NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON REORGANIZATIONS INVOLVING INSOLVENT SUBSIDIARIES

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New York State Bar Association Tax Section

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I. Introduction

This report sets forth the proposals of the New York Bar Association Tax Section on the U.S. federal income tax treatment of reorganizations involving insolvent subsidiaries.[1] The exclusive focus of the report is on potential reorganizations of a domestic or foreign corporate subsidiary, *i.e.*, a corporation whose parent corporation owns stock meeting the requirements of section 1504(a)(2).[2] Because special Code provisions govern reorganizations of corporations in bankruptcy,[3] and because corporate subsidiaries are often reorganized outside of bankruptcy, the report deals with reorganizations of non-bankrupt target subsidiaries. In particular, the report offers suggestions as to how the Internal Revenue Service (the "Service") and the Treasury Department ("Treasury") might interpret and expand, through regulations, existing provisions of the Code and regulations to provide greater flexibility to undertake business-motivated reorganizations of insolvent subsidiaries within a corporate group (i.e., internal restructurings). Other forms of insolvent company restructurings outside of bankruptcy, such as downstream transactions, acquisitions of a solvent corporation by an insolvent acquirer, and potential section 351 transactions, are not considered in this report. In our experience, such restructurings are less

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[1] The principal authors of this report are Lawrence Garrett and Stuart Goldring. Significant drafting was done by Christine Agnew, Lisa Joire, Jacob Lee, Adam Mukamal, Chayim Neubort, and Michael Tingoli. Significant comments were received from Kim Blanchard, Karen Gilbreath, Jonathan Kushner, Michael Schler, and Linda Swartz.

[2] Unless otherwise specified, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder. The report focuses on corporate subsidiaries meeting this stock ownership test because the stock ownership of most subsidiaries meets this test, and this level of stock ownership is required for a tax-free liquidation under section 332.

[3] Section 368(a)(1)(G) provides rules governing the qualification for tax-free reorganization treatment of certain transfers of assets in a bankruptcy case under title 11 of the U.S. Code or in receivership, foreclosure, or similar proceedings. The New York Bar Association Tax Section has previously commented on the application of these "G" Reorganization provisions. New York State Bar Association, Tax Section, Committee on Bankruptcy, Report on Reorganizations Under Section 368(a)(1)(G): Recommendations for Proposed Regulations, 85 TNT 231-85 (Nov 25, 1985).

prevalent and either present different issues or do not regularly implicate the issues discussed below.

Both "upstream" and "sideways" restructurings are analyzed in this report. For purposes of this report, an upstream restructuring is an actual or deemed transfer of the assets of the insolvent subsidiary to its parent corporation through merger, liquidation, or conversion into an entity that is disregarded pursuant to Treas. Reg. § 301.7701-3. In an upstream restructuring, intercompany stock and debt is cancelled (actually or constructively).[4] A sideways restructuring is a transfer of the assets of the insolvent subsidiary to a brother-sister corporation (the "acquiring subsidiary") through merger or otherwise.[5] In a sideways restructuring, intercompany debt of the insolvent subsidiary generally is either cancelled or assumed and the stock of the insolvent subsidiary is exchanged for stock of the acquiring subsidiary.

Part II of the report provides a summary of our conclusions. Part III summarizes the state of current law concerning restructurings of insolvent subsidiaries. In Part IV, we discuss the principal impediments to tax-free treatment of such restructurings. The policies that in our view should guide the resolution of issues are set forth in Part V. Part VI analyzes our recommendations in greater depth. We offer a few concluding thoughts in Part VII.

II. Summary of Conclusions

A. Upstream Restructurings of Insolvent Subsidiaries

1. Within a consolidated group, a transfer of the assets of an insolvent subsidiary to its parent corporation in liquidation of the subsidiary generally should qualify as a tax-free reorganization. As under current law, upstream restructurings should not

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[4] Intercompany stock and debt would be constructively cancelled for federal income tax purposes, although they would remain outstanding as a matter of state law, if the subsidiary were merged or converted into a limited liability company that is disregarded for federal income tax purposes.

[5] A sideways restructuring would include a transfer of the stock of one subsidiary to another subsidiary, followed by an actual or deemed liquidation of the target subsidiary through an election under Treas. Reg. § 301.7701-3 to treat the target as disregarded.

qualify for tax-free treatment under section 332 because there is no distribution with respect to the subsidiary's common stock.

Mechanically, for purposes of determining qualification as a reorganization (but not for purposes of determining qualification under section 332), we suggest that the parent corporation should be considered to have contributed any intercompany debt to the subsidiary's capital immediately before the reorganization in a separate transaction. Pursuant to Treas. Reg. § 1.368-1(e), the continuity of interest ("COI") requirement would be deemed to be satisfied by virtue of the parent corporation's receipt of the subsidiary's assets. However, as under current law, other requirements for a tax-free reorganization, including the business purpose requirement of Treas. Reg. § 1.368-1(b) and the continuity of business enterprise ("COBE") requirement of Treas. Reg. § 1.368-1(d), would have to be satisfied in order for the transaction to qualify. If these requirements are satisfied, the subsidiary would recognize no gain or loss pursuant to section 361(a) and (c). The parent corporation would recognize no gain or loss pursuant to section 354 (and would not trigger any excess loss account) with respect to the deemed exchange of its subsidiary stock, and the consolidated group would not be entitled to any worthless stock deduction under section 165(g) or any net deduction under section 166 in respect of the subsidiary's debt. The parent corporation generally would succeed to the subsidiary's tax attributes under section 381.

2. We believe that similar treatment with respect to upstream mergers of nonconsolidated corporations or the transfer of substantially all of the assets of a nonconsolidated subsidiary to its parent corporation. However given that Treasury's authority so to provide is unclear, we believe that such treatment be made available by election. Pursuant to such an election, the merger of a nonconsolidated domestic affiliate into its parent corporation, or the deemed or actual transfer of the assets of a foreign affiliate to its domestic parent corporation, would qualify for tax-free reorganization treatment. Any election

would have to be consistently applied by all parties to the transaction. In addition, it may be appropriate to adopt certain anti-abuse rules in connection with making the election available to taxpayers. Moreover, where no election is made and a worthless stock deduction is claimed, regulations should provide that tax attributes of the subsidiary that may carryover to the parent corporation (i.e., where a taxpayer takes the position under current law that the restructuring qualifies as a tax-free reorganization) are subject to limitation under section 382(a) pursuant to section 382(g)(4)(D).

B. Sideways Reorganizations of Insolvent Subsidiaries

1. Within a consolidated group, a transfer of the assets of an insolvent subsidiary to another consolidated group member (other than a parent corporation), in connection with the elimination of the subsidiary's separate existence for federal income tax purposes, generally should qualify as a tax-free reorganization. Mechanically, the parent corporation would be considered to have contributed any intercompany debt to the insolvent subsidiary's capital (and assumed certain third party debt, if applicable) immediately before the reorganization in a separate transaction. The parent corporation would then be deemed to receive stock of the acquiring subsidiary in the reorganization in exchange for the insolvent subsidiary's stock. The COI requirement would be deemed to be satisfied by virtue of the parent corporation's receipt of acquiring subsidiary stock. However, as under current law, other requirements for a tax-free reorganization, including the business purpose requirement and the COBE requirement would have to be satisfied in order for the transaction to qualify.

As in an upstream reorganization, the target subsidiary would recognize no gain or loss pursuant to section 361(a) and (c). The parent corporation would recognize no gain or loss pursuant to sections 354 (and would not trigger any excess loss account) with respect to the deemed exchange of its subsidiary stock and the consolidated group would not be entitled to any worthless stock

deduction pursuant to section 165(g) or any net deduction under section 166 in respect of the subsidiary's debt. However, the parent's basis in its stock of the insolvent subsidiary would be added to its basis in its acquiring subsidiary stock. The acquiring subsidiary generally would succeed to the target subsidiary's tax attributes under section 381.

2. Taxpayers should be permitted to elect similar treatment with respect to the transfer of all or substantially all of the assets of a nonconsolidated subsidiary to another subsidiary. For example, pursuant to such an election, the merger of an insolvent nonconsolidated domestic subsidiary into the acquiring domestic subsidiary may qualify for tax-free reorganization treatment. Any election would have to be consistently applied by all parties to the transaction. Anti-abuse rules similar to those described above with respect to upstream reorganizations could be applied as well.

III. Summary of Existing Authorities Addressing Reorganizations of Insolvent Corporations

In theory, an upstream restructuring could qualify, under appropriate circumstances, as a complete liquidation of the subsidiary under section 332 or a reorganization under section 368(a)(1)(A) or (C); a sideways restructuring could qualify as a reorganization under section 368(a)(1)(A), (C), or (D).[6]

Current law regarding upstream and sideways restructurings of insolvent subsidiaries is uneven. There is a fair degree of clarity in existing case law and IRS rulings with respect to a number of critical issues relating the qualification of upstream restructurings for tax-free treatment, although recent developments call in question whether older precedents still control. In contrast,

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[6] Reorganizations under section 368(a)(1)(F) are not discussed in this report because they involve a single operating company.

substantial uncertainty remains about whether sideways restructurings of insolvent subsidiaries can qualify for tax-free reorganization treatment.

A. Brief Summary of Statutory and Non-Statutory Requirements

Under section 332, a corporate taxpayer recognizes no gain or loss on the receipt of property distributed "in complete liquidation" of another corporation.[7] A distribution is "in complete liquidation" if (1) the corporate shareholder is affiliated with the liquidating corporation under section 1504(a)(2) from the time the plan of liquidation is adopted until the time of the distribution; (2) the distribution is in complete cancellation or redemption of all of the corporation's stock; and (3) the property is transferred either within the taxable year or under a plan of liquidation within a 3-year period.[8]

In order to qualify as a good reorganization, a transaction must meet both certain statutory requirements and three judicial requirements. To qualify as a reorganization under section 368(a)(1)(A) ("A" Reorganization), the transaction must be a statutory merger or consolidation "effected pursuant to the laws of the United States or a State or the District of Columbia."[9] To qualify as a reorganization under section 368(a)(1)(C) ("C" Reorganization), one corporation must acquire substantially all of the target corporation's assets, in exchange solely for all or a part of the acquiring corporation's voting stock.[10] To qualify as a reorganization under section 368(a)(1)(D) ("D" Reorganization), (1) a corporation must transfer all or a part of its assets to another corporation; (2) immediately after the transfer, the transferor, one or more shareholders of the transferor, or a combination thereof, must be in control of the transferee corporation;[11] and

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[7] Section 332(a).

[8] Section 332(b).

[9] Section 368(a)(1)(A); Treas. Reg. § 1.368-2T(b)(1)(ii). In addition, by operation of merger law, the acquiring corporation must acquire the assets of the target corporation and the target corporation must cease to exist. Mergers involving disregarded entities have somewhat more complicated rules governing their qualification as A Reorganizations.

[10] Section 368(a)(1)(C). Under Treas. Reg. § 1.368-2(d)(4)(i), prior ownership of the subsidiary stock by the parent does not prevent the solely for voting stock requirement of section 368(a)(1)(C) from being met.

[11] Control for "D" Reorganizations is determined under section 368(a)(2)(H).

(3), in pursuance of the plan, stock or securities of the transferee corporation must be distributed in a transaction under section 354, 355, or 356.[12]

In addition to these statutory requirements, under current law, to qualify as a reorganization under section 368, the transaction must meet three judicially created requirements – COBE, business purpose, and COI. To meet the COBE requirement, the acquiring corporation must either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets in a business.[13] To meet the business purpose requirement, the transaction must have a business purpose independent of its tax savings.[14] In order to meet the COI requirement, a substantial part of the proprietary interests in the target corporation must be preserved. The COI requirement is generally satisfied through the receipt by target shareholders of equity in the acquiring corporation; however, it may also be satisfied by exchanging stock of the target corporation for a direct interest in the target corporation's enterprise (as happens in an upstream restructuring).[15]

B. Current Law Concerning Upstream Restructurings of Insolvent Corporations

Qualification for tax-free treatment under section 332. Under current law, section 332 does not apply to liquidations of insolvent subsidiaries. In *H.G. Hill Stores, Inc. v. Commissioner*,[16] because of the subsidiary's insolvency, the court held that the parent received no property upon

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12 Section 368(a)(1)(D).

13 Treas. Reg. § 1.368-1(d)(1)

14 The origin of the business purpose requirement for reorganizations was *Gregory v. Helvering*. 293 U.S. 465 (1935). The regulations under section 368 state that "[t]he purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, *as are required by business exigencies*…." Treas. Reg. § 1.368-1(b) (emphasis added). *See also* Treas. Reg. § 1.368-1(c) ("A scheme… that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan *having no business or corporate purpose*, is not a plan of reorganization.") (emphasis added); Treas. Reg. § 1.368-2(g) ("the readjustments involved in the exchanges or distributions effected in the consummation [of a reorganization] must be undertaken for *reasons germane to the continuance of the business* of a corporation a party to the reorganization.") (emphasis added).

15 Treas. Reg. § 1.368-1(e)(1)(i). Courts have given some definition to what is "substantial" enough to meet this standard. According to the Supreme Court in *John A. Nelson Co. v. Helvering*, for example, as little as 38% of the total consideration received by target shareholders may be sufficient. 296 U.S. 374 (1935).

16 44 B.T.A. 1182 (1941)(applying section 112(b)(6) of the Revenue Act of 1936, the predecessor of section 332).

the cancellation of its stock and, therefore, did not qualify for section 332 nonrecognition treatment.[17] The current regulations under section 332 specify that the recipient corporation must receive at least partial payment for the stock that it owns in the liquidating corporation.[18] In addition, the Service has consistently ruled that an insolvent corporation cannot liquidate tax-free under section 332 because the shareholders receive no distribution with respect to their stock.[19]

Qualification for tax-free treatment under Section 368. The Service's position, as set forth in Rev. Rul. 58-296, is that an upstream restructuring of an insolvent corporation cannot qualify as a tax-free reorganization. In this ruling, the Service ruled that a merger of an insolvent subsidiary into its creditor-parent failed to qualify as a tax-free "A" Reorganization. The Service reasoned that:

> the transfer of all the debtor-subsidiary's assets to the creditor-parent in a transaction which is a merger or consolidation under the applicable state statutes is a transfer made in satisfaction of indebtedness. Since all of the property of the subsidiary is worth less than the debt, no part of the transfer is attributable to the stock interest of the parent. The transaction is therefore neither a nontaxable distribution under section 332 of the [Code] nor a tax-free "reorganization" under section 368(a)(1)(A) of the Code.

In Rev. Rul. 70-489, the Service reiterated its view that an upstream restructuring of an insolvent subsidiary failed to qualify as a tax-free reorganization. This revenue ruling is particularly significant as it was issued following the Service's acquiescence to the result reached by the Tax Court in *Norman Scott, Inc. v. Commissioner* (discussed further below), holding that a sideways restructuring could qualify as a tax-free reorganization where there essentially was an identity of shareholder and creditor interests.[20]

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[17] *Id.* at 1183. In *Hill*, the parent was permitted to claim a worthless stock deduction on the liquidation of its insolvent subsidiary. *Id.*

[18] Treas. Reg. § 1.332-2(b).

[19] See, e.g., Rev. Rul. 59-296, 1959-2 C.B. 87; Rev. Rul. 68-602, 1968-2 C.B. 135; Rev. Rul. 68-359, 1968-2 C.B. 161; Rev. Rul. 70-489, 1970-2 C.B. 53. The origin and development of authorities in this area is set out more comprehensively in Los Angeles County Bar Association, Taxation Section, Corporate Tax committee, The Missed Regime Change: A Fresh Look at Section 332 Liquidations of Insolvent Subsidiaries, 2003 TNT 94-124 (May 15 2003).

[20] 48 T.C. 598 (1967), AOD, 1967-104 (Dec. 7, 1967) (the Service acquiesced in result only). To some extent, in liberalizing the COI rules, the Service may have undercut its traditional view that upstream

Qualification for tax-free treatment by making a capital contribution. Absent an independent business purpose, a transaction cannot qualify for tax-free treatment by having the parent make a capital contribution to render its subsidiary solvent in anticipation of the upstream restructuring. In Rev. Rul. 68-602,[21] a subsidiary was insolvent because of debt owed to its sole shareholder. The corporate shareholder cancelled the indebtedness and liquidated the subsidiary, intending to qualify as a complete liquidation under section 332 and, thereby, inheriting the subsidiary's net operating loss carryover. The Service disregarded the cancellation of debt immediately before the liquidation because it was an integral part of the liquidation and had no independent significance. Because this step was disregarded, the Service ruled that the corporate shareholder received nothing in exchange for its stock interest in the subsidiary.[22] This rationale also applies to preclude transactions involving such capital contributions from qualifying as reorganizations because of failure to meet the COI requirement.[23]

Remaining Uncertainties. Despite the areas of relative clarity described above (at least in terms of the Service's position), current law remains unclear, in theory and in practice, as to a number of critical aspects governing the treatment of upstream restructurings.

First, if a subsidiary is potentially insolvent due to intercompany advances from its parent, considerable uncertainty may exist as to whether such advances constitute debt or equity for federal income tax purposes. Often, the proper characterization of intercompany advances is less than clear, and qualification as a tax-free reorganization may hinge on a fact-based determination as to their status. For example, if the intercompany advance were recharacterized as preferred or

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reorganizations cannot qualify as tax-free reorganizations. Because regulations now confirm that COI is satisfied in an upstream reorganization through the parent's direct ownership of the subsidiary's business, some commentators have argued that the requisite COI exists even where the subsidiary is insolvent. *See* Jerred G. Blanchard, Jr. et. al., *Workouts Involving Affiliated Groups of Corporations*, U.S.C. L. Center, Tax Inst., Major Tax Planning – USC Law School Annual Institute on Federal Taxation 55-5 (2003).

[21] 1968-2 CB 135.

[22] It is unclear whether a different result is achieved within a consolidated group. Under Treas. Reg. § 1.1502-13(g)(3) and Prop. Treas. Reg. § 1.1502-13(g)(3), it may be possible to argue that the intercompany debt may viewed as deemed satisfied immediately before the capital contribution in a separate transaction that renders the subsidiary solvent. *But see* Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* § 33.03[4][c], at 33-81 (2d ed. 2003).

[23] *See* Rev. Rul. 59-296, 1959-2 C.B. 87.

common equity for federal income tax purposes, an upstream restructuring of the subsidiary may qualify as a tax-free reorganization because the parent corporation could then satisfy the COI requirement; it would be continuing its proprietary interest through the direct ownership of the subsidiary's business.

In *Spaulding Bakeries Inc. v. Commissioner*,[24] the parent corporation owned both common and preferred stock in an insolvent subsidiary. The subsidiary liquidated and distributed assets to the parent that were worth less than the liquidation preference on the preferred stock. The Second Circuit held, under a predecessor to section 332, that a partial payment on preferred stock did not constitute a liquidation because no assets were distributed with respect to the common stock.[25] If the payment on the preferred stock had exceeded its liquidation preference, the transaction would have qualified as a liquidation because there would have been at least a partial distribution with respect to the common stock.[26]

At the time of the *Spaulding Bakeries* decision, a transaction could not qualify as a reorganization under section 368(a)(1)(C) because the parent corporation already owned some subsidiary stock. In the *Bausch & Lomb* case, the Second Circuit held that an upstream restructuring could not qualify as a "C" Reorganization because the acquirer received the assets of the subsidiary at least in part in exchange for its interest in the target and not solely for its own voting stock.[27] In 1998, the Service effectively overruled this result. Under the so-called "anti-*Bausch & Lomb*" regulations, prior ownership of the subsidiary stock by the parent does not necessarily prevent the solely for voting stock requirement of section 368(a)(1)(C) from being met.[28] Under current law, therefore, it seems that a *Spaulding Bakeries*-type transaction could qualify as tax-free under the section 368 reorganization provisions.

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[24] 27 T.C. 684 (1957), *nonacq.*, 1957-2 C.B. 8, *aff'd*, 252 F.2d 693 (2d Cir. 1958).

[25] *See also H.K. Porter Co. v. Comm'r*, 87 T.C. 689 (1986).

[26] *Spaulding Bakeries*, 27 T.C. at 688.

[27] *Bausch & Lomb Optical Co. v. Comm'r*, 267 F.2d 75 (2d Cir. 1959) (holding that the acquiror's previous ownership of some of the target's stock disqualified an asset acquisition from being a "C" reorganization, treating the target corporation as redeeming the previously held stock with some of the assets it transferred to the acquiror).

[28] Treas. Reg. § 1.368-2(d)(4)(i).

Second, a recent field service advice could be read to call into question whether "mere insolvency" precludes reorganization status. FSA 200226004[29] raised the issue of whether insolvency alone is enough to prevent there from being a distribution on shareholder stock. In FSA 200226004, a U.S. holding corporation "checked the box" on two foreign entities, then claimed a worthless stock loss on the common stock of both of the foreign entities. Despite the fact that the foreign entities were insolvent, the Service argued against the worthlessness of the stock because of a number of facts, including: (1) the fact that the businesses continued to operate as before; (2) the foreign entities had been unaware of the change in form; (3) it was unclear whether the U.S. corporation had written the stock off as worthless on its books; (4) it was unclear if the stock had been cancelled; and (5) the beneficial ownership of the U.S. corporation had not changed.

It is not clear how the Service could deny the worthless stock deduction on the basis that the stock of the subsidiary is not worthless without concluding that the upstream restructuring qualified for tax-free treatment under either section 332 or 368. Possibly the Service's position in the FSA was based on the theory that a subsidiary's insolvency does not assure that its stockholders would not receive any value in a restructuring. Often, shareholders of an insolvent company are able to extract some value in a workout. Thus, the Service may be signaling that the distribution requirement for a section 332 liquidation can be satisfied even by an insolvent subsidiary, provided that the shareholders would be able as a practical matter to obtain value in a workout; in this view, only true worthlessness, not mere insolvency, would be disqualifying. If so, even greater uncertainty would be injected into the law governing upstream restructurings.

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[29] (June 28, 2002).

C. Current Law Governing Sideways Restructurings of Insolvent Corporations

The treatment of sideways restructurings, at least in terms of the Service's position, is significantly less certain than the treatment of upstream restructurings. Sideways restructurings have two potential pathways to tax-free treatment: (1) under the doctrine underlying *Norman Scott*, which appears to hold that the COI requirement is satisfied where there is substantial identity in the shareholder and creditor interests, or (2) as a "D" Reorganization, which (at least in certain circumstances) appears to permit COI to be satisfied by the fact of common ownership regardless of the consideration given for the sideways reorganization.

Sideways Reorganizations involving an Identity of Shareholder and Creditor Interests. In certain cases, courts have concluded that sideways restructurings of insolvent subsidiaries qualify as tax-free reorganizations. The basis for this conclusion appears to be that, where the ownership of the shareholder and creditor interests is in the same hands, it is not necessary to determine for COI purposes the capacity in which the creditor-shareholder received the stock of the acquiring corporation.

In *Norman Scott*,[30] a merger in which two insolvent sister corporations merged into a third sister corporation was held to have met the requirements for a valid reorganization. Norman Scott and his wife owned 99% of the common stock of three corporations: Norman Scott, Inc., River Oaks Motors, Inc. ("River Oaks"), and Houston Continental Motors Ltd., Inc. ("Continental"). River Oaks and Continental were insolvent, by virtue of debt owed to Norman Scott, Inc. and to third party creditors. Norman Scott individually was liable for certain debts of River Oaks and Continental as a result of having endorsed such debts. Norman Scott, Inc. was not insolvent. River Oaks and Continental were merged into Norman Scott, Inc. In the merger, the shares of River Oaks and Continental were, in form, exchanged for additional shares of Norman Scott, Inc.

The Service challenged the qualification of the mergers for tax-free reorganization status. The Service argued that:

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[30] 48 T.C. 598 (1967), *action on dec.*, 1967-104 (Dec. 7 1967) (the Service acquiesced in result only).

> since the stock of River Oaks and Continental had no value the properties were in substance transferred to Norman Scott**,** Inc. as a creditor as payment on the debt; that there was not in substance an exchange of stock for stock, or of equity for equity; that the transfers were of "property" of a net value less than the debt owned by each corporation to petitioner and that the transaction merely served to satisfy in part that indebtedness and at the same time to have petitioner assume certain liabilities which Norman Scott individually would otherwise have had to pay.[31]

The Tax Court rejected the Service's position, finding that the COI requirement was satisfied because the insolvent target corporations' shareholders received a proprietary interest in the acquiring corporation *either* as shareholders or as creditors.

> The receipt by Norman and Janie Scott of petitioner's stock may have been as stockholders of River Oaks and Continental or as creditors of two insolvent corporations. The latter could be so either because they possessed a 99-percent interest in the petitioner corporation which was River Oaks' and Continental's largest single creditor outside of the Commercial Credit Corp., or because, as an accommodation endorser on several of the insolvent corporations' notes payable, Norman Scott would soon inevitably become a creditor for amounts paid to satisfy such notes. A creditor of an insolvent corporation qualifies as having a proprietary interest in such corporation. [Citations omitted.] Thus Norman and Janie Scott had a proprietary interest in River Oaks and Continental prior to the merger, either as stockholders or as creditors. It is not necessary for us to determine the exact nature of their interest for surely it was one or the other. In return for their interest, which had value as stockholders if the corporations were not insolvent in a bankruptcy sense and as creditors even if the corporations were insolvent, they were issued stock of petitioner. As such, the holders of the proprietary interest in both River Oaks and Continental maintained the requisite proprietary interest in petitioner as the surviving corporation of the merger.[32]

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31 AOD, 1967-104 (Dec. 7, 1967)

32 48 T.C. at 604.

The Tax Court further rejected the Service's argument that the mergers affected nothing more than the repayment of indebtedness owed to Norman Scott, Inc. In so doing, the Tax Court explicitly distinguished a sideways reorganization, like the one involved in *Norman Scott*, from upstream reorganizations, like those involved in Rev. Rul. 59-296 and *H.G. Hill Stores*:

> In Rev. Rul. 59-296 the respondent placed reliance on *H.G. Hill Stores [citation omitted]*. In that case we found that amounts received by the parent corporation which was also the principal creditor of its insolvent subsidiary were received as a creditor rather than a stockholder. Accordingly, we upheld the parent corporation's contention that it was correct in taking a bad debt deduction for debts owed by its subsidiary in excess of the value of the assets transferred to it. We think the *Hill Stores* case is distinguishable, as is the revenue ruling which relies on it. The issue in the *Hill Stores* case was whether the transaction before

The Service ultimately acquiesced in the result reached in *Norman Scott*, although it rejected the broad sweep of the Tax Court's reasoning. In the Service's view, COI was satisfied, but only because there was a virtual identity of shareholder and creditor interests:

> In view of the fact that Norman and Janie Scott owned about 99 percent of the common stock in River Oaks and Continental, the result reached in this case is reasonable. However, since there is language in the opinion which seems to indicate that the exchange of debt in River Oaks and Continental for stock in Norman Scott**,** Inc. would not have disqualified the transaction as a 368(a)(1)(A) merger even if Norman and Janie Scott did not own 99 percent of the stock in River Oaks and Continental, unqualified acquiescence would be misleading. Also the opinion is misleading where it suggests that creditors of an insolvent corporation have a proprietary interest therein prior to the time they invoke legal processes to enforce their legal rights of full priority. [Citations omitted.][33]

One year following the Tax Court's decision in *Norman Scott*, the Eighth Circuit reached a similar result in *Adkins-Phelps*. [34] The latter case involved a merger of J.F. Weinmann Milling Company ("Weinmann") into Adkins-Phelps, Incorporated ("Adkins-Phelps"). An individual, Mrs. Weinmann, owned approximately 99% of the shares of Weinmann and one-sixth of the shares in Adkins-Phelps. Mrs. Weinmann also was one of the largest creditors of Weinmann. In connection with the merger, Mrs. Weinmann agreed to treat a portion of the debt as having been contributed to capital. The court rejected the Service's assertion that the COI requirement was not satisfied, applying reasoning consistent with *Norman Scott*:

> the Court was the satisfaction of an indebtedness or the liquidation of an insolvent subsidiary which was in fact a distribution in cancellation of the parent corporation's stock. This Court properly rejected the latter theory because in order to have a liquidation under section 112(b)(6) of the Revenue Act of 1936 the transfer must have been in cancellation or redemption of the parent's stock in the subsidiary. Since we found that the disputed transfer was motivated by the parent's position as a creditor rather than as a stockholder, the statutory language prohibited treatment of the transaction as a liquidation. Rather than a liquidation, the petitioner in this case is claiming the right to enter into a statutory merger under section 368(a)(1)(A). Nowhere in the statute or the applicable regulations is there a requirement that the stock or assets received by a transferee corporation in a merger be received in the role of a stockholder rather than a creditor. Thus the statutory language which compelled us in the *Hill Stores* case to find that there could not have been a liquidation is not present in the statutory provisions dealing with mergers. 48 T.C. at 605.

[33] AOD, 1967-104 (Dec. 7, 1967)

[34] *See also United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir.1968) (disregarding whether a shareholder/creditor received her stock as a shareholder or as a creditor).

> No appropriate action has here been taken to divest the stock equity interest. The claims of all creditors have been adjusted and satisfied. An equity stock interest in the Weinmann stock has been established in Mrs. Weinmann and such interest which was exchanged for stock in Adkins-Phelps establishes the required continuity of interest.
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> In any event, Mrs. Weinmann was a substantial creditor of the corporation. The claims of other substantial creditors were satisfied. Thus it would seem to make little difference whether Mrs. Weinmann received her stock in Adkins-Phelps, Inc., as a stockholder or a creditor of the old corporation. [Citations omitted.][35]

Sideways Restructurings under Section 368(a)(1)(D). The "D" Reorganization provisions provide a second route to qualification of a sideways restructuring as a tax-free reorganization.[36] Two aspects of the requirements applicable to "D" Reorganizations – the COI rules and the distribution requirement -- are likely to be critical to the analysis.

The section 368 regulations suggest that the COI rules generally applicable to other reorganizations do not apply to "D" Reorganizations, at least not pursuant to the same terms. Treas. Reg. § 1.368-1(b) states that COI is required to qualify as a reorganization, "except as provided in Section 368(a)(1)(D)." As applied to corporate subsidiaries, the critical aspect is that the COI requirement generally appears to be subsumed by the control requirement; the transferor, one or more shareholders of the transferor, or a combination thereof, must be in control of the transferee corporation immediately after the transfer for the transaction to qualify as a "D" Reorganization.[37] That is, if the control requirement is satisfied, it appears that satisfaction of the COI requirement will not be precluded by the fact that the acquiring corporation predominantly, or even entirely, provides non-stock consideration for the acquisition.

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[35] 400 F.2d at 742.

[36] *Seiberling Rubber Co. v. Comm'r*, 169 F.2d 595 (6th Cir. 1948), *rev'g* 8 T.C. 467 (1947) (holding that a transaction that did not qualify as another type of reorganization nevertheless qualified as a "D" Reorganization).

[37] The definition of control in section 304(c) is applicable. Section 304(c) defines control as "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock."

In Rev. Rul. 70-240, [38] for example, a sister corporation sold its operating assets to its brother corporation for cash equal to their fair market value, used a portion of the cash to pay its liabilities, and then liquidated, distributing the remaining proceeds to the common shareholder. The Service ruled that the transaction qualified as a "D" Reorganization, a result that it could not reach if the COI requirement applied based on traditional measures – i.e., how much of the acquisition consideration is stock. Consistent with Rev. Rul. 70-240, a sideways reorganization of an insolvent subsidiary should not fail to qualify as a "D" Reorganization based on a failure to satisfy COI because the parent corporation will satisfy the control requirement and, as such, will maintain its proprietary interest in the insolvent target subsidiary.

The distribution and exchange requirements applicable to "D" Reorganizations are potentially another important impediment to achieving tax-free treatment of a sideways restructuring of an insolvent corporation. Pursuant to this requirement, the target corporation must distribute stock or securities of the acquiring corporation in a distribution to which section 354 applies. Section 354(a)(1) applies to an exchange, pursuant to the plan of reorganization, of stock or securities of the target corporation for stock or securities of the acquiring corporation.

The distribution and exchange requirement potentially presents two difficulties as applied to an insolvent target. First, the acquiring corporation might be deemed to have simply acquired the assets of the target corporation in exchange for the assumption of third party debt or the repayment of intercompany debt (i.e., debt owed by the target to the acquirer). In such case, the target corporation would appear not to have received any acquiring corporation stock that it may distribute. Second, if the target corporation is insolvent by virtue of intercompany debt owed to its parent that does not constitute a security (e.g., open account debt), any acquiring stock actually, or deemed to be, received by the target corporation would be deemed to be exchanged for target debt not constituting a security, thereby violating the requirement that there be an exchange of acquiring corporation stock for target corporation stock or securities.[39]

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[38] 1970-1 C.B. 81.

[39] For a general discussion of what constitutes a security under section 354, see Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 12.41[3] (7th ed. 2000).

Rev. Rul. 70-240 appears to address the first problem. In the ruling, the Service effectively deemed there to be an issuance and distribution to the common shareholder because such an issuance and distribution in the case where the ownership of the target and acquiring corporations was identical would simply have been a "meaningless gesture." Where an insolvent subsidiary and the acquiring subsidiary are wholly owned, directly or indirectly, by the same parent corporation, the issuance of an additional share of stock by the acquiring may be viewed as meaningless.[40] However, Rev. Rul. 70-240 did not deal with a situation in which share ownership is not identical and thus the issuance of a share of acquiring stock might not be meaningless in a sideways restructuring of an insolvent subsidiary where there is minority ownership (which would be diluted if there were an actual issuance of shares). In addition, the issuance of shares may not be meaningless where the subsidiary is insolvent by virtue of debt to a third party creditor, which may have a priority claim on any additional consideration issued by the acquiring corporation.

In the context of a sideways restructuring (in contrast to an upstream restructuring), it may be possible to avoid the problems discussed above by having the parent corporation contribute intercompany debt of the target corporation to capital prior to the restructuring. In Rev. Rul. 78-330,[41] the Service ruled that the cancellation of debt by a parent corporation in order to avoid section 357(c) gain on a subsequent "D" Reorganization should be respected. The Service reasoned that such contribution has independent economic significance because it results "in a genuine alteration of a previous bona fide business relationship." As discussed above, in Rev. Rul. 68-602, the capitalization of debt prior to an upstream restructuring was essentially transitory because the upstream restructuring eliminated its continuing effect; in contrast, the capitalization of debt in Rev. Rul. 78-330 permanently altered the capital structure of the target corporation, which alteration remained in effect following a subsequent sideways restructuring. By analogy to Rev. Rul. 78-330, a strong case can be made that a capitalization of intercompany debt that renders solvent a subsidiary in anticipation of a sideways restructuring ought to be

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[40] As discussed below, this rationale may not hold where the subsidiary is insolvent by virtue of debt to a third party creditor, which may have a priority claim on any additional consideration issued by the acquiring corporation.

[41] 1978-2 C.B. 147.

respected as a separate transaction that permits the restructuring to satisfy the distribution requirement of a "D" Reorganization.[42]

IV. Principal Impediments to Qualification for Tax-free Reorganization Treatment

Historically, the COI requirement as developed by the courts and adopted by the Service in regulations, and the exchange requirement of section 354(a), have represented the principal impediments to qualification of insolvent company restructurings as tax-free reorganizations. To a lesser extent, the "substantially all of the assets" requirement applicable to "C" and "D" Reorganizations and the COBE requirement also have been obstacles.

A. The COI Requirement

To constitute a tax-free reorganization, the owners of the proprietary interests in a corporation must establish, among other things, that they have retained a continuing equity interest in the acquiring corporation – the so-called COI test. The purpose of the COI requirement is to distinguish a mere readjustment of equity interests entitled to tax-free treatment, from a sale that ought to be taxable. COI requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.[43] For purposes of granting a ruling in this context, the Service generally requires the taxpayer to represent that the former owners will receive and retain at least 50% of the value of their prior stock interest in the form of a continued proprietary interest in the reorganized entity.[44]

The fundamental purpose for requiring COI is unchanged by the fact that a company is insolvent. However, determining who are the "owners" of the company prior to and after the reorganization in order to effectuate this purpose is complex.

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[42] In at least one context, the Service adopted this rationale in finding that a transaction constituted a "D" reorganization. The transaction consisted of a contribution of debt to the target subsidiary by the parent corporation, the liquidation of the target subsidiary into parent, and the reincorporation of the target subsidiary's assets into a newly formed acquiring subsidiary. FSA 199915005 (Apr. 16, 1998).

[43] Treas. Reg. § 1.368-1(e)(1).

[44] Rev. Proc. 74-26, 1974-2 C.B. 478.

In a typical reorganization of a solvent corporation, the shareholders own the proprietary interests. Accordingly, the class of persons with respect to which COI is measured is clear.

In cases involving the reorganization of a financially distressed corporation, determining who should be deemed to own the proprietary interests, not to mention the extent of each such person's proprietary interest, prior to the reorganization is far from clear. In certain circumstances, courts have recognized (and in the context of "G" Reorganizations, Congress has recognized) that creditors should be considered to step into the shoes of the shareholders for purposes of determining whether COI has been satisfied. These circumstances generally involve the initiation of formal proceedings by creditors. As discussed above, outside of these circumstances, and except where there is a virtual identity of ownership of debt and equity (e.g., as in *Norman Scott*), creditors have not been treated as proprietors for COI purposes. Moreover, as described below, even where creditors are treated as proprietors, difficult interpretive issues remain.

Once formal proceedings have been initiated, treating creditors rather than shareholders as owners of the proprietary interests makes a lot of sense, because the creditors effectively own the company and often have funded its corporate tax attributes (asset basis, net operating losses, etc). The landmark case that laid the framework for modern COI jurisprudence in the insolvency context is *Helvering v. Alabama Asphaltic Limestone Co*.[45] In *Alabama Asphaltic*, all of the stock of the acquiring corporation was received by noteholders and other creditors of the insolvent corporation in an involuntary bankruptcy proceeding. The Service argued that, because the shareholders failed to receive stock of the acquiring corporation, there was no COI and, therefore, no "reorganization" for tax purposes. The Supreme Court, however, held that the continuing equity interest of the insolvent corporation's *creditors* in the acquiring corporation satisfied the COI requirement. The Court stated that the creditors, by virtue of their right under the bankruptcy laws to "absolute priority" over the shareholders, had "stepped into the shoes" of the shareholders for COI purposes.[46] This occurred, apparently, not at the time of the reorganization, but, according to the Court, upon "the date of the institution of bankruptcy

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45 315 U.S. 179 (1942).

46 Id. at 183.

proceedings[, since f]rom that time on, [the creditors] had effective command over the disposition of the property." In the companion case *Palm Springs Holding Corp. v. Commissioner*,[47] the Supreme Court similarly viewed creditors as proprietors where they instituted a foreclosure action (as opposed to a bankruptcy proceeding) to acquire effective control over the debtor's property.

Applying *Alabama Asphaltic* to situations where the absolute priority rule of the substantive bankruptcy law was not strictly followed or where the most junior class of creditors to receive consideration received cash or other consideration not qualifying under the COI rules was problematic.[48] The Tax Court dealt with both of these issues in *Atlas Oil & Refining Corp. v. Commissioner*,[49] wherein the first mortgage bondholders (holding $961,400 in claims) in a bankruptcy reorganization received new bonds with the same face amount containing less favorable terms (including an interest rate reduction) than those originally issued by the debtor corporation, the second mortgage bondholders (holding $1,500,750 in claims) received stock valued at $435,000 in the acquiring corporation, the most junior class of creditors (holding no more than $505,379 in claims) received only a small cash distribution of 10 cents on the dollar, and $100,000 was contributed by third parties for common stock. Nevertheless, COI was found to exist, there being $435,000 of continuing proprietary interests distributed to the first mortgage bondholders, even though a more junior class received only cash.[50]

The Tax Court in *Atlas Oil* went to considerable lengths to eliminate strict compliance with the absolute priority rule as a prerequisite for COI in a bankruptcy reorganization, by relying on the arm's length negotiations that underlay the plan approved by the bankruptcy court to

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47 315 U.S. 185 (1942).

48 Pursuant to the absolute priority rule, amounts are distributed to claimants in accordance with the priority of their claims, from highest to lowest.

49 36 T.C. 675 (1961), acq. 1962-2 C.B. 3.

50 It is not clear what weight is accorded to the value of equity consideration received. In Commissioner v. Newberry Lumber & Chemical Co., bondholders of the debtor corporation in receivership received 100% of the stock and bonds of the reorganized entity. The court held there was a valid reorganization even though stock had only nominal value. 94 F.2d 447 (6th Cir. 1938). One might argue that Newberry was thinly capitalized so under general tax principles, the reorganized company's debt should be considered equity for purposes of determining continuity. *Cf.* LeTulle v. Scoffield, 308 U.S. 415 (1938). Alternatively, one might argue that ownership of 100% of the stock is itself substantial enough to satisfy the continuity of interest requirement without regard to the stock's underlying value.

demonstrate that "each class of bondholders [was provided] with an interest in the new company substantially in proportion to the amount of the equity which was to be surrendered therefor, and that no equities were recognized that did not in fact exist."[51] The Tax Court held that "practical adjustments" which might result in technical violations of the absolute priority rules – such as lowering the interest rates on senior debt where junior creditors are also allowed to participate – will not destroy COI, at least if the "unjustified" participation of the junior creditors can be described as "insubstantial."[52]

The Tax Court in *Atlas Oil* held that the most junior creditors of the acquired corporation to receive some consideration should not be considered its only former owners; so restricting the class of proprietors would have defeated COI. The court did not explicitly address the basis for this holding, but one possibility is that the cash received by the junior creditors was treated as received by the second mortgage bondholders and then transferred to the junior creditors. Alternatively, it may be that the junior creditors' participation was viewed as so "insubstantial" that they were irrelevant for COI purposes. Certain language in the opinion ("all of the equity vested in the second mortgage bondholders and . . . all of the latter received stock …"[53]) would support this reading.

If the Tax Court had applied the absolute priority rule on the date that the bankruptcy proceedings were initiated, the first bondholders would have owned 100% of the company and there could have been no COI because the first bondholders did not receive equity upon the consummation of such proceedings. Instead, the Tax Court used a "relation back" approach to COI whereby the determination of which creditors owned a proprietary interest in the company was determined at the consummation (rather than the commencement) of the bankruptcy case.[54]

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51 Id. at 685.

52 Id. at 685-86.

53 Id. at 689.

54 The *Atlas Oil* court stated,

> Inasmuch as there is no requirement that any surviving creditor retains his status in the new corporation, and they are all permitted, although fully protected, to share in the new stock distribution, all creditors *receiving stock* may be deemed "former owners" at the time they receive it in determining whether the continuity-of-interest rule is satisfied.

Id. at 688 (emphasis in original). Citing *Maine Steel, Inc. v. United States*, 174 F. Supp. 702 (D. Me. 1959), the court also stated,

Some may argue that the Tax Court's departure from the absolute priority rule in *Atlas Oil* is inconsistent with the Supreme Court's analysis in *Alabama Asphaltic*. The better argument is that *Atlas Oil* is a logical extension of *Alabama Asphaltic* and that the Tax Court's "relation back" approach is an overlay – not a departure from -- the absolute priority rule. The Tax Court has certainly embraced this extension and, in the context of "G" Reorganizations, Congress has as well.[55]

Since *Atlas Oil,* taxpayers have become comfortable with the notion that the COI analysis begins with the most senior class of creditors who actually receive equity interests and ends with the last group of creditors/shareholders who receive any stock consideration for their claims/interests. So long as the plan does not exclude any middle tier creditors (i.e., by giving them cash consideration rather than stock), the COI requirement should be satisfied.

One of the principal issues that remains outstanding in the wake of *Atlas Oil* is whether the judicial parameters of the COI requirement have been strictly defined or whether *Atlas Oil* demonstrates a more fluid approach to determining continuity in the insolvency context that takes into account the "practical adjustments" that take place as part of the negotiation process among creditors to resolve claims in the most cost-efficient manner. For example, assume that there are three classes of creditors (senior, middle-tier and junior). If the senior class receives stock worth less than its claim, middle-tier creditors receive non-equity consideration and the junior creditors receive a token amount of equity consideration, one could argue based on dicta in *Atlas Oil* that such a "practical adjustment" does not break continuity because their unjustified participation can only be described as insubstantial for purposes of determining continuity.

> [C]reditors who have a bona fide interest remaining *who in fact receive stock in the new corporation*, by relation back, can be deemed to have been equity owners at the time of the transfer, so as to be capable of satisfying the continuity-of-interest requirement that stock go to former owners. While "effective command" over the properties in an insolvency proceeding is necessary to change the creditors into equity owners to satisfy continuity of interest, the fact that a protected class may have had "effective command" over the assets in such proceedings will not *make* them equity owners for participation purposes if they do not in fact exercise their right to anticipate in the equity distribution of the new corporation.
> *Id.* (emphasis in original).

Under this interpretation the Tax Court could (and perhaps should) have held expressly that the second mortgage bondholders of the debtor corporation (who received stock in the acquiring corporation) and its junior creditors (who received only cash) were all "owners" and that, as to the class of "owners" as a whole, the continuity of interest test was met.

[55] S. Rep. No. 96-1035, at 35 (1980).

Alternatively, one might consider redeeming the middle-tier creditors' claims prior to the commencement of the case, arguing that a possible extension of the Tax Court's decision in *Atlas Oil* would be to ignore such creditors because one only looks to those creditors at the consummation of the case (rather than the commencement) to identify the proprietary interest holders for purposes of determining continuity.[56]

Where formal proceedings have not been instituted, it is not entirely clear whether the creditors should be taken into account for purposes of determining whether the COI requirement has been satisfied. Under a strict reading of *Alabama Asphaltic* and its progeny, one might well think that creditors should not be counted. The Court in *Alabama Asphaltic* stated that ownership of the equity shifts to creditors " . . . not later than the time when the creditors took steps to enforce their demands against their insolvent debtor." In that case, initiating the bankruptcy proceedings was the right time to transmute the creditors into equity owners. The difficulty outside of formal insolvency proceedings is pinpointing the point in time when the "creditors" have taken sufficient steps to cross the line between creditor and equity owner. Another layer of complexity in this context is determining who the "creditors" are, because informal insolvency workouts are more likely to involve related parties.

As described above, in a number of cases where the creditors have not instituted formal insolvency proceedings, but where there was substantial overlap between the creditor and stockholder groups, courts have held that the COI requirement has been satisfied. However, even if there is significant shareholder/creditor overlap, it is not clear what weight (if any) is placed on the relative priority of creditors or whether any consideration is given to whether their claims as creditors and shareholders should be bifurcated.

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[56] *See* Gordon D. Henderson and Stuart J. Goldring, TAX PLANNING FOR TROUBLED CORPORATIONS §605.1.4, at 303 (2003 ed.).

B. Section 354 Considerations

Section 354 provides two obstacles to the treatment of insolvent company restructurings as tax-free pursuant to the reorganization. The first is definitional in the sense that it affects whether certain transactions can qualify as reorganizations under section 368. The second is consequential in the sense that it affects the treatment of the holders of target stock and debt in a transaction qualifying as a reorganization under section 368.

Section 354 as a Definitional Obstacle. In acquisitive "D" Reorganizations, unlike "A" and "C" Reorganizations, the stock or securities of the acquiring corporation received pursuant to the plan of reorganization must be distributed "in a transaction which qualifies under section 354 . . . or 356."[57] Section 354(a)(1) provides that:

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization is, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 354(b) further provides that:

> Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1), unless [(A) the corporation acquires substantially all of the assets of the transferor and (B) distributes all of its assets thereafter pursuant to the plan of reorganization].

Under a literal reading, the reference in the "D" Reorganization provision to section 354 would appear to require that at least one shareholder or security holder of the transferring corporation receives stock or securities of the acquiring corporation. Significantly, this requirement is of no

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[57] Section 368(a)(1)(D). Although "G" reorganizations also contain this requirement, as indicated earlier the scope of this report is limited to insolvency reorganizations of non-bankrupt corporations. Nevertheless, our discussion herein is consistent with the prior recommendations of the Tax Section in our 1985 Report. *See* New York State Bar Association Tax Section, *Report on Proposed Regulations on Continuity of Business Enterprise in Corporate Reorganizations* (May 21, 1980), at 5-9.

moment in the case of a solvent corporation, since the receipt of stock by shareholders of the transferring corporation is the *sine qua non* of a good "D" Reorganization. In the context of an insolvent corporation, however, the only distribution of stock may be to creditors, possibly none of whom are security holders.

This presents an interesting situation in the context of reorganizations of insolvent subsidiaries. For example, assume Parent has stock and debt of subsidiary A, that A is insolvent by reason of such debt and that the stock of A is worthless. Subsidiary A now transfers its assets to solvent subsidiary B and liquidates, in a transaction which under the Tax Court's decision in *Norman Scott* would not be precluded from qualifying as a good section 368 reorganization. If a technical requirement of "D" Reorganizations, however, is the receipt of stock by at least one shareholder or security holder and the intercompany debt does not constitute a security, it would appear that the described transfer would fail as a "D" Reorganization.

An interesting variation occurs if (i) the target and acquiring subsidiaries are both domestic corporations, and (ii) the acquisition occurs by merger. In such case, it would appear that the transaction qualifies as an "A" Reorganization, but not a "D" Reorganization; reorganization treatment would be available under the *Norman Scott* case. Moreover, no gain would be recognized under section 357(c) by the target corporation on the acquiring corporation's assumption of liabilities in excess of basis.[58]

As discussed below, we believe that a reorganization of an insolvent (controlled) subsidiary should be treated roughly equivalent to, and not better than, a restructuring of solvent subsidiaries. Accordingly, we believe that the receipt of stock by one shareholder or security holder should *not* be a condition of "D" Reorganization treatment.

Supportive of the absence of a technical distribution requirement to stockholders in a "D" Reorganization is the statutory predecessor to the modern day "D" Reorganization that was

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[58] If the group filed a consolidated return, no section 357(c) gain would be recognized even in a "D" reorganization. Treas. Reg. § 1.1502-80(d).

considered by the Supreme Court in *Helvering v. Southwest Consolidated Corp.*[59] At issue in that case were the provisions of section 112(g)(1) of the 1934 Act, which were ultimately incorporated into the 1939 Act. In that case, only creditors received stock of the acquiring corporation. The Commissioner argued that the transaction did not qualify as a reorganization, and the Court agreed. As it related to the predecessor of today's "C" Reorganization, the transfer failed since solely voting stock was not issued. As to a "D" Reorganization, the Court declared that, because the creditors were not "stockholders" (although they may be equity holders for COI purposes, under the reasoning of *Alabama Asphaltic*), they did not satisfy the requirement that the same stockholders be in control both before and after the transfer. The court did not, however, indicate that the failure to have an actual distribution of stock to stockholders was, in and of itself, a death knell. Had it so ruled, it could have dispensed with the last third of its opinion. Rather, in addressing the "D" Reorganization predecessor, it did so solely based on the lack of control before and after.

Tracing the "D" Reorganization provisions forward up through the 1954 Code, when the section 354 distribution requirement was added, we can find no express intent to change the operation of the "D" Reorganization provisions in this regard. Rather, the only intent appears to have been to impose the "substantially all" and "liquidation" requirements.

Historically, any discussion of the "at least one shareholder or security holder" aspect of section 354 has centered on its application in the context of "G" Reorganizations. Within that context, the presence of a "one shareholder or security holder" requirement can be the difference between whether a transfer of assets qualifies as a tax-free reorganization or not at all. As we have previously discussed in our "G" Reorganization report (cited above), we do not believe that the imposition of a "one shareholder or security holder" condition to have been intended by Congress. Rather, the reference to section 354 appears to have been intended to incorporate the provisions of section 354(b).[60] Nevertheless, perhaps out of an excess of caution or perhaps as a true believer, the Service has required in its private letter rulings involving qualifying "G"

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[59] 315 U.S. 194 (1942).

[60] *See* H. Rep. No. 96-833, at 33 (1980); S. Rep. No. 96-1035, at 35 (1980);

Reorganizations that at least one shareholder or security holder of the transferor receive stock or securities of the acquiring corporation.[61]

As a policy matter, to condition corporate level reorganization treatment on the presence of tax-free treatment at the shareholder or creditor level (much less only technically one such shareholder or creditor) serves no apparent purpose. Any plausible purpose that one might suggest was seemingly already addressed, as of the introduction of the section 354 distribution requirement in 1954, by the stockholder control requirement of "D" Reorganizations as well as the COI requirement.[62]

The Effect of Section 354 on the Treatment of Holders of Target's Stock and Debt. Section 354 is an obstacle to tax-free treatment at the shareholder or debtholder level in an insolvent company restructuring because it extends nonrecognition treatment only to the exchange of target corporation stock or securities for acquiring corporation stock or securities. Nonrecognition treatment is not available to the extent that (1) target corporation stock is cancelled (in form or in substance), (2) target debt is forgiven, (3) acquiring corporation stock is received in exchange for target corporation non-security debt, or (4) target corporation non-security debt is exchanged for acquiring corporation non-security debt with materially different terms. As a policy matter, for the reasons discussed in greater detail below, we believe that it is inappropriate to accelerate "outside" losses or gains associated with an investment in an insolvent subsidiary solely as a result of certain intragroup restructurings.

Consistent with our views of the underlying policies, our recommendations effectively prevent insolvency from (1) causing potential reorganizations of insolvent subsidiaries from failing to qualify under section 368 on the basis that no shareholder or securityholder receives stock of the acquiring subsidiary in its capacity as such, and (2) permitting the acceleration of

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[61] *See, e.g.*, PLR 9841006 (June 25, 1998); PLR 9217040 (Jan. 28, 1992); PLR 8909007 (Nov. 30, 1988); PLR 8503064 (Oct. 24, 1984).

[62] "Conceptually, there is no essential connection between the preservation of asset basis and other tax attributes at the corporate level and the existence of someone at the shareholder or creditor level who will have comparable gain or loss recognized." William T. Plumb, Jr., *The Bankruptcy Tax Act*, U.S.C. Law Center Tax Inst. 8-1, 8-22 (1981).

"outside" losses and gains on the basis that nonrecognition treatment is not available under section 354 even where the transaction qualifies under section 368. As discussed further below, this result is accomplished through a deemed contribution of debt to capital immediately prior to the reorganization, thereby facilitating a deemed exchange of acquiring corporation stock for target corporation stock.

D. Substantially All Requirement

In order for an upstream or sideways reorganization to qualify under section 368(a)(1)(D) (as this section relates to acquisitive reorganizations to which sections 354 and 356 apply) and section 368(a)(1)(C), the target corporation must transfer "substantially all" of its assets or properties to the acquiring corporation (the "Substantially All Requirement").[63] The Substantially All Requirement may preclude qualification of certain restructurings involving insolvent companies if assets are disposed of to satisfy claims in connection with the restructuring; this is particularly true with respect to potential foreign-to-foreign reorganizations, which cannot qualify as "A" Reorganizations.

Although the original purpose of the Substantially All Requirement is not well articulated in the legislative history, the 1954 Senate report accompanying the bill that contained the Substantially All Requirement suggests that the purpose was to prevent transactions that are divisive in nature from qualifying as acquisitive reorganizations under section 368(a).[64] Courts have on occasion proffered slightly different interpretations of the intended purpose, in one instance describing the requirement as a "limited codification of the general nonstatutory 'continuity of business

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[63] The text of section 368(a)(1)(C) actually refers to the "properties" of the transferor rather than "assets." However, the terms have been used interchangeably. The Substantially All Requirement appears repeatedly in the tax-free reorganization area of the Code. In addition to the references in section 368(a)(1)(C) and section 354(b)(1)(A), the phrase appears in section 368(a)(2)(D) and section 368(a)(2)(E).

[64] *See* S. Rep. No. 83-1622, at 274 (1954) (stating that the purpose of the requirement was to "insure that the tax consequences of the distribution of stocks or securities to shareholders or security holders in connection with divisive reorganizations will be governed by the requirements of section 355.").

enterprise' requirement applicable to all reorganizations."[65] The original purpose of the Substantially All Requirement contained in section 368(a)(1)(C), which can be traced back to the section's predecessor in the 1921 Code, is not discussed in the legislative history. Presumably, the original purpose was similar, if not the same, as the requirement contained in section 354(b)(1)(A). Courts have, however, historically interpreted the requirement contained in section 354(b)(1)(A) more expansively than in the section 368(a)(1)(C) context due to the need to shut down abusive liquidation-reincorporation transactions that occurred prior to the repeal of the *General Utilities* doctrine in 1986.

Case Law. Various courts have discussed the Substantially All Requirement, but none have prescribed a definitive test. Those that have considered the requirement in the acquisitive context have focused on the nature and amount of assets retained by the target corporation and the purposes for which they were retained.[66] Cases in which the Substantially All Requirement has been held to be violated have generally been limited to situations in which the target corporation retained a portion of its assets (or proceeds from the disposition thereof) that were subsequently distributed to its shareholders (directly or indirectly) or were used by the target corporation for the purpose of engaging in a continuing business.[67] Where all of the operating

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[65] *Smothers v. United States*, 642 F.2d 894, 899 (5th Cir. 1981), *aff'g* 45 A.F.T.R. 2d 596 (S.D. Tex. 1979) (citing *Reef Corp. v. Commissioner*, 368 F.2d 125, 132 (5th Cir. 1966)). At the time section 354(b)(1)(A) was enacted, the COBE requirement was a judicial doctrine that had not yet been adopted in the Treasury regulations.

[66] *See, e.g., Western Indus. Co. v. Helvering*, 82 F.2d 461 (D.C. Cir. 1936) (Substantially All Requirement satisfied in a reorganization qualifying under the predecessor to section 368(a)(1)(C) where the target corporation transferred 80% of its gross assets and retained the remaining 20%; approximately 38% of the retained assets were used to satisfy target corporation's liabilities); *Milton Smith v. Commissioner*, 34 B.T.A. 702 (1936) (Substantially All Requirement satisfied in a reorganization qualifying under the predecessor to section 368(a)(1)(C) where the target corporation transferred 71% of its gross assets and retained the remaining 29%; approximately 88% of the retained assets were used to satisfy target corporation's liabilities and the remainder, which consisted primarily of liquid (non-operating) assets, were distributed to target corporation's shareholders pursuant to the plan of reorganization).

[67] The retention of assets solely for the purpose of repaying liabilities of the target corporation has generally not been considered to contravene the purpose of the requirement. *See, e.g.,* Rev. Rul. 57-518, 1957-2 C.B. 253.

assets of a corporation have been the subject of a transfer, the courts have had little difficulty in concluding that a transfer of "substantially all" of the assets has occurred.[68]

The courts have not focused on the solvency of the target corporation in making their determinations. In fact, courts have found on several occasions the Substantially All Requirement has been satisfied where the target corporation was insolvent.[69] Thus, so long as the asset transfer has otherwise comported with the underlying policy of the Substantially All Requirement, the mere insolvency of a target corporation has simply not been deemed relevant to the analysis.

Service's Current Ruling Position. Under the Service's current ruling guidelines, the Substantially All Requirement will "ordinarily" be considered satisfied only where there is a transfer of assets representing at least 90% of the fair market value of the net assets of the target corporation and 70% of the target corporation's gross assets.[70] Because the net assets of the insolvent target corporation will always have a zero fair market value, it is arguable that the 90% net asset test will never be satisfied (because the denominator is zero). Alternatively, it can be argued that the 90% net asset test is always met because the acquiring corporation has, by definition, acquired all of the target corporation's net assets. The 70% gross assets test can further complicate matters. For example, there are definitional issues, such as determining the time that is the correct reference point for measurement; in a nonbankruptcy workout, it may be

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[68] *See, e.g., American Mfg. Co.* v. *Commissioner*, 55 T.C. 204 (1970) (Substantially All Requirement of section 354(b)(1)(A) satisfied where all the operating assets of a corporation were transferred in a section 368(a)(1)(D) reorganization even though the transferred assets represented only 51 percent of all assets); *James Armour, Inc.* v. *Commissioner*, 43 T.C. 295 (1964) (Substantially All Requirement of section 354(b)(1)(A) satisfied where all the operating assets of a corporation were transferred in a section 368(a)(1)(D) reorganization even though the transferred assets represented less than 20 percent of all assets).

[69] *See, e.g., Southland Ice Co. v. Commissioner*, 5 T.C. 842 (1945) (Substantially All Requirement satisfied in a reorganization qualifying under the predecessor to section 368(a)(1)(C) where an insolvent target corporation transferred (not in a bankruptcy or similar proceeding) essentially all its assets to an acquiror (the retained assets were transferred to creditors) in exchange for acquiror stock that was issued to the target corporation's creditors (no consideration was issued to the target corporation's shareholders, who were not related to the target corporation's creditors); *Roosevelt Hotel Co. v. Commissioner*, 13 T.C. 399 (1949) (same); and *Westfir Lumber Co. v. Commissioner*, 7 T.C. 1014 (1946) (same); *Peabody Hotel Co. v. Commissioner*, 7 T.C. 600 (1946) (same, except that the target corporation was in bankruptcy, though the predecessor to former section 370 was not discussed).

[70] Rev. Proc. 77-37, 1977-2 C.B. 568.

particularly difficult to distinguish dispositions that are pursuant to the plan of reorganization from those that precede it. Moreover, once the reference point is chosen, subsequent dispositions of assets may be problematic if the proceeds are used to pay down debt. The Service's formulation of its ruling position, which appears to have been chosen to promote administrative convenience (as opposed to reflecting specific boundaries of existing case law), may preclude an insolvent target corporation from satisfying the Service's safe harbor requirements.[71]

It should be noted that the Service generally has applied a more liberal standard in the context of "G" Reorganizations. In several private letter rulings, the Service required only that more than 50% of the target corporation's gross assets and more than 70% of its operating assets held as of the measurement date be acquired in the reorganization. No net asset test was required to be satisfied.[72] Since the issuance of Revenue Procedure 77-37, significant developments in the corporate tax law have effectively narrowed the purpose and role of the Substantially All Requirement. For example, the codification of the COBE doctrine in 1980,[73] the enactment of section 368(a)(2)(G)[74] in 1984, the repeal of the *General Utilities* doctrine in 1986 and the enactment of the current section 382(c) in 1986[75] were each intended to safeguard against many of the historical concerns that led to the enactment of the Substantially All Requirement. More recently, the extension of "A" Reorganization treatment to certain mergers into disregarded entities under Treas. Reg. § 1.368-2T is in a similar vein and presumably reflects a conscious policy decision that the Substantially All Requirement ought not to be an impediment to reorganization treatment in these transactions. In light of these safeguards and the special

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71 There appears to be no published guidance suggesting that the Substantially All Requirement cannot not (per se) be satisfied in the case of an asset transfer by an insolvent corporation.

72 *See, e.g.*, PLR 9335029 (Sept. 3, 1993); PLR 9409037 (Dec. 7, 1994).

73 *See* Treas. Reg. Sec. 1.368-1(d). This requirement ensures that either a significant line of target corporation's historic business or a significant portion of target corporation's business assets are transferred to the acquiror. With this backstop, and assuming no assets are retained by a target corporation or transferred (directly or indirectly) to its shareholders (which is unlikely if the target corporation is insolvent), it is difficult to conceive of a factual scenario that would violate the purpose of the Substantially All Requirement.

74 Section 368(a)(2)(G) provides that an acquisition qualifies as a reorganization under section 368(a)(1)(C) only if the target corporation is liquidated as part of the reorganization plan.

75 Section 382(c) generally treats a new loss corporation that does not continue the business enterprise of the old loss corporation at all times during the two-year period following the change date as having a zero section 382 limitation for any post-change year. The provision only applies to reorganizations that result in an ownership change, and thus would likely not apply to a reorganization involving members of the same affiliated group.

circumstances often attending restructurings of insolvent companies, a strong case can be made that more liberal standards should be developed for "C" and "D" Reorganizations involving insolvent companies.

At a minimum, the Service ought to clarify that restructurings involving insolvent subsidiaries satisfies its 90% net assets test. The Service should consider providing more liberal guidelines for nonbankruptcy restructurings of insolvent subsidiaries, such as guidelines similar to those that the Service apparently has applied to "G" Reorganizations in the private letter ruling context. We note, however, that providing special rules for applying the Substantially All Requirement to non-bankrupt, insolvent companies could create a disparity between the treatment of solvent and insolvent subsidiaries that puts pressure on valuations in order to determine insolvency. An alternative approach would avoid this problem by excluding from the determination the effect of asset dispositions where the assets or the proceeds thereof are used to satisfy debt, and by applying this standard to both solvent and insolvent targets. Because asset dispositions are less likely to be a significant feature of intra-group restructurings of subsidiaries, and because these alternatives raise more general policy issues, we do not make a recommendation as to how the Service ought to address the Substantially All Requirement at this time.

D. Continuity of Business Enterprise

The origins of the COBE doctrine stem from two cases in the early 1930s, *Courtland Specialty Co. v. Comm'r.*,[76] and *Gregory v. Helvering*.[77] Although the issues in these two cases involved COI and business purpose, the cases contain dicta alluding to a COBE requirement.[78] In 1935, following the *Gregory* decision, the Service issued regulations which, for the first time,

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[76] 60 F.2d 937 (2d Cir. 1932), *aff'g*, 22 B.T.A. 808 (1931), *cert. denied*, 228 U.S. 599 (1933).

[77] 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).

[78] In *Courtland*, the court stated that "[r]eorganization presupposes continuance of business under modified corporate forms." 60 F.2d at 942. In *Gregory*, the Court stated that a reorganization "means a transfer made 'in pursuance of a plan of reorganization' . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either." 293 U.S. at 469.

contained a COBE requirement for a valid "D" Reorganization.[79] The regulations contained only a brief statement regarding COBE without expanding on the extent of continuity required by COBE.[80] Since then, COBE has been developed by the courts. The cases make clear that COBE is not satisfied where the transferee does not conduct any business and is used merely as a liquidating vehicle for the transferor's assets.[81] The cases also make clear that the transferee need not engage in the same business as the transferor for COBE to be satisfied, at least so long as the transferee is engaged in some business.[82] The cases that have considered the issue reach conflicting results, however, on whether COBE is satisfied where the transferor's assets are liquidated, either prior or subsequent to the transfer, and the proceeds of the liquidation are used by the transferee in a business.[83]

The current COBE regulations have adopted the position that the use of proceeds from the liquidation of the transferor's assets does not satisfy COBE. The regulations state that for COBE to be satisfied, the transferee must either continue a significant historic business of the transferor or the transferee must use a significant portion of the transferor's historic business assets in a business.[84] The examples contained in the regulations illustrate that the proceeds from the liquidation of the transferor's assets are not the transferor's historic business assets, and thus the

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79 Treas. Reg. 86 § 112(g)-1 (1935).

80 The 1935 regulations merely stated that "[r]equisite to a reorganization under the code are a continuity of the business enterprise under the modified corporate form." *Id*.

81 *See, e.g., Standard Realization Co. v. Comm'r*, 10 T.C. 708 (1948), *acq.* 1948-2 C.B. 3.

82 *See, e.g., Pebble Springs Distilling Co. v. Comm'r*, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir. 1956), *cert. denied*, 352 U.S. 836 (1956). At one point, the [Service] took a contrary position and ruled that the transferee must engage in the same business as the transferor, *see* Rev. Rul. 56-330, 1956-2 C.B. 204, but the [Service] subsequently reversed its position, *see* Rev. Rul. 63-29, 1963-1 C.B. 77 (revoking Rev. Rul. 56-330 and, among other things, ruling that the transferee need not engage in the same business as the transferor), *obsolete* Rev. Rul. 81-25, 1981-1 C.B. 132.

83 *Compare Becher v. Comm'r*, 22 T.C. 932 (1954), *aff'd* 221 F.2d 252 (2d Cir. 1955) (holding that COBE is satisfied even where "the assets acquired by Chandler consisted primarily of cash and assets which were to be converted to cash") *and Bentsen v. Phinney*, 199 F. Supp 363 (S.D. Tex. 1961) (holding that the transfer of real estate and the proceeds of real estate from corporations that were engaged in the land development business to a new corporation engaged in the insurance business would satisfy the regulation's COBE requirement even though it appears that the transferred real estate was sold off and only the proceeds used to capitalize the insurance business), *with Mitchell v. United States*, 451 F.2d 1395 (Ct. Cl. 1971) (holding that sale of assets by one corporation to another did not constitute a reorganization where the transferor was liquidating and the transferee bought the assets with the intention of selling them immediately) *and Wortham Machinery Co. v. United States*, 521 F.2d 160 (10th Cir. 1975), *aff'g* 375 F. Supp. 835 (D. Wyo. 1974) (same).

84 Treas. Reg. § 1.368-1(d).

use of those proceeds by the transferee will not satisfy COBE under the regulations.[85] The preamble to the final COBE regulations issued in 1980 explain the regulation's position by stating that the tax-free treatment afforded to reorganizations is based on the notion that the shareholders of the transferor have retained their investment in the transferor through their interests in the transferee. The preamble argues that the use of the proceeds by the transferee insufficiently links the two investments and therefore tax-free treatment should not be afforded.[86]

The regulation's requirement that the transferor's business continued, or the transferor's assets used, by the transferee be significant, can pose difficulties for insolvency reorganizations. For example, in order to pay off its creditors, a debtor may be forced to sell its profitable businesses, retaining only the business that incurred the losses because only the profitable businesses have attracted a buyer. Conversely, a debtor may sell the businesses that incurred the losses and reorganize around a profitable business so that it can focus on a more manageable business. Cases where the value of the business retained, around which the reorganization is focused, is less than one-third of the total value, present the issue whether the business retained by the transferee is significant enough to satisfy the regulation's requirements.[87]

We recognize that at least some amount of the debtor's business, or some portion of its assets, should be continued or used by the transferee, although some of the case law may support a contrary position.[88] The issue becomes, however, whether the standard should be relaxed and the debtor's financial situation should be taken into account in insolvency cases. In connection with the imposition of the Substantially All Requirement for "G" Reorganizations, Congress recognized the economic realities of a debtor's troubled situation, including the need to sell assets or divisions to pay off creditors or to raise cash in order to leave the debtor with more

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85 Treas. Reg. § 1.368-1(d)(5) examples 3-5.

86 T.D. 7745, 45 FR 86433.

87 Example 1 in the regulations, which is based on *Lewis v. Comm'r*, 176 F.2d 646 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948), illustrates that the retention by the transferee of 1 of 3 equally valued businesses satisfies COBE. However, the minimal amount that will be considered significant remains unclear. For example, it is unclear whether one-third was intended to be a minimal threshold. Additionally, it is unclear whether a business valued at one-third of the transferor's total value would be significant if there was another business valued at more than one-third of the total value.

88 *See* cases cited *supra* note 83

manageable operating assets to continue in business.[89] The same considerations may be viewed as applicable in insolvency cases.[90] This is in accord with our recommendations to Treasury in 1980 in response to the then-proposed COBE regulations.[91] Nevertheless, we note that providing special COBE rules for insolvency cases would create a disparity between the treatment of solvent and insolvent subsidiaries, and place a greater administrative burden on taxpayers and the Service to determine insolvency.

V. Policies that Should Guide Resolution of Issues

A. Providing Clarity

As described above in Part III, current law as to the treatment of liquidations or reorganizations of insolvent subsidiaries is complex, and its application to various business-motivated restructurings is often unclear. For example, the determination of whether a subsidiary is solvent or insolvent is highly factual, often requiring difficult judgments about valuation. In addition, solvency may turn on whether intercompany accounts are debt or equity for U.S. federal income tax purposes. In many cases, distinguishing between debt and equity with respect to intercompany capital investments requires close calls concerning the nature of these relationships. Accordingly, the current law treatment of upstream transactions often turns on valuation and other factual judgments not easily made.

Similarly, it is unclear whether the COI requirement is met in sideways transactions when the target subsidiary is insolvent. As described above, COI requires that a substantial part of the value of the stock in the target corporation be preserved by being exchanged for a proprietary interest in the issuing corporation. If the target stock is worthless, the target *shareholders* may

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89 *See* S. Rep. No 96-1035, at 36.

90 We recognize that the Substantially All Requirement, even where applicable, is not a backstop to a relaxed COBE standard. *See* Rev. Rul. 88-48, 1988-1 C.B. 117 ("C" reorganization Substantially All Requirement was satisfied where the transferor sold 50% of its historic assets prior to the transfer and then transferred the proceeds of sale together with the remaining historic assets).

91 *See* New York State Bar Association Tax Section, *Report on Proposed Regulations on Continuity of Business Enterprise in Corporate Reorganizations* (May 21, 1980).

receive no proprietary interest in the acquiring corporation in their capacity as such (i.e., they may receive a proprietary interest in the acquiring corporation only in their capacity as the target corporation's *creditors*).

The complexity and ambiguity inherent in current law has undesirable consequences. First, it impedes legitimate transactions undertaken for non-tax reasons. As a general matter, there is particular need for clarity in the law concerning insolvent companies because whether a transaction qualifies as a tax-free reorganization may determine whether an insolvent company, in fact, will be able to restructure. As applied to insolvent subsidiaries, the consequences may be less severe, but the inability to restructure operations within a corporate group may substantially undermine the group's ability to achieve business efficiencies. Second, the lack of clarity as to tax results under current law encourages taxpayers to take the most favorable positions to the detriment of the fisc.

B. Facilitating Business-Motivated Restructurings

Management strategies evolve over time, and adjustments to the legal structure of a corporate group often must follow. In one economic environment, it may make sense to have business units in separate legal entities; in another, it may be better to combine units of formerly separate subsidiaries.

With respect to solvent subsidiaries, subchapter C of the Code provides a number of useful, albeit imperfect, mechanisms to achieve the desired restructuring within a corporate group without a tax "toll charge." Indeed, the Service and the Treasury have recently removed some of the impediments to internal restructurings: for example, by repealing the *Bausch & Lomb* doctrine through the adoption of Treas. Reg. § 1.368-2(d)(4), and by narrowing the scope of the liquidation – reincorporation doctrine in the context of upstream reorganizations that are followed by transfers of assets under section 368(a)(2)(C).[92] New regulations permitting certain

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[92] *See, e.g.*, PLR 200028027 (Apr. 18, 2000) (ruling that a wholly owned subsidiary may dissolve into its parent and the parent may then transfer a "not so insignificant amount" of the subsidiary assets to one or more

mergers into disregarded entities to qualify as "A" Reorganizations also facilitate internal restructurings.

Nevertheless, as described above, traditional interpretations of certain doctrines under current law – particularly the COI requirement – are important roadblocks to internal restructurings within a corporate group where insolvent subsidiaries are involved. Revising these rules to accommodate these restructurings seems appropriate, so long as sufficient safeguards (e.g., business purpose and COBE requirements) remain substantially in place to police abuse.

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controlled corporations tax-free, probably as an upstream "C" Reorganization followed by a contribution of assets under section 368(a)(2)(C)). The Service now will not normally issue rulings or determination letters on the "tax effect of the liquidation of a corporation preceded or followed by the transfer of all or a part of the business assets to another corporation (1) that is the alter ego of the liquidating corporation, and (2) which, directly or indirectly, is owned more than 20 percent in value by persons holding directly or indirectly more than 20 percent in value of the liquidating corporation's stock." *See* Rev. Proc. 2003-3, 2003-1 C.B. 113 (section 4.01 (23)).

C. Limiting Opportunities To Duplicate or Accelerate Losses Where Legal Ownership of a Business Unit Is Restructured, But the Business Is Retained

Current law may afford certain opportunities to duplicate or accelerate tax losses associated with investments in the stock of a subsidiary. As one example of acceleration of tax losses, a subsidiary that is insolvent by virtue of debt owed to its parent corporation can be converted to a limited liability company that is disregarded under Treas. Reg. § 301.7701-3. Because no amount is deemed received by the parent corporation in respect of its common stock investment (all assets are deemed distributed in repayment of the intercompany debt), the transaction does not qualify as a section 332 liquidation and appears not to qualify as a tax-free reorganization. A worthless stock deduction appears to result with respect to the common stock under section 165(g), and would qualify as an ordinary loss if the stock ownership and gross receipts test of section 165(g)(3) are satisfied.[93] In such case, the group's loss in respect of the subsidiary is accelerated, even though it retains the underlying business.[94]

Opportunities for loss duplication also may exist. For example, assume that a subsidiary is funded, in part, with preferred stock (rather than intercompany debt) and the value of its assets subsequently diminishes so that they are worth less than the preferred stock liquidation preference. If the subsidiary is merged into the parent corporation, the transaction may qualify as a tax-free reorganization under section 368(a)(1)(A), thereby permitting the subsidiary's tax attributes to carryover to the parent under section 381; this result may obtain because the parent corporation, in its capacity as preferred shareholder, continues its proprietary interest in the business pursuant to Treas. Reg. § 1.368-1(e). However, the parent arguably is entitled to a worthless stock deduction with respect to its common stock, which is cancelled without consideration in the merger. Moreover, it would appear that the transaction technically does not trigger a section 382 limitation on inherited attributes under section 382(g)(4)(D) because the

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93 Some or all of the loss may be disallowed under Treas. Reg. § 1.337(d)-2T.

94 Current law appears to preclude loss duplication in this transaction as the parent does not succeed to the attributes of the subsidiary under section 381. *See also* Treas. Reg. 1.1502-35T(f) (providing that the portion of any consolidated net operating losses ("NOLs") attributable to the subsidiary expires as of the beginning of the following year).

subsidiary (i.e., the loss corporation) ceases to exist and the shareholder (i.e., the parent) does not continue to own stock in the successor (i.e., itself).[95]

Accordingly, one measure by which to analyze proposed alternatives to current law treatment of insolvent subsidiary restructurings is the degree to which it facilitates business-motivated transactions without expanding opportunities for loss acceleration or duplication.

D. Promoting Consistency

One goal of writing new rules for insolvent subsidiary restructurings ought to be to increase consistency of treatment across certain measures. Three such measures – consistency in treatment by the parties to the transaction, consistent treatment at the shareholder/creditor and corporate levels, and consistent treatment vis-à-vis historic characterizations – are addressed below.

At a minimum, any new regulations addressing insolvent subsidiary restructurings should require consistent treatment of a transaction by all parties to the transaction to the maximum extent possible. If the transferee treats a transaction as a tax-free reorganization permitting it access to the tax attributes of the transferor, the transferor should be required to characterize the transaction in the same manner. Conversely, one party to the transaction treats the transaction as taxable, the other party should do so as well. As under current law, shareholder level treatment should be governed by whether the transaction qualifies as a tax-free reorganization.

Reorganization treatment permitting survival and inheritance of tax attributes also seems inconsistent with the recognition of bad debt or worthless stock deductions by the

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[95] The parent corporation's ability to utilize attributes such as NOLs of the subsidiary may be limited by common law doctrines. In *Marwais Steel Co. v. Commissioner*, a parent made a loan to its subsidiary, which then lost all of the money and generated an NOL. The parent took a bad debt deduction for the loan and then liquidated the subsidiary under section 332. Section 108(e)(6) was not yet in place to trigger COD income to the subsidiary. The Ninth Circuit held that the parent could not succeed to its subsidiary's NOL carryovers because the NOLs arose as a result of economic losses that the parent had previously recognized for tax purposes as deductions for bad debts. 38 T.C. 633 (1962), *aff'd*, 354 F.2d 997 (9th Cir. 1965).

shareholder/creditor. Under current law, it appears possible to achieve an acceleration of the "outside" loss in the context of a restructuring of an insolvent subsidiary. This result seems inconsistent with the fact that the group has retained the underlying business and thus its ultimate economic position in regard to that business has not crystallized. Accordingly, we believe that a strong case can be made that the better policy answer is to defer losses due to partial or full worthless of intercompany stock or debt in sideways reorganizations. Upstream reorganizations are a closer call because the choice is between denying such losses and allowing them currently; however, on balance, we would eliminate such losses for insolvent subsidiaries, consistent with the elimination of outside gain or loss on an upstream reorganization of a solvent subsidiary.

Finally, some policy response may be in order where the corporate group previously chose to capitalize its subsidiary with debt and that choice yielded net tax benefits. In such circumstances, it would seem appropriate to recapture these benefits as a "price" of permitting access to the tax-free reorganization provisions of section 368. In the consolidated return context, the matching rules of Treas. Reg. § 1.1502-13(c) and (g) are likely to have eliminated any such benefits and, assuming these rules are not modified, no special rules appear necessary. However, in the separate return context, consideration should be given to adopting a recapture rule, provided it is administrable.

VI. Analysis of Recommendations

A. Overview

In general, we believe that the Service and Treasury should expand opportunities for corporate groups to reorganize insolvent subsidiaries. In our view, this result could be best accomplished by the adoption of regulations addressing such restructurings. In particular, such regulations should provide a mechanism for these reorganizations to satisfy the COI and section 354 exchange requirements. In the our view, however, these regulations should be limited to the promotion of reorganizations that are undertaken for business reasons, and in which the group continues the subsidiary's business. Accordingly, the business purpose and COBE requirements of current law should continue to apply in determining whether an upstream or sideways

restructuring of an insolvent subsidiary qualifies for tax-free reorganization treatment. We believe that this approach will enhance clarity in a confused area of tax law, facilitate business-motivated transactions, police abuse by limiting opportunities for loss acceleration or duplication, and provide for more consistent treatment of the various participants in an insolvent subsidiary restructuring.

In reaching our recommendations, we considered an alternative approach in which regulations would expand the rationale of *Alabama Asphaltic* to the insolvent corporate subsidiary context. Under this approach, objective measures would be identified to demarcate the point at which the creditors of insolvent subsidiaries have become, in substance, the proprietors for COI purposes. Because corporate subsidiaries are often restructured outside of bankruptcy and without the creditors first pursuing legal process to recover their advances, other measures would have to be identified for this approach to be useful.

One possibility is that creditors would be permitted to receive stock in a reorganization and be counted as proprietors for COI purposes if the subsidiary met some objective test of insolvency. However, this approach would tend to exacerbate, rather than to mitigate, valuation difficulties. Nor could the problem be easily solved by focusing on balance sheet insolvency, as there could be significant assets and liabilities that are not on the balance sheet. Moreover, even if the COI requirement could be overcome on this basis, the section 354 exchange requirement would remain a significant obstacle to tax-free treatment. Because intercompany debt is often in the form of an informal advance with no stated maturity, a demand note, or shorter-term note, it is unlikely that the exchange of acquiror stock for target debt would qualify for tax-free treatment under section 354(a).

We also considered and rejected an elective regime in which taxpayers could elect to treat transactions involving insolvent subsidiaries meeting specified criteria as qualifying or not qualifying for tax-free reorganization status. First, we thought that identifying these criteria and applying them to specific factual circumstances would involve many of the valuation and interpretational difficulties inherent in current law. Second, the availability of elective treatment for insolvent subsidiaries would create a more favorable regime for these companies, as

compared to solvent companies, and thus could place considerable pressure on the definition and determination of insolvency. Third, we believed an elective regime would put the fisc at a disadvantage, if made generally available, and absent the imposition of appropriate limitations and anti-abuse rules; without such rules, taxpayers likely would elect against the government (i.e., would elect tax-free or taxable treatment, as the case may be, only when it was to their advantage to do so).

B. Upstream Restructurings

We believe that current law rules concerning the qualification of upstream restructurings for tax-free treatment under section 332 should be retained. In particular, as described above, under existing authorities, including Rev. Rul. 68-602, upstream restructurings in which no property is distributed in respect of common stock still would not qualify under section 332. Qualification under section 332 neither requires a continuity of the subsidiary's business enterprise nor apparently a business purpose.[96] Accordingly, in the our view, the reorganization provisions, which require both a real and substantial business purpose and COBE, are a better vehicle for expanding tax-free treatment of upstream restructurings.

The Service and Treasury should issue regulations under the consolidated return rules and section 368 providing that a liquidation of an insolvent consolidated subsidiary generally would qualify as a tax-free reorganization, provided that the business purpose, COBE, and (in the case of a C reorganization) substantially all assets and solely for voting stock requirements are satisfied. Such treatment would prevail notwithstanding the fact that, under general principles of tax law, the parent corporation would be considered to receive such assets in full or partial satisfaction of intercompany debt or in exchange for the assumption of third party debt.

In the case of a merger of the insolvent subsidiary into its parent under state or federal law, reorganization treatment would be achieved under section 368(a)(1)(A). If the transfer did not

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[96] Qualification under section 332 is essentially elective because taxpayers may structure their deals to qualify or not qualify. *See, e.g., Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956); *Comm'r v. Day & Zimmermann, Inc.*, 151 F.2d 517 (3rd Cir. 1945).

occur by merger, the transaction would qualify as a reorganization under section 368(a)(1)(C). In light of the anti-*Bausch & Lomb* regulations under Treas. Reg. § 1.368-2, the "solely for voting stock" requirement ordinarily would not impede reorganization treatment. Reorganization treatment could be achieved where the subsidiary is deemed to be eliminated for federal income tax purposes (but remains a separate entity for state law purposes), such as where the subsidiary is merged into an limited liability company (potential A reorganization) or converted into a limited liability company under a state law that permits conversion without a merger (potential C reorganization).

Where a subsidiary is insolvent because of intercompany debt owed to the parent corporation, the mechanism for achieving tax-free reorganization treatment would be the deemed contribution of the debt to the subsidiary in a separate transaction.[97] The parent corporation then would be considered to acquire the assets of the subsidiary in exchange for the issuance of parent shares and the assumption of remaining subsidiary debt. No gain or loss would be recognized on this step to the parent corporation pursuant to section 1032 and to the subsidiary pursuant to section 361(a). Finally, the subsidiary would be deemed to distribute the parent shares to the parent. The subsidiary would recognize no gain or loss on the distribution pursuant to section 361(c). No gain or loss would be recognized (and no excess loss account would be triggered under Treas. Reg. § 1.1502-19) by the parent pursuant to section 354(a).

In the case of a subsidiary that is insolvent by reason of third party debt (including debt held by an affiliate other than its parent corporation), such debt would be considered to be assumed by the parent to the extent necessary to render the subsidiary solvent. The assumption would be

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[97] The deemed contribution would be separate only for purposes of applying section 368 and related provisions to the upstream restructuring. Accordingly, the deemed contribution would not be considered to make the subsidiary solvent for purposes of applying section 332.

It may make sense to apply section 108(e)(6) to the deemed contribution. Because section 108(e)(6) looks to the creditor's basis in the debt, rather than its fair market value, the difficulties in valuing the subsidiary's assets and liabilities are avoided. In the consolidated group context, treating the debt as satisfied for an amount equal to its fair market value, which may be required pursuant to Treas. Reg. § 1.1502-13(g)(3), would involve the same valuation analysis as would be used in determining the subsidiary's solvency in the first place.

deemed to occur in a separate capital contribution.[98] With the subsidiary now treated as solvent, the remainder of the transaction would be deemed to occur in the same manner as described above with respect to a subsidiary that is insolvent by reason of debt owed to its parent.

Where a subsidiary is not insolvent, but the liquidation preference of its preferred stock exceeds the value of its assets (e.g., a *Spaulding Bakeries* situation), the preferred stock would be treated as having been first recapitalized into common stock in a separate transaction qualifying under section 368(a)(1)(E). For purposes of section 368, the upstream reorganization of the subsidiary would be treated as a subsequent transaction that would be deemed to occur as described above.

In any case, the parent corporation would not be entitled to any worthless stock deduction under section 165(g). Such result seems consistent with the spirit of Treas. Reg. §§ 1.1502-80(c) and 1.1502-19(c)(1)(iii)(A) in that these provisions generally defer any worthless stock deduction until the group has disposed of the subsidiary's assets. Our recommendation would eliminate the worthless stock deduction, as the group has retained the business. Similarly, any excess loss account that the parent has with respect to the subsidiary's stock would be eliminated pursuant to the Treas. Reg. § 1.1502-19(b)(2)(i).

Accordingly, our proposal would address loss duplication issues with respect to insolvent consolidated subsidiaries differently than they are dealt with under Treas. Reg. § 1.1502-35T. This regulation essentially allows the recognition of the outside stock loss in a connection with an upstream restructuring of an insolvent subsidiary, but eliminates any unutilized inside loss. In contrast, our proposal would eliminate the outside stock loss and permit the parent to succeed to the subsidiary's losses and asset basis. As such, it also would address the acceleration of the recognition of outside loss through an upstream restructuring. In effect, to recognize its outside loss, a group would have to dispose of the subsidiary's business through a disposition of its stock or assets.

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[98] The regulations should provide that the resulting change of obligor alone would not be deemed to be a significant modification of the third party debt, assuming the rules of Treas. Reg. § 1.1001-3(e)(4)(i)(B) would be satisfied if the assumption were deemed to occur in the reorganization itself.

Upstream restructurings outside of the consolidated group context are more complicated for at least two reasons. First, we have serious concerns about the authority of the Service and Treasury to mandate rules contrary to prevailing and longstanding judicial interpretations of current Code provisions (e.g., *Hill Stores*).[99] Second, the separate return context more clearly raises a consistency concern. In the consolidated return context, the rules of Treas. Reg. § 1.1502-13(c) and (g) generally prevent the group's decision to capitalize its consolidated subsidiaries with debt rather than equity from distorting consolidated taxable income. No similar rules exist in the separate return context, and it may be plausibly argued that, having made the decision to capitalize a subsidiary with debt, the parent corporation should be held to the consequences of the decision if the subsidiary later becomes insolvent.

Nevertheless, on balance, we believe that a modified version of the regulatory regime discussed above for consolidated groups ought to apply for separate return groups. This result is supported by the difficulties for taxpayers and the Service alike in determining the existence of insolvency and the economic benefit of permitting groups to restructure to achieve business efficiencies.

Accordingly, we would permit separate return groups, including foreign subsidiaries of a consolidated group, to elect to apply a similar regime as described above for reorganizations within consolidated groups. Any such election would be valid only if all participants in the transaction (including the subsidiary and the parent in its various capacities) treat the transaction consistently with the election.[100] In addition, we believe such election should be conditioned on the group agreeing to recapture certain benefits of having capitalized the subsidiary with debt over a defined period. Thus, for example, in order to qualify for the election, the group would have to surrender the benefits of any worthless or partially worthless bad deduction under section 166 or any worthless stock deduction taken within the period.[101] Similarly, if the overall

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[99] A similar argument could be made in the consolidated return context. *See Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001).

[100] Consideration would need to be given whether the participation in the election would be required with respect to minority shareholders or holders of non-security debt (who absent a tax-free reorganization would have a taxable event).

[101] Coordination rules would be needed to assure that the recapture provisions do not unfairly penalize taxpayers. For example, where the parent corporation had previously taken a bad debt deduction under section 166,

level of U.S. federal income taxation were reduced over the period through the subsidiary's taking interest deductions and the parent's accruing interest income, such reduction would be recaptured. By analogy to section 382(l)(5)(B), an appropriate period would include the year of the upstream restructuring and the three preceding years.

Adoption of an additional anti-abuse rule would be appropriate for separate return groups that fail to elect to treat the upstream restructuring as a tax-free reorganization and forego any worthless stock deduction. In such circumstances, regulations should provide that, if the parent corporation takes a worthless stock deduction prior to the restructuring, section 382(g)(4)(D) will apply to any pre-change losses of the subsidiary to which the subsidiary may succeed under section 381 (e.g., in a *Spaulding Bakeries* situation in which the taxpayer may assert that it is entitled to both a worthless stock deduction and inherit the subsidiary's losses). Such a regulation would foreclose the possibility that section 382(g)(4)(D) is technically inapplicable because the parent will not continue to own the loss corporation's stock (or stock of its successor).

C. Sideways Restructurings

As illustrated by the *Norman Scott* case, sideways restructurings historically have been more favorably treated than upstream restructurings. However, the basis for the result reached in the case and its scope and limitations remain unclear. We recommend that the Service and Treasury, by regulation, provide a firmer foundation for treating sideways restructurings as tax-free reorganizations in appropriate cases.

The Service and Treasury should adopt a regulation providing that mergers or other transfers of substantially all of the properties of an insolvent consolidated subsidiary to another member of the consolidated group (other than the parent corporation) generally should qualify for tax-free

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the subsidiary would likely recognize cancellation of debt income under section 108(e)(6) in the deemed capital contribution and may be required to reduce its attributes under section 108(b). Recapture should not be applied in a manner that eliminates both the outside and inside loss. In a similar vein, a prior worthless stock deduction may have already given rise to a zero section 382 limitation pursuant to section 382(g)(4)(D).

reorganization treatment, provided that the business purpose and COBE requirements of Treas. Reg. § 1.368-1(b) and (d) are satisfied. Notwithstanding the favorable result in *Norman Scott*, the COI and section 354 exchange requirements under current law are unnecessary impediments to legitimate business-motivated restructurings. For example, it may be efficient to merge the operations of two brother-sister corporations in a consolidated group. However, neither the COI nor the section 354 exchange requirements may be satisfied if an insolvent brother corporation were merged into a solvent sister corporation; in such case, under general principles of tax law, the parent corporation would not be considered to receive stock of the acquiring corporation in exchange for its stock in the target corporation, but instead would be considered to receive such stock in exchange for intercompany debt owed by the target to the parent.

To remedy the difficulties that sideways restructurings have in qualifying under the COI and section 354 exchange requirements, regulations could deem certain transactions to occur prior to, and separate from, the potential reorganizations. These deemed transactions would be designed to render the target subsidiary solvent prior to the reorganization transaction, thereby allowing the normal reorganization rules to apply to that transaction. Nevertheless, it should be noted that, for reorganization treatment to apply, all other requirements would have to be satisfied, including business purpose and COBE.

Specifically, where the target subsidiary is insolvent by virtue of intercompany debt owed to the parent corporation, regulations would provide that, immediately before the reorganization, the parent corporation would be deemed to contribute such debt to the capital of the subsidiary[102]

The parties then would be deemed to proceed with the reorganization transaction, with the parent exchanging acquiring subsidiary stock for target subsidiary stock. In general, the target corporation would recognize no gain or loss pursuant to section 361(a) and (c) and the acquiring corporation would recognize no gain or loss pursuant to section 1032. The parent corporation would recognize no gain or loss upon the exchange of acquiring subsidiary stock for target

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[102] The rules of Treas. Reg. 1.1502-13(g)(3) would apply to the deemed contribution. However, as discussed above, it may make sense to apply section 108(e)(6) to the deemed contribution.

subsidiary stock pursuant to section 354(a). No worthless stock deduction would be permitted pursuant to Treas. Reg. §§ 1.1502-80(c) and 1.1502-19(c)(1)(i). The parent's basis in the target subsidiary's stock exchanged (as enhanced by the deemed capital contribution) would carry over to the acquiring subsidiary stock received; if no such stock actually were received, the basis would be added to the parent's existing shares of the acquiring subsidiary.[103]

To the extent that the acquiring corporation actually assumes debt deemed contributed to capital prior to the reorganization, the acquiring subsidiary would be deemed, in a separate transaction occurring immediately after the reorganization, to redeem an equivalent amount of its stock deemed issued in the reorganization. Generally, such a redemption should be viewed as dividend-equivalent and, within the context of a consolidated return, any resulting income pursuant to section 301 should be excluded from gross income.[104]

In a case where the target is insolvent by virtue of debt owed to a creditor other than the parent corporation (e.g., a third party creditor), immediately prior to the potential reorganization, there would be a series of deemed assumptions of such debt, first by the parent corporation, and then by the acquiring subsidiary. These assumptions would be treated as separate capital contributions and distributions.[105] With the target subsidiary now solvent, the remainder of the transaction would proceed as discussed above.

As in the case of an upstream restructuring, the mechanic for a situation, like *Spaulding Bakeries*, in which the value of a solvent subsidiary's assets are worth less than the liquidation preference of the subsidiary's preferred stock would be that the preferred stock would be deemed to be recapitalized into common stock in a separate transaction prior to the reorganization. Section 354(a)(1)(E) would apply to the recapitalization, resulting in tax-free treatment. Once again, the remainder of the reorganization transaction would proceed as discussed above.

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103 *See* Treas. Reg. § 1.1502-19(g), Example 2.

104 Treas. Reg. § 1.1502-13(f)(1). In effect, the treatment of the assumed liability would be consistent with the treatment of boot in an intercompany reorganization under Treas. Reg. § 1.1502-13(f)(3).

105 The regulations should provide that the resulting change of obligor alone would not be deemed to be a significant modification of the third party debt, assuming the rules of Treas. Reg. § 1.1001-3(e)(4)(i)(B) would be satisfied if the assumption were deemed to occur in the reorganization itself.

On balance, we would permit corporate groups not filing consolidated returns to elect into similar rules where the assets of a nonconsolidated subsidiary were acquired by an affiliate (other than the parent corporation). This election would permit a tax-free combination of an insolvent domestic subsidiary with another domestic subsidiary even if the group did not file a consolidated return. Similarly, this election may permit a tax-free reorganization involving an insolvent controlled foreign corporation. As with upstream restructurings, it would seem appropriate to have rules recapturing certain U.S. federal income tax benefits (e.g., prior worthlessness deductions for intercompany stock or debt) attributable to prior treatment of intercompany investments as debt.

Unlike the upstream restructuring context, a special rule under section 382(g)(4)(D), would not be needed where no election is made in respect of a sideways restructuring outside of consolidation. In these circumstances, the acquiring subsidiary probably should be viewed, under current law, as the successor to the target subsidiary. This result applies pursuant to section 382(l)(8) and Treas. Reg. § 1.382-2(a)(1)(v).

VII. Conclusion

To summarize, we recommend that the Service and the Treasury adopt regulations designed to facilitate tax-free treatment of business-motivated restructurings of insolvent subsidiaries within a corporate group. The mechanism for achieving this result ought to be through application of the tax-free reorganization provisions of section 368, rather than through the tax-free liquidation provisions of section 332; the business purpose and continuity of business enterprise requirements for reorganization treatment provide important safeguards and are not prerequisites to a qualifying section 332 liquidation.

We believe that our approach strikes a reasonable balance for taxpayers and the government alike: on the one hand, expanding access to the "inside" tax attributes of an insolvent subsidiary and, on the other hand, reducing opportunities for duplication of losses and acceleration of "outside" losses.