NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON CHARACTERIZING "OVERLAP" TRANSACTIONS UNDER SUBCHAPTER C

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Report No. 1229

New York State Bar Association Tax Section

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I. INTRODUCTION

This report of the New York State Bar Association Tax Section discusses the characterization of certain corporate transactions that may qualify as more than one type of tax-free reorganization under the Internal Revenue Code (the "Report").[1] In recent years, the Treasury Department (the "Treasury") and Internal Revenue Service (the "Service") have issued significant guidance that has eliminated obstacles deemed unnecessary to protect the integrity of the subchapter C reorganization provisions. As a result of these developments, the number of permissible transactions that will qualify for nonrecognition treatment under the reorganization rules has increased.[2] A side effect of this expansion has been an increase in the uncertainty with respect to the characterization of certain transactions in which a corporation transfers assets to one or more corporations and liquidates for Federal income tax purposes, where the transaction has the potential to satisfy the requirements of multiple types of reorganizations or other tax-free transactions ("Overlap Transactions").

There are significant stakes involved in determining the characterization of Overlap Transactions, including whether gain or loss is recognized by the target corporation or its shareholders, the post-transaction location of tax attributes, and the computation of stock basis. Consequently, the Service and taxpayers struggle with characterizing Overlap

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[1] The drafters of this Report were Karen Gilbreath Sowell, Eric Solomon, and Gary Scanlon. Helpful comments were received from John Barrie, Kimberly Blanchard, Peter Blessing, Jared Dunkin, Pamela Fuller, Larry Garrett, Marcy Geller, Adam Ingber, Russell Kestenbaum, Jonathan Kushner, Deborah Paul, Michael Schler, David Schnabel, Jodi Schwartz, David Sicular, Linda Swartz, and Gordon Warnke.

[2] All "section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations thereunder.

Transactions, especially in the current environment in which the need for certainty has become even more important.[3] An example of an Overlap Transaction is a transaction in which a corporation ("Target") contributes most of its assets to a subsidiary corporation ("Sub") in exchange for Sub stock and Target liquidates into its parent corporation ("Parent").[4] Is this a downstream section 368 reorganization, in which Sub inherits the Target attributes and Target and Parent recognize gain on the assets that are distributed to Parent in the liquidation? Or is this a section 351 exchange of Target assets for Sub stock followed by an upstream section 368 reorganization or liquidation, in which Parent inherits the Target attributes and there is no gain recognition to Target or Parent?[5]

This simple example illustrates the importance of characterizing the transaction. We believe it is important to adopt an approach that will provide uniformity and certainty for taxpayers and the Service. This Report considers various possible approaches for determining the characterization of Overlap Transactions in the context of current law.

We note that historically the characterization of a transaction has determined the identification of the acquiring corporation for purposes of where the tax attributes reside following the reorganization. If the rules of sections 381 and 312 were modified to delink the characterization of a transaction from the location of attributes, it may be possible to adopt different approaches to characterization. This Report does not consider whether that connection

3 In September 2010, the Service released the final schedule ("Schedule UTP") and instructions for disclosing uncertain tax positions. Beginning with the 2010 tax year, corporate taxpayers with assets that equal or exceed $100 million will be required to provide the Service with information about tax positions that affect their U.S. Federal income tax liabilities by filing a Form 1120 Schedule UTP with their income tax returns. A corporation must disclose each Federal income tax position taken on its income tax return if: (1) the position is taken on a tax return for the current or prior tax year and (2) either the corporation or a related party recorded a reserve for U.S. Federal income tax in an audited financial statement for the position or did not record a reserve for the tax position based on an expectation to litigate. Instructions to Form 1120, Schedule UTP (2010), p. 1.

4 *See* PLRs 201026010 (Dec. 18, 2009) and 200733002 (May 15, 2007), discussed *infra*.

5 Characterization of the transaction also could affect Parent's basis in Sub and whether minority shareholders of Target receiving Parent stock will receive nonrecognition treatment.

is necessary or appropriate or assess whether the rules of sections 381 and 312 that govern the movement of attributes should be reconsidered.

Part II of the Report is a background section reviewing the relevant provisions for tax-free transactions that involve the transfer of assets, recent developments that have contributed to the occurrence of Overlap Transactions, and relevant law that provides insight into potential resolution of the issues. Part III outlines the approaches that may be used to characterize Overlap Transactions and illustrates the pros and cons of the models using common fact patterns. Part IV summarizes our recommendations.

II. BACKGROUND

A. Asset reorganizations

The issues with respect to Overlap Transactions arise in the context of potential reorganizations involving the transfer of assets of a target corporation ("asset reorganizations"). Section 368 provides for the following types of asset reorganizations:

- a statutory merger or consolidation ("A reorganization");[6]
- the acquisition by one corporation, in exchange for stock of a corporation which is in control of the acquiring corporation, of substantially all of the properties of another corporation by statutory merger or consolidation ("forward triangular merger");[7]
- the acquisition by one corporation, in exchange solely for its voting stock, of substantially all of the properties of another corporation ("C reorganization");[8]
- the acquisition by one corporation, in exchange solely for the voting stock of a corporation which is in control of the acquiring corporation, of substantially all of the properties of another corporation ("triangular C reorganization");[9]
- a transfer by a corporation of substantially all of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination

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

7 Section 368(a)(1)(A), (a)(2)(D).

8 Section 368(a)(1)(C).

9 Section 368(a)(1)(C) (parenthetical language).

thereof, is in control of the corporation to which the assets are transferred ("D reorganization");[10]

- a mere change in identity, form, or place of organization of one corporation, however effected ("F reorganization");[11]
- a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case ("G reorganization").[12]

As illustrated in Part III, determining the proper characterization of an Overlap Transaction may involve an analysis of the transaction under many of these asset reorganization definitions. Common to qualification as a C, D, or G reorganization, as well as a forward triangular merger or triangular C reorganization, is the determination of whether substantially all of the assets of the target corporation have been acquired by a single corporation (the "substantially all requirement").[13] An A reorganization does not implicate the substantially all requirement, but requires a transfer of assets pursuant to State law.[14] An F reorganization involves a reorganization of a single operating company, typically with a newly formed corporation.[15] A G reorganization, in addition to satisfying the substantially all requirement, must be undertaken in a bankruptcy or similar context.

B. Section 332 liquidations

Section 332 provides that a parent corporation will not recognize gain or loss on the receipt of property distributed in complete liquidation of its controlled subsidiary and, under section 334, will succeed to the subsidiary's basis in the distributed assets. Consistent with this

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10 Section 368(a)(1)(D), 354(b)(1)(B).

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

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

13 Section 368(a)(1)(C) (acquiring corporation must acquire "substantially all of the properties of another corporation" solely in exchange for voting stock); section 354(b)(1)(A) ("[Section 354(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…the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets); section 368(a)(2)(D) (the acquisition by one corporation in exchange for the stock of its parent "of substantially all of the properties of another corporation" can qualify as an A or G reorganization).

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

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

treatment as a tax-free type of reorganization of businesses, under section 337 the subsidiary does not recognize gain or loss on the transfer of its assets. As discussed below, a liquidation will not qualify under section 332 if enough assets are reincorporated in connection with the liquidation to prevent a complete liquidation.[16]

When a transaction qualifies as both a section 332 liquidation and a section 368(a) reorganization, the transaction will be characterized under section 332.[17] The nonrecognition treatment accorded as a result of the characterization under section 332 applies only to the parent corporation. Any minority shareholder of the subsidiary, therefore, will recognize gain or loss as if it sold its shares, unless the liquidation also qualifies as a section 368 reorganization so that section 354 can protect the minority shareholder from recognition. Assume Parent corporation owns 90 percent of Target and shareholder A owns the remaining 10 percent. If Target merges into Parent and A receives Parent stock in exchange for Target stock, the transaction can qualify as both a section 332 liquidation with respect to Parent and an A reorganization with respect to A. Thus, two characterizations apply to the same transaction, resulting in different nonrecognition provisions applying to the different shareholders. Parent is treated as receiving

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[16] In addition, in order to qualify as a section 332 liquidation, the parent corporation must own stock that satisfies the requirement of section 1504(a)(2), the subsidiary must generally distribute its property in complete cancellation or redemption of all its stock, the transfer of property must be made within a certain period of time, and the subsidiary must be solvent.

[17] In *Kansas Sand and Concrete, Inc. v. Commissioner*, 462 F.2d 805 (10th Cir. 1972), P acquired all the stock of S, and S subsequently merged into P under state law in a transaction described in section 368(a)(1)(A). Under the law at the time, the parent would have taken a basis in the subsidiary's assets equal to the subsidiary's basis in such assets if the A reorganization rules were applied and a basis equal to the parent's basis in the subsidiary stock if the complete liquidation rules were applied. The court interpreted Reg. §1.332-2(d) to mean that "where there is a complete liquidation, the liquidation provisions of Section 332 take precedence over the reorganization provisions." 462 F.2d 805, 807. Citing *American Manufacturing Co., v. Commissioner*, 55 T.C. 204 (1970), the court held that "the transaction, even though qualifying under Section 368(a)(1)(A) as a reorganization, must be treated as a complete liquidation for federal income tax purposes." The court held that "Section 332 takes precedence over Section 368 in these particular circumstances." *See also* section 332(b) flush language("[F]or purposes of this subsection a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (A) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, on an exchange described in section 361, and (B) the complete cancellation or redemption under the plan, as a result of exchanges described in section 354, of the shares not owned by the taxpayer.") and Reg. §1.332-2(d).

the Target assets in exchange for its Target stock under section 332,[18] with basis in the assets determined under section 334, while A is treated as receiving Parent stock in exchange for A's Target stock under section 354, with A's basis in Parent stock determined under section 358.

C. Attribute movements under section 381

In each type of acquisitive asset reorganization, the target corporation must liquidate pursuant to the plan of reorganization. As a result of the elimination of the corporate existence of the transferor, rules are necessary regarding the attributes of the liquidated entity.[19] Section 381 provides generally that the "acquiring corporation" in an asset reorganization or section 332 liquidation "shall succeed to and take into account, as of the close of the day" of the transfer, all the attributes of the transferor corporation described in section 381(c). Earnings and profits ("E&P") are such an attribute.[20]

In the context of a section 332 liquidation, the "acquiring corporation" for purposes of section 381 is defined as the corporation which acquires the assets of its subsidiary corporation. In the context of an asset reorganization, the "acquiring corporation" is the corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation.[21] In this regard, the definition of acquiring corporation under section 381 is independent of the determination of the acquiring corporation for purposes of section 368. Thus, if a single corporation acquires all of the assets of the target corporation in a transfer pursuant to the plan of reorganization, that corporation succeeds to the attributes of the target corporation even if it is not the acquiring

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18 Reg. §1.332-2(d) and (e), *Example*.

19 In contrast, the attributes of a target corporation acquired in a stock acquisition remain in the target corporation. Other than as provided by sections 382, 383, and 384, generally a stock acquisition does not affect the attributes of the target corporation.

20 Section 381(c)(2).

21 Reg. §1.381(a)-1(b)(2).

corporation in the reorganization. However, where no one corporation ultimately acquires all of the assets of the target corporation, the regulations designate the corporation which *directly acquires* the assets of the target as the acquiring corporation for purposes of section 381, even if that corporation ultimately retains none of the target assets.[22] In this situation, the acquiring corporation under section 368 will inherit the attributes of the target corporation.

Considering the example in the Introduction (Target contributes most, but not all, of its assets to Sub in exchange for Sub stock and Target liquidates into Parent), to determine which entity (Parent or Sub) inherits the attributes of Target, we must first determine which "directly acquires" the assets of Target in the reorganization, i.e., which is the section 368 acquiring corporation.[23] Whether Parent or Sub is the acquiring corporation will depend on whether this Overlap Transaction is treated as a downstream C, D, or F reorganization (of Target into Sub) or an upstream section 332 liquidation or C reorganization (of Target into Parent). If the transaction is treated as a downstream reorganization, Sub will succeed to the attributes of Target. If it is treated as an upstream liquidation or reorganization, Parent will succeed to the attributes of Target. Thus, attribute movement under the current regulatory scheme depends in large part on the Federal tax characterization of the transaction.

The section 381 regulations provide for the possibility of an allocation of E&P independent of the Federal tax characterization of the overall transaction. Regulation §1.381(c)(2)-1(d) provides that, where the assets of the transferor corporation are transferred to one or more corporations controlled by the acquiring corporation, "whether any portion of the

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[22] *Id. See also* Reg. §1.381(a)-1(b)(2)(ii), *Example 4* (X acquires all the assets of Z in a C reorganization and contributes 50 percent of the Z assets to wholly owned Y and 50 percent of the assets to wholly owned M; X is the acquiring corporation for purposes of section 381); CCA 200911010 (July 8, 2008) (A acquires all the assets of T in a D reorganization and contributes 100 percent of the T assets to wholly owned A1, which in turn contributes 50 percent of the T assets to A2; A1 is the acquiring corporation for purposes of section 381).

[23] The transfer of most of the assets to Sub would probably preclude the liquidation of Sub from qualifying as a section 332 liquidation.

earnings and profits received by the acquiring corporation under section 381(c)(2) is allocable to such controlled corporation or corporations shall be determined without regard to section 381. See paragraph (a) of §1.312-11." Regulation §1.312-11(a) requires "proper adjustment and allocation" of the E&P of the transferor corporation between the transferor and the transferee corporation as a result of certain nonrecognition transactions, including a section 351 transfer which precedes or follows "a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation."[24] The Service appears to have adopted an administrative position that, in general, it is not appropriate to allocate E&P when a corporation's assets are divided among multiple corporations in connection with an asset reorganization or section 332 liquidation.[25]

D. Section 351 exchanges

Section 351 provides that no gain or loss is recognized on a transfer of property to a corporation solely in exchange for stock of the corporation if immediately after the exchange, the transferor or transferors "control" the transferee corporation (the "control requirement").[26] "Control" under section 368(c) is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of each class of outstanding non-voting stock.[27] Post-

[24] Some commentators have taken the view that, notwithstanding the language, Reg. §1.312-11(a) does not authorize the allocation of E&P in a section 351 transfer following a reorganization. *See* Jasper L. Cummings, Jr., *E&P Allocation When Target Property Dropped After Asset Reorganization* (Oct. 11, 2005); *see also Mansfield v. United States*, 141 Ct. Cl. 579 (1958) (under Reg. §1.312-11(a), before amendment in 1955, the transfer by a corporation of part of its assets to a newly formed subsidiary in return for all the subsidiary's stock does not shift any of the parent's E&P to the subsidiary where the parent remains in existence after the transfer; "[the regulation] is not an absolute requirement for an allocation in all kinds of taxfree exchanges. We are of the opinion that the regulation merely requires a "proper" allocation once it is established that an allocation is necessary at all.") A discussion of E&P allocation pursuant to Reg. §1.312-11(a) is beyond the scope of this Report. For a thorough analysis of this subject, *see* Daniel Halpern, *Carryovers of Earnings and Profits*, 18 Tax L. Rev. 289 (1962-1963).

[25] *See, e.g.,* PLR 201026010 (Dec. 18, 2009); IRS CCA 200911010 (July 8, 2008); PLR 9231068 (Feb. 3, 1992).

[26] Section 351(a).

[27] Rev. Rul. 59-259, 1959-2 C.B. 115.

exchange events may result in a failure by a transferor to satisfy the control requirement of section 351(a).[28] Nonetheless, section 351(c)(1) provides that, in determining whether the control requirement has been satisfied, "the fact that any corporate transferor distributes part or all of the stock in the corporation which it receives in the exchange to its shareholders shall not be taken into account." Accordingly, in the example in the Introduction, Target's distribution of the Sub stock when Target liquidates into Parent should not affect the qualification of the downstream transfer of assets to Sub as a section 351 exchange. Note, however, there is an argument that, if the upstream transfer itself qualifies as a C reorganization, then Target technically will not have distributed the stock of Sub within the meaning of section 351(c), but instead will be viewed as receiving the stock of Sub from Target in its capacity as an acquiring corporation in exchange for its own deemed issued stock. Because there is no policy concern presented and the shareholder will own the stock of Sub as a result of an actual distribution or as part of a reorganization exchange, we believe the Service should clarify that section 351(c) applies to provide that the control requirement is satisfied in a downstream contribution that is followed by an upstream reorganization.[29]

A section 351 exchange, unlike a reorganization under section 368 or a liquidation qualifying under section 332, is not a transaction described in section 381(a). As such, a transfer that qualifies for nonrecognition treatment under section 351(a) does not result in the transferee

[28] *See, e.g.,* Rev. Rul. 79-70, 1979-1 C.B. 144 (control did not exist when a preexisting binding contract required the transferor to later sell 40 percent of the stock of the transferee corporation); *Intermountain Lumber Co. v. Commissioner*, 65 T.C. 1025 (1976) (control did not exist where an incorporator irrevocably agreed to transfer 50 percent of the stock he received in exchange for his transfer); *cf. National Bellas Hess, Inc. v. Commissioner*, 20 T.C. 636 (1953), *aff'd*, 220 F.2d 415 (8th Cir. 1955) (subsequent issuance of stock one year after initial section 351 exchange was a separate transaction from the initial transfer because no binding obligation to issue additional stock existed); Rev. Rul. 2003-51, 2003-1 C.B. 938 (a transfer of assets to the first corporation in exchange for an amount of stock in the first corporation constituting control satisfies the control requirement of 351 even if, pursuant to a binding agreement entered into by the transferor with a third party prior to the exchange, the transferor transfers the stock of the first corporation to a second corporation simultaneously with the transfer of assets by the third party to the second corporation and, immediately thereafter, the transferor and the third party are in control of the second corporation).

[29] Note the terms "distribution" and "exchange" are not mutually exclusive as used in the Code. For instance, section 302(a) describes the tax consequences of "a distribution in part or full payment in exchange for the stock."

inheriting any attributes of the corporate transferor, unless all the assets are transferred in a section 351 exchange pursuant to a plan of a reorganization.[30] Therefore, if the downstream transfer in the example in the Introduction qualifies as a section 351 exchange, rather than a reorganization, Sub would not inherit any attributes of Target.

E. *Bausch & Lomb* repeal

In *Bausch & Lomb v. Commissioner*,[31] the Second Circuit held that a parent corporation's pre-existing ownership of stock of a subsidiary prevented an upstream transfer of substantially all of the assets of the subsidiary to the parent in exchange for parent's voting stock from qualifying as a C reorganization. Prior to the transaction at issue, Bausch & Lomb Optical Company ("B&L") owned 79.9 percent of the outstanding shares of Riggs Optical Company ("Riggs"). In order to consolidate the operations of Riggs with its own operations, B&L issued solely voting stock in exchange for all the Riggs assets. Two weeks later, pursuant to a prearranged plan, Riggs liquidated, distributing its sole asset, the stock of B&L, pro rata to B&L and the minority shareholders. The B&L shares returned to B&L in the transaction became treasury stock. The Service argued, and the Tax Court and Second Circuit agreed, that, viewing the asset acquisition and liquidation together, the transaction failed the "solely for voting stock requirement" of section 368(a)(1)(C). Specifically, the Second Circuit determined that, in substance, B&L acquired 21 percent of the assets of Riggs in exchange for B&L voting stock and 79 percent of the assets in exchange for its Riggs shares upon the subsidiary's liquidation. The stock in Riggs used to acquire 79 percent of the Riggs assets was "additional consideration" in violation of the solely for voting stock requirement.

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[30] *But see* note 24, *supra*, on the possibility of an allocation of earnings and profits when a section 351 exchange precedes or follows a reorganization or liquidation, pursuant to Reg. §1.312-11(a).

[31] 267 F.2d 75 (2d Cir.1959), *aff'g* 30 T.C. 602 (1958), *cert. denied*, 361 U.S. 835 (1959). *See also* Rev. Rul. 54-396, 1954-2 C.B. 147 (same facts as *Bausch & Lomb*).

On May 19, 2000, the Treasury and Service issued final regulations repealing the *Bausch & Lomb* doctrine (the "Anti-*Bausch & Lomb* Regulations").[32] Under the Anti-*Bausch & Lomb* Regulations, an acquiring corporation's prior ownership of stock of the target corporation (i.e., "old and cold" target stock) will not preclude an upstream acquisition from qualifying as a C reorganization.[33] The preamble to the proposed Anti-*Bausch & Lomb* Regulations sets forth two reasons why the government overruled the *Bausch & Lomb* doctrine.[34] First, the legislative history of section 368(a)(1)(C) demonstrates that the purpose of the solely for voting stock requirement is "to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations."[35] In this regard, the preamble states that "a transaction in which the acquiring corporation converts an indirect ownership interest in assets to a direct interest in those assets does not resemble a sale." In fact, this view was already reflected in regulations issued with respect to the continuity of interest ("COI") requirement.[36] The COI regulations provide that "a proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise."[37] The COI requirement is the judicial parallel to the legislative "solely for voting stock" requirement, and thus each implicate the same sale versus

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[32] Reg. §1.368-2(d)(4), T.D. 8885 (May 19, 2000).

[33] Reg. §1.368-2(d)(4)(i). If, in connection with a potential reorganization, an acquiring corporation acquires stock of the target corporation for consideration other than acquiring voting stock, the consideration provided for such stock will be treated as boot for purposes of applying the boot relaxation rule of section 368(a)(2)(B). If, however, non-stock consideration is used by the acquiring corporation in a transaction that constitutes a qualified stock purchase of the stock of a target corporation within the meaning of section 338(d)(3), although no section 338 election is made, the acquiring corporation's target stock will be treated as "old and cold" for purposes of determining whether a subsequent dissolution of target into acquiring constitutes an upstream C reorganization. Reg. §1.338-3(d)(4).

[34] REG-115086-98 (June 14, 1999).

[35] *Id.* Section 202(c)(2) of the Revenue Act of 1921 did not specify or limit the type of consideration that was permissible in a reorganization, arguably allowing an all-cash transaction to qualify as a tax-free merger. The solely for voting stock requirement was adopted in section 112(g)(1) of the Revenue Act of 1934 in order to "remove the danger that taxable sales [could] be cast into the form of a reorganization." H.R. Rep. No. 704, 73rd Cong., 2d Sess. 12-14 (1934); S. Rep. No. 558, 73d Cong., 2d Sess. 16-17 (1934).

[36] T.D. 8760 (Jan. 23, 1998) (these regulations are discussed more fully below).

[37] Reg. §1.368-2(e)(1); *see also* Reg. §1.368-2(e)(6), *Example 7*.

reorganization concern. Therefore, the preamble to the proposed Anti-*Bausch & Lomb* regulations concludes that Congress could not have intended that the ownership of shares of the target corporation by the acquiring corporation prior to a transfer of the target corporation's assets to the acquiring corporation would violate the solely for voting stock requirement of section 368(a)(1)(C).

The preamble also provides that the holding of *Bausch & Lomb* contrasts with the tax-free treatment of upstream A reorganizations of the target corporation into the acquiring corporation where the acquiring corporation owns "old and cold" target stock.[38] The preamble states that, in an upstream A reorganization, a section 354 exchange is deemed to occur even if, in form, there is no such exchange. The Treasury and Service could find no policy justification for treating a C reorganization differently from an upstream A reorganization where the acquiring corporation owns stock in the target corporation immediately prior to the transaction.

As a result of the repeal of the *Bausch & Lomb* doctrine, taxpayers may combine the operations of a subsidiary with its shareholder by making a check-the-box election under Reg. §301.7701-3. Assuming the transaction otherwise satisfies the requirements for tax-free treatment, the transaction will qualify as a C reorganization. While the subsidiary remains in existence for legal purposes, for tax purposes its assets and attributes will move to the shareholder under section 381 (assuming all of the subsidiary's assets are not thereafter transferred to another corporation pursuant to the plan of reorganization).

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[38] *See, e.g.* Rev. Rul. 58-93, 1958-1 C.B. 188, discussed *infra* (upstream merger of a 79% subsidiary into its parent qualifies as an upstream A reorganization).

F. Remote continuity and Reg. §1.368-2(k) (the "-2(k) Regulations")

The history of the -2(k) Regulations began in 1937 with *Groman v. Commissioner*.[39] In *Groman*, the acquiring corporation ("Glidden") entered into an agreement to acquire all the assets of Metals Refining Company ("Indiana"). Pursuant to the agreement, the shareholders of Indiana transferred their Indiana stock to a newly formed subsidiary of Glidden ("Ohio"), in exchange for a combination of cash, Glidden shares, and Ohio shares. Thereafter, Indiana dissolved. The Supreme Court held that Glidden was not a "party to the reorganization" within the meaning of the Code as it had received nothing in the exchange. Therefore, the receipt of the stock of Glidden was taxable as boot to the former shareholders of Indiana. The Court refused to grant nonrecognition treatment with respect to the receipt of the Glidden stock, citing to the purpose of the reorganization provisions, which is to provide nonrecognition where "the interest of the stockholders of a corporation continues to be definitely represented in substantial measure in a new or different one."[40] In this regard, the stock of Glidden to the former Indiana shareholders represented an attenuated, rather than substantial, interest in Ohio and the former assets of Indiana.

The Supreme Court extended *Groman* in *Helvering v. Bashford*.[41] In *Bashford*, the Court held that the stock of an initial acquiring corporation was boot to the target shareholders when that corporation subsequently dropped the target stock to a controlled subsidiary. In *Bashford*, Atlas and its newly formed controlled subsidiary ("Sub") acquired the stock of each of three competitors, Peerless, Black Diamond, and Union ("Targets"), in exchange for a mix of consideration including cash and stock of Atlas and Sub. After the initial exchange

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[39] 302 U.S. 82 (1937).

[40] *Id.* at 89.

[41] 302 U.S. 454 (1938).

with shareholders of Targets, Atlas contributed the portion of the stock of Target it had acquired to Sub. The taxpayer argued that Atlas' receipt of the stock of Targets pursuant to the reorganization distinguished the case from *Groman*. The Court, however, rejected this argument, finding Atlas' ownership of the Targets stock "transitory and without real substance," because "it was part of a plan which contemplated the immediate transfer of the stock or the assets or both of the three reorganized companies to the new Atlas subsidiary."[42] Accordingly, the Atlas stock was taxable boot to the shareholders of Targets. The rule expressed in *Groman* and *Bashford* that only the stock of the corporation that ultimately acquires all the assets or stock of a target corporation is considered qualifying property for purposes of obtaining nonrecognition treatment and satisfying COI has become known as the "remote continuity doctrine."

The remote continuity doctrine has been limited by legislation.[43] In 1954, Congress amended section 368(a)(1)(C) to allow triangular asset reorganizations by adding the parenthetical that a corporation may acquire the assets of a target corporation "in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation." Congress also enacted section 368(a)(2)(C) to protect an acquisition of assets from being disqualified as an A or C reorganization as a result of a post-acquisition contribution of the assets of the target corporation to a controlled subsidiary. In 1964, Congress amended section 368(a)(1)(B) and section 368(a)(2)(C) to permit, respectively, the use of parent's voting stock in a triangular B reorganization and a single drop of acquired stock to a controlled subsidiary after a

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[42] 302 U.S. at 458.

[43] *Groman* and *Bashford* are still reflected in the prohibition of the use of both stock of the parent and subsidiary in certain triangular reorganizations. *See* section 368(a)(2)(D)(i) (no stock of controlled subsidiary may be used in forward triangular merger); section 368(a)(1)(B) and (C) (consideration must be solely voting stock of acquiring corporation or solely voting stock of its controlled parent). *See also* Reg. §1.368-2(c) ("Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation."); Reg. §1.368-2(d) ("However, if the properties of [the acquired corporation] are acquired in exchange for voting stock of both [the controlling corporation] and [the acquiring corporation], the transaction will not constitute a reorganization under section 368(a)(1)(C).")

B reorganization.[44] In 1968, Congress enacted section 368(a)(2)(D) and, in 1970, section 368(a)(2)(E), to provide that forward and reverse triangular mergers may qualify as A reorganizations.[45]

In 1998, the Treasury and Service issued final regulations regarding the COI and continuity of business enterprise ("COBE") requirements (the "Continuity Regulations").[46] The Continuity Regulations included the original version of the -2(k) Regulations. The Continuity Regulations subsumed remote continuity into the COBE qualified group concept. As explained in the preamble to the Continuity Regulations:

> "[R]emote continuity of interest focuses on the link between the T shareholders and the former T business assets following the reorganization. In § 1.368-1(d), as effective prior to these final regulations, COBE focuses on the continuation of T's business, or the use of T's business assets, by the acquiring corporation. Section 1.368-1(d), as revised herein, expands this concept by treating the issuing corporation as conducting a T business or owning T business assets if these activities are conducted by a member of the qualified group or, in certain cases, by a partnership that has a member of the qualified group as a partner… . The IRS and Treasury Department believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny."[47]

The Continuity Regulations provide that, for purposes of satisfying COBE, an acquiring corporation ("issuing corporation") is treated as holding all of the businesses and assets of all of the members of a qualified group.[48] Under the Continuity Regulations, as amended in 2007, a qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting

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44 P.L. 88-272, section 218(b)(1) (1964).

45 P.L. 90-621, section 1(a) (1968) and P.L. 91-693, section 1(a) (1971).

46 T.D. 8760 (Jan. 23, 1998).

47 *Id.*

48 Reg. §1.368-2(d)(4).

the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one or more of the other corporations.[49]

The -2(k) Regulations in the 1998 Continuity Regulations provided that a transaction otherwise qualifying as an A, B, C, or G reorganization "shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled [within the meaning of section 368(c)] in each transfer by the transferor corporation." In 2007, the Treasury and Service modified the -2(k) Regulations,[50] which, according to the preamble, "continue the trend of broadening the rules regarding transfers of assets or stock following an otherwise tax-free reorganization where the transaction adequately preserves the link between the former T shareholders and the T business assets."[51] Specifically, the -2(k) Regulations provide that a transaction otherwise qualifying as a reorganization under section 368(a) "shall not be disqualified *or recharacterized*" as a result of one or more transfers (including distributions) so long as certain requirements, such as COBE, are satisfied. Commentators have interpreted the "or recharacterized" language as adopting a "first to the finish line" approach to Federal tax characterization.[52] Under this approach, if the first step of a transaction would qualify as a tax-free reorganization, and the requirements of the -2(k) Regulations are otherwise satisfied, that characterization would control, even if the integrated transaction that includes subsequent steps would also qualify as a reorganization.

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49 Reg. §1.368-1(d)(4)(ii). Under the 1998 Continuity Regulations, the issuing corporation and the corporation whose assets the issuing corporation relied on for purposes of COBE had to be connected through a chain of corporations in which each corporation possessed section 368(c) control over its subsidiary. The qualified group definition was expanded by T.D. 9361 (Oct. 25, 2007), to permit qualified group members to aggregate their direct stock ownership of a corporation in determining whether they own the requisite section 368(c) control in such corporation (provided that the issuing corporation owns directly stock meeting such control requirement in at least one other corporation).

50 T.D. 9361 (Oct. 25, 2007).

51 *Id.*

52 New York State Bar Association Tax Section Report No. 1152 (Apr. 4, 2008), *reprinted in* 2008 TNT 68-23 (Apr. 8, 2008).

The -2(k) Regulations, building off of section 368(a)(2)(C) and in concert with the Continuity Regulations, to some extent have effectively overruled the Supreme Court's holding in *Bashford* that an acquiring's corporation "transitory ownership" of target assets will be disregarded for purposes of section 368, at least where the transaction otherwise satisfies the requirements of the -2(k) Regulations. However, much of the rule in *Groman* has survived the changes to the Code and regulations outlined above. For example, the Code still does not allow a second-tier subsidiary to use grandparent stock to acquire assets, although the same result could be achieved by having the grandparent corporation acquire the assets directly and contribute the assets down the chain to the third-tier subsidiary.[53] Therefore, the initial direction of the assets remains significant in determining whether a restructuring transaction satisfies a given paragraph of section 368(a), whereas the impact of any post-reorganization transfer has been minimalized.

The operation of the -2(k) Regulations means the form of an upstream transfer of assets will be respected as an upstream reorganization into the transferee parent corporation assuming the relevant requirements are satisfied, regardless of whether following the upstream transfer significant assets (or all the assets) are reincorporated into another entity that is part of the qualified group of the transferee corporation.[54] Thus, the assets of a corporation can be divided into two or more corporations without incurring a *General Utilities* tax under section 311 and without having to satisfy the requirements of section 355. Unless after the upstream reorganization all the assets of the target corporation are transferred to a single corporate

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[53] *But see* Michael L. Schultz, *Are Tax-Free Mergers With 'Grandparent' Stock Now Possible?*, 2010 TNT 182-5 (Aug. 18, 2010), in which the author contends that a forward merger in exchange for grandparent stock may qualify under current law as a tax-free A reorganization. With Congress' rejection of the judicially created remote continuity doctrine, according to the author, "[t]he specific rules for forward triangular mergers provided in section 368(a)(2)(D) need no longer be viewed as defining the limits of the law (if indeed they ever did)."

[54] The *Bausch & Lomb* repeal has significantly expanded the possibilities for engaging in a transaction that is accorded recognition treatment, and that results in a division of a corporation's assets that would otherwise be taxed under section 311.

transferee, under current administrative practice the attributes of the target corporation will always reside upstream in the acquiring corporation.[55]

G. Proposed F reorganization regulations

On August 12, 2004, the Service issued proposed regulations establishing the criteria to be satisfied in order for a transaction to constitute a "mere change" within the meaning of section 368(a)(1)(F) (the "Proposed F Regulations").[56] Pursuant to the Proposed F Regulations, a transaction that involves an actual or deemed transfer qualifies as a reorganization only if:

> (i) all the stock of the resulting corporation, including stock issued before the transfer, is issued in respect of stock of the transferring corporation;
>
> (ii) there is no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation;
>
> (iii) the transferring corporation completely liquidates in the transaction; and
>
> (iv) the resulting corporation does not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer.[57]

The Proposed F Regulations apply to transactions occurring on or after the date such regulations are published as final regulations.[58]

According to the preamble, the second requirement, which allows a change of ownership that has no effect other than a redemption of less than all the shares of the corporation,

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[55] As discussed below, it is not clear under current law whether a division of assets that occurs prior to a purported reorganization will be recharacterized under the liquidation-reincorporation doctrine, preventing reorganization treatment and resulting in recognition with respect to any assets not reincorporated and the attributes located in the deemed acquiring corporation instead of the upstream acquirer.

[56] REG-106889-04 (Aug. 12, 2004). Section 368(a)(1)(F) defines a reorganization as "a mere change in identity, form, or place of organization of one corporation, however effected."

[57] Prop. Reg. §1.368-2(m)(1)(i).

[58] Prop. Reg. §1.368-2(m)(6).

is intended to conform to case law. In *Reed v. Commissioner*,[59] for instance, the Fifth Circuit held that an indirect sale of a corporation's assets to a new corporation resulted in an F reorganization even though 48 percent of the stock of the transferor corporation was redeemed in the transaction. Citing *Davant v. Commissioner*[60] for the proposition that the test of whether or not events should be stepped together is functional, not temporal, the court determined that the simultaneous transfer and redemption "must be viewed as separate and distinct occurrences."[61] The court reasoned that an F reorganization contemplates a single corporation and, in that regard, the transferor "could have completely redeemed the stock of 48 percent of its shareholders without changing the state of its incorporation. A complete redemption is not a characteristic of a reorganization."[62] Because there was no substantial change in the corporate operation of the transferring corporation, the transaction qualified as an F reorganization.

The Proposed F Regulations provide an example that illustrates the second requirement. In the example, A and B own 75 and 25 percent, respectively, of the stock of X. In the merger of X into Y, a newly formed corporation, A surrenders her X stock for cash from X's reserves and B surrenders his X stock for all the stock of Y. Because the change in ownership caused by A's surrender of her stock in X has no effect other than that of a redemption of less than all the X shares, the merger of X into Y is a "mere change" that qualifies as an F reorganization.[63]

Permitting a transaction to qualify as an F reorganization despite a redemption of most of the stock of the corporation can result in the creation of Overlap Transactions. For

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[59] 368 F.2d 125 (5th Cir. 1966), *aff'g* T.C. Memo 1965-72, *cert. denied*, 386 U.S. 1018 (1967).

[60] 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

[61] 368 F.2d 125,134.

[62] *Id*.

[63] Prop. Reg. §1.368-2(m)(5), *Example 2*.

example, if substantially all of the assets of a corporation are distributed in redemption of stock of a corporate distributee, and the remaining assets of the corporation are transferred to a newly formed corporation and the transferring corporation liquidates, it is unclear whether the transaction should be considered an F reorganization (having literally complied with all the requirements in the Proposed F Regulations) preceded by a section 302 redemption or, alternatively, an upstream C reorganization and a deemed contribution of the remaining assets to a newly formed corporation.

In considering the finalization of the Proposed F Regulations, we recommend clarifying the rule allowing for redemptions in an F reorganization to apply only when 100 percent of the operating assets of the target corporation are transferred to the new acquiring corporation.[64] We do not believe the use of operating assets to redeem the interests of a shareholder in an F reorganization is consistent with the concept of an F reorganization as a "mere change in identity, form, or place of organization of one corporation, however effected".

H. Liquidation-reincorporation doctrine

The liquidation-reincorporation doctrine has been an additional source of uncertainty for purposes of Federal tax characterization. To qualify as a complete liquidation under section 332, a liquidating subsidiary must be treated as distributing all of its assets to its immediate shareholder in complete liquidation. Under the liquidation-reincorporation doctrine, a corporate dissolution may not qualify as a complete liquidation within the meaning of sections 331 or 332 if as part of the overall plan some or all of the dissolved entity's assets are ultimately held by a corporation directly or indirectly owned by the former shareholders of the dissolved

[64] Comments on other aspects of the Proposed F Regulations that do not directly affect Overlap Transactions are beyond the scope of this Report.

entity. The ostensible liquidation is prevented by the reincorporation of the original corporation's assets in another corporation controlled by the same shareholders.[65]

The liquidation-reincorporation doctrine developed to combat a particular type of transaction that arose before the repeal of the *General Utilities* doctrine.[66] Prior to the repeal, corporations engaged in liquidation-reincorporation transactions to dispose of their assets tax-free under former sections 336 or 337, while the shareholders would obtain a basis offset and capital gain treatment under section 331 (rather than dividend treatment) on the liquidation of the corporation ("Oldco"), and a newly formed corporation ("Newco") would obtain the Oldco assets with a stepped-up basis. Courts denied these tax benefits by either (1) collapsing the liquidation-reincorporation transaction to result in an acquisitive reorganization under section 368(a)(1)(D) under which Newco would take a carryover basis in the corporate assets, and the Oldco shareholders would have dividend treatment for any assets that they received,[67] or (2) treating the acquiring corporation as the "alter ego" of the purported liquidated corporation, thus recasting the liquidation and reincorporation as a section 301 distribution of those assets that were not reincorporated (with no accompanying reorganization).[68] With respect to the D

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65 *See Telephone Answering Service Co., Inc. v. Commissioner* ("*TASCO*"), 63 T.C. 423, 433 (1974), *aff'd*, 547 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977) (no "complete liquidation" under section 332 where shareholder of dissolved corporation transferred the dissolved corporation's operating assets (15 percent of the gross value of all the assets) to a new corporation; "[a complete liquidation] evidences an intent to require a bona fide elimination of the corporate entity and does not include a transaction in which substantially the same shareholders continue to utilize a substantial part of the directly owned assets of the same enterprise in uninterrupted corporate form").

66 In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), the Supreme Court held that a corporation did not recognize gain upon a distribution of an appreciated asset (the stock of a subsidiary) to its shareholders. The *General Utilities* doctrine thus stands for the proposition that a corporation generally may make in-kind distributions with respect to its stock without the incidence of corporate level gain (or loss).

67 *See, e.g., Babcock v. Phillips*, 372 F.2d 240 (10th Cir. 1967), *cert. denied*, 387 U.S. 918 (1967); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1960), *cert. denied*, 368 U.S. 836 (1961); *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), *cert. denied*, 352 U.S. 824 (1956); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947). *See also James Armour, Inc. v. Commissioner*, 43 T.C. 295, 305 (1964) ("It is well settled that it is proper to consider the situation as it existed at the beginning and end of a series of steps to determine whether a statutory reorganization occurred, and that the liquidation of a corporation may be merely a step in a reorganization.")

68 *See, e.g., TASCO*, 63 T.C. 423, 435 (concluding that former section 337 did not apply to a corporation's sale of the stock of

reorganization approach, the courts adopted a flexible attitude toward the requirements of a D reorganization, such as (i) the requirement in section 354(b) that there be an actual exchange of stock, and (ii) the requirement in section 354(b) that substantially all the assets of the transferor corporation be acquired by the transferee corporation.[69]

In the Tax Reform Act of 1986, Congress addressed the liquidation-reincorporation issue by repealing prior sections 336 and 337 as part of the repeal of the *General Utilities* doctrine.[70] This approach mooted most of the concerns previously addressed by the IRS and the courts by the liquidation-reincorporation doctrine. The general requirement of corporate-level gain recognition on the distribution of a corporation's appreciated assets effectively eliminated one of the principal tax incentives for attempting a liquidation-reincorporation transaction.

Since the repeal of former sections 336 and 337, the continuing scope of the liquidation-reincorporation doctrine has been unclear. In a footnote, the *TASCO* court indicated that it would not "necessarily preclude the applicability of [prior section 337] where the amount of such assets remaining in corporate solution can be said to be de minimis."[71] The Service has issued rulings concluding that a liquidation qualifies under sections 332 and 337 notwithstanding

its wholly owned subsidiaries, where "[t]he only result of the transaction was to place [some assets] and a sizable amount of cash in the shareholders' hands. New TASCO was merely the alter ego of [TASCO] with respect to all of its directly owned business assets; its formation and utilization served no purpose other than masking a distribution as one in complete liquidation."); Reg. §1.331-1(c) ("A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of other property. See sections 301 and 356.")

[69] *See, e.g., Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1960), *cert. denied*, 368 U.S. 836 (1961), *reh'g denied*, 369 U.S. 826 (1962) (an exchange of stock of the transferee corporation for stock of the transferor corporation is not required where the exchange is meaningless because the same shareholders owned all of the transferor and transferee corporation's stock); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964) (51 percent of assets, constituting all of the operating assets, satisfied the substantially all requirement); *Grubbs v. Commissioner*, 39 T.C. 42 (1962) (failure of target to liquidate was not an impediment to a reorganization on the facts); *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981) (15 percent of assets were substantially all where they constituted all operating assets).

[70] For repeal of the *General Utilities* doctrine, *see* P.L. 99-514, sections 631-33 (1986).

[71] *TASCO*, 63 T.C. 423, 436, fn. 9.

a reincorporation of a small percentage of the assets of the liquidating corporation.[72] More recently, in PLR 200949031,[73] the Service issued rulings under sections 331 and 336 despite the reincorporation of as much as 30 percent of the assets of the liquidating corporation.[74] While not necessary for the characterization of Overlap Transactions, we recommend that the Service adopt a standard for determining when a reincorporation of assets precludes characterization as a complete liquidation. The issuance of administrative guidance would provide certainty for taxpayers in characterizing transactions as a liquidation or not a liquidation for accurate reporting and risk assessment, without the time and expense of a private letter ruling.

As discussed above, when a transaction qualifies as both a section 332 liquidation and a section 368(a) reorganization, the liquidation characterization trumps the reorganization characterization.[75] Although the liquidation-reincorporation doctrine may apply to prevent a dissolution from constituting a complete liquidation within the meaning of section 332, when a transfer of assets satisfies the requirements of the -2(k) Regulations, the doctrine has no application in determining whether a transaction qualifies as a reorganization.[76] Therefore, whether an upstream transaction followed by a transfer of some or all of the assets of the liquidating corporation is a complete liquidation or a reorganization will depend on the uncertain scope of liquidation-reincorporation. Generally there is no significance to the treatment of an

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72 *See, e.g.,* PLR 9253027 (Oct. 2, 1992) (reincorporation of less than 5 percent of gross and net assets); PLR 9210041 (Dec. 12, 1991) (reincorporation of less than 3 percent of operating assets); PLR 9132055 (May 14, 1991) (merger of Sub into Distributing qualified as a liquidation under section 332, even though some assets were reincorporated in Controlled); PLR 9015050 (Jan. 16, 1990) (reincorporation of leases with nominal value); PLR 9015050 (Jan. 16, 1990) (reincorporation of leases with nominal value); PLR 8847059 (Aug. 29, 1988) (sales to affiliates representing less than 5 percent of gross assets); PLR 8812082 (Dec. 31, 1987) (reincorporation of certain subsidiary stock representing less than 1 percent of gross and net assets); PLR 8725034 (Mar. 20, 1987) (assets that could not be owned by a life insurance company, and having a value not in excess of 5 percent of the total value of the liquidating subsidiary's assets, were sold to a sister subsidiary).

73 Aug. 24, 2009.

74 The percentage of assets to be reincorporated was not redacted in the published private letter ruling.

75 *See* note 17, *supra.*

76 *See* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of a more than 80 percent-owned subsidiary into its parent, followed by a drop of all the assets and liabilities to a new subsidiary, could not qualify as a section 332 liquidation because there was no complete liquidation, but it did qualify as an A reorganization followed by a section 368(a)(2)(C) drop).

upstream asset transfer as a section 332 liquidation or a section 368 reorganization as the characterization under each will result in no recognition by the parties and the same rules govern the location of the attributes. In some transactions, however, it may be unclear whether the reorganization requirements are satisfied (e.g., if significant assets were disposed of prior to the upstream transfer), and certainty is needed to ensure that liquidation treatment will not be denied under the liquidation-reincorporation doctrine.

There is a question whether the liquidation-reincorporation doctrine has applicability in the context of the liquidation requirement for reorganizations where the -2(k) Regulations do not apply. The legislative history to section 368(a)(2)(G), which requires the target corporation in a C reorganization to liquidate, does not discuss this issue.[77] Where there is an upstream reorganization followed by a transfer of assets described in the -2(k) Regulations, it is apparent that the Treasury and Service believe that section 368(a)(2)(C) and the -2(k) Regulations preclude an application of the liquidation-reincorporation doctrine to disqualify or recharacterize a transaction.[78] If a transfer in connection with a reorganization transaction is not described in the -2(k) Regulations, however, the potential application of the liquidation-reincorporation doctrine is not certain. Thus, the issue is present in any transaction in which a transfer of assets to a corporation is followed by a liquidation of the transferor corporation unless

[77] *See* H.R. Rep. No. 861, 98th Cong., 2d Sess. 844 (1984), *reprinted at* 1984-3 C.B. (vol. 2) 98 (under the Senate amendment, a transaction can qualify as a C reorganization only if the transferor corporation distributes all of its assets (less those retained to meet claims), including consideration received from the acquiring corporation and any retained assets, within 12 months after the acquisition).

[78] In PLR 200952032 (Sept. 24, 2009), the reincorporation of 100 percent of the assets of a dissolving corporation into two controlled corporations qualified as an upstream C reorganization followed by section 368(a)(2)(C) drops. In the ruling, P owned Holdco, which owed S1 and S2, which owned business assets as a tenancy in common ("TIC"). S1 converted to a single member LLC ("S1 LLC" and the "Reorganization"), S1 LLC transferred the TIC to S2 (the "TIC Transfer"), then S1 LLC converted back into a corporation ("New S1" and the "Reincorporation"). The Service ruled that the Reorganization was an upstream C reorganization of S1 into Holdco and, as a result of section 368(a)(2)(C) and the -2(k) Regulations, the upstream C reorganization would not be disqualified or recharacterized by reason of the TIC Transfer or the Reincorporation (each a section 351 exchange).

the transferee of the assets is the acquiring corporation in a downstream or sideways reorganization.

The example in the Introduction raises this issue. If the example in the Introduction does not qualify as a downstream reorganization, it is not clear whether Target's transfer of assets to Sub prior to the liquidation of Target results in the application of the liquidation-reincorporation doctrine such that the liquidation cannot qualify as a reorganization, resulting in recognition with respect to any assets not reincorporated and the attributes located in the deemed acquiring corporation instead of the upstream acquirer. Consistent with the policy determination in the -2(k) Regulations that restructurings of this kind are not considered to be in contravention of the principles of section 311 or the requirement that divisive transactions be subject to the requirements of section 355, we recommend that the Treasury and Service clarify that the liquidation-reincorporation doctrine has no application in the context of a reincorporation preceding or following a reorganization.

I. Rev. Rul. 58-93

Against the backdrop of these recent developments, a revenue ruling issued more than fifty years ago has renewed significance. In Rev. Rul. 58-93,[79] Y, a State C corporation, was owned 79 percent by X, also a State C corporation, and 21 percent by various individuals. X wanted to operate the business of Y through a wholly owned State B subsidiary. Y transferred all of its assets, subject to its liabilities, to newly formed Z, a State B corporation, in exchange for all of Z's stock. Immediately thereafter, Y merged into X, with the minority shareholders of Y exchanging their Y stock for X stock. The assets of Y were transferred to Z prior to the statutory merger (rather than after) because X was not licensed to operate a small loan business

[79] 1958-1 C.B. 188.

in State B and therefore could not directly receive the Y assets. The Service first noted that section 368(a)(2)(C) did not literally protect a pre-reorganization drop. That provision references the transfer of assets "which were acquired in the transaction". Nonetheless, the Service believed that section 368(a)(2)(C) should apply because "the ultimate effect is practically the same, and it is not believed that the timing of the transfer of the assets to the new subsidiary (under the facts of the instant case) should disqualify the upstream A reorganization of Y into X." In order to bring Y's transfer of its assets to Z within the purview of section 368(a)(2)(C), the transaction was recast as if Y first merged into X in a reorganization within the meaning of section 368(a)(1)(A), and then X contributed the former assets of Y to newly formed Z.

There are two aspects of Rev. Rul. 58-93 that have enduring relevance to the characterization of Overlap Transactions. First, Rev. Rul. 58-93 resequences a "down-up" transaction as an "up-down" transfer of assets, thus permitting (or requiring) the taxpayer to disavow the form of its transaction. Second, the ruling might be interpreted as suggesting that for purposes of Federal tax characterization, an upstream A reorganization predominates over a downstream D reorganization in an Overlap Transaction. In other words, even if the transaction at issue is respected as a downstream transfer followed by an upstream merger, Rev. Rul. 58-93 might be interpreted as expressing a preference for the upstream merger to define the overall transaction.

The Service did not employ the resequencing aspect of Rev. Rul. 58-93 in a recent private letter ruling. The relevant facts of PLR 201026010[80] are as follows: S1 owned 100 percent of S2, which owned 100 percent of each of S3 and S4. S2 owned a percentage of S1 (hook stock). Pursuant to an integrated transaction, S2 contributed assets to S3 and S4 (the

[80] Dec. 18, 2009.

"Contributions"), respectively, and then S2 merged into S1 (the "Merger"), thereby eliminating the hook stock. The Service ruled that each Contribution qualified as a section 351 exchange and the Merger constituted an upstream A reorganization. Significantly, unlike the resequencing in Rev. Rul. 58-93, the Service provided that each Contribution "will be treated for federal income tax purposes in accordance with its form as occurring prior to the Merger."

In PLR 200733002,[81] the Service ruled that a downstream transfer of assets of a target corporation followed by an upstream merger constituted a section 351 exchange followed by an upstream A reorganization. In that ruling, Parent, a Country X corporation, owned approximately 95 percent of Subsidiary 1, a Country Y corporation, with the remaining 5 percent of Subsidiary 1 owned by minority shareholders. Subsidiary 1 operated Business A in Country Y and other countries. Parent wanted to integrate Subsidiary 1's non-Country Y Business A operations with its own and eliminate the minority interest in Subsidiary 1, while continuing to operate the Country Y Business A through a wholly owned Country Y corporation. For foreign law reasons, Parent could not obtain direct ownership of the Country Y Business A operations "even as an interim step in an overall transaction providing for such operations to be conducted by a Parent subsidiary." Accordingly, Parent caused Subsidiary 1 to transfer its Business A operations in Country Y to a newly formed Subsidiary 2, a Country Y corporation, in exchange for all the stock of Subsidiary 2 (the "Contribution"). Immediately thereafter, Subsidiary 1 merged into Parent, with the minority shareholders exchanging their Subsidiary 1 shares solely for Parent shares (the "Merger").

The Service ruled that the Merger qualified as an A reorganization, with Parent inheriting the tax attributes of Subsidiary 1 under section 381. Significantly, the Service did not

[81] May 15, 2007.

rule on the Contribution, except to say, unlike the resequencing in Rev. Rul. 58-93, that it would "be treated for federal income tax purposes in accordance with its form as occurring prior to the Merger." PLR 200733002 does note, however, that the IRS entered into a closing agreement with Parent and Subsidiary 2, "which will provide, among other things, that the Contribution is an exchange under § 351(a) and that the basis of the assets received by Subsidiary 2 in the Contribution will be determined under § 362(a)." Public comments made by the author of the ruling raised the possibility that the initial downstream transfer should have been a D reorganization rather than a section 351 exchange because substantially all of the assets may have been transferred to Subsidiary 2.[82] However, it was noted by the Service that the government could not be sure whether the substantially all requirement of section 368(a)(1)(D) would have been satisfied in the downstream transfer, so the Service issued a ruling that could provide certainty to the transaction regardless of the amount of assets that were transferred.[83]

The origins of Rev. Rul. 58-93 are obscure. There is no contemporaneous General Counsel Memorandum ("GCM") that explains it. Nonetheless, several GCMs written in the 1970's shed some light on the concerns of the Service at the time. Many of the concerns the Service had under the 1954 Code have since been resolved through legislative and administrative action. As a result of such developments, today both the validity and the utility of Rev. Rul. 58-93 are questionable.

In GCM 35653,[84] GCM 37491,[85] and GCM 37493,[86] the Service refers to a memorandum found in the "legal file" of Rev. Rul. 58-93. Based on this memorandum, the

82 Amy S. Elliott, *IRS Explains Reasoning Behind 'A' Reorg Merger Ruling*, 2009 TNT 186-6 (Sept. 28, 2009).

83 *Id.*

84 Feb. 4, 1974.

85 Apr. 10, 1978.

86 Apr. 10, 1978.

GCMs espouse the view that the primary concern in the ruling is the preservation of the E&P of Y, the target corporation.[87] Specifically, in Rev. Rul. 58-93, the Service in 1958 was concerned that (1) Y's pre-merger contribution of 100 percent of its assets to Z would not result in an allocation of Y's E&P to Z[88] and (2) Y's post-contribution merger into X would cause the E&P to be "extinguished in an unintended and undesirable way."[89] Without the protection of section 368(a)(2)(C), it can be conjectured that, in the opinion of the Service, the upstream merger of Y into X would be taxable under section 331, thus resulting in the elimination of Y's E&P.[90] While X and the minority shareholders would recognize gain (or loss) on the liquidation of Y, the gain would be taxed at capital gain rates and with basis offset, and X would hold stock in the resulting corporation, Z, with no E&P to fund future dividends.[91]

If the downstream transfer of Y's assets to Z could itself qualify as a reorganization, then the Service's concern regarding the bailout of Y's E&P would be mooted.

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87 *See* GCM 37491 (according to the memorandum, "the transactions [in Rev. Rul. 58-93] were restructured to ensure that Z would succeed to Y's tax attributes, primarily its earnings and profits").

88 *See* GCM 37491 ("It was believed that if the transactions were treated as consummated, the transfer from Y to Z would be merely a section 351 transaction in which such attributes would not carry over.")

89 GCM 37493.

90 The rationale for the Service's view that the merger of Y into X would not qualify as a tax-free A reorganization (and thus X would not succeed to the E&P of Y under section 381) is by no means clear. However, a reasonable assumption is that the remote continuity doctrine played a role. Congress, by enacting section 368(a)(2)(C) in 1954, limited the application of the remote continuity doctrine of *Groman* and *Bashford*, but it did not repeal it. Outside the protection of section 368(a)(2)(C), as in the case of a downstream asset transfer preceding a merger, the remote continuity doctrine still had relevance. For the upstream merger to qualify as a reorganization under section 368(a), the shareholders of Y (the minority shareholders and X) would have to preserve their proprietary interest in Y through a sufficient amount of stock in an acquiring corporation or, for X as the acquiring corporation, through a direct interest in the business enterprise of Y. However, the Y minority shareholders did not receive Z stock, nor did X obtain a direct interest in the business enterprise of Y. For an interesting discussion on the relevance of the remote continuity doctrine to Rev. Rul. 58-93, *see* Jasper L. Cummings, Jr., *Mergers, Reincorporations, and Groman*, 2010 TNT 162-5 (July 20, 2010).

91 The E&P bailout concern that motivated Rev. Rul. 58-93 possibly is reflected in the current language of Reg. §1.312-11(a). As amended in 1960, that provision requires "proper adjustment and allocation" of the E&P of the transferor corporation between the transferor and the transferee corporation as a result of certain nonrecognition transactions. Generally, no allocation must be made as a result of exchanges described in section 351(a), except where a contribution precedes or follows "a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation." The regulation perhaps excepts such transactions from the generally applicable rule that no E&P allocation is necessary in a section 351 exchange because of the potential that E&P of the transferor could be eliminated in the preceding or subsequent transaction. For a thorough analysis of "proper adjustment and allocation" under Reg. §1.312-11(a), *see* Daniel Halpern, *Carryovers of Earnings and Profits*, 18 Tax L. Rev. 289 (1962-1963) and Jasper L. Cummings, Jr., *E&P Allocation When Target Property Dropped After Asset Reorganization* (Oct. 11, 2005).

In such case, Z, the acquiring corporation for both section 368 and section 381 purposes, would succeed to the E&P of Y.[92]

It is curious that the Service in 1958 would not have determined that the transaction could qualify as a downstream reorganization. The Service certainly believed that a downward transfer of assets could qualify as a reorganization. In fact, one year earlier, in Rev. Rul. 57-465,[93] the Service ruled that downstream merger qualified as a D reorganization. In Rev. Rul. 57-465, corporation X owned all of the outstanding stock of corporation Y. Corporation Y, a foreign holding company, owned all of the outstanding shares of corporation Z, a foreign operating company. The investment in the stock of corporation Z comprised over one-half of the assets of corporation Y. The assets of corporation Z consisted principally of accounts receivable, inventories and fixed assets. For valid business reasons, corporation Y merged into corporation Z, with corporation Y ceasing to exist and corporation Z as the surviving legal entity.[94] The Service concluded that the downstream merger of corporation Y into corporation Z qualified as a D reorganization, and the exchange of shares by corporation X was nontaxable under section 354(a)(1).[95]

A potential explanation that the downstream transfer of the assets of Y in Rev. Rul. 58-93 could not qualify as a D reorganization is that the transaction, at that time, would

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92 *See* GCM 37491 ("[The memorandum] noted that the same results would obtain if the exchange between Y and Z were to qualify as a C reorganization.")

93 1957-2 C.B. 250.

94 Note that the Service had previously unsuccessfully argued that the merger of a parent holding company into its operating subsidiary was the equivalent of a liquidation of the parent holding company. *See H. Grady Manning Trust v. Commissioner*, 15 T.C. 930 (1950) (nonacq.); *Commissioner v. Estate of Gilmore*, 130 F.2d 791 (3d Cir. 1942), *acq., nonacq. withdrawn,* 1946-2 C.B. 2; *Commissioner v. Estate of Webster,* 131 F.2d 426 (5th Cir. 1942), *acq., nonacq. withdrawn,* 1946-2 C.B. 5. *See also Isidor Kahn,* 36 BTA 954 (1937), *aff'd per curiam sub nom. Helvering v. Einhorn*, 100 F.2d 418 (2d Cir. 1938); *Commissioner v. Kann*, 130 F.2d 797 (3d Cir. 1942).

95 The transaction described in Rev. Rul. 57-465 could not qualify as an A reorganization at that time because the target corporation and acquiring corporation were not domestic corporations. Former Reg. §1.368-2(b) defined the words "statutory merger" in section 368(a)(1)(A) as referring to a merger effected in pursuance of the laws of the United States or a State or Territory or the District of Columbia. Under the current regulations, however, a qualifying merger or consolidation can be carried out under the laws of a foreign country. *See* T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006); Reg. §1.368-2(b)(1)(iii), *Examples 13 and 14*.

have failed the “control requirement” of section 368(a)(1)(D). That provision defines a reorganization as “a transfer by a corporation of all or a part of its assets to another corporation *if immediately after the transfer the transferor, or one or more of its shareholders* (including persons who were shareholders immediately before the transfer), or any combination thereof, *is in control of the corporation to which the assets are transferred*; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.” In 1958, control for purposes of section 368(a)(1)(D) was defined by section 368(c), which required ownership of 80 percent of the total voting power of a corporation and 80 percent of the number of shares of each class of non-voting stock.[96] Significantly, X in Rev. Rul. 58-93 X owned only 79 percent of the stock of Y immediately before the transaction (in contrast to the X in Rev. Rul. 57-465, which wholly owned Y). While X acquired 100 percent of the stock of Z as a result of the upstream merger of Y into X, X did not obtain control of Z as a result of its status as a shareholder of Y, i.e., in a section 354 distribution. Rather, if the transaction were analyzed as a downstream reorganization, X obtained 79 percent of Z as a shareholder of Y, and acquired the remaining 21 percent of Z from the minority shareholders of Y in exchange for X stock.

The language of Rev. Rul. 57-465 provides support for this hypothesis. In that ruling, the Service ruled that the requirements of section 354(b) would be satisfied in the reorganization "since (a) the assets of Y corporation are to be transferred to only one transferee under the plan of merger, (b) Y corporation will retain no assets and will go out of existence, and (c) the stock of Z corporation held by X corporation after the merger will not represent any greater property rights than the stock of Y corporation held prior to the merger.” Significantly,

[96] *See* Rev. Rul. 59-259, 1959-2 C.B. 115. Section 368(a)(2)(H), which liberalized the definition of control for purposes nondivisive D reorganizations, was not added until 1986.

the final condition would not be satisfied in Rev. Rul. 58-93, where the stock of Z held by X after the transaction did represent greater property rights than the stock of Y held before the transaction.

By 1976, the Service had changed course, concluding that the initial drop down of assets could in fact qualify as a C reorganization.[97] Because in a downstream reorganization the attributes of Y would be preserved in Z, GCM 37493 suggests that Rev. Rul. 58-93 should be modified to reflect that "there no longer is any reason to restructure the transactions in that case." Moreover, in the Tax Reform Act of 1986, Congress added section 368(a)(2)(H), which cross-references the section 304(c) standard (direct or constructive ownership of at least 50 percent of voting power or at least 50 percent of value) for purposes of determining control in an acquisitive D reorganization.[98] Therefore, the downstream transfer in Rev. Rul. 58-93 could qualify as both a C and D reorganization under current law.

This is where the sequencing and prioritizing implications of Rev. Rul. 58-93 converge. As the above discussion demonstrates, the recast of Rev. Rul. 58-93 was necessary at the time to further section 312 policy. Under the circumstances as they appeared to the Service in 1958, the resequencing was the only possible method of compelling Z to succeed to the tax attributes of Y and, thus, to prevent the disappearance of Y's E&P. Perhaps Rev. Rul. 58-93 does not imply a preference for upstream reorganizations over downstream reorganizations. The Service simply did not believe in 1958 that the downstream transfer could qualify as a reorganization.

Rev. Rul. 58-93 stands in contrast to the principle that, provided there is valid business purpose for a merger of two corporations, it is well settled that the parties are free to

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[97] Rev. Rul. 76-188, 1976-1 C.B. 99.

[98] P.L. 99-514, Sec. 1804(h)(2) (1986).

choose the direction of the merger. For example, in Rev. Rul. 75-161,[99] the Service held that a merger of X into Y resulted in gain recognition under section 357(c) (as then in effect) due to an excess of X's liabilities over the basis of the assets transferred, but the Service stated that no gain would have resulted if Y had instead merged into X, because Y's liabilities were less than the basis of its assets.

Consistent with this rule that the direction of the reorganization controls for section 368 purposes, it is well settled law that a corporation is free either to liquidate under section 332 (if it is owned by a controlling corporate shareholder) or section 331 (if it is not owned by a controlling corporate shareholder), or instead a corporation is free to merge or transfer its assets to its operating subsidiary in a downstream section 368 reorganization. This is an area in subchapter C where a taxpayer is free to alter the tax consequences of its business combination by its choice of the direction of the merger or asset transfer. Initially, the Service challenged this electivity by trying to construct a section 331 liquidation when a holding company was eliminated by a downstream merger or asset transfer, but the Service was unsuccessful in litigating its position.[100] Having lost these cases, the Service has acquiesced to the view that a taxpayer is free to choose whether to liquidate a holding company or to eliminate it through a downstream section 368 reorganization.[101]

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[99] 1975-1 C.B. 114.

[100] For example, in *Commissioner v. Estate of Gilmore*, 130 F.2d 791 (3d Cir. 1942), *acq., nonacq. withdrawn,* 1946-2 C.B. 2, the Third Circuit held that a downstream merger of a holding company, the principal asset of which was the stock of its subsidiary corporation, into that subsidiary qualified as a downstream reorganization. Likewise, in *George v. Commissioner*, 26 T.C. 396 (1956), *acq., nonacq. withdrawn*, 1956-2 C.B. 5, approximately 56 percent of the net assets of a holding company was comprised of a 50 percent stock interest in an operating company. Contemporaneously with the transfer by the operating company of all its assets to a new corporation in exchange for its voting shares, the holding company transferred all its assets, except for its 50 percent share interest in the operating company, to the new corporation in exchange for additional voting shares of the new corporation. The court held that the transfer of the operating company's assets to the new corporation was a reorganization, notwithstanding the fact that the holding company did not transfer its stock in the operating company to the new corporation.

[101] *See* Rev. Rul. 70-223, 1970-1 C.B. 79 (merger of a parent corporation into its wholly owned subsidiary was a reorganization within the meaning of section 368(a)(1)(A); *see also* PLR 200515012 (Apr. 15, 2005) (A reorganization of holding company into less than 1 percent owned subsidiary); PLR 9837002 (June 5, 1998) (D reorganization where parent owned

Despite the Service's evolved view toward respecting a downstream transfer as a reorganization, Rev. Rul. 58-93 has not been modified. As GCM 37491 notes, the ruling "has been a useful tool for the Service to cite as general authority for restructuring transactions in appropriate cases." This could be a reference to the fact that the recast in Rev. Rul. 58-93 protects minority shareholders of the target corporation from taxation. Were the transaction respected as a downstream reorganization of Y into Z, followed by a distribution of the Z stock to X in complete liquidation of Y (by merger), X would be treated as exchanging its Y stock for Z stock tax-free under section 354. However, the minority shareholders' receipt of the X stock in exchange for their Y stock would be taxable under section 1001. Section 354 would not protect the minority shareholders because X stock would not be stock of a "party to the reorganization". X's involvement in the transaction would be merely in the role of a fellow shareholder of Y, rather than the acquiring corporation. However, treating the initial contribution as a section 351 exchange, and the upstream merger as an A reorganization, would provide nonrecognition treatment to the minority shareholders, as they would receive stock of the acquiring corporation, X, under section 354.

Even in this regard, the utility of Rev. Rul. 58-93 has been reduced as a result of the expansion of the permissible methods of reorganization under section 368. As discussed above, Congress amended the Code in the 1950's and 1960's to permit several variations of triangular reorganizations. As a result, the parties in Rev. Rul. 58-93 could, in 2010, structure the transaction to qualify for nonrecognition without X acquiring the assets of Y, through a merger of Y into Z with the minority shareholders of Y receiving X stock in a transaction that

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100 percent of the stock of the acquiring sub); PLR 9510072 (Dec. 15, 1994) (D reorganization where parent owned 100 percent of the stock of the acquiring sub; PLR 9119050 (Feb. 13, 1991) (A reorganization where parent owned more than 80 percent of the stock of acquiring sub); and PLR 9121013 (Feb. 1, 1991) (A reorganization where parent owned 100 percent of the stock of acquiring sub).

qualifies an A reorganization by reason of section 368(a)(2)(D).[102] Likewise, Y could transfer its assets to Z with the minority shareholders of Y receiving X voting stock in a transaction that qualifies as a triangular C reorganization.[103]

The continued vitality of Rev. Rul. 58-93 must be considered in connection with the issuance of guidance addressing the characterization of Overlap Transactions. Rev. Rul. 58-93 is inconsistent with the approach recommended by the Tax Section in this Report and, thus, would need to be revoked if the recommendation is adopted. Even if no formal guidance is issued in the area, Rev. Rul. 58-93 should be reconsidered in light of the uncertainty it creates, particularly when contrasted with the Service's administrative approach in private letter rulings.

III. ALTERNATIVE APPROACHES TO CHARACTERIZING OVERLAP TRANSACTIONS

A. Overview of Approaches

For purposes of this Report, an Overlap Transaction is any corporate transaction in which a corporation transfers assets to one or more corporations and liquidates for Federal tax purposes. The end result of an Overlap Transaction may be accomplished in more than one series of steps. As such, an Overlap Transaction may be characterized as more than one type of section 368 reorganization or other tax-free transaction described in sections 332 or 351. Consequently, depending upon the chosen characterization, an Overlap Transaction may result in gain to the target corporation or its shareholders, and the chosen characterization will determine the location of the target attributes following the transaction and will affect the determination of stock basis. An Overlap Transaction does not include a transaction in which a target corporation

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[102] *See* PLR 200439003 (May 21, 2004) (valid A reorganization by reason of section 368(a)(2)(D)). For a discussion of PLR 200439003, *see* Richard W. Bailine, *Section 368(c) Control: When Is it Needed?*, 32 J. of Corp. Tax'n 28 (Jan. 2005).

[103] In fact, even in 1958, the transaction could have been structured as a triangular C reorganization, in which Z acquired all the assets of Y in exchange for X voting stock, which X voting stock would be distributed by Y in dissolution with nonrecognition to X and the minority shareholders under section 354. *See* Rev. Rul. 57-278, 1957-1 C.B. 124 ("*Bausch & Lomb* doctrine" is inapplicable to disqualify a triangular C reorganization despite parent corporation's prior "old and cold" 72 percent ownership of the target corporation immediately before the reorganization).

transfers its assets to another corporation in a qualifying reorganization, followed by a transfer of assets by the acquiring corporation to another corporation pursuant to the -2(k) Regulations.

In order to provide uniformity and certainty to the system, we recommend that the Treasury and Service adopt in formal guidance a uniform approach to characterizing Overlap Transactions. Prior to adopting an approach, however, we believe it is important to determine whether the adoption of the approach is appropriate in the context of cross-border transactions.

The Tax Section has considered seven approaches to characterizing Overlap Transactions: the Upstream Approach, the Directional Approach, the Directional / Minority Shareholder Approach, the Directional / Nonrecognition Approach, the Directional / Merger Approach, the Multiple Reorganizations Approach, and the Election Approach. This section of the Report explains the general operation and the pros and cons of each approach, demonstrates through a series of examples how each method of characterization would apply to specific Overlap Transactions, and discusses related issues that would need to be addressed. This Report does not address issues arising in cross-border transactions.

Upstream Approach. The Upstream Approach would characterize an Overlap Transaction as an upstream reorganization or liquidation, if the requirements are satisfied, with one or more section 351 contributions (or taxable transfers if section 351 does not apply). A transaction would be respected in accordance with its legal and temporal form, yet an actual or deemed upstream transfer of assets pursuant to the transaction would predominate for purposes of characterization under sections 332 and 368. Even in a case in which 100 percent of the target corporation assets are transferred to a subsidiary prior to the liquidation of the target corporation into its parent, the Upstream Approach would characterize the transaction as an upstream reorganization or liquidation of the target corporation into its parent if the requirements are satisfied. Any transfer of assets to a corporation other than the shareholder of the target corporation as part of the Overlap Transaction would be treated as an exchange potentially described in section 351. If the Overlap Transaction does not qualify as an upstream reorganization or liquidation, then the transaction would be tested to determine whether it satisfies the requirements for a downstream reorganization.

The Upstream Approach is consistent with the result in Rev. Rul. 58-93 that treats a transaction as an upstream reorganization and would provide consistent results with other upstream reorganizations, continuing the trend in the law toward allowing for the tax-free division of assets between related corporations. The Upstream Approach would eliminate the potential for gain recognition on assets transferred upstream by the transferor and would eliminate the potential for gain recognition by any minority shareholder that receives parent stock. Overlap Transactions that qualify as upstream reorganizations or liquidations under the Upstream Approach will result in the attributes of the target corporation being inherited by its parent corporation unless all the assets are transferred to a single subsidiary. The Upstream Approach does not permit taxpayers electivity to determine, based on their form, the Federal tax consequences of their transaction.

Directional Approach. The Directional Approach would determine the characterization of Overlap Transactions in a manner consistent with the order of the taxpayer's chosen steps. Under this approach, each transfer of assets is analyzed, in chronological order, to determine the first set of steps that constitutes a reorganization. Specifically, the first transfer of assets is analyzed to determine whether it is sufficient to constitute a transfer that is part of a reorganization. If it is sufficient, the reorganization of which it is a part is treated as the reorganization under the Directional Approach, and there can be no other reorganization. If the first transfer is not sufficient to constitute a transfer that is part of a reorganization, then the second transfer is analyzed to determine whether it constitutes a transfer that is part of a reorganization. If the second transfer is not sufficient to constitute a transfer that is part of a reorganization, each subsequent transfer would be analyzed. Steps cannot be reordered to arrive at a characterization that differs from that of the first reorganization identified. Once a reorganization is identified, any prior or subsequent step is analyzed in the context of the reorganization transaction.

The Directional Approach generally provides a characterization that is consistent with the order of the taxpayer's chosen steps. As illustrated below, under the Directional Approach, if assets are transferred downstream and such transfer is sufficient to satisfy the asset transfer requirement of a C, D, or F reorganization, or the target corporation merges downstream in a qualifying A reorganization, the transaction will be characterized as a downstream reorganization (assuming all other requirements are satisfied). Otherwise, the Directional Approach will result in all transactions characterized as upstream reorganizations if the requirements are satisfied. If the Directional Approach results in the characterization as a downstream reorganization, the "unwanted assets" (i.e., assets that do not move in the downstream transfer) will be nonqualified property, taxable to the target corporation on its distribution under section 361(c)(2) and taxable to the target shareholder as boot (probably treated as a dividend) under section 356(a). Further, a minority shareholder of the target corporation will recognize gain or loss under section 1001 on the receipt of parent corporation stock in exchange for its target stock. Under the Directional Approach, the attributes of the target corporation will be inherited by the downstream acquiring corporation if that transfer qualifies as a reorganization; otherwise the attributes will be inherited by the parent corporation unless all the assets are then transferred to a single subsidiary.

Directional / Minority Shareholder Approach. The Directional / Minority Shareholder Approach would follow the Directional Approach, but would characterize a transaction as an upstream reorganization for a minority shareholder if the transaction is otherwise characterized as a downstream reorganization with respect to the target and acquiring corporations. The Directional Approach raises an issue regarding whether the Treasury and IRS have the authority to promulgate a rule that denies the minority shareholder nonrecognition treatment if the transaction also qualifies as an upstream reorganization. Further, because the minority shareholder is not in control of the facts and order of transaction steps, it may not be appropriate to treat the minority shareholder consistent with the other parties to the reorganization.

The Directional / Minority Shareholder Approach will result in a different characterization for the minority shareholder than the other parties to the reorganization. The Code provides for a similar inconsistency in the context of an upstream liquidation that qualifies as a section 332 liquidation for the eighty percent owner and a reorganization for a minority shareholder. The reorganization characterization allows the minority shareholder to receive tax-free treatment. Similarly, the Directional / Minority Shareholder Approach would provide the minority shareholder nonrecognition treatment.

Directional / Nonrecognition Approach. The Directional / Nonrecognition Approach would follow the Directional Approach, but if the transaction would be characterized as a downstream reorganization under the Directional Approach and such characterization would result in gain or loss recognition by the target or parent corporation or a minority shareholder of the target corporation, the transaction would be characterized as an upstream reorganization so that the target and parent corporations and its shareholders would not recognize gain or loss.

The Directional / Nonrecognition Approach would provide additional transactional flexibility to the corporations to determine the location of the target corporation's attributes because a single retained asset would convert a downstream reorganization into an upstream reorganization. Further, the Directional / Nonrecognition Approach would provide nonrecognition treatment to the target corporation and its minority shareholders. Unlike the Directional / Minority Shareholder Approach, the Directional / Nonrecognition Approach would result in the same characterization of the transaction for all parties.

Directional / Merger Approach. The Directional / Merger Approach would follow the Directional Approach, but an actual statutory merger or consolidation under state or foreign law would control the characterization of the transaction. The Directional / Merger Approach, like the Directional Approach, would analyze each transfer of assets in chronological order of each legal step, with the first asset transfer that is part of a reorganization controlling the characterization of the transaction. However, if there is a transfer of assets effected by a merger in the transaction, that merger would define the overall transaction, regardless of whether another entity acquired substantially all of the target corporation's assets before or after the merger. If more than one merger occurs in a single transaction, a rule would be necessary to define which merger predominates.

In an Overlap Transaction involving a merger, any uncertainty related to assessing whether the substantially all requirement is satisfied for nonrecognition treatment would be eliminated. However, the Directional / Merger Approach would not be relevant in any Overlap Transaction that does not involve a merger and there is no apparent justification for elevating one particular reorganization type in priority over the others. The Directional / Merger Approach could reach odd results in any case in which a transfer of significant assets precedes the merger. For example, if the target corporation first distributes substantially all its assets to its parent and then merges downstream, the Directional / Merger Approach would disregard the upstream reorganization and treat the transaction as a downstream merger.

Multiple Reorganizations Approach. The Multiple Reorganizations Approach would apply when a transaction is characterized as a downstream reorganization under the Directional Approach or the Directional / Merger Approach. In general, the Multiple Reorganizations Approach would allow a transaction to qualify under multiple tax-free provisions, thus minimizing potential recognition by the parties. Under the other approaches, as illustrated below, if a transaction is characterized as a downstream reorganization and if not all the assets are transferred downstream, there will be recognition with respect to the retained assets when the target corporation liquidates. In contrast, the Multiple Reorganizations Approach would allow the liquidation that concludes a downstream reorganization and satisfies the liquidation requirement under section 368(a)(2)(G) (for a C reorganization) or section 354(b)(1)(B) (for a D reorganization) to also qualify as a transfer in a separate upstream reorganization. Therefore, any gain or loss recognition that would result from the application of the Directional Approach would be eliminated. For example, if less than all the assets of the target corporation are transferred downstream in a qualifying reorganization, the remaining assets and the subsidiary stock received in the downstream transfer would be viewed as transferred in an upstream reorganization. Section 361 would apply to the upstream transfer to provide that all the assets of the target corporation will be treated as exchanged for qualifying property.[104] Further, if the Directional Approach results in a downstream reorganization and the target corporation has a minority shareholder, the minority shareholder would receive nonrecognition treatment on the exchange of target corporation stock for parent corporation stock under section 354.

We note that the Multiple Reorganizations Approach could apply to transactions between unrelated corporations unless it were written to apply solely with respect to transactions among related corporations.[105]

If an Overlap Transaction qualifies as both a downstream reorganization and an upstream reorganization, under the Multiple Reorganizations Approach, neither characterization predominates over the other. Thus, rules would be necessary to determine which reorganization controls for purposes of determining the consequences of the transaction. A rule would be necessary to address which reorganization transaction controls for purposes of determining the location of the attributes following the transaction. A rule would be necessary to determine the basis of the stock of the transferee in the downstream reorganization in the hands of the transferee in the upstream reorganization. Because the downstream and upstream reorganizations will be completed at the same time, at the conclusion of the liquidation, a "first to finish" rule could not be employed. Presumably, these special rules would be consistent with the treatment of the Overlap Transaction as either a downstream reorganization or an upstream

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[104] We note that in Rev. Rul. 2000-5, 2000-1 C.B. 436, the Treasury and Service concluded that one corporation could not engage in two simultaneous merger transactions, citing S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954); S. Rep. No. 169, 98th Cong., 2d Sess. 204 (1984). In Rev. Rul. 2000-5, the Treasury and Service considered two situations involving the "merger" of a target corporation under state law: (1) the target corporation transferred some of its assets and liabilities to an acquiring corporation, but retained the remainder of its assets and liabilities and remained in existence following the transaction, and (2) the target corporation transferred some of its assets and liabilities to each of two acquiring corporations and the target corporation liquidated. Although section 368(a)(1)(A) defines a reorganization merely as a "statutory merger or consolidation," and each transaction at issue was effected under a state law merger statute, Rev. Rul. 2000-5 nonetheless refused to extend reorganization treatment to either transaction.

[105] For example, if a target corporation transfers substantially all its assets to an unrelated acquiring corporation in a C reorganization and the Multiple Reorganizations Approach applies, the target could distribute the retained assets and the acquiring corporation stock to its corporate shareholder in a separate C reorganization. This avoidance of section 361(c) gain recognition seems inappropriate. *Cf.* section 361(a)(4) (sections 311 and 337 do not apply to the distribution).

reorganization, but not a combination of both. Consequently, the Multiple Reorganizations Approach will resemble either the Upstream Approach or the Directional Approach. If the Directional Approach is chosen and the downstream reorganization predominates for purposes of attributes and basis, the Multiple Reorganizations approach would allow the upstream reorganization to eliminate any recognition by the target corporation on assets that were not transferred as part of the downstream reorganization and any recognition by the minority shareholder of target that exchanges its target stock for parent corporation stock.

The elimination of gain under the Multiple Reorganizations Approach is consistent with the ability to divide corporate assets under the -2(k) Regulations. However, based on the construct of the reorganization provisions, it appears that Congress did not intend for a single transaction to be characterized as two different reorganization types. Further, the Multiple Reorganizations Approach would require a complex system of rules to control the consequences of the transaction.

Election Approach. The Election Approach would permit taxpayers to elect the Federal tax characterization of an Overlap Transaction, so long as the requirements of the chosen characterization are satisfied and the Code does not provide a rule of priority. The Treasury and Service could require that the election be made by the corporate parties to the transaction at the time of the transaction, and that such an election would be irrevocable and binding on all parties to the transaction.

The Election Approach recognizes that an Overlap Transaction by definition has no clear form or substance. Therefore, the Election Approach would allow the taxpayer to select the characterization that is most beneficial from a tax perspective. While the Code allows for electivity by taxpayers to the extent they can structure their transactions to qualify as one type of reorganization or another, the Code does not otherwise provide for electivity.

B. Examples

The following examples illustrate the potential application of the seven approaches outlined above. Each example assumes there are no other steps relevant to the analysis and that all statutory and regulatory requirements are otherwise satisfied. For purposes of the examples below, we have assumed that all aspects of current law remain unchanged.

Example 1: Downstream Transfer, Followed by Liquidation

> **Example 1(a):** P owns 100 percent of the outstanding stock of S, which owns 100 percent of the outstanding stock of X. Pursuant to a single, integrated plan, the following steps occur (in chronological order): (1) S transfers substantially all of its assets to X, and (2) S distributes its remaining assets, and the stock of X, to P, in dissolution of S.[106]

Upstream Approach. Presumably the reincorporation of substantially all the assets in X would preclude Step 2 from characterization as a section 332 liquidation. Because the upstream transfer is not undertaken by merger, the upstream transaction would not qualify as

[106] If X were instead owned by P and S transfers its assets to X and does not receive consideration in exchange, an additional issue arises that needs resolution. The treatment of a non-value-for-value exchange between a brother and sister corporation is not clear. Viewing S and X as separate entities with their own corporate interests, S has gratuitously transferred an economic benefit to X. Is this a gift from S to X? A constructive dividend from S to P followed by a contribution from P to X? A transfer from S to X in deemed exchange for X stock followed by a distribution of X stock to P? The Code and regulations generally assume that transactions between taxpayers, other than capital contributions and distributions with respect to a corporation's stock, are structured as arm's length, equal value transactions. In the event of a noneconomic transaction, the tax law gives effect to the transaction's "true nature" by recasting the transaction. *See, e.g.,* Reg. §1.351-1(b)(1) (providing that where stock in a section 351 transfer involving multiple parties is received in disproportion to the property transferred, "the entire transaction will be given tax effect in accordance with its true nature…."). The transfer could be viewed as an equal value exchange followed by a series of "true-up" transfers (the "Assets-Over Recast") or, where the parties to the transaction have a direct or indirect common parent, a distribution to this common parent, followed by one or multiple transfers to account for the value shift from the transferor to the transferee (the "Assets-Up Recast"). Another possible approach to rationalize the uneconomic nature of the formless transaction is to treat P as having contributed S stock to X, with S redeeming its stock for the S assets that are transferred to X (the "Stock-Down Approach"). We are not aware of any authorities or private rulings that invoke this recast.

If the Treasury and Service adopt the Directional Approach for characterizing Overlap Transactions, we recommend adopting the Assets-Over Recast as more consistent with the concept that the movement of the assets should dictate the Federal tax characterization of the transaction. The Assets-Over Recast harmonizes with recent regulatory approaches adopted for purposes of determining the tax consequences of stockless reorganizations, including basis allocation and other consequences. See Reg. §1.358-2(a)(3)(iii) and Reg. §1.368-2(l)(2)(i). The Assets-Up Recast is more consistent with the Upstream Approach and has support in the constructive distribution precedent under section 482. *See* Rev. Rul. 78-83, 1978-1 C.B. 79; Rev. Rul. 69-630, 1969-2 C.B. 112.

an A reorganization. Whether the upstream transaction qualifies as an upstream C reorganization depends on whether the X stock is a "substituted asset" taken into account for purposes of determining whether substantially all the assets have been transferred. In Rev. Rul. 88-48,[107] the Service held that the substantially all requirement of section 368(a)(1)(C) was satisfied where, immediately prior to the target corporation's transfer of assets to the acquiring corporation, the target corporation sold 50 percent of its assets to unrelated parties for cash and immediately transferred that cash and its other properties to the acquiring corporation.[108] Rev. Rul. 88-48 concludes that the transaction described therein satisfied the substantially all requirement and was not divisive because the prior sale of the historic business assets was to unrelated purchasers, and the sale proceeds were transferred to the acquiring corporation and not retained by the transferor corporation or its shareholders. Based on Rev. Rul. 88-48, Step 2 may be treated as a transfer of substantially all of S's assets to P, which assets are comprised of the operating assets distributed in Step 2 and the X stock. We note the transaction described in Example 1(a) involves a transfer to a related person (i.e., from S to X in actual or deemed exchange for X stock), while the sale in Rev. Rul. 88-48 involved unrelated parties. The substantially all requirement is intended to prohibit the use of the section 368 provisions to divide a company tax-free as divisive transactions must satisfy the rigorous tests of section 355.[109] The -2(k) Regulations allow taxpayers to achieve tax-free divisions of a corporation's assets in transactions that produce the same end result as Overlap Transactions. Consistent with the -2(k) Regulations, the tax-free division of assets between related corporations in the context of Overlap Transactions seems appropriate. Therefore, we believe the stock of X should be taken into

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[107] 1988-1 C.B. 117.

[108] *See also* Rev. Rul. 2001-25, 2001-1 C.B. 1291 (the post-acquisition sale of 50 percent of target corporation's operating assets does not violate the substantially all requirement of section 368(a)(2)(E)).

[109] *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954); S. Rep. No. 169, 98th Cong., 2d Sess. 204 (1984).

account for purposes of determining whether substantially all of the assets of S were transferred to P. Assuming the Treasury and Service agree with this conclusion, the Upstream Approach would apply to treat the liquidation of S as a C reorganization and the transfer to X would be treated as a section 351 exchange.[110]

Despite the fact that X receives substantially all of the assets of S, P, as the transferee in the reorganization, would be the acquiring corporation for purposes of section 381 and would inherit S's attributes. Neither S (under section 361) nor P (under section 1032) would recognize any gain or loss in the transaction. P's basis in its S stock would disappear in the upstream reorganization, and P would have a carryover basis in the assets (including the X stock) received from S under section 362(b). If S was owned in part by another shareholder and the shareholder received P stock in exchange for its S stock in Step 2, under section 354 the minority shareholder would not recognize gain or loss. Note these results are the same as would be obtained if S distribute its assets to P in liquidation of S and P then contributes some assets to X in exchange for X stock. Under the -2(k) Regulations, the characterization of the upstream reorganization would not be affected by the subsequent contribution to X.

The same results would obtain if S transfers all of its assets to X and then liquidates. Like the facts of Rev. Rul. 58-93, the only asset transferred upstream to P is the X stock. Nonetheless, applying the substituted assets theory, Step 2 could qualify as an upstream C reorganization. If so, as in Example 1(a), the Upstream Approach would result in tax-free treatment to S under sections 351(a) (Step 1) and 361(a) (Step 2), and a carryover basis for P in the stock of X. Regulation §1.381(a)-1(b)(2)(i) provides that the acquiring corporation for

110 As noted above, there is an issue as to whether the distribution of the X stock as part of the section 361 exchange in the upstream reorganization satisfies section 351(c), which allows a transferor in a section 351 exchange to distribute the transferee stock to its shareholder. We recommend the Treasury and Service confirm that section 351(c) is satisfied in this context.

purposes of section 381 is "that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation." The regulation does not require that the ultimate transferee's acquisition of the assets must be after the reorganization. Rather, it seems sufficient that the receipt of the assets is pursuant to the same plan as the reorganization. Assuming that regulation language is broad enough to encompass pre-reorganization transfers, then X, not P, should inherit the attributes of S. However, because the Upstream Approach characterizes Example 1(a) as an upstream C reorganization because the stock of X is transferred, an argument could be made that P should succeed to the S attributes. Because all the assets of the target corporation are contributed to X, we believe the better approach would be to conclude the attributes travel with the actual assets to X. This would be the same result that would obtain if S distributes all its assets to P in liquidation of S and P then contributes all the S assets to X in exchange for X stock.

Directional Approach. Under the Directional Approach, whether Step 1 is a transfer that is part of a potential downstream C or D reorganization depends on the quantum of the assets transferred. Because S transfers substantially all of its assets in Step 1, the Directional Approach would define the reorganization by that transfer as part of a downstream reorganization. If Step 1 was instead accomplished by merger, the transaction would be characterized as a downstream A reorganization. Consequently, X would be the acquiring corporation for purposes of section 368(a) and would inherit S's attributes under section 381.

S would recognize no gain or loss on the distribution of the X stock to P pursuant to section 361(c)(1), but would recognize gain (but not loss) under section 361(c)(2) on the distribution of its remaining assets to P.[111] Section 356 applies to any gain recognized by P with

[111] The distribution of the X stock and S's other assets pursuant to the liquidation of S, which concludes the C or D reorganization into X, is governed by section 361 and not section 337. *See* section 361(c)(4), providing that the provisions

respect to its S stock as a result of receiving the remaining assets of S. Pursuant to section 358, P's basis in the X stock is the same as P's basis in the S stock, decreased by the boot and increased by the gain recognized. If S was owned in part by another shareholder and that shareholder received P stock in exchange for its S stock, the minority shareholder would recognize gain or loss on the exchange of S stock for P stock under section 1001 because P is not a party to the downstream reorganization.

If X were a newly formed corporation, an issue arises under the Directional Approach as to whether, under the Proposed F Regulations, Step 1 could be a transfer that is part of an F reorganization. Generally, under current law, a transaction will not qualify as an F reorganization unless the assets of the old corporation are virtually identical to the assets of the new corporation.[112] However, under the "F in the bubble" concept, a change in the composition of assets (or shareholders) of the transferring corporation in a separate step as part of a larger transaction (i.e., before or after the reorganization) generally will not disqualify an F reorganization.[113] The Proposed F Regulations do not appear to require complete asset identity, even within the "bubble" of section 368(a)(1)(F), because the Proposed F Regulations allow for redemptions of less than all the stock as part of the F reorganization.[114] In fact, in Example 2 of the regulations, a 75 percent shareholder of the transferring corporation surrenders her stock in the transferor in exchange for cash pursuant to the merger that purports to effect the F

of sections 311 and 337 do not apply to any distribution described in section 361(c)(1).

112 *See* Rev. Rul. 96-29, 1996-1 C.B. 50 (a transaction does not qualify under section 368(a)(1)(F) unless there is no change in the assets of the corporation).

113 *Id.* In Situation 1 of Rev. Rul. 96-29, corporation Q planned to make a public offering of its stock and, as part of that plan, it reincorporated in State N. In Situation 2 of Rev. Rul. 96-29, corporation W planned to acquire the business of corporation Z, and as part of that plan, W reincorporated in State R. In both Situations, the reincorporation qualified as an F reorganization. The Service ruled that "in each of Situations 1 and 2, the reincorporation transaction qualifies as a reorganization under [section] 368(a)(1)(F), notwithstanding the other transactions effected pursuant to the same plan."

114 *See* Prop. Reg. §1.368-1(m)(i)(1)(B), *Reed v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *aff'g* T.C. Memo 1965-72, *cert. denied*, 386 U.S. 1018 (1967).

reorganization. While the example involves the use of cash to redeem the shareholder, the operative rule does not specify that only non-operating assets may be used to redeem stock in the F reorganization. Therefore, if the Proposed F Regulations are made effective without change to this redemption provision, the downstream transfer to newly formed X could qualify as an F reorganization, despite the redemption of P's S stock in dissolution of S in exchange for the unwanted S assets. In considering the finalization of the Proposed F Regulations, we recommend revising the rule allowing for redemptions in the F reorganization to apply only when 100 percent of the operating assets of the target corporation are transferred to the new acquiring corporation. We do not believe the use of operating assets to redeem the interests of a shareholder or make distributions is consistent with the concept of an F reorganization as a "mere change in identity, form, or place of organization of one corporation, however effected".

Directional / Minority Shareholder Approach. If S has a minority shareholder, under the Directional / Minority Shareholder Approach, Example 1(a) would be characterized as a downstream reorganization for determining the tax consequences to P, S, and X, and an upstream C reorganization for the minority shareholder. Thus, P and S would recognize gain on any assets not transferred to X, but the minority shareholder's exchange of S stock for P stock would receive nonrecognition treatment under section 354.

Directional / Nonrecognition Approach. If S does not transfer all of its assets to X, or if S has a minority shareholder, the Directional / Nonrecognition Approach would characterize Example 1(a) as an upstream C reorganization. P and S would not recognize gain on any assets not transferred to X, and the minority shareholder would not recognize gain or loss on the exchange of its S stock for P stock under section 354.

Directional / Merger Approach. After applying the Directional Approach, if Step 2 is accomplished by merger, the merger would predominate and Example 1(a) would be characterized as an upstream A reorganization instead of a downstream reorganization, with the same consequences described in the Upstream Approach.

Multiple Reorganizations Approach. The Directional Approach would characterize Step 1 as a transfer in a downstream C or D reorganization, with the attributes of S residing in X following the transaction. Under the Multiple Reorganizations Approach, Step 2 could also qualify as an upstream C reorganization because P would acquire substantially all of S's assets in the form of X stock. Thus, Step 2 serves a dual function as the back-end liquidation in the downstream reorganization and the asset transfer in the upstream reorganization. Consequently, S would not recognize gain on the assets that are not transferred downstream to X because those assets would be part of the section 361 exchange with P in the upstream reorganization. Further, if S had a minority shareholder that received P stock in exchange for its S stock, the minority shareholder would not recognize gain or loss because P is a party to the upstream reorganization and, thus, section 354 would apply. Because there are two qualifying reorganizations, special rules would need to be provided to determine whether the S attributes are inherited by X or P, and whether P's basis in the X stock is determined under section 358 by reference to its basis in the S stock or a carryover basis under section 362.

Election Approach. The taxpayer could elect under the Election Approach to characterize Example 1(a) as either a downstream reorganization, with results consistent with the Directional Approach, or an upstream C reorganization, with results consistent with the Upstream Approach.

Example 1(b): Same facts as Example 1(a), except that (1) S transfers 50 percent of its assets to X, and (2) S transfers 50 percent of its assets and the stock of X to P, in dissolution of S.

Upstream Approach. Under the Upstream Approach, the distribution by S of 50 percent of its operating assets and the X stock is analyzed for qualification as a transfer in a reorganization or a complete liquidation. The 50 percent reincorporation of the assets of X perhaps prevents the transaction from qualifying as a complete liquidation under section 332. In order to provide consistency and certainty to these characterization issues, we recommend the Treasury and Service adopt a clear standard for determining when a reincorporation of assets precludes characterization as a complete liquidation Because the upstream transfer was not undertaken by merger, the transaction does not qualify as an A reorganization. Whether the transaction qualifies as an upstream C reorganization depends on whether the X stock is taken into account for purposes of determining whether substantially all the assets have been transferred under the substituted asset theory of Rev. Rul. 88-48. Assuming the X stock is taken into account, the Upstream Approach should result in an upstream C reorganization, with tax-free treatment to S under section 351(a) (Step 1)[115] and section 361(a) (Step 2). P should inherit the attributes of S under section 381. P's basis in its former S stock would disappear in the upstream reorganization, and P would have a carryover basis in the assets (including the stock of X) received from S under section 362(b). Any minority owners of S that receive P stock would have nonrecognition treatment under section 354.

Directional Approach. The Directional Approach results in the same characterization and consequences as the Upstream Approach, though by a different analytical

[115] As noted above, there is an issue as to whether the distribution of the X stock as part of the section 361 exchange in the upstream reorganization satisfies section 351(c), which allows a transferor in a section 351 exchange to distribute the transferee stock to its shareholder. We recommend the Treasury and Service confirm that section 351(c) is satisfied in this context.

route. Under the Directional Approach, whether Step 1 is a transfer that is part of a potential C or D reorganization depends on the quantum of the assets transferred in Step 1. Because in this example S does not transfer substantially all of its assets to X, the transfer in Step 1 cannot be a transfer pursuant to a potential downstream reorganization.

The Directional Approach then considers Step 2 to determine whether it is sufficient to constitute a transfer that is part of a reorganization. If, as discussed above, Rev. Rul. 88-48 applies to treat the X stock resulting from the Step 1 transfer as replacement property for the S assets transferred in that step, substantially all the assets would be transferred by S to P and Step 2 should qualify as an upstream C reorganization. We note that application of the Rev. Rul. 88-48 substituted assets theory to respect the X stock as part of the S assets will result in all Overlap Transactions qualifying as upstream reorganizations (assuming all other relevant requirements are satisfied) under the Directional Approach, except when the first step involves the transfer of substantially all the assets to X, as in Example 1(a).

As discussed in Example 1(a), if X were a newly formed corporation, an issue arises under the Directional Approach as to whether, under the Proposed F Regulations, Step 1 could be a transfer that is part of an F reorganization. The Proposed F Regulations do not appear to require complete asset identity, even within the "bubble" of section 368(a)(1)(F), because the Proposed F Regulations allow for redemptions of less than all the stock as part of the F reorganization.[116] Therefore, if the Proposed F Regulations are finalized without change to this redemption provision, the downstream transfer to newly formed X could qualify as an F reorganization, despite the redemption of P's S stock in dissolution of S in exchange for 50 percent of the S assets. As indicated previously, in considering the finalization of the Proposed F

[116] *See* Prop. Reg. §1.368-1(m)(i)(1)(B), *Reed v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *aff'g* T.C. Memo 1965-72, *cert. denied*, 386 U.S. 1018 (1967).

Regulations, we recommend revising the rule allowing for redemptions in the F reorganization to apply only when 100 percent of the operating assets of the target corporation are transferred to the new acquiring corporation. We do not believe the use of operating assets to redeem the interests of a shareholder is consistent with the concept of an F reorganization as a "mere change in identity, form, or place of organization of one corporation, however effected".

Directional / Minority Shareholder Approach. The Directional / Minority Shareholder Approach would result in the same characterization as the Directional Approach.

Directional / Nonrecognition Approach. The Directional / Nonrecognition Approach would result in the same characterization as the Directional Approach.

Directional / Merger Approach. While, under the Directional Approach, Step 1 would not constitute a transfer that would be part of a downstream C or D reorganization, if Step 1 is accomplished by merger, the downstream transfer could qualify as an A reorganization. In such case, the assets other than X stock transferred in Step 2 would result in gain recognized by S under section 361(c)(2) and gain recognized by P under section 356. Further, any minority shareholders of S that receive P stock in the exchange would recognize gain or loss under section 1001 because P is not a party to the downstream A reorganization.

Multiple Reorganizations Approach. Because substantially all the assets are not transferred in Step 1, Example 1(b) could not result in a downstream C reorganization. If Step 1 is accomplished by merger, however, and qualified as a downstream A reorganization, the Multiple Reorganizations Approach could result in the characterization of Step 2 as an upstream reorganization as well. Assuming the reincorporation of assets into X would render section 332 inapplicable, if the stock of X is taken into account for purposes of the substantially all requirement under the Rev. Rul. 88-48 substituted assets theory, the liquidation in Step 2 could qualify as an upstream C reorganization. Consequently, neither S (pursuant to section 361(a)) nor P (pursuant to section 1032) would recognize gain on the assets transferred to P in Step 2, and any minority shareholder of S that receive P stock would have nonrecognition treatment under section 354. Because there are two qualifying reorganizations, special rules would need to be provided to determine whether the S attributes are inherited by X or P and whether P's basis in the X stock is determined under section 358 by reference to its basis in the S stock, or a carryover basis under section 362.

Election Approach. Because substantially all the assets are not transferred in Step 1, Example 1(b) could not qualify as a downstream C reorganization. If Step 1 is accomplished by merger, however, Example 1(b) could qualify as both a downstream A reorganization and an upstream C reorganization. Under the Election Approach, the taxpayer could choose to characterize Example 1(b) as a downstream A reorganization, with gain recognized by S on the distribution of the assets not transferred to X and the S attributes inherited by X, or as an upstream C reorganization, with no gain recognition by S and the S attributes inherited by P.

Example 2: Distribution, Followed by Downstream Transfer, Followed by Liquidation

> **Example 2(a):** P owns 100 percent of the outstanding stock of S, which owns 100 percent of the outstanding stock of X. Pursuant to a single, integrated plan, the following steps occur (in chronological order): (1) S distributes substantially all of its assets to P, (2) S transfers its remaining assets to X, and (3) S dissolves, distributing the X stock to P.

Upstream Approach. Example 2(a) could qualify as a section 332 liquidation if the quantum of assets reincorporated in X does not prevent the transaction from qualifying as a complete liquidation. Because the upstream transfer was not undertaken by merger, the transaction would not qualify as an A reorganization. However, the transaction would qualify as an upstream C reorganization and the transfer to X would be treated as a section 351 exchange.[117]

P, as the transferee in the reorganization, will succeed to S's attributes under section 381. Neither S (under section 361) nor P (under section 1032) would recognize any gain or loss in the transaction. If S was owned in part by another shareholder and the shareholder received P stock in exchange for its S stock in Step 2, under section 354 the minority shareholder would not recognize gain or loss.

Note that the same results would obtain if S distributes its assets to P in liquidation of S and P then contributes some assets to X in exchange for X stock. The -2(k) Regulations and section 368(a)(2)(C) provide that a transfer to a qualified group member will not affect the characterization of a reorganization.

Directional Approach. The Directional Approach would result in the same characterization and consequences as the Upstream Approach.

Directional / Minority Shareholder Approach. The Directional / Minority Approach would result in the same characterization as the Upstream Approach.

Directional / Nonrecognition Approach. The Directional / Nonrecognition Approach would result in the same characterization as the Upstream Approach.

Directional / Merger Approach. Under the Directional / Merger Approach, Example 2(a) could quality as an upstream C reorganization. If Step 2 is accomplished by merger, the merger would predominate and Example 2(a) would be characterized as a downstream A reorganization of S into X. The assets distributed to P in Step 1 would result in

[117] As noted above, there is an issue as to whether the distribution of the X stock as part of the section 361 exchange in the upstream reorganization satisfies section 351(c), which allows a transferor in a section 351 exchange to distribute the transferee stock to its shareholder. We recommend the Treasury and Service confirm that section 351(c) is satisfied in this context.

gain recognized by S under section 361(c)(2) and gain recognized by P under section 356. If S has a minority shareholder that receives P stock in the exchange, the minority shareholder would recognize gain or loss under section 1001 because P is not a party to the downstream A reorganization.

Multiple Reorganizations Approach. Because substantially all the assets are not transferred in Step 2, Example 2(a) could not qualify as a downstream C reorganization. If Step 2 is accomplished by merger of S into X, however, Example 2(a) could qualify as a downstream A reorganization, and under the Multiple Reorganizations Approach, it could also qualify as an upstream C reorganization. Qualification as an upstream transaction would mean that none of the parties to the transaction would recognize any gain or loss on the transaction. Because there are two qualifying reorganizations, special rules would need to be provided to determine whether the S attributes are inherited by X or P and whether P's basis in the X stock is determined under section 358 by reference to its basis in the S stock, or a carryover basis under section 362.

Election Approach. Because substantially all the assets are not transferred in Step 2, Example 2(a) could not qualify as a downstream C reorganization. If Step 2 is accomplished by merger, however, Example 2(a) could qualify as both a downstream A reorganization and an upstream C reorganization. Under the Election Approach, the taxpayer could choose to characterize Example 2(a) as a downstream A reorganization, with gain recognized by S on the distribution of the assets not transferred to X and the S attributes inherited by X, or as an upstream C reorganization, with no gain recognition by S and the S attributes inherited by P.

> **Example 2(b):** Same facts as Example 2(a), except that (1) S distributes 50 percent of its assets to P, (2) S transfers 50 percent of its assets to X in exchange for X stock, and (3) S liquidates.

*Upstream Approach***.** Under the Upstream Approach, the distribution by S of 50 percent of its assets and the X stock is analyzed for qualification as a transfer in a reorganization or liquidation. The 50 percent reincorporation of the assets of X perhaps prevents the transaction from qualifying as a complete liquidation under section 332. Because the upstream transfer was not undertaken by merger, the transaction does not qualify as an A reorganization. Whether the transaction qualifies as an upstream C reorganization depends on whether the X stock is taken into account for purposes of determining whether substantially all the assets have been transferred under the substituted assets theory of Rev. Rul. 88-48.[118] Assuming the X stock is taken into account, the Upstream Approach should result in an upstream C reorganization, with tax-free treatment to S under section 351(a) (Step 1)[119] and section 361(a) (Step 2). P should succeed to all the attributes of S under section 381. P's basis in its former S stock should disappear in the upstream reorganization, and P should have a carryover basis in the assets (including the stock of X) received from S under section 362(b). Any minority shareholders of S that receive P stock would have nonrecognition treatment under section 354.

Directional Approach. The Directional Approach results in the same characterization and consequences as the Upstream Approach, though by a different analytical route. Under the Directional Approach, whether Step 1 is sufficient to constitute a transfer that is part of a potential C reorganization depends on the quantum of the assets transferred. The assets transferred in Step 1, by itself, do not constitute substantially all the S assets.

The Directional Approach then considers Step 2. Because only 50 percent of the S operating assets are transferred to X in Step 2, the transfer in Step 2 would not be sufficient to result in a downstream C or D reorganization.

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118 As indicated above, we do not believe the liquidation-reincorporation doctrine should be relevant to transfers in connection with reorganization exchanges.

119 As noted above, there is an issue as to whether the distribution of the X stock as part of the section 361 exchange in the upstream reorganization satisfies section 351(c), which allows a transferor in a section 351 exchange to distribute the transferee stock to its shareholder. We recommend the Treasury and Service confirm that section 351(c) is satisfied in this context.

If X were a newly formed corporation, an issue arises under the Directional Approach as to whether, under the Proposed F Regulations, Step 2 could be a transfer that is part of an F reorganization. Therefore, if the Proposed F Regulations are finalized without change to the redemption provision, the downstream transfer to newly formed X could qualify as an F reorganization, despite the redemption of P's S stock in dissolution of S in exchange for 50 percent of the S assets. As indicated previously, in considering the finalization of the Proposed F Regulations, we recommend revising the rule allowing for redemptions in the F reorganization to apply only when 100 percent of the operating assets of the target corporation are transferred to the new acquiring corporation. We do not believe the use of operating assets to redeem the interests of a shareholder is consistent with the concept of an F reorganization as a "mere change in identity, form, or place of organization of one corporation, however effected".

Because the transfers in Steps 1 and 2 would not by themselves or together result in a reorganization, the Directional Approach would then consider whether Step 3 results in a reorganization. Assuming the X stock would be taken into account for purposes of the substantially all requirement under the substituted assets theory of Rev. Rul. 88-48, Example 2(b) could qualify as an upstream C reorganization.

If, in Example 2(b), S distributes 10 percent of its assets in Step 1 and contributes 90 percent of its assets to X in Step 2, the transaction would result in characterization as a downstream C or D reorganization. Each step would be considered in order to determine whether it, together with the preceding steps, would result in a transfer of sufficient assets to qualify as part of a reorganization. In this case, the transfer in Step 1 does not, by itself, satisfy the substantially all requirement necessary for a C reorganization. The transfer in Step 2 is a transfer of substantially all the assets and, therefore, the reorganization would be defined by this transfer as a downstream C or D reorganization. We note that the upstream transfer in Step 1 combined with the distribution of the stock of X as a substituted asset in Step 3 would constitute substantially all the assets. However, under the Directional Approach as described above, because the transfer in Step 2 was sufficient to constitute a transfer that is part of a reorganization, the reorganization would be defined by Step 2 and the transfer in Step 3 would not need to be tested.

Directional / Minority Shareholder Approach. The Directional / Minority Shareholder Approach would result in the same characterization as the Directional Approach.

Directional / Nonrecognition Approach. The Directional / Nonrecognition Approach would result in the same characterization as the Directional Approach.

Directional / Merger Approach. Under the Directional Approach, Example 2(b) could qualify as an upstream reorganization. If Step 2 were accomplished by merger, under the Directional / Merger Approach, the merger would predominate and Example 2(b) would be characterized as a downstream A reorganization of S into X. The assets distributed to P in Step 1 would result gain recognized by S under section 361(c)(2) and gain recognized by P under section 356. If S has a minority shareholder that receives P stock in the exchange, the minority shareholder would recognize gain under section 1001 because P is not a party to the downstream A reorganization.

Multiple Reorganizations Approach. If, applying the Directional / Merger Approach, Step 2 is accomplished by merger and qualified as a downstream A reorganization, the Multiple Reorganizations Approach could result in the characterization of Example 2(b) as an upstream C reorganization as well. If the stock of X is taken into account for purposes of the substantially all requirement under the substituted assets theory of Rev. Rul. 88-48, the distribution of assets in Step 1 and the liquidation in Step 3 could qualify as an upstream C reorganization. Consequently, neither S (pursuant to section 361(a)) nor P (pursuant to section 1032) would recognize gain on the assets transferred to P in Steps 1 or 3, and any minority shareholder of S that receives P stock would have nonrecognition treatment under section 354. Because there are two qualifying reorganizations, special rules would need to be provided to determine whether the S attributes are inherited by X or P and whether P's basis in the X stock is determined under section 358 by reference to its basis in the S stock, or a carryover basis under section 362.

Election Approach. Because substantially all the assets are not transferred to X, Example 2(b) could not qualify as a downstream C reorganization. If Step 2 is accomplished by merger, however, Example 2(b) could qualify as both a downstream A reorganization and an upstream C reorganization. Under the Election Approach, the taxpayer could choose to characterize Example 2(b) as a downstream A reorganization, with gain recognized by S on the distribution of the assets not transferred to X and the S attributes inherited by X, or as an upstream C reorganization, with no gain recognition by S and the S attributes inherited by P.

IV. SUMMARY OF RECOMMENDATIONS[120]

We recommend that the Treasury and Service issue guidance setting forth a rule for characterizing Overlap Transactions. Such a rule is critical to eliminating confusion and uncertainty in the context of business reorganizations among related corporations. In order to avoid unforeseen results, however, we believe any such rule should be adopted only after examining its application in the cross-border context.

[120] Our recommendations are made in the context that the current law related to attributes under sections 312 and 381 is not modified. If changes are made to this area of the law, our recommendations may also change.

A majority of the Tax Section recommends the adoption of the Directional / Minority Shareholder Approach. In general, the majority believes when a taxpayer engages in a downstream transfer of assets that is sufficient to qualify as part of a reorganization, that transfer should define the characterization of the overall transaction for purposes of the target and acquiring corporations and the majority shareholder of the target corporation, including whether gain or loss is recognized by the target corporation or the majority shareholder, the post-transaction location of tax attributes, and the computation of stock basis. For purposes of a minority shareholder of the target corporation, however, the majority of the Tax Section does not believe the exchange of target stock should result in gain recognition. The Directional / Minority Shareholder Approach would characterize the transaction as an upstream reorganization with respect to any minority shareholder of the target corporation.

The only transaction that would be affected differently by the adoption of the Directional / Minority Shareholder Approach than by the Upstream Approach is the downstream transfer of sufficient assets to qualify as a reorganization. If there are assets that are not transferred in the downstream transfer, under the Directional / Minority Shareholder Approach, the target corporation would recognize gain on the distribution of the retained assets, and the parent corporation would be taxed on the receipt of the retained assets under section 356. In addition, the parent corporation's basis in the surviving subsidiary's stock would be computed under section 358 rather than under section 362(b) under the Directional / Minority Shareholder Approach. Under the Upstream Approach, the Directional / Nonrecognition Approach, the Multiple Reorganizations Approach, and the Election Approach (if upstream reorganization treatment is elected), there would be nonrecognition treatment for retained assets.

A minority of the Tax Section recommends the adoption of the Directional Approach, without the special characterization rule for a minority shareholder of the target corporation. Thus, if a transaction is characterized as a downstream reorganization under the Directional Approach, a minority shareholder in the target corporation would recognize gain or loss on the exchange of its stock. This minority does not believe it is appropriate to characterize a single reorganization transaction in multiple ways in order to eliminate gain for the minority shareholder. If a minority shareholder has a built-in loss in its target corporation stock, the minority may want to recognize that loss. Further, in other areas of subchapter C, the minority shareholder is taxed in the context of a transaction that qualifies as tax-free to the other parties.[121]

The Upstream Approach provides a clear rule that can be rationalized in light of the legal developments that trend in the direction of allowing tax-free divisions of assets among related corporations. However, we believe if a taxpayer transfers assets downstream and such transfer is sufficient to result in a reorganization, the downstream reorganization should predominate. We believe the Directional / Merger Approach is arbitrary and we believe the Multiple Reorganizations Approach is complex and questionable from policy and authority perspectives. We believe the Directional / Nonrecognition Approach has the same result as the Election Approach, but with the complexity of having to analyze the various tax consequences of multiple potential tax-free reorganization characterizations. Thus, we would not favor the adoption of any of these approaches.

Because qualification as a reorganization is transactionally elective under the Code, and in recognition that there are contexts in which taxpayers cannot undertake the steps necessary to achieve the desired tax characterization (e.g., legal or regulatory restrictions), a

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121 *See, e.g.,* Reg. §1.338-3(d)(1),(d)(5), *Example* (reorganization of target corporation following qualified stock purchase, without section 338(g) election, satisfies COI for purposes of qualifying the reorganization as to the purchasing corporation and its affiliates, but not as to third-party shareholders to the target corporation).

minority of the Tax Section recommends the Election Approach. Those members do not believe it is necessary to require gain or loss recognition that could result from the application of the Directional / Minority Shareholder Approach because the -2(k) Regulations already allow for the tax-free division of assets in similar transactions within a related group of corporations.

In addition, we have made several recommendations throughout the Report in order to allow any adopted approach to function optimally. Those recommendations, and the page references for discussion, are as follows:

1. In considering the finalization of the Proposed F Regulations, we recommend revising the rule allowing for redemptions in an F reorganization to apply only when 100 percent of the operating assets of the target corporation are transferred to the new acquiring corporation. Pages 12-14.

2. We recommend that the Treasury and Service clarify that the liquidation-reincorporation doctrine has no application in the context of a reincorporation preceding or following a reorganization. Pages 14-17.

3. Rev. Rul. 58-93 should be reconsidered, and perhaps revoked. Even if no formal guidance is issued in the area, Rev. Rul. 58-93 should be reconsidered in light of the uncertainty it creates, particularly when contrasted with the Service's administrative approach in private letter rulings. Pages 17-23.

4. Regardless of the approach chosen, we encourage the Treasury and Service to adopt a single recast model for purposes of characterizing formless transactions (i.e., the transfer of assets to a sister corporation where no consideration is received in exchange). Page 28, footnote 106.

5. We recommend the Treasury and Service confirm that under the substituted assets approach of Rev. Rul. 88-48, when assets are transferred to another entity in exchange for stock of the transferee, the transferee stock should be taken into account in determining whether the substantially all requirement is satisfied in a subsequent reorganization transfer. Pages 28-29.