

**NEW YORK STATE BAR ASSOCIATION
TAX SECTION**

**REPORT ON TRANSFERS OF ASSETS OR STOCK
FOLLOWING A CORPORATE REORGANIZATION**

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I. Introduction

This report of the New York State Bar Association Tax Section comments on the proposed amendments to regulations addressing transfers of assets or stock following a corporate reorganization (“Report”).²

Over the last several years the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) have studied the area of post-reorganization transfers of assets and stock. To date, the Treasury and IRS have issued final regulations that give taxpayers guidelines for whether transfers of assets or stock affect the characterization and treatment of a putative reorganization.³ As a result of continued study, the Treasury and IRS recently issued proposed regulations that contain amendments to those rules. We are pleased that the Treasury and IRS continue to issue guidance to give taxpayers flexibility in aligning their businesses following an acquisition that otherwise qualifies as a tax-deferred reorganization. In light of developments in the area of post-reorganization

¹ The drafter of this Report was Karen Gilbreath. Substantial comments were received from Michael Schler, Linda Swartz, and Gordon Warnke. Helpful comments were received from Kimberly Blanchard, Patrick Browne, Peter Canellos, Lawrence Garrett, Gary Mandel, and Diana Wollman.

² REG-165579-02 (March 1, 2004).

³ Treas. Reg. Section 1.368-1(d), 1.368-2(f), and 1.368-2(k). The regulations issued to date, and thus the subject of this Report, address downstream transfers of assets and stock to corporations and partnerships following a putative reorganization. Similar issues are raised by upstream transfers of assets and stock, the subject of a separate report by this Section. See New York State Bar Association Tax Section, Report No. 1060 on Distributions Following Tax-Free Reorganizations (May 19, 2004).

transfers, and considering the stated policy and rationale for the proposed amendments, however, we recommend changes to better implement those policies and eliminate confusion and traps for the unwary. In addition, we offer some technical comments on the proposed amendments.

Part II of the Report sets forth the summary of the Section's recommendations. Part III is a background section detailing the history of the current regulations regarding post-reorganization transfers of assets and stock and the proposed amendments to those regulations. Part IV explores the Section's recommendations in detail and illustrates the effects of our recommendations.

II. Summary of Recommendations

This Report addresses the extent to which post-reorganization transfers of assets or stock should affect the characterization of a putative reorganization. While this Report specifically addresses transfers of assets or stock following a reorganization, similar issues are presented where assets or stock are distributed from the acquiring corporation (so-called "push-ups"). When the Treasury and IRS issue guidance on push-ups following a reorganization, the recommendations described herein, if adopted for transfers of assets or stock, should similarly be adopted as part of that guidance. Our principal recommendations are as follows:

1. Redefine "qualified group" to include subsidiaries that are controlled within the meaning of Section 1504 (without regard to the exceptions in Section 1504(b)).

2. Align the COBE rules with the step transaction guidance for determining whether post-reorganization restructurings affect the qualification of the transaction under Section 368. Under this proposal, a reorganization would not be disqualified as a result of any integration of the assets or stock of the parties to the reorganization as long as the qualified group conducts the target's business within the meaning for Treas. Reg. Section 1.368-1(d).
3. Regardless of whether the Treasury and IRS adopt our recommendations 1. and 2., we make several technical recommendations that we believe are necessary for the 2004 Proposed Regulations to operate effectively.

III. Background

a. Corporate Reorganizations

The corporate reorganization provisions exempt from the general rule of gain recognition certain transactions that are merely readjustments of continuing interests in property under modified corporate forms.⁴ Section 368 and the regulations thereunder describe the seven forms of reorganizations and set forth the requirements for each. In addition to the statutory requirements, generally, a transaction must satisfy the business purpose, continuity of interest, and continuity of business enterprise requirements.⁵ Satisfying the requirements for the various provisions in Section 368 is not elective and the tax consequences and cost of the transaction are dependent on the characterization.

⁴ Treas. Reg. Section 1.368-1.

⁵ Treas. Reg. Section 1.368-1(b), (c), -2(g), and *Gregory v. Helvering*, 293 U.S. 465 (1935) (business purpose); Treas. Reg. Section 1.368-1(d) (continuity of business enterprise); Treas. Reg. Section 1.368-1(e) (continuity of interest). Note that a reorganization described in Section 368(a)(1)(E) does not require satisfaction of the continuity of interest requirement.

If the requirements for qualification as a reorganization are satisfied, the target shareholders will recognize gain only if money or property other than acquiring stock is received.⁶ The shareholders' basis in acquiring stock will be the same as the basis in the target stock surrendered, with certain adjustments, and the holding period for the target stock will be tacked onto the new acquiring stock.⁷ The target corporation will not recognize gain or loss on the transfer of its assets to the acquiring corporation in an asset reorganization and generally will not recognize gain upon the assumption of its liabilities,⁸ and the acquiring corporation will have a carryover basis in the assets or stock acquired.⁹ The effect of these provisions is to defer the taxation on any appreciation in the shareholders' stock and the acquired property until the investment is later liquidated. If the requirements of Section 368 are not satisfied, the seller(s) are taxed on the appreciation of the assets or stock transferred and the acquiring corporation will have a fair market value basis in the assets or stock acquired.¹⁰ Because of the significant differences in tax consequences depending upon whether a transaction qualifies under Section 368, we believe that it is an important policy that the governing rules provide taxpayers with certainty and avoid traps for the unwary.¹¹

⁶ Sections 354 and 356.

⁷ Sections 358 and 1223(1).

⁸ Sections 357 and 361.

⁹ Section 362.

¹⁰ Sections 1001, 1012.

¹¹ See New York State Bar Association Tax Section, Report No. 1042 on Treatment of Restricted Stock in Corporate Reorganization Transactions (Oct. 23, 2003); New York State Bar Association Tax Section, Report No. 1050 on Continuity of Interest and Pre-Closing Stock Value Fluctuation (Jan. 23, 2004); New York State Bar Association Tax Section, Report No. 1051 on Treatment of Variable Consideration in Tax-Free Reorganizations (Feb. 4, 2004); New York State Bar Association Tax Section, Report No. 1060 on Distributions Following Tax-Free Reorganizations (May 19, 2004); New York State Bar Association Tax Section, Report No. 1061 on Temporary Regulations § 1.368-2T Relating to "A" Reorganizations Involving Disregarded Entities ((May 26, 2004).

b. Continuity of Business Enterprise (“COBE”)

In order to qualify as a tax-free corporate reorganization, the acquiring corporation must continue the historic business of the target corporation or use a significant portion of the target’s historic assets in a business.¹² The policy underlying the COBE requirement, as well as all of the other judicial requirements, is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form.¹³ Thus, the focus of the COBE rules is whether there is a sufficient “link” between the target corporation shareholders and the assets or stock acquired by the acquiring corporation.¹⁴

The 1998 Regulations. In the late 1990’s, the IRS and Treasury undertook an extensive study of the area of COBE (as well as continuity of interest) and published regulations that provided a framework for applying the existing COBE rules where target assets or stock is transferred to controlled corporations or partnerships (the “1998 Regulations”).¹⁵ As part of this project, the Treasury and IRS addressed the proper role and scope of the “remote continuity” doctrine derived from the *Groman v. Comm’r* and *Helvering v. Bashford* decisions,¹⁶ and determined that the policy concern raised by these cases - whether there is a sufficient link between the target shareholders and the target’s business following the reorganization -was sufficiently addressed by the COBE rules as

¹² Treas. Reg. Section 1.368-1(d)(1).

¹³ Treas. Reg. Section 1.368-1(b).

¹⁴ Preamble to original COBE regulations, 1981 Fed. Tax Rep. CCH ¶6342, Vol. 10.

¹⁵ T.D. 8760, 1998-1 C.B. 803.

¹⁶ 302 U.S. 82 (1937); 302 U.S. 454 (1938). In *Groman*, the Supreme Court held that the target shareholders were taxable when they received parent corporation stock in a transaction in which target assets were acquired by a subsidiary. In *Bashford*, the Supreme Court held that the target shareholders were taxable when parent acquired the stock of the target corporations and transferred the stock or assets of each target corporation to a subsidiary.

promulgated in 1998. Thus, no additional rules were provided for the remote continuity doctrine and this troublesome and broadly applied doctrine had no continuing separate role after the 1998 Regulations.

The 1998 Regulations generally require that the “issuing” corporation (defined as the acquiring corporation or the controlling parent of the acquiring corporation in a triangular reorganization) satisfy the COBE test by looking to the members of its “qualified group”.¹⁷ 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 of the corporations, and stock meeting the requirements of Section 368(c) in each of the corporations is owned directly by one of the other corporations. Section 368(c) defines “control” for purposes of the reorganization provisions as the ownership of stock possessing at least 80 percent of the voting power of all classes of voting stock and at least 80 percent of the total number of shares of all nonvoting stock of the corporation. It appears from the preamble to the 1998 Regulations that the Treasury and IRS believed that Section 368(c) was the appropriate measure for what constitutes a qualified group because it generally determines what constitutes control for purposes of Section 368. The 1998 Regulations, however, went beyond the statutory language of Section 368(c) by allowing multiple transfers of acquired stock or assets within the qualified group, effectively adding an attribution rule to Section 368(c).¹⁸ Thus, the acquiring corporation can transfer the acquired assets to an 80 percent owned S1, S1 can drop them to its 80

¹⁷ Treas. Reg. Section 1.368-1(d)(4).

¹⁸ Note that the IRS had ruled in private rulings that such multiple transfers did not violate the COBE requirement. *See, e.g.*, PLR 9536032 (June 15, 1995); PLR 9151036 (Sept. 25, 1991).

percent owned S2, etc., with the result that the link between the acquired assets and the target shareholders may be significantly diluted where the subsidiaries are not wholly owned.

The rules for attributing a business to a corporation that owns a partnership interest take into account both management control and economic interest. Specifically, the issuing corporation is treated as conducting the business of a partnership if either (1) members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business, or (2) one or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business.¹⁹

c. Step Transaction Doctrine

In determining whether a transaction qualifies as a reorganization under Section 368, “the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine.”²⁰ Thus, an integrated transfer(s) of assets or stock following a putative reorganization raises the question of whether the transaction continues to fit within the definitions provided under Section 368.

Section 368(a)(2)(C), part of the Congressional response to limit the remote continuity doctrine, provides that a transaction otherwise qualifying as a Type A, B, C, or G reorganization shall not be disqualified by reason of the fact that part of all of the

¹⁹ Treas. Reg. Section 1.368-1(d)(4)(iii)(B).

²⁰ Treas. Reg. Section 1.368-1(a), *but see*, Treas. Reg. Sections 1.368-2(f), and (k) (described below) and 1.338-3(d). Following the issuance of the proposed regulations in 1997, commentators were confused as to whether compliance with the proposed COBE regulations meant that the post-reorganization transfers would be given independent significance and thus, the transaction would not be subject to recast. Thus, the Treasury and IRS added the language quoted above.

acquired assets or stock are transferred to a controlled subsidiary.²¹ Thus, Section 368(a)(2)(C) turns off the step transaction doctrine such that the transfer is viewed independently from the acquisition and the nominal acquiring corporation continues to be viewed as the acquiring corporation. As Congress became aware of other transaction types that implicated the remote continuity doctrine, it enacted new legislation to address the problem on a piecemeal basis.²² As written by Congress, Section 368(a)(2)(C) is limited in several important respects. First, Section 368(a)(2)(C) does not describe transfers following types of reorganizations other than the four listed in the provision. Second, the language permits transfers of “acquired” stock or assets, and thus, stock transfers following asset acquisitions and asset transfers following stock acquisitions are not addressed by the Code. Finally, the provision does not address successive transfers or transfers made to corporations or other entities that are not controlled by the acquiring corporation within the meaning of Section 368(c).

The 1998 Regulations incorporated Section 368(a)(2)(C) in Treas. Reg. Section 1.368-2(k) (the “-2(k) Rule”), and in many ways, the -2(k) Rule subsumed the COBE rules because, without the assurance that the step transaction doctrine would not apply, taxpayers could not be certain as to their tax treatment. The 1998 Regulations provided

²¹ “(C) TRANSFERS OF ASSETS OR STOCK TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1)(A), (1)(B), (1)(C), AND (1)(G) CASES.—A transaction otherwise qualifying under paragraph (1)(A), (1)(B), (1)(C), and (1)(G) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.” The provision was added to the Code in 1954, first with respect only to Type C reorganizations as a companion to the triangular Type C reorganization provision. It was amended to add the other types of listed reorganizations in subsequent years as the issue was brought to Congress’ attention. S. Rep. No. 1622, 83d Cong., 2d Sess. 51 (1954).

²² S. Rep. No. 830, 88th Cong., 2d Sess. 82 (1964) (adding parenthetical language to Section 368(a)(1)(B) to allow triangular B reorganizations and dropdowns of stock after a Type B reorganization); S. Rep. No. 1653, 90th Cong., 2d Sess. 3 (1968) (enacting Section 368(a)(2)(D) to permit forward triangular mergers); S. Rep. No. 1533, 91st Cong., 2d Sess. 1 (1970) (enacting Section 368(a)(2)(E), permitting reverse triangular mergers).

that if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in the –2(k) Rule, or assets are transferred to a partnership in which the transferor is a partner if the COBE requirement is satisfied (the “–2(f) Rule”). While not explicit, the –2(f) Rule gave taxpayers comfort that post-reorganization transfers of assets to partnerships that satisfied the COBE rules would not be recast under the step transaction.

Consistent with the COBE rules, the –2(k) Rule expanded upon Section 368(a)(2)(C), by allowing for the successive transfer of acquired stock or assets to members of the qualified group, and added a special rule for transfers of stock or assets following a reverse triangular merger. The –2(k) Rule did not otherwise depart from the language of Section 368(a)(2)(C). Thus, for Type D, Type E, and Type F reorganizations, there was no comfort that the transaction would not be integrated with a subsequent transfer of assets. Further, there was no comfort that assets could be transferred following a Type B reorganization, or that after a triangular asset reorganization (*e.g.*, an (a)(2)(D) or a triangular Type C reorganization) the issuing corporation could transfer the acquiring corporation stock without upsetting the putative reorganization. Finally, the –2(k) Rule did not address transfers to partnerships that meet the COBE standards of the 1998 Regulations. Thus, while the –2(f) Rule effectively separates a reorganization that satisfies the COBE rules from a subsequent transfer of

target assets to a partnership, it does not apply to separate a reorganization that satisfies the COBE rules from the subsequent transfer of target stock to a partnership.²³

In recognizing that certain of these limitations were not intended by Congress and that Section 368(a)(2)(C) is a permissive provision, the Treasury and IRS issued Rev. Rul. 2001-24²⁴, providing that the a parent corporation's contribution of acquiring corporation stock to a controlled subsidiary does not disqualify a forward triangular merger from qualifying under Section 368(a)(2)(D), and Rev. Rul. 2002-85²⁵, providing that the transfer of assets to a controlled subsidiary would not prevent a transaction from qualifying as a Type D reorganization.

The 2004 Proposed Regulations. On March 1, 2004, the Treasury and IRS issued proposed amendments to the -2(k) Rule, effective for transactions occurring after the regulations are made effective (the “2004 Proposed Regulations”).²⁶ Because Section 368(a)(2)(C) was intended to be permissive rather than exclusive, the Treasury and IRS propose to extend its principles to certain transfers of stock and assets after all types of reorganizations. Thus, the revised -2(k) Rule would provide that a transaction would not be disqualified as a reorganization as a result of the transfer or successive transfers to one or more controlled corporations of part or all of (i) the assets of any party to the reorganization or (ii) the stock of any party to the reorganization other than the issuing corporation.²⁷

²³ See, e.g., Treas. Reg. Section 1.368-2(k)(3), Example 3.

²⁴ 2001-2 C.B. 1290.

²⁵ 2002-52 I.R.B. 986.

²⁶ REG-165579-02.

²⁷ Conforming amendments would be made to the COBE rules of Treas. Reg. Section 1.368-1(d) and the

IV. Recommendations

a. Define Qualified Group with Reference to Section 1504

As this Section has commented before, we do not believe there is either a technical or a policy reason to define the appropriate “family” to which acquired assets and stock can be transferred in satisfaction of the COBE rules using solely the Section 368(c) control definition.²⁸ The authority for the COBE rules extends beyond Section 368(c). As a judicially created doctrine, the authority for developing the COBE rules derives from case law, and neither Section 368(c) nor any other provision that Congress has enacted limits the Treasury and IRS’ authority to promulgate rules that implement the policy articulated by the courts.

Fundamentally, we believe that transfers of assets or stock to corporations that are controlled within the meaning of Section 1504 (without regard to the exceptions in Section 1504(b)) maintain a sufficient continuing link between the target corporation’s business and the target shareholders, and in fact, may be a superior “control” relationship for purposes of the COBE tests because Section 1504 requires the ownership of at least eighty percent of the value of the subsidiary.²⁹ Further, without the addition of the Section 1504 definition for qualified group, those taxpayers that have arranged their corporate structures to satisfy the Section 1504 requirement but do not otherwise satisfy

-2(f) Rule.

²⁸ See New York State Bar Association Tax Section, Report on the Proposed Regulations Addressing the Remote Continuity and Continuity of Business Enterprise Doctrine, July 30, 1997

²⁹ See Clinton Administration’s FY 2000 proposal to conform the control test for tax-free incorporations, distributions, and reorganizations to the Section 1504 definition. General Explanations of the Administration’s Revenue Proposals, February, 1999. *See also*, New York State Bar Association Tax Section, Report on the Administration’s Proposal to Amend the “Control” Test in Section 368(c) (July 8, 1999).

the Section 368(c) standards are not able to redeploy assets or stock following an acquisition in a reorganization transaction. Most domestic affiliated groups file consolidated returns and it is common in consolidated groups for a subsidiary to be owned by two or more members of the group. For example, Parent may own S1 and S2, and S1 and S2 may each own 50% of S3. These so-called “diamond” patterns would satisfy the Section 368(c) test only if either S1 or S2 owns 80% of the stock of S3.

Interestingly, the 2004 Proposed Regulations, if effective, would create an anomaly if the qualified group definition does not include Section 1504 relationships. The 2004 Proposed Regulations would allow an acquiring corporation to transfer stock to multiple subsidiaries as long as the members of the qualified group own, in the aggregate, stock that meets the requirements of Section 368(c).³⁰ Thus, the 2004 Proposed Regulations would allow the acquiring corporation to create a diamond pattern following the acquisition of stock or the acquisition of assets in a triangular reorganization; however, absent the adoption of this recommendation, the acquiring corporation cannot transfer assets or stock into a diamond pattern. There is no policy or technical reason that such a distinction should be made. The target assets are in the same place relative to the target shareholders in both cases.

We recognize that, in connection with the 1998 Regulations, the Treasury and IRS considered the question of whether Section 1504 was a more appropriate measure for

³⁰ Example 7 in the 2004 Proposed Regulations provides that after the acquisition of stock of target in exchange for voting stock of acquiring, acquiring transfers 10 percent of the target stock to each of 10 subsidiaries that are wholly owned by acquiring. The example concludes that the transaction qualifies as a triangular Type B reorganization and that COBE is satisfied because the subsidiaries, all members of the qualified group, own stock of target meeting the requirements of Section 368(c).

purposes of the COBE rules and defining the qualified group. Based upon the evolution of the COBE rules and the –2(k) Rule since that time, we believe it would be appropriate to reconsider the decision made in 1998. Using the Section 1504 standard is certainly consistent with reorganization policy and furthers the goal of rationalizing the reorganization rules. While for decades, Congress, the Administration, taxpayers and practitioners have explored and petitioned for the reform of the reorganization rules in the Code, there is no indication that this is any priority for Congress.³¹ Thus, we encourage the Treasury and IRS to continue their efforts to rationalize the reorganization rules.

We note that because of the statutory guidance provided in Section 368(a)(2)(C) and the general use of Section 368(c) in defining control for reorganization purposes, the COBE rules should continue to sanction post-reorganization transfers to companies that satisfy the current definition of qualified group. We do not believe that providing both the Section 368(c) and Section 1504 relationship tests undermines the COBE rules in any manner or creates anomalous results. Further, including Section 1504 in the definition of qualified group does not provide inappropriate tax planning opportunities for taxpayers; in fact, it would eliminate some of the electivity for taxpayers to choose between taxable and tax-free treatment.

If the Treasury and IRS do not agree that they have the authority to change the definition of qualified group for COBE generally, we recommend that the adoption of the

³¹ See, e.g., ALI FEDERAL INCOME TAX PROJECT, *Subchapter C – Corporate Acquisitions* (Tent. Draft No. 1, 1977) and (Tent. Draft No. 2, 1979); Senate Finance Comm. Staff’s Preliminary Report of “Reform and Simplification of the Income Taxation of Corporations” (Sept. 22, 1983); Joint Tax Comm. Examines Tax Aspects of Mergers, 85 TNT 73-75 (April 11, 1985); Stephen C. Todrys, *The Corporate Reorganization Reorganization Act of 2001*, TAX FORUM, No. 537 (Dec. 6, 1999).

Section 1504 standard be made at least for taxpayers who file a consolidated return under the broad authority of Section 1502.

b. The COBE Rule and the –2(k) Rule Should Be Aligned

We recommend that the –2(k) Rule and the COBE rules should operate in tandem, such that any post-reorganization restructuring that satisfies the standards of COBE should be viewed as independent of the reorganization. We believe that adoption of this recommendation is critical in furthering the important policy goal of providing certainty for taxpayers in corporate transactions. Specifically, we propose that the –2(k) Rule be modified to provide that a transaction that in form qualifies as a reorganization under Section 368 shall not be disqualified as a result of any restructuring involving the stock or assets of any party to the reorganization, so long as the requirements of Treas. Reg. Section 1.368-1(d) are satisfied.³² Without the assurance in the –2(k) Rule that a transaction will not be recast even where the COBE rules are satisfied, a transaction that was intended to be tax-free may become taxable. The policies that were considered in drawing the lines in the COBE rules for when there is a sufficient link between the acquired assets or stock and the target shareholders would not be undercut in any way by extending the COBE model to the step transaction doctrine arena. We believe that any transaction that in form satisfies the reorganization requirements and satisfies the COBE rules is a “reorganization” as contemplated by Congress – it constitutes a mere

³² Note that this proposal is written to provide merely that post-reorganization restructurings will not disqualify an otherwise qualifying reorganization. The Treasury and IRS instead could consider adopting a broader rule providing that a reorganization transaction will be analyzed and characterized independent of any post-reorganization restructuring. This broader articulation of the rule may affect other long-standing step transaction guidance. *See, e.g.*, Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 2001-46, 2001-2 C.B. 321, Situation 2; Rev. Rul. 2004-83, 2004-32 I.R.B. 1 (July 16, 2004) (an acquisition that in form qualifies as a stock reorganization is stepped together with a subsequent liquidation or merger).

readjustment of continuing interests in the reorganized business - and should not be subject to recast because of post-acquisition restructurings.³³

This proposal to align the step transaction guidance with the COBE rules would advance the current guidance, as proposed to be amended, in two important ways. First, because the proposal is tied to the satisfaction of the COBE rules, it would make available post-reorganization restructurings (in addition to asset or stock transfers and successive transfers) that under current law may be stepped together with the putative reorganization. For example, assume that following a forward triangular merger in which target merges into a subsidiary (“S”) of the issuing corporation (“P”), P transfers the stock of S to another subsidiary of P (“S1”), and S is then merged into a subsidiary of S1 (“S2”). Under current law, taxpayers may be concerned that this transaction would be recast as a failed triangular reorganization involving the merger of target into S2 for grandparent, P, stock. Under our proposal, as long as the transaction otherwise satisfies the requirements for a forward triangular merger under Section 368(a)(2)(D), the fact that the acquired assets were redeployed within the qualified group would not affect the treatment of the transaction because the acquired business would be conducted within P’s qualified group within the meaning of Treas. Reg. Section 1.368-1(d). The type of transaction that is chosen to integrate target’s business following a reorganization should not be relevant, as long as the COBE standards are satisfied.

A second place that the current COBE rules and the –2(k) Rule, as amended by the 2004 Proposed Regulations, are not aligned is with respect to transfers of stock or

³³ H.R. Rep. No. 83-1337, A134 (1954).

assets to partnerships.³⁴ Thus, under our proposal, if the issuing corporation acquires the stock of target in a Type B reorganization or a reverse triangular merger described in Section 368(a)(2)(E) and contributes the acquired stock to a partnership, satisfaction of the control requirement would be determined without taking into account the transfer to the partnership as long as the COBE requirements were satisfied.³⁵ There is no policy reason to integrate post-reorganization transfers to determine whether the control requirement is satisfied.³⁶ The 1998 Regulations, as proposed to be amended by the 2004 Proposed Regulations, already turn off the step transaction doctrine when analyzing satisfaction of the control requirement when the stock is transferred or successively transferred to one or more members of the qualified group, therefore adding an attribution and aggregation concept to the definition of Section 368(c). For example, the control requirement is satisfied if, following a Type B reorganization, the acquiring corporation transfers the stock to 10 different subsidiaries.³⁷ If the Treasury and IRS adopt our proposal, some members have suggested that it might also be appropriate for the Government to modify the COBE standards adopted in the 1998 Regulations for partnerships to require the acquiring group to have a greater economic interest in the partnership.³⁸

³⁴ One minor consequence of this proposal is that taxpayers would not have to rely on the -2(f) Rule for comfort on transactions involving asset transfers to partnerships. Thus, all the relevant step transaction guidance would be contained in a single rule.

³⁵ This application would extend to triangular asset reorganizations as well.

³⁶ For example, see Rev. Rul. 2003-51, 2003-21 I.R.B. 938 (shareholder's disposition of stock received in a Section 351 exchange was not considered in applying the control requirement because the disposition was also a nonrecognition transfer). The IRS and Treasury determined that respecting the independent steps did not undermine the policies of Section 351, and therefore, there was no reason to integrate the steps.

³⁷ See Example 7 of the 2004 Proposed Regulations.

³⁸ In particular, some members have questioned whether the safe harbor standards of Treas. Reg. Section 1.368-1(d)(4)(iii), Examples 7 through 10 (generally, a one-third economic interest or a twenty percent economic interest with management control) provide the necessary "link" between the target corporation business and the target shareholders.

As with the COBE rules, we do not believe that the government's authority for applying the step transaction doctrine is limited by any provision of the Code. Thus, the limitations in the language Section 368(a)(2)(C) should not restrain the government in its formulation of the step transaction principles to be applied in the context of post-reorganization transfers.³⁹ However, even if the Treasury and IRS believe that Section 368(a)(2)(C) is the basis for their authority in issuing step transaction guidance in the area of post-reorganization restructurings, we believe that the Treasury and IRS have the authority to read Section 368(a)(2)(C) permissively to implement this proposal.

Notably, the Treasury and IRS have consistently viewed the explicit language of Section 368(a)(2)(C) as permissive, thus allowing successive transfers in the 1998 Regulations and in allowing transfers following reorganization types that were not specifically enumerated in Section 368(a)(2)(C) in the 2004 Proposed Regulations. The types of transfers allowed by our proposal would no more contravene Section 368(a)(2)(C) than the types of transfers allowed in those earlier sets of Regulations. Equally importantly, by expanding the COBE rules to include transfers to subsidiaries meeting the definition of Section 1504 and expanding the -2(k) Rule to provide that post-reorganization transfers that satisfy the COBE rules will be viewed independently from the putative reorganization, the goal of rationalizing the reorganization provisions will be furthered and taxpayers will be able to engage in transactions with greater certainty.

³⁹ In fact, one commentator argues that because the -2(k) Rule restated and incorporated Section 368(a)(2)(C) and the remote continuity doctrine, the language of Section 368(a)(2)(C) is not relevant at all. See Michael Schultz, *Comments on REG-165579-02: Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization*, (Mar. 17, 2004), reprinted in 2004 TNT 61-25 (Mar. 30, 2004).

c. Technical Comments

Regardless of whether the Treasury and IRS adopt our recommendations described above, we recommend that the 2004 Proposed Regulations should be clarified in the following ways:

1. The –2(k) Rule should be clear that it applies to all types of reorganizations for which COBE is relevant, including those that are not specified in Section 368(a)(2)(C).

2. There is an inconsistency in the application of the –2(k) Rule and the COBE rules, as amended by the 2004 Proposed Regulations, with the result that the COBE rule is more restrictive than the –2(k) Rule. The COBE rule, unlike the –2(k) Rule, applies only to the issuing corporation’s qualified group and not to the target corporation’s qualified group. For example, assume that Acquiring acquires the stock of Target in a Type B reorganization, and transfers half of the Target stock to each of wholly owned subsidiaries S1 and S2. This transfer satisfies both the –2(k) Rule and the COBE rule, as amended. If Target then transfers its assets to Target Sub, a wholly owned subsidiary of Target, the COBE rule would not be satisfied because Target Sub is not controlled within the meaning of Section 368(c) by Acquiring. The –2(k) Rule, on the other hand, would be satisfied.

This inconsistency creates a trap for the unwary and is difficult to rationalize from a policy perspective. Thus, we propose that the COBE rule should be expanded in light of the 2004 Proposed Regulations to apply not only to the issuing corporation’s qualified group, but also to the target corporation’s

qualified group. Consequently, Target Sub would be part of Target's qualified group, and the subsequent transfer of assets to Target Sub would satisfy both COBE and the -2(k) Rule. This fact pattern illustrates the need for the adoption of the proposals outlined above.