorganizations historically have served as a weapon against abusive liquidation-reincorporation transactions, the statutory definition of "D" reorganizations is broad and judicial interpretation of the statutory requirements has generally been flexible.

16 The Service's attempts to synthesize the continuity requirement with the broad control requirement have been strained. *See, e.g.*, PLR 9111055 (Dec. 19, 1990) (applying family attribution principles to treat the continuity requirement as satisfied in a purported "D" reorganization).

"control" requirement of 368(c) on which the "qualified group" definition in the Proposed Regulations is currently based.

It is equally questionable whether Remote Continuity and COBE apply in divisive "D" reorganizations. Section 355 and the regulations apply a separate and distinct continuity regime. Shareholder continuity of interest is required by Treas. Reg. §1.355-2(c)(1); however, this test differs from the continuity of proprietary interest required in most non-divisive reorganizations.[17] Section 355(d) forces the distributing corporation to recognize gain if the spin-off shifts a "50-percent interest" to a less than 5-year shareholder or shareholders. In addition, section 355(b) and Treas. Reg. §1.355-3(b) establish a stringent active business requirement test that supersedes the historic business continuity and asset continuity tests of Treas. Reg. §1.368-1(d).

If the elaborate and restrictive section 355 statutory and regulatory requirements are satisfied, there should be no need for a taxpayer also to meet nebulous, judicially-created doctrines such as "remote continuity" and "continuity of business enterprise" under section 368(a)(1)(D). Indeed, application of the Remote Continuity doctrine to divisive "D" reorganizations is inherently inconsistent with the *Morris Trust* doctrine.[18] Under this case law and the Service's own rulings, a distributing corporation can spin-off a controlled corporation and, pursuant to a plan, the distributing corporation can merge into an

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[17] Continuity is required on the part of those persons who "directly or indirectly" were shareholders of the corporation. Reg. §1.355-2(c). This "directly or indirectly" language is inherently inconsistent with remote continuity principles that require a direct nexus between the historic target shareholders and the transferred assets. *Cf.* Rev. Rul. 62-138, 1962-2 C.B. 95. Thus, as discussed below, remote continuity principles have generally been ignored in section 355 transactions. *See, e.g., Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966).

[18] *See Commissioner v. Morris Trust, supra* n.14.

unrelated corporation, in which the distributing corporation's shareholders have a less than 80-percent "controlling" interest.[19] Transfer of all of the distributing corporation's stock or assets (as to which shareholders are required to retain "continuity of interest" under section 355) presumably would violate Remote Continuity if it applied.[20] Under these authorities, therefore, the doctrine cannot be applicable to a divisive "D" reorganization.[21]

While it may be desirable to clarify that these doctrines do not apply to divisive "D" reorganizations, applying the Proposed Regulations as currently drafted to divisive reorganizations is not the way to achieve this. The Proposed Regulations limit permissible asset transfers to "controlled" corporations. The merger of a distributing corporation into an acquirer in which shareholders of the distributing corporation receive less than an 80 percent interest would be a transfer of

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19 Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83; Rev. Proc 96-30 at Appendix A. Stock of the distributing corporation also can be acquired in a "B" reorganization. The form of merger is restricted to "A" and "B" reorganizations because of the "substantially all" requirement that applies in other reorganizations. *See Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937).

20 Importantly, at issue is not satisfaction of continuity in the subsequent reorganization but satisfaction of continuity in the initial divisive reorganization. Shareholders are required to retain continuity in the distributing corporation under the regulations. See Reg. §1.355-2(c). Yet in a *Morris Trust* transaction they immediately exchange their stock in the distributing corporation for an interest in another corporation. The Remote Continuity doctrine suggests precisely that the transfer of stock or assets to a different corporation, *however closely related*, destroys continuity. Thus the Remote Continuity issue would be present even on the facts of *Morris Trust*, where shareholders took back more than 50 percent of the acquirer's stock. Nevertheless, the court held that the divisive transaction qualified as a tax-free.

21 The same issue may arise in successive acquisitive reorganizations pursuant to a plan.

assets to a corporation outside the "qualified group". Thus, if applied to *Morris Trust* transactions, the regulations would effectively overrule this court and Service sanctioned doctrine. While we recognize that legislation has been proposed by the Administration (and certain members of Congress) effectively to repeal the *Morris Trust* doctrine, these proposals have not been enacted and should not in any event affect the application of the COBE doctrine in divisive "D" reorganizations.

Consequently, we recommend the Service clarify that the Proposed Regulations do not apply to "D" reorganizations, because the Remote Continuity and COBE requirements are not applicable to these reorganizations. If the Service disagrees that these doctrines do not apply under current law, however, it should extend the relief under the Proposed Regulations to non-divisive "D" reorganizations. The Proposed Regulations, as currently drafted, should not be extended to divisive reorganizations in any event, because they would implicitly conflict with long-standing Treasury policy as reflected in the *Morris Trust* doctrine.

The Proposed Regulations also do not apply to "F" reorganizations, which like "D" reorganizations, are not subject to section 368(a)(2)(C). As discussed above, we question whether the remote continuity doctrine has continuing vitality or applies to "F" and "D" reorganizations. Thus, where an "F" reorganization otherwise qualifies, it should not be disqualified by reason of a transfer of assets to a lower-tier entity. In any event, an "F" Reorganization generally will not be combined with a subsequent transaction under the step transaction doctrine.[22]

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[22] *See* Rev. Rul. 96-29, 1996-24 I.R.B. 5 modifying Rev. Rul. 79-250, 1979-2 C.B. 156. Rev. Rul. 96-29 describes two situations. In the first, a corporation merged into a corporation newly organized in the new state of choice and converted its shares to shares of the new corporation. The new corporation immediately sold shares of its stock to the public and redeemed all the outstanding shares of nonvoting preferred. The second situation involved a manufacturing corporation that was owned by two individuals and that conducted business through several subsidiaries. This corporation entered into an agreement under

If the Service has a different view on the application of the Remote Continuity doctrine to "F" reorganizations, however, the Proposed Regulations should certainly be extended to "F" reorganizations.

4. *Transfers To Partnerships.*

a. *Summary of New Rules*

Under the current COBE regulations, the acquiring corporation must either (i) continue the target corporation's historic business (or, where target corporation has more than one line of business, a significant historic line of business) ("Business Continuity") or (ii) use a "significant portion" of target corporation's historic business assets in a business ("Asset Continuity"). Satisfaction of these tests depends on the facts and circumstances of a particular transaction. Examples suggest, however, that a line of business constituting one-third of the total value of businesses conducted is "significant" and perhaps, by extension, that one-third of the historic operating assets is a significant portion of the historic assets.[23] Transfer of the target's historic business assets to a partnership raises difficult issues as to how these rules should be applied to the indirect ownership of assets, or indirect conduct of a business, through a partnership.

(..continued)
which an unrelated target merged into one of its subsidiaries. Shareholders of the target corporation received newly issued preferred shares from the manufacturing corporation for their target shares. To change its place of organization, the manufacturing corporation merged into a newly organized corporation in another state. Shareholders in the manufacturing corporation surrendered their common and preferred shares for identical common and preferred shares in the newly-organized corporation. Rev. Rul. 96-29 specifically precludes stepping together a change of stock ownership with a formally separate reincorporation, implicitly relying on the fact that the reincorporation itself does not result in the change of stock ownership.

[23] See Treas. Reg. §1.368-1(d)(5), Example 1.

The Proposed Regulations provide guidelines for applying the Business and Asset Continuity tests of the current regulations when assets are transferred to a partnership. These guidelines generally adopt an "aggregate" approach to partnerships. The Proposed Regulations address how a partnership business or assets are to be attributed to the transferring corporate partner for purposes of satisfying the current Business or Asset Continuity tests.

For purposes of the Business Continuity test, a corporate partner will be deemed to conduct a target's historic business (conducted primarily through a partnership) if it (i) performs active and substantial management functions as a partner with regard to the business or (ii) holds a "significant" interest in the partnership.[24] Although the Proposed Regulations state this provision in the disjunctive -- i.e., one test appears to be based solely on corporate partner *activities*, the other on corporate partner *ownership* -- Example 8 seems to indicate that

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[24] In effect, the first test permits some partial attribution of the underlying partnership business. Presumably, if sufficient functions of the historic business are conducted at the corporate partner level without regard to the partnership's activities, the Business Continuity test could be satisfied under current law. Where the historic business is primarily conducted by the partnership using its employees and assets, the corporate partner is deemed to conduct that business if the corporate partner's own officers and employees supervise and direct these activities and provide sufficient managerial direction. Cf. Rev. Rul. 92-17, 1992-1 C.B. 142. The second test will simply attribute the underlying business to a corporate partner whose interest is sufficiently significant. Cf. Rev. Ruls. 85-197 and 85-198, 1985-2 C.B. 120. The fact that either of these tests is met will not obviate the need to determine under the current regulations whether the partnerships activities rise to the level of conducting the target's historic business. For example, if the partnership were to continue to conduct only one of the target's three historic lines of business, it would still be necessary to show that this line of business is "significant" under the current regulations. Similarly, the fact that the corporate partner has a "significant interest" in a partnership conducting the business conducted most recently by the target will be unavailing if that business is not the target's "historic" business under the current rules.

corporate level managerial functions must be coupled with some minimum interest in the partnership.[25] If so, at a minimum we believe this requirement should be explicitly stated (even if the minimum percentage interest will depend on all the facts and circumstances).[26]

For purposes of the Asset Continuity test, the corporate partner will be deemed to own a portion of the underlying partnership assets based on its "interest" in the partnership. Thus, for example, if the historic business assets are transferred to and held by a partnership in which the transferor has a 33 percent interest, the corporate transferor will be treated as owning 33 percent of the historic assets for purposes of the Asset Continuity test. Asset Continuity requires more than mere ownership, however. It requires that the historic assets be *used in a business*, albeit a business different than the target's historic business. The Proposed Regulations therefore state that the corporate partner will be deemed to be engaged in "a PRS" partnership business if it meets either of the

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[25] Example 8 indicates that active and substantial management functions coupled with a 20 percent interest satisfies the continuity of business enterprise requirement.' Presumably, the inclusion of the fact that the partner owned a 20 percent interest is not accidental. See also Treasury Official Says Retroactive Election For COSI and COBE Regs Unlikely, 97 Tax Notes Today 91-31 Document 97-12944 (reporting remarks of Associate Tax Legislative Counsel Rooney apparently confirming that this 20 percent interest may be a requirement).

[26] The current statement in Prop. Reg. §1.368-1(d)(5)(v)(C), that satisfaction of these tests alone is not enough, is cryptic and ambiguous. It could be interpreted as requiring some continuing *ownership* of underlying partnership assets. However, since it applies equally to the "significant interest" test, it could more plausibly be read to clarify that the business conducted by the partnership must meet the Business Continuity test in its own right. For example, if the partnership continues only one historic line of business that line must be "significant" under the current rules. Thus taxpayers reading the current language could quite reasonably assume that no minimum interest is required and that a one percent general partnership interest coupled with substantial management functions at the corporate partner level suffices.

tests applicable to Business Continuity with respect to the partnership.[27]

In effect, one or the other of the "active and substantial management" or "significant interest" tests must be met to satisfy not only Business Continuity but also Asset Continuity.[28] Asset Continuity will therefore be relevant only if the underlying business conducted by the partnership is not the target's historic business. In that event, the partner will be deemed to own its proportionate share of the historic assets owned by the partnership. This proportionate share must itself constitute a "significant portion" of the historic assets under the current regulations.[29]

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[27] This requirement assumes the partner could not use indirectly owned assets in its *own* business. For example, acquirer may acquire target's hotel business and simply contribute all of the historic land and buildings to a partnership in which it is a 80 percent partner. If it leases the buildings from the partnership and uses them as part of its own hotel business, COBE should be satisfied even though there may be no underlying partnership-level "PRS business" to be attributed to the corporate partner.

[28] It is unclear why the "active and substantial management" test will ever be relevant for purposes of Asset Continuity. If the partner has a "significant" (more than 33 percent) interest, it will be deemed to be engaged in a partnership business and will also own a "significant portion" of the underlying historic assets. Where it owns a less than "significant" interest (and must rely on active and substantial management to be engaged in a partnership business) its proportionate interest in the underlying historic assets is unlikely to be a "significant portion" as required by the current regulations, unless the word "significant" means different things in different places in the COBE regulations.

[29] Presumably, ownership of a significant interest in the partnership does not guarantee satisfaction of COBE because the partnership may not continue the target's historic business and may itself dispose of a portion of the historic assets. A significant interest in less than all the historic assets may or may not be a "significant portion" in the aggregate. Similarly, for example, if an acquiring corporation disposed of two of the three target businesses, the Committee would not consider a one third interest in a partnership which conducts the one remaining business to be sufficient to satisfy the requirements.

b. Nature of partnership interest.

As discussed above, the application of the Proposed continuity of business enterprise regulations where assets are transferred to a partnership generally will require a determination of the corporate transferor's "interest" in the partnership. The Proposed Regulations do not explain how the magnitude of an interest in a partnership should be determined, but stress in the Preamble that this is a facts and circumstances determination. The transfer of assets acquired in a reorganization to a partnership should occur most often in the context of the formation of an operating joint venture. The interest received in a venture frequently will not involve complex special allocations of partnership items. As drafted, therefore, the Proposed Regulations should provide adequate guidance in most business situations in which the issue will arise.

Because of the flexibility offered by Subchapter K, however, there are likely to be numerous arrangements that involve more complex allocations that will make determination of the corporate partner's "interest" more difficult. A corporate partner may, for example, receive a proportionate interest in profits and losses that differs from its capital interest, a "carried interest," a proportionate interest in profits that differs from its proportionate share of losses in a given year, or an interest that includes special allocations of partnership items that could have the effect of shifting economic consequences of ownership of the assets away from or to the contributing partner.

Definitive rules for quantifying a corporate partner's partnership interest in this context are likely to be inordinately complex. The Committee therefore generally supports the facts and circumstances approach of the Proposed

Regulations.[30] Without a well-defined expression of the policy goals behind the continuity of business enterprise requirement, however, it may not be possible to determine which facts and what circumstances are significant, making it difficult or impossible to predict whether an interest in the partnership is "significant," or what portion of the underlying assets should be treated as owned by a partner.

As the goal of the Proposed Regulations presumably is to minimize uncertainty in this area, we believe it would be helpful at least to provide certainty as to the magnitude of interest that is sufficient in cases not involving "exotic" partnership interests. The Committee therefore recommends the Proposed Regulations establish an express regulatory safe harbor indicating that a 33 and one-third or greater interest in both profits and capital will be deemed to be "significant" but that lesser percentages or more complex interests may be significant depending on all the facts and circumstances.

c. *Active management by corporate partner.*

The Proposed Regulations provide that COBE may be satisfied if the corporate partner "has active and substantial management functions as a partner" with respect to the partnership business. The regulations provide no guidance regarding what constitutes "active and substantial" management functions. Example 8 suggests these functions include (1) decision-making regarding significant business decisions, and (2) regular participation in the overall supervision, direction and control of employees. The Preamble suggests that this test was

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[30] The approach is consistent with the approach in similar situations elsewhere in the regulations. *See, e.g.,* Treas. Reg. § 1.367(a)-1T(c)(3)(ii) (defining a partner's "proportionate share" of partnership assets by reference to the rules and principles of sections 701 through 761).

derived from that set forth in Revenue Ruling 92-17.[31]

The Committee believes additional guidance regarding the types of activities constituting "active and substantial" management functions would be helpful. As it may be difficult to define "active and substantial" management, the guidance could take the form of further examples.

As discussed above, the regulations should clarify the relationship between the test and the cryptic language in Prop. Reg. Section 1.368-1(d)(5)(v)(C) to the effect that satisfaction of the test, alone, is not sufficient. If a minimum partnership interest is required in addition to "active and substantial" management, this should be spelled out clearly in the regulations and not merely implied by Example 8 and the general "facts and circumstances" approach of the regulation.

Further, as the "active and substantial management" test is irrelevant if the partner also owns a more than 33 percent interest in the partnership,[32] adopting a minimum 20 percent interest requirement would limit the relevance of the "active management" test to situations where the partner owned between 20 and 33 percent of the partnership. The Committee considers this unnecessarily restrictive and believes that a lower percentage interest combined with more significant corporate-level activity could also meet the test. We recommend instead that the 20 percent interest be adopted as a regulatory safe- harbor threshold. Thus, the regulations should specify that a 20 percent interest in profits and capital combined with "active and substantial management" will meet the Business

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[31] 1992-1 C.B. 142.

[32] The test would be irrelevant because the interest would be "significant" and would meet the Business Continuity or Asset Continuity test without regard to the corporate partner's managerial activities.

Continuity test.[33]

d. Indirectly owned partnerships.

The proposed regulations do not address whether the target assets may be transferred to a lower-tier partnership. The regulations discuss the corporate partner's "interest" without specifying whether this interest must be direct. For certain tests -- such as the "active and substantial management" test -- a direct/indirect interest distinction should be irrelevant. For other tests that look to the corporate partner's interest in the partnership, however, the distinction may be important. The examples should deal with transfers to indirectly owned partnerships.

The Committee believes transfers to lower-tier partnerships should be permitted if the transaction otherwise meets the Proposed Regulation requirements and there are valid non-tax reasons for transferring assets to a tiered partnership. Permitting multiple transfers is consistent with the "aggregate" approach of the regulations, which ignore the separate entity status of partnerships.[34] The relevant question is whether the

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[33] Example 8, should therefore state that satisfaction of COBE is based on satisfaction of this safe-harbor (along with active and substantial management functions) but that ownership of a lower percentage interest in the partnership might also satisfy the test based on all the facts and circumstances including the degree and extent of managerial activity at the corporate partner level.

[34] The Service's objection in earlier pronouncements to contributions of target assets to partnerships was that a partnership cannot be a "party to the reorganization." The Service reasoned that a partnership that receives all of the target assets as part of the plan of reorganization, must be treated under the step transaction doctrine as the direct transferee. *See, e.g.*, G.C.M. 35117 (Nov. 15, 1972); and G.C.M. 39150 (Mar. 1, 1984). The Proposed Regulations resolve this issue by adopting an aggregate theory of partnerships and treating the underlying assets as owned by the partners.

corporate partner has retained a sufficient economic interest in the underlying assets. Because the Proposed Regulations adopt a facts and circumstances test, rather than a bright line threshold, in measuring interests in the partnership, the rules should apply to an indirect interest without the need for modification in most circumstances. The final regulations should clarify that the corporate partner's interest may be direct or indirect, provided it otherwise satisfies the requirements of the regulations.

To the extent a particular threshold (such as a 33 percent interest) is created by the Proposed Regulation for an interest to be significant, a corporate partner should be treated as having satisfied this threshold based on its indirect interest in the partnership that ultimately receives the assets. A contrary rule would be inconsistent with the aggregate approach to partnerships adopted in the Proposed Regulations.[35]

The proposed regulations do not address situations where interests in a partnership are owned by more than one member of a Qualified Group. Given the general principle that

[35] The Committee recognizes there are circumstances in which this aggregate approach may be difficult to reconcile with the definition of a Qualified Group, which adopts a strict entity approach. For example, assume there are successive transfers of assets to 80%-owned subsidiaries, culminating in a transfer to a partnership in which the group's corporate partner has a 34 percent interest. Because there is no attribution for purpose of the section 368(c) test for control, a Qualified Group is determined by reference to the interest of the corporation at each respective level in the chain of ownership. Accordingly, by permitting transfers within a Qualified Group without limitation, the Proposed Regulations may permit successive transfers that significantly dilute the acquiring corporation's interest in the transferred assets. Although the economic interest of the acquiring corporation in the underlying partnership assets may be lower than would be acceptable under a pure aggregate approach, the dilution of the acquirer's interest in the assets is of a type permitted by the regulations. Accordingly, the significance of the "interest" should be tested without regard to dilution resulting from the structure of the corporate Qualified Group. That is, the actual corporate partner's interest, rather than the common parent's interest, should be measured.

sufficient control of the assets exists with respect to any member of the Qualified Group, and given the aggregate theory of partnerships adopted in the Proposed Regulations, it would seem appropriate to examine the nature and extent of the partnership interests held by the Qualified Group as a whole. Accordingly, for purposes of determining the corporate transferor's interest in the transferee partnership, the Committee believes that interests held by all members of the Qualified Group in the transferee partnership should be aggregated and attributed to the corporate transferor.

e. *Transfers of stock to partnerships.*

The preamble to the proposed regulations states that they do not permit the transfer of stock (as opposed to assets) to a partnership if the Code imposes a "control" requirement.[36]

We believe the Proposed Regulations reflect a decision not to recharacterize a transaction where there is no abuse of the reorganization provisions and the transaction is consistent

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[36] Of the statutory descriptions of the various forms of reorganization, a number have a "control" requirement. For example, a "B" reorganizations is described as a transaction in which the acquirer acquires the target corporation solely for voting stock and has control of the target immediately after the acquisition; an "(a)(2)(D)" reorganization is described as a transaction in which the target assets are acquired in exchange for stock of a corporation which is in "control" of the acquiring corporation. As for most other purposes of section 368, control is defined in section 368(c) (primarily by reference to voting power).

The issue whether control requirements are satisfied when stock of a "controlled" corporation is immediately transferred to another entity has been considered in a number of different contexts. For example, under section 351 it may be unclear whether assets have been transferred to a corporation that the transferors control immediately thereafter if as part of the same plan, the stock of that corporation is disposed of. Generally, unless there is a *binding commitment* to make the transfer, the control requirement is satisfied. *See American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948); *Intermountain Lumber Co.*, 65 T.C. 1025 (1976).

with business realities. This approach avoids the troubling application of "substance over form" principles to reorder the formal steps in a transaction in a way that causes it to fail a technical statutory requirement. We see no reason why the same logic should not apply when stock is transferred to a partnership.

The application of a "control" requirement does, however, raise difficult issues. Thus, if the fiction of legal personality is ignored, the corporate transferor of stock within the Qualified Group will retain control in the sense that it may effectively direct how the stock is voted. This may not be the case when stock is transferred to a partnership even if the "proportionate interest" of the transferor is significant. For example, the corporate partner that holds a 95 percent limited partnership interest in a partnership may divest itself of voting control by transferring stock to the partnership, if operational control is exercised by the general partner and governed by the partnership agreement. Therefore, while the continued distinction between stock and asset transfers exalts form over substance and may ultimately need to be addressed, we concur with the Service's decision not to address these issues now in the interest of finalizing the regulations expeditiously.

5. *Miscellaneous Issues.*

a. *Application of Section 381.*

The Proposed Regulations request comments on whether the regulations under section 381 will need to be revised to reflect the proposed changes.

Section 381 was enacted to resolve uncertainties under prior law regarding the carryover of tax attributes to the acquiring corporation in a reorganization.[37] It generally

[37] *See, e.g., New Colonial Ice Co. v. Helvering*, 292 U.S. 435

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provides that in "A," "C," non-divisive "D," "E" and "F" reorganizations, the acquiring corporation succeeds to the target's tax attributes and items enumerated in section 381(c). Although section 381 applies to transfers of assets that occur as part of a reorganization under section 368, section 381 currently does not apply to transfers of assets under section 351.

The regulations under section 381 already address the treatment of triangular reorganizations in detail, providing that there may only be one "acquiring corporation" for purposes of section 381 -- that is, only one corporation will be entitled (or required) to inherit the transferor's tax attributes and items.[38] In general, the acquiring corporation will be (1) a corporation that ultimately acquires all of the assets of the transferor in the reorganization or (2) if no single corporation acquires all of the assets, the corporation that initially acquires the assets.[39]

To the extent all of the assets are transferred to a third- or lower-tier entity, however, the treatment of the transaction under section 381 may be unclear. Section 381 contemplates that the assets are transferred "as part of the reorganization." As discussed below, the Proposed Regulations merely clarify that an otherwise qualifying reorganization will not be disqualified by asset- or stock transfers under the remote continuity or COBE doctrines, but do not otherwise alter the

(..continued)
(1934); *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957).

[38] Treas. Reg. §1.381(a)-1(b)(2).

[39] Thus, in a fairly simple triangular merger, the acquiring corporation generally is the entity that receives all of the operating business assets of the transferor. However, where assets are divided among the initial acquirer and its subsidiaries, the initial acquirer is deemed to inherit the transferor's attributes. In that case, section 381 does not apply to the asset transfers to the various subsidiaries which, for example, are not required to adopt the target corporation's inventory accounting method. Treas. Reg. §1.381(a)-1(b)(3).

reorganization rules. (For example, they do not change the rule against issuing "grandfather" stock). Thus, the transfer to a third- or lower-tier entity may be a separate transaction under section 351 rather than an integral part of the reorganization and the assets will not be acquired as "part of" the reorganization. In these circumstances, the initial acquirer may inherit the target attributes. Similarly, if the operating assets are transferred to a partnership, the initial acquirer rather than the entity that actually holds the target's operating assets may inherit the target's attributes.[40] Thus, corporate attributes may be separated from the associated operating assets.

It could be argued that the section 381 regulations should be revised to reflect the ability of the corporate acquirer to transfer substantially all of the target's assets to a partnership or corporation under the Proposed Regulations. However, the discontinuity under section 381 between reorganizations under section 368 and asset transfers under section 351 or section 721 is inherent in the existing rules. *See, e.g.*, Rev. Rul. 64-73, *supra*. We believe that any policy concerns should be addressed as part of a separate project, rather than as part of the finalization of the Proposed Regulations.

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40 *Cf.* Treas. Reg. §1.381(a)-1(b)(3)(ii).

b. Proposed regulations limited to continuity.

The Proposed Regulations limit their scope to continuity of proprietary interest and continuity of business enterprise issues, stating that they do not otherwise change current law, for example, by permitting the direct issuance of "grandfather" stock in a reorganization. As a policy matter, continuing the distinction between asset dropdowns and triangular reorganizations involving grandfather stock (and between asset and stock dropdowns, discussed above) elevates form over substance. Conforming this treatment may, however, raise issues that go beyond remote continuity and business continuity -- in particular, this will raise issues regarding the statutory authority for such a reorganization requirement. While the Committee believes these issues will ultimately have to be addressed, it concurs with the Service's decision to focus on common business transactions that most frequently present problems that do not raise these more difficult issues.

c. Cause to be directed transactions.

The Committee supports the Service's long-standing position that a transfer of target assets made directly to a lower-tier entity at the acquirer's direction is treated as an acquisition of the assets by the acquirer and dropdown to the lower-tier entity if the acquirer has "dominion and control" of the assets (so-called "Cause to be Directed" transactions). See Rev. Rul. 70-224, 1970-1 C.B. 79, Rev. Rul. 64-73, 1964-1 (Part 1) C.B. 142, and GCM 30887 (Supp.) (in which Rev. Rul. 64-73 was considered).

In Rev. Rul. 70-224, the Service ruled that a transaction qualified as a reorganization within the meaning of section 368(a)(1)(C) and section 368(a)(2)(C) when the acquiring corporation caused the assets of target corporation to be transferred directly to a corporation controlled by acquiring, rather than being transferred through the acquiring corporation to the controlled corporation. In reaching this conclusion, the Service explained that, as of the effective time of the reorganization, the acquiring corporation had "dominion and control" of target corporation's assets, and therefore the acquiring corporation was deemed to have received the target corporation's assets and transferred them to its controlled corporation.

In Rev. Rul. 64-73, the Service ruled that a transaction qualified as a reorganization within the meaning of section 368(a)(1)(C) where the acquiring corporation caused some of the assets of target corporation to be transferred directly from target corporation to a wholly-owned subsidiary of a corporation controlled by the acquiring corporation. According to GCM 30887 (Supp.), the Service reached the conclusion in Rev. Rul. 64-73 by recharacterizing the transaction as if two separate steps were executed: (1) acquiring corporation acquired "substantially all" of target corporation's assets, as required by section 368(a)(1)(C) and (2) acquiring corporation transferred target corporation's assets to a wholly-owned subsidiary of a corporation controlled by the acquiring corporation in a series of transactions governed by section 351. The Service did not require the transaction to be analyzed under the control requirements of section 368(a)(2)(C) because the Service viewed section 368(a)(2)(C) as "a *nonexclusive* Congressional renunciation of the *Groman-Bashford* doctrine in C reorganizations." (Emphasis added).

The Committee believes that taxpayers should not be compelled formally to transfer target corporation stock or assets through each of the acquiring corporation and its intervening subsidiaries under state law to qualify the transaction as a reorganization. In some cases, regulatory restrictions will preclude this form; in others, this will generate multiple levels of state transfer taxes and unnecessary fees from recording (and rerecording) title of the transferred target stock or assets. Cause to be Directed Transactions avoid these problems without violating the letter or spirit of the Proposed Regulation. Favorable treatment for federal tax purposes under the regulations should not be conditioned on the acquirer's willingness to absorb duplicative state taxes.

The Committee concurs in the Service's conclusion that a partnership should be treated as an aggregate of its partners, and not as an entity separate from its partners, in analyzing a transaction with respect to continuity of interest. The analysis of Cause to be Directed Transactions should be the same regardless of whether the ultimate transferee entity is a subsidiary corporation or a partnership to which stock or assets are permitted to be transferred under the Proposed Regulations.[41] Federal tax treatment generally does not, and should not, turn on state law formalities regarding the transfer of title but on dominion and control over the transferred assets.

The Committee asks that when the Proposed Regulations are finalized, they clarify, in the preamble or otherwise, that they are not intended to alter or affect the treatment of Cause to be Directed Transactions under current law.

[41] Cf. PLR 9106037 (ruling that a section 351 exchange occurred where corporate transferor transferred assets, at the direction of corporate acquirer, to a trust, which was 99.9% beneficially owned by a partnership).

d. *Definition of acquiring corporation.*

In the context of "C" reorganizations, it may be unclear whether the "solely for voting stock" requirement has been met if liabilities of the target are assumed by a corporation other than the nominal acquirer.[42] Section 368(a)(1)(C), which requires that the exchange be "solely for voting stock," provides that the assumption of liabilities by the *acquiring* corporation does not cause this requirement not to be met. The Service, however, has adopted the position that there may be only one acquiring corporation for this purpose. Accordingly, when target assets subject to liabilities are divided within the group, that division arguably may disqualify the entire reorganization.[43]

As this issue does not directly involve remote continuity of interest or business enterprise it is arguably beyond the scope of the Proposed Regulations. As discussed above, the Committee generally supports the Service's decision to

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[42] Early case law held that the assumption of liabilities in a reorganization was boot -- *i.e.*, equivalent to cash. *See U.S. v. Hendler*, 303 U.S. 564 (1938). Congress generally addressed this issue from the perspective of the target and its shareholders in section 357.

[43] *See* Rev. Rul. 70-107, 1970-1 C.B. 78. In that ruling, the parent in a triangular reorganization assumed part of the target's debts. The Service held that the subsidiary was the acquiring corporation and therefore debts assumed by the parent were boot for purposes of the "solely for voting stock" rule. This rule does not apply, however, in other types of reorganizations that lack this statutory language of section 368(a)(1)(C). *See* Rev. Rul. 73-257, 1973-1 C.B. 189 (no boot, provided corporation assuming the debt is a party to the reorganization). In Rev. Rul. 70-224, 1970-1 C.B. 74, the Service held that directing all of the assets to be transferred to a subsidiary did not prevent the parent from being the acquiring corporation. Therefore, its assumption of part of the debt did not invalidate the transaction, which was treated as a merger into the parent followed by a separate section 351 transfer of substantially all the assets to a subsidiary. The Service has itself suggested that Rev. Rul. 70-107 was wrongly decided and should be revoked. See G.C.M. 39102 (Dec. 21, 1983).

limit the scope of the regulations in the interests of providing guidance as expeditiously as possible. On the other hand, this particular problem is closely related to the types of issues presented by triangular reorganizations.[44] As the Service has itself recognized, the rationale in Revenue Ruling 70-107 is questionable and there appears to be no tax policy reason for the position adopted by the Service.[45] Notwithstanding the caveats in the Preamble, the permissive approach of the Proposed Regulations may mislead taxpayers into assuming that asset transfers will not threaten reorganizations that otherwise qualify. This creates a real risk of technical foot-faults by taxpayers if the transferred assets are subject to liabilities. Therefore, the Committee urges the Treasury Department to clarify this issue as part of, or in conjunction with, the finalization of the Proposed Regulations.

6. Effective Date

The Committee has considered whether the regulations should be effective retroactively for transactions completed on or after the date of proposal. As the regulations merely adopt a more restrained government application of a judicially-created doctrine, it is arguably appropriate to apply this interpretation to earlier transactions that might otherwise have been adversely affected by the doctrine. Transactions may, however, have been structured and priced on the assumption that they would (or would not) be tax free.

The Committee believes that retroactive relief is less important than prompt finalization of the regulations. Therefore, the Committee recommends that the regulations be

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[44] In effect, this issue goes to the ability to transfer liabilities (as opposed to assets) within the group. While distinct as a theoretical matter, as a business matter it may be impossible to transfer assets separately from associated liabilities.

[45] *See* G.C.M. 39102, *supra*.

finalized promptly with their current prospective effective date. If the Proposed Regulations are finalized with a prospective effective date, however, the Service should reconsider the portion of the effective date rule that would apply the old rules to transactions occurring after the effective date pursuant to a binding written agreement entered into before that date. We believe most taxpayers will prefer to be governed by the new rules; the "binding agreement" rule will merely put pressure on practitioners and the Service to resolve issues such as whether a modification to or contingency in the agreement excludes the agreement from this rule. Therefore, the "binding agreement" provision either should be eliminated and the new rules applied to all transactions closing after the effective date or parties with the power to cancel contracts should be given the right to elect the application of the new rules.

Conclusion

While there are a few areas in which they might be modified, overall, the Proposed Regulations represent a significant improvement over the Service's previous approach to these issues. The Committee commends the Service for adopting a clear, administrable set of rules founded on the statutory language of section 368 and consonant with modern business realities. Sharply reduced reliance on arcane doctrines like Remote Continuity can only improve the transparency and efficient administration of the tax system.