New York State Bar Association
Tax Section

Report on Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations

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I. INTRODUCTION

This Report of the New York State Bar Association Tax Section[1] comments upon recently issued proposed regulations that would add a "net value" requirement for qualification of a transaction under sections 351, 368 or 332 (the "Proposed Regulations").[2] The Proposed Regulations also address the circumstances under which creditors will be treated as the proprietors of a corporation for purposes of the continuity of interest ("COI") requirement. We commend the Internal Revenue Service (the "Service") and the Department of the Treasury ("Treasury") for focusing on the issues underlying the Proposed Regulations and for undertaking this project with a view to providing greater clarity in an area where the law is particularly unclear. In light of the existing authorities, however, and considering the stated policies and rationale for the Proposed Regulations, we recommend changes to better implement those policies and eliminate inappropriate characterizations of transactions.

Generally, the Proposed Regulations would add the following "net value" requirements:

1. Section 351. For an exchange of property to qualify under section 351, the Proposed Regulations require the transferor to transfer property with a net value and receive (or be deemed to receive) stock having net value in the exchange. In other words, the transferor must transfer property in excess of the liabilities assumed plus the money or other property ("boot") issued by the transferee, and the transferee must issue (or be deemed to issue) stock with value.

2. Section 368. For a potential reorganization to qualify under section 368, the Proposed Regulations provide that the target corporation must surrender net value to the acquiring corporation, and the target corporation must receive net value from the acquiring corporation. In other words, the value of the property

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[1] This Report is the joint work product of the Committee on Reorganizations, the Committee on Bankruptcy and Net Operating Losses, and the Committee on Consolidated Returns. The principal authors of the Report are Lawrence Garrett, Stuart J. Goldring, Russell Nance, Joel Scharfstein, Karen Gilbreath Sowell, Linda Z. Swartz, and Hagai Zaifman. The Report was coordinated by Karen Gilbreath Sowell and Linda Z. Swartz. Helpful comments were received from David Hariton, Kimberly Blanchard, Lynne Edelstein, David Miller, and Michael Schler. Except as otherwise indicated, all references herein to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or to Treasury Regulations promulgated thereunder.

[2] REG-163314-03.

transferred by the target corporation must exceed the liabilities assumed by the acquiring corporation and the boot issued by the acquiring corporation (and in the case of a stock acquisition, the inside asset value must exceed the liabilities of target and the boot received), and the target corporation must receive (or be deemed to receive) stock with value from the acquiring corporation.

3. Section 332. For a liquidation to qualify for tax-free treatment under section 332, there must be a receipt of net value in respect of all shares owned by the shareholder. In other words, the shareholder must receive property with value in cancellation of each class of stock. As discussed below, this rule is already reflected in current law.

The preamble to the Proposed Regulations (the "Preamble") gives insights into the approach taken in the Proposed Regulations. The Preamble focuses on the statutory construct of sections 332 and 351, and certain reorganization forms described in section 368, as containing a requirement that the transferor exchange its assets for stock of the transferee (or, in the case of section 332, a cancellation or redemption requirement).[3] Because all of these sections seem to impose a requirement that stock be issued or exchanged, the Service and Treasury desired to adopt a unifying standard. In light of the fact that existing law requires a distribution of net value with respect to the shareholder's stock for qualification under section 332, it appears that the Government chose to provide consistency and uniformity among the various provisions by proposing a net value standard for sections 351 and 368 to conform to the law as developed under section 332.

There are substantial differences in tax results depending upon whether a transaction qualifies under the various tax-free provisions implicated by the Proposed Regulations. Generally, no gain or loss is recognized by the transferor corporation and its shareholders in a tax-free transaction. The transferee in a tax-free transaction receives the acquired property with a carryover basis and tacks on the holding period of the transferor. In the case of a section 332 or section 368 transaction, the transferee succeeds to the transferor's attributes under section 381. If a transaction does not qualify as tax-free, gain or loss may be recognized by the transferor corporation and its shareholders. The transferee generally will take a fair market value basis in the transferred property and begin a new holding period. The transferee will not succeed to the transferor's attributes under section 381. The adoption of the net value requirement as drafted in

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[3] Section 332 provides, in part, that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation . . . only if . . . the distribution is by such other corporation *in complete cancellation or redemption of all of its stock.*" Emphasis added. Section 351 provides, in part, that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely *in exchange for stock* in such corporation." Emphasis added. Section 354 provides, in part, that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are . . . *exchanged solely for stock or securities* . . . in another corporation a party to the reorganization." Emphasis added. Finally, section 361 provides that "[n]o gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and *exchanges property* . . . *solely for stock or securities* in another corporation a party to the reorganization." Emphasis added.

the Proposed Regulation would result in many transactions that appear to be mere reorganizations of businesses being characterized as sales for which losses may be available.

In a prior report, we made recommendations for dealing with insolvent subsidiaries that undertake liquidations or reorganizations.[4] Generally, our NYSBA 2003 Report recommended that future rules addressing restructurings involving insolvent subsidiaries should allow for qualification as tax-free reorganizations under section 368 and not allow losses to be realized. That is, assuming the other requirements for tax-free treatment are satisfied, we recommended the adoption of rules that would render the subsidiary solvent and qualify the transaction under section 368. Those recommendations were based on four policy considerations: providing clarity, facilitating business-motivated restructurings, limiting opportunities to duplicate or accelerate losses and promoting consistency.

Although the recommendations of the NYSBA 2003 Report were not implemented in the Proposed Regulations, we continue to believe that the four policies identified in the NYSBA 2003 Report should drive the direction of any regulations in this area. We also continue to believe that our prior recommendations would appropriately implement these policies. As discussed in this Report, the Proposed Regulations would not implement two of these very significant policies: the Proposed Regulations would not facilitate business-motivated restructurings, and the Proposed Regulations would allow taxpayers to duplicate and accelerate losses. Especially in the context of transactions occurring within an affiliated group, it seems that the Proposed Regulations would reach results that are undesirable as a policy matter. We urge the Service and Treasury to reconsider the proposals made in the NYSBA 2003 Report.[5]

If the Service and Treasury nevertheless determine to adhere to the policies and direction of the Proposed Regulations, we submit the comments herein for consideration prior to any such rules being made effective. This Report will focus on analyzing the effect of the Proposed

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[4] N.Y. St. Bar Assoc. Tax Sec., *Reorganizations Involving Insolvent Subsidiaries*, 101 Tax Notes 761 (Nov. 10, 2003) (the "NYSBA 2003 Report"). The NYSBA 2003 Report focused primarily on consolidated subsidiaries, although affiliated subsidiaries that do not join in the filing of a consolidated return were also addressed.

In addition, many of the issues presented in connection with the implementation of the COI requirement to creditors were considered in a 1985 report of the Tax Section, which made recommendations for proposed regulations implementing the reorganization provisions under section 368(a)(1)(G) ("G reorganizations"). N.Y. St. Bar. Assoc. Tax Sec., *Report on Reorganizations Under Section 368(a)(1)(G); Recommendations for Proposed Regulations*, 1985 Tax Notes 231 (Nov. 25, 1985) (the "NYSBA 1985 Report").

[5] We recognize that the NYSBA 2003 Report did not address potential section 351 transactions and transactions occurring outside of the affiliated group context. This Report adequately expresses our views of section 351 transactions where there is not a transfer of net value. We would be happy to expand the analysis in our NYSBA 2003 Report to address transactions outside the affiliated group context in a manner that is consistent with the approach of the NYSBA 2003 Report if the Service and Treasury intend to reconsider the direction of the rules in this area.

Regulations in each of the separate contexts to which they apply and providing recommendations to improve their operation in such contexts.

We have significant concerns about the Proposed Regulations that are discussed in detail in the individual sections of this Report and are summarized here. We question whether creating a uniform set of rules applicable to section 332, 351 and 368 transactions is appropriate given the reality that each of these sections has its own technical requirements and precedential history and implicates potentially different policy concerns. In our view, given the complexities and particularities of each of these sections, a single guiding principle is unlikely to be appropriate in all contexts.

We believe that the Proposed Regulations would impede certain business-motivated restructurings that are appropriately within the scope of the reorganization provisions. Because the net value requirement can transform an otherwise tax-free transaction into a taxable one where there is a single dollar of excess assets or liabilities, the rules will reach illogical results in certain cases, such as where a third party attributes value to an enterprise that is not reflected in the company's liquidation value. In addition, such a system inevitably will create traps for the unwary as well as preserve or expand planning opportunities for beneficial tax consequences. For example, the Proposed Regulations would allow for potential loss duplication in certain upstream transactions.

Finally, even if an economic exchange of property for stock is required in all contexts, the promulgation of a specific set of rules for calculating the existence or absence of net value would create a complicated infrastructure that will be difficult to administer in practice. Further, because the determination of whether there is net value requires an analysis of the value of all the assets and all the obligations of the transferor (and in the case of sections 351 and 368, the transferee), the application of the Proposed Regulations will require extensive interpretation and difficult valuations in order to be properly and consistently applied.

After providing a summary of the recommendations made in the Report, we divide the discussion of the Proposed Regulations into four sections, each providing relevant background and a more detailed explanation of the recommendations. Section III addresses section 351 transactions. Section IV discusses reorganizations (other than upstream restructurings) under section 368, including an extensive discussion of the COI requirement. Section V discusses upstream restructurings, including section 332 liquidations and upstream reorganizations. Section VI is devoted to a discussion of special considerations relating to liabilities, which impact the entirety of our Report.

II. SUMMARY OF CONCLUSIONS

A. Section 351 Transactions

We recommend that the net value requirement in the Proposed Regulations be modified to require only that the transferee must issue stock that has value in exchange for the property transferred in a putative section 351 transfer. Value for this purpose would be defined as the value that a third party willing buyer would pay for the stock, instead of the corporation's net asset value (as in the Proposed Regulations). This requirement would be satisfied only if the stock received or deemed received is properly viewed as received in exchange for the property transferred.

B. Reorganizations

We recommend that the Service and Treasury eliminate the net value requirement for reorganizations from the Proposed Regulations, and clarify that no exchange requirement will be imposed on sideways reorganizations outside of the bankruptcy context. We believe that the COI requirement addresses the policy concerns expressed in the Proposed Regulations, and we are concerned about the confusion and traps for the unwary that would result from the adoption of a net value requirement for reorganizations.

Further, we offer recommendations to improve specific aspects of the COI provisions of the Proposed Regulations: (1) priority claims which receive special treatment under the Bankruptcy Code should also receive special treatment for COI purposes; (2) the final regulations should contain an example demonstrating the disproportionate receipt of acquiring corporation stock and other property among the senior class of creditors; (3) the Service and Treasury should clarify the circumstances in which the receipt of stock by a creditor or shareholder will be disregarded for COI purposes; (4) amounts received on partially secured creditor claims without a formal allocation between the bifurcated portions of the claim should be allocated based on the regulations under section 108(e); and (5) pre-transaction payments should affect COI only if made in connection with the transaction.

C. Upstream Restructurings

On balance, we support the conclusion in the Proposed Regulations that an upstream restructuring of an insolvent subsidiary cannot qualify as tax-free under section 332 or section 368. We offer some observations and considerations regarding interactions with the consolidated return regulations that are created by the Proposed Regulations, as well as issues that arise when a subsidiary corporation transfers its assets to the parent corporation with respect to one class of stock while the other class receives nothing.

D. Liabilities

We agree that if a net value requirement or modified COI provisions are adopted, liabilities should be broadly defined for purposes of determining net value and a definition of liability similar to the definition of "obligation" in Treasury Regulation section 1.752-1(a)(4)(ii) should be adopted. We recommend generally that all liabilities should be valued using a fair market value approach because it offers the best economic determination of whether net value has been surrendered and received. In recognition that such an approach creates numerous and difficult valuations, we further recommend that the Service and Treasury consider including certain safe harbors for valuation purposes. In the case of a non-recourse liability that exceeds the value of the property securing it, we recommend that the amount of liability assumed would be limited to the value of property transferred that secures the liability. Finally, we recommend that the principles of section 357(d) should be used to determine the extent to which liabilities are assumed.

III. SECTION 351 TRANSACTIONS

A. Background

Section 351(a) provides, in relevant part, that no gain or loss shall be recognized if property is transferred to a corporation (the "transferee") by one or more persons (the "transferor(s)") solely in exchange for stock in the transferee corporation. If the sum of the amount of liabilities assumed by the transferee in the section 351 exchange exceeds the total adjusted basis of the property transferred, the transferor generally recognizes gain under section 357(c). The basis of property transferred generally equals the transferor's basis in such property increased by the amount of gain recognized by the transferor, including section 357(c) gain. If the basis of the property transferred is greater than the value of the property, however, the basis may be reduced.[6] If section 351 does not apply, section 1001 requires gain or loss to be recognized (subject to section 267 and Treasury Regulation section 1.1502-13) by the transferor and the transferee generally receives a cost basis in the property determined under section 1012.

The Proposed Regulations would add the requirement that to have an *exchange* of property for stock under section 351(a), the transferor must transfer property with net value and the stock received from the transferee must have value (*i.e.*, the transferee may not be insolvent). Specifically, Proposed Regulation section 1.351-1(a)(1)(iii) provides that stock will not be treated as issued for property (and, therefore, section 351(a) will not apply to the exchange) if either:

(i) the fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed (including an obligation for which the transferee is the obligee and that is extinguished in connection with the transfer) plus the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 351(a)) received in connection with the transfer (the "Section 351 Net Value Exchange requirement"); or

(ii) the fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer (the "Section 351 Net Value Receipt requirement").

There is no minimum net value necessary for the Section 351 Net Value Exchange requirement or the Section 351 Net Value Receipt requirement (together, the "Section 351 Net

[6] Under section 362(e)(2), added in 2004 by the American Jobs Creation Act of 2004 (H.R. 4520), in a section 351 exchange between U.S. persons, if the transferee's aggregate basis in property transferred in a section 351 exchange would (but for Section 362(e)(2)) exceed the fair market value of such property, then the transferee's aggregate basis in such transferred property shall not exceed fair market value. The aggregate basis reduction is allocated among the transferred property in proportion to the respective built-in losses. Alternatively, a transferor and transferee may jointly and irrevocably make an election pursuant to which the transferor's basis in the stock received shall not exceed its fair market value immediately after the transfer. If the transferor in the section 351 exchange is foreign or tax-exempt, section 362(e)(1) applies instead, with the result that all property transferred receives a fair market value basis in the hands of the transferee.

Value requirements"). As long as the transferor transfers property with net value of one penny and the stock received has value of one penny, the Section 351 Net Value requirements are satisfied. The valuation issues created by the Proposed Regulations are burdensome to taxpayers and difficult to administer for the Service, especially in the case of section 351 transactions that often involve related persons and intercompany liabilities.

Current law does not appear to require a net value exchange in a section 351 transaction. There is no legislative history to section 351 or its predecessor provision that sheds any light on this question. The legislative history to section 357(c) is silent as to its applicability in the case where the transferor does not transfer net value. Generally, the courts have applied section 357(c) without regard to whether the property transferred has a value in excess of the liabilities assumed, thus implying that section 351 would apply in a case in which net value is not transferred.[7] While the Service historically has followed the courts' approach in its administrative practice,[8] in recent years the Service seems to have reconsidered that thinking in the context of certain transactions that it deems undesirable.[9]

Interestingly, section 362(d), added by Congress in 1999,[10] may be read to suggest that a transfer in which the liabilities assumed exceed the value of the assets transferred can qualify under section 351. In determining the basis of property transferred in the hands of the transferee in a section 351 transaction, section 362 provides that the basis will be equal to the basis in the hands of the transferor increased by the amount of gain recognized by the transferor on such transfer, including gain recognized as a result of the application of section 357(c) (where

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7 See, e.g., *Sohmer & Co. v. U.S.*, 86 F. Supp. 670 (S.D.N.Y. 1949), in which the court considered whether the incorporation of a proprietorship was tax-free under the predecessor provision to section 351. While it was not proven whether the transferee (and thus, the proprietorship) was solvent, the court noted, "[e]ven if I were to find that the corporation was insolvent, I would nevertheless have concluded that the transfer was tax free." *See also Lessinger v. Comm'r*, 872 F.2d 519 (2d Cir. 1988) (providing that the transferor "cured" his section 357(c) exposure resulting from the incorporation of his business with "negative net worth" by contributing his own note); *Rosen v. Comm'r*, 62 T.C. 11 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975) (providing that section 357(c) applied to the incorporation of a "clearly insolvent" business).

8 *See* GCM 33915 (Aug. 26, 1968), where the Service considered a proposed revenue ruling (never published) addressing the application of section 357 where the liabilities assumed exceeded the basis and fair market value of the property transferred. The Service determined that if Congress had intended to limit the application of section 357(c) to transfers where the value of the property transferred exceeded the liabilities assumed, it could have done so.

9 *E.g., compare* FSA 200023016 (Mar. 1, 2000) (providing that transfer of worthless properties does qualify under Section 351) with FSA 2000205003 (Oct. 5, 2001) (reversing FSA 200023016) and FSA 200043007 (July 22, 2000) (assuming that section 351 would apply in order to advance arguments under section 482 and section 269). In the transaction the subject of these FSAs, generally, a member of a consolidated group (A) transferred built-in loss property to subsidiary D formed outside of the consolidated group in exchange for auction rate preferred stock, and other subsidiaries contributed income producing property to the subsidiary in exchange for common stock and preferred stock. Thereafter, subsidiary A sold its auction rate preferred stock, recognizing a loss, and subsidiary D sold or abandoned its loss property.

10 Section 3001(b)(2), Miscellaneous Trade and Technical Corrections Act of 1999 (P.L. 106-36).

liabilities are assumed in excess of the basis of the property transferred). As a response to inappropriate tax planning,[11] Congress added section 362(d) to limit the increase in basis resulting from gain recognized due to the assumption of liabilities to the fair market value of the transferred property.[12] Thus, it does not appear that Congress intended to make any statement regarding the question at hand.

B. Analysis and Recommendations

We do not believe it is necessary for the Service and Treasury to adopt a unifying standard for all Code provisions that provide for tax-free treatment. Section 351 transactions implicate different concerns than liquidations and reorganizations. First, as stated in the Preamble, the net value requirement has the same purpose as that underlying the COI requirement. As a result, consistent with recently issued regulations that provide that COI is not required for reorganizations under sections 368(a)(1)(E) and (F) (respectively, "E reorganizations" and "F reorganizations"),[13] the Proposed Regulations do not apply to those single entity reorganizations. COI is not required for section 351 exchanges either, so presumably, the net value requirement must be necessary to further some other purpose. Second, unlike liquidations governed by section 332 and reorganizations described in section 368, the attributes of the transferor in a section 351 transaction do not carry over to the transferee under section 381. Therefore, concerns regarding carryovers of attributes do not exist. Third, as discussed more fully below, stock in a corporation often has value in excess of the net asset value (or liquidation value) of the corporation. This value could be attributable to the right to participate in the future growth of the business or to the synergies created by combining certain assets with expertise (the so-called "option value"). Option value may not be relevant in the case of a liquidation because the stock is permanently extinguished in the transaction, leaving only liquidation value to be distributed to the shareholders.

Like the other tax-free provisions, however, section 351 (and its predecessor provision) was enacted in order to facilitate the incorporation of a business and remove any tax impediments to such readjustments.[14] We believe that this policy must be considered in assessing the Proposed Regulations and the role for a net value requirement.

Based on the Code language and the policies of section 351, we believe that it is appropriate for the Service and Treasury to determine that section 351 should not apply if the stock received or deemed received does not have value attributable to the property transferred.

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[11] As described in the proposal entitled "Restrict Basis Creation Through Section 357(c)," Department of the Treasury, "General Explanations of the Administration's Revenue Proposals," February 1999, "if a foreign transferor transfers an asset that partially secures a line of credit, taxpayers have taken the position that gain would be computed under section 357(c) by treating the entire liability as an amount realized and the transferee's basis in the asset would be increased accordingly."

[12] If the Proposed Regulations are adopted in their current form, section 362(d) would become deadwood.

[13] *See* T.D. 9182, 70 Fed. Reg. 9219 (Feb. 25, 2005).

[14] Section 202(b), Revenue Act of 1918, 40 Stat. 1057. *See also*, *Caruth v. U.S.*, 688 F. Supp. 1129 (N.D. Tex. 1987), *aff'd*, 865 F.2d 644 (5th Cir. 1989).

We do not agree, however, that the creation of the Section 351 Net Value Transfer requirement and its complexity is necessary to protect the policies of section 351. Further, we are concerned that the mechanical Section 351 Net Value Exchange requirement may render certain transactions taxable that should satisfy the technical requirements of section 351 and its spirit. In addition, we believe the Section 351 Net Value Receipt requirement is not necessary, and in fact, reaches an incorrect result where there is "option value" associated with the transferee entity.

We recommend that the Section 351 Net Value requirements in the Proposed Regulations be modified to require only that the transferee must issue stock that has value in exchange for the property transferred in a putative section 351 transfer. Value for this purpose would be defined as the value that a third party willing buyer would pay for the stock, instead of the corporation's net asset value (as in the Proposed Regulations). "Stock" for this purpose would include nonqualified preferred stock as defined in section 351(g).

We believe that this formulation of the Section 351 Net Value requirements protects the determination made by the Service and Treasury that an exchange of net value is required in a tax-free transaction, but is flexible enough to accommodate transactions that would not otherwise satisfy the Proposed Regulations but should be afforded tax-free treatment. These recommendations, and their relationship with the Section 351 Net Value requirements of the Proposed Regulations, are discussed below.

C. Analysis of Section 351 Net Value Exchange Requirement and Effect of Our Recommendations

1. Base Case: Property Transferred is Overencumbered

Section 351 requires that property be transferred in exchange for stock (or, in constructive exchange where issuance would otherwise be a "meaningless gesture").[15] The Section 351 Net Value Exchange requirement appears to focus on whether, in substance, there could be stock issued by the transferee in exchange for the property transferred. The requirement looks at the value of property transferred as compared to the amount of liabilities assumed plus the amount of boot received. If, economically, there is no stock issued, then the Section 351 Net Value Exchange requirement is not satisfied.

Example 4 of the Proposed Regulations illustrates the proposed Section 351 Net Value Exchange requirement in the context of section 351 transactions involving excess liability assumptions:

> A, an individual, transfers an apartment building with a fair market value of $175x to Corporation X. The building is subject to a nonrecourse obligation of $190 and no other asset is subject to that liability. A receives 10 shares of Corporation X stock in the exchange. Immediately after the exchange,

[15] *See, e.g.*, Rev. Rul. 64-155, 1964-1 C.B. 138; *Lessinger v. Comm'r*, 85 T.C. 824 (1985), *rev'd*, 872 F.2d 519 (2d Cir. 1989).

Corporation X is solvent[16] and A owns 100% of its outstanding stock. Under Proposed Regulation section 1.351-1(a)(1)(iii), the 10 shares of Corporation X stock received by A will not be treated as issued for property because the fair market value of the apartment building does not exceed the amount of A's liabilities assumed by Corporation X. Therefore, section 351 does not apply to the exchange.[17]

Under certain facts, it may not make a significant difference whether section 351 applies to the transaction described in Example 4 or not, because gain may be recognized by the transferor regardless. If section 351 does not apply, however, the determination of Corporation X's basis in the transferred property is not clear. Assume, for illustration, that A's basis in the building transferred in Example 4 is $180. If this transaction qualified under section 351, A would recognize $10 of gain under section 357(c), A's basis in the Corporation X stock would be $0,[18] and Corporation X's basis in the building would be $175.[19] Thus, the loss in the property has been preserved in Corporation X's hands.[20]

If, as a result of the Section 351 Net Value Exchange requirement, Example 4 is not a qualifying section 351 transaction, presumably, A is treated as transferring the building to Corporation X in a sale transaction taxable under section 1001. Under Treasury Regulation section 1.1001-2, A's amount realized would be $190, the full amount of the nonrecourse liability assumed by Corporation X, resulting in $15 of gain.[21] The law is unclear as to what basis Corporation X would take in the property, and thus, the loss may not be preserved in Corporation X's hands.[22] Under *Pleasant Summit Land Corp. v. Comm'r,*[23] Corporation X would take a basis in the building equal to its fair market value of $175. However, under *Estate*

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16 It is unclear whether, in this example, Corporation X is solvent because it owned other properties prior to the transfer or because in determining solvency the Service disregarded the excess of the nonrecourse liability over the fair market value of the asset securing the liability. *See* Rev. Rul. 92-53, 1992-2 C.B. 48 (for purposes of determining whether a debtor is insolvent for purposes of section 108(d)(3), the excess adjusted issue price of a nonrecourse debt over the fair market value of the property securing the debt is disregarded).

17 The example does not articulate the resulting consequences to A and Corporation X. As discussed below, an examination of the results is important to understanding the impact of the Proposed Regulations.

18 I.R.C. § 358.

19 I.R.C. § 362(d)(1).

20 We note that following the enactment of section 362(e), it is no longer possible to duplicate the built-in loss in property transferred in a section 351 transaction.

21 *See Tufts v. Comm'r,* 461 U.S. 300 (1983); *Crane v. Comm'r,* 331 U.S. 1 (1947).

22 We note that there would continue to be a difference in holding period depending upon whether the transfer qualified under section 351.

23 *Pleasant Summit Land Corp.*, 863 F.2d 263 (3d Cir. 1988).

of Franklin v. Comm'r,[24] Corporation X would take a basis of $0 in the transferred asset. *Franklin* and its progeny deny basis as the result of nonrecourse seller financed mortgage indebtedness that significantly exceeds the value of the purchased property.

Under other facts, however, the consequences could be quite different, largely because certain losses from sales between related persons may be deferred or disallowed under section 267. Assume, instead, that A's basis in the building is $200. If the transaction qualified under section 351, Corporation X would have a basis of $175 in the building[25] and A would have a basis of $10 in its Corporation X stock.[26] A's economic loss would be preserved in the stock A receives from Corporation X. If section 351 did not apply, A would realize a loss of $10 that would be disallowed under section 267(a).[27] As discussed above, it is not clear what Corporation X's basis in the building would be.

We note that our proposed revision to the Section 351 Net Value requirements would preserve the results of Example 4, a case in which a single owner transfers property with a value that is less than the liabilities assumed by the transferee. Even though stock is issued in the transaction, we agree with the conclusion of the Proposed Regulations that this transaction looks more like a sale than a reorganization transaction.[28]

In light of the fact that the Section 351 Net Value requirements will cause more transactions to be taxable under section 1001, we urge the Service and Treasury to clarify the results under case law to provide that the transferee corporation will have a basis in the transferred property equal to the fair market value of the property. We do not think it is appropriate that the transferor's entire basis in the transferred property would disappear merely as a result of the transfer. This clarification would take considerable pressure off of the Section 351 Net Value requirement as well as provide appropriately consistent results.

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[24] *Estate of Franklin v. Comm'r,* 544 F.2d 1045 (9th Cir. 1976), *aff'g*, 64 T.C. 752 (1975). *See also* Rev. Rul. 77-110, 1977-1 C.B. 58; Rev. Rul. 78-29, 1978-1 C.B. 62.

[25] I.R.C. § 362, as adjusted by section 362(e)(2). This assumes that an election under section 362(e)(2)(C) is not made. If, however, a section 362(e)(2) election were made, A would have a basis of $0 in the Corporation X stock and Corporation X would have a basis of $200 in the building. Thus, the loss would have been shifted to Corporation X.

[26] I.R.C. § 358.

[27] Section 267(a) denies a loss from the sale or exchange of property by a shareholder who owns more than fifty percent of the stock of a corporation (either directly or by attribution). In general, section 267(d) allows the loss disallowed under section 267(a) to reduce gain on a later sale or exchange of the property.

[28] This conclusion assumes that the stock issued in the transaction is not issued in exchange for the property because there is no "room" for the stock to be issued where the property is over encumbered and there is a single owner of the transferee. Some commentators have questioned whether this "ordering" rule is appropriate. *See* Japser L. Cummings, Jr., *New Prop. Regs. Change Rules for Transactions Where Property of Stock Lacks Net Value*, 103 J. Tax'n 14 (July 2005).

2. Application of Section 351 Net Value Exchange Requirement Where Transferee Stock has Value

As drafted, the Section 351 Net Value Exchange requirement combines the liability assumption with any boot issued to determine whether economically there could be stock issued in the exchange. Even if stock is physically issued in the exchange, such stock may have no value.[29] If the stock does have value, depending upon the facts, it may be difficult to attribute such value to the property that was contributed in the exchange. Such stock may instead be issued for some other reason, such as compensation or a gift.[30]

This approach of calculating whether there is, economically, any stock issued in the exchange generally seems appropriate in the context of a wholly-owned subsidiary. Assume that A exchanges property valued at $100, subject to a $60 liability, in exchange for $40 cash and Corporation X stock. It seems clear that any stock issued has no value, and therefore, was not issued in exchange for the property transferred.

In other cases, however, the calculation may not reflect economic reality. For example, assume that, in addition to A, shareholder B owns an interest in Corporation X. A and B formed Corporation X to develop new pharmaceuticals and, upon formation, transferred all the assets necessary to develop Drug 1. A owns the intellectual property necessary to develop Drug 1 into Drug 2. The property is valued in the hands of the transferor at $100, but is subject to a liability of $110. If A transfers the property to Corporation X, new value in the joint venture will be created as a result of X's ability to develop Drug 2, and A receives stock in Corporation X valued at $30. The Section 351 Net Value Exchange requirement, however, could be read to provide that A's exchange would not qualify as tax-free under section 351 because, under the formula, when the liability assumed is taken into account and the increase in the enterprise value by $30 is not taken into account, there is no economic "room" for stock to be issued.

The effect of the operation of the Section 351 Net Value Exchange requirement in this fact pattern would be to suggest that the $30 of stock is not "stock" within the meaning of the Code because it is not respected under the Section 351 Exchange requirement. We are concerned that such an implication could only create anomalies that would lead to confusion, inappropriate planning, and traps for the unwary. Further, we believe that this transaction should be afforded section 351 treatment and that the $30 of stock should be respected for all purposes as stock received in exchange for the transferred property. Our recommended revision to the Section 351 Net Value requirements would treat this transaction as a qualifying section 351 exchange.

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[29] *See Meyer v. U.S.*, 121 F. Supp. 898 (Ct. Cl. 1954), *cert. denied*, 348 U.S. 929 (1955) (concluding that "worthless" property could not be "exchanged" for stock of the transferee within the meaning of the statute).

[30] *See* Treas. Reg. § 1.351-1(b)(1) ("[W]here stock is received in disproportion to a transferor's interest, the transaction will be given tax effect in accordance with its true nature.")

3. Treatment of Nonqualified Preferred Stock

In determining whether stock could be exchanged for the transferred property, the Proposed Regulations treat nonqualified preferred stock ("NQPS") as boot. While the subject of NQPS, and the anomalies created by section 351(g), is clearly beyond the scope of this Report, it seems inappropriate to include NQPS as boot in the calculus of whether the Section 351 Net Value Exchange requirement is satisfied. For one, it is not counted as boot in the reorganization provisions of the Proposed Regulations. More importantly, though, it raises additional questions about the status of the transferor and the treatment of transactions involving multiple transferors. For example, if A contributes to Corporation X property valued at $100 (with a basis of $50), subject to a $60 liability, in exchange for $40 of NQPS, under the Proposed Regulations, A's exchange is not within section 351. Thus, A recognizes gain of $50 under section 1001 and Corporation X has a basis of $100 in the property. This, by itself, is not particularly noteworthy, however, because if section 351 did apply, A would still recognize gain under section 351(b) and Corporation X would still have a basis of $100 in the property.

However, if, as part of the same transaction, B transfers property to Corporation X in exchange for 50% of the Corporation X stock, does B have a taxable event as well, or does A remain a "co-transferor"? We believe that such a transaction should qualify as a section 351 exchange for all the parties. As the Section 351 Net Value requirements are interpretative regulations, we do not believe it necessary to exacerbate the number of anomalies created by section 351(g). The mere fact that Congress determined that certain equity instruments should be treated as boot does not mean that such characterization should control for purposes of measuring net value.

4. Net Value Receipt Requirement

While not illustrated in the Proposed Regulations, the Section 351 Net Value Receipt requirement is implicated if property is transferred to a transferee corporation that is insolvent following the contribution. Thus, even if the transferor transferred valuable property for transferee stock and no liabilities were assumed, section 351(a) would not apply if the transferee corporation did not have positive value immediately after the transfer. To illustrate, assume A transfers property valued at $100 to its wholly-owned Corporation X, which prior to A's transfer has assets valued at $50 and liabilities of $200. After the transfer, Corporation X has liabilities in excess of the value of its assets, and thus, the Section 351 Net Value Receipt requirement is not satisfied. This fact pattern likely would remain a tax-free transfer characterized as a capital contribution under section 118.[31]

Assume that Corporation X was owned 80% by A and 20% by B. If A transfers property valued at $100 to Corporation X in exchange for Corporation X stock, and such stock has value, we believe section 351 should apply, regardless of the fact that X's liabilities exceed the value of its assets. Measuring the "value" of stock by assessing the net asset value (or liquidation value) of the corporation is inappropriate. Liquidation value does not account for any control premium attributable to voting rights or any going concern value that would be valued by third parties.

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31 *See Comm'r v. Fink*, 483 U.S. 89 (1987).

In the Preamble, the Service and Treasury state that using liquidation value "better identifies whether a target corporation transfers property in exchange for stock than a rule that looks to the issuance or failure to issue stock, because, when the parties are related, the issuance or failure to issue stock might be meaningless." We appreciate the difficulties involved in transfers between wholly-owned entities. The transaction illustrated above in which the potential section 351 transaction involves more than a single shareholder is not an uncommon situation, however, and results from arm's length negotiations. Thus, the standard for measuring value should make sense in all section 351 transactions, not just those that occur between wholly-owned entities. We note that in determining whether a third party has "purchased" a target corporation, the Service and Treasury have acknowledged that a corporation may have value even where there is no net asset value.[32]

As discussed above, we do not believe it is necessary to employ a uniform rule for all tax-free transactions. The fact that liquidation value is the standard used in assessing whether a corporation has liquidated within the meaning of section 332 is not relevant to a potential section 351 contribution. We agree that in the context of a liquidation of a corporation, it may be appropriate to focus on the net asset value because the subsidiary's existence is permanently eliminated in the transaction, making it clear that the stock will not appreciate in time. In contrast, in a section 351 transaction, the corporation issuing the stock remains as a going concern and the owners of the corporation will benefit from future appreciation of the stock. Further, the Section 351 Net Value Receipt requirement, like the Section 351 Net Value Exchange requirement, when applied to fact patterns in which valuable stock is actually issued by the transferee in exchange for property, could be read to say that such stock is not "stock" within the meaning of the Code. The problems that could be created in the tax law as a result of such a reading are substantial.

We recommend that the Section 351 Net Value Receipt requirement be eliminated in final regulations. Our proposal, that section 351 applies if stock with economic value is received in the exchange, should protect the concerns underlying the Section 351 Net Value Receipt requirement, while recognizing that it is possible for a corporation to have value where there is no net asset value.

IV. REORGANIZATIONS (Other than Upstream Reorganizations)

Under existing law, two principal issues potentially impede the qualification of transactions involving insolvent corporations as reorganizations under section 368. First, certain types of reorganizations described in section 368 explicitly require an exchange of acquiring corporation stock for target corporation stock or assets.[33] Section 368(a)(1)(D) also appears to

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32 *See* Treas. Reg. § 1.338-3(b)(2) (recognizing that it is possible to have a "purchase" of stock notwithstanding that no amount may be paid for the stock). This rule, modified in the acquisition of T.D. 8940, Feb. 12, 2001, was adopted in order to allow a section 338 election to be made for a subsidiary that was technically insolvent.

33 Section 368(a)(1)(B) ("B reorganizations"), section 368(a)(1)(C) ("C reorganizations") and section 368(a)(2)(E) ("reverse triangular mergers") require the issuance of voting stock in exchange for the stock or assets transferred.

contain a stock exchange requirement for reorganizations described in that subsection ("D reorganizations") given its specific reference to section 354.[34] Where a section 354 exchange requirement applies, at least one target corporation stockholder or security holder must exchange its target corporation stock or securities for stock or securities of the acquiring corporation (or its parent) pursuant to the transaction. No explicit stock issuance requirement or reference to section 354, however, appears in the definition of either a section 368(a)(1)(A) reorganization (an "A reorganization") or a section 368(a)(2)(D) reorganization.[35] The Proposed Regulations disregard these differences in statutory language and effectively impose a stock exchange requirement for all reorganizations by requiring the transfer and receipt of net value by target corporations in all asset transactions and by target corporation shareholders in all stock transactions (the "Reorganization Net Value requirement").[36] The Preamble supports the position of the Reorganization Net Value requirement, at least in part, with an assertion that, under existing law, all reorganizations require an exchange of stock, suggesting that a valid reorganization requires a section 354 exchange.[37]

Second, all acquisitive reorganizations must satisfy the COI requirement, providing generally that the holders of a substantial part of the proprietary interests in the target corporation must receive proprietary interests in the "issuing corporation."[38] The issuing corporation is the corporation whose stock is issued in the transaction, whether that is the acquiring corporation or, in a triangular reorganization, the corporation in control of the acquiring corporation. In most cases involving insolvent corporations, particularly outside of a bankruptcy or formal insolvency

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34 *See* NYSBA 2003 Report, at 771-72. Section 368(a)(1)(D) states that a transaction qualifies as a D reorganization "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." We stated in the NYSBA 2003 Report that, despite the statutory language, we do not believe that Congress intended a section 354 exchange requirement for D reorganizations. Furthermore, in the NYSBA 1985 Report, we recommended that, given the legislative history, proposed regulations provide that no section 354 exchange requirement exists in a G reorganization. *See* NYSBA 1985 Report, § II.

35 *See* NYSBA 2003 Report, at 772.

36 *See* Prop. Reg. § 1.368-1(f).

The Proposed Regulations continue the recent trend of excepting E and F reorganizations from selected non-statutory reorganization requirements by excluding these transaction forms from the net value requirement. We believe that this exclusion is appropriate in light of the recent elimination of COI and COBE requirements for E and F reorganizations and the similar policy considerations underlying the net value requirement and the COI and COBE requirements. T.D. 9182, 70 Fed. Reg. 9219 (2005); Treas. Reg. § 1.368-1(b).

37 *See* REG-163314-03 (Mar. 10, 2005) (citing section 354 in connection with the statement that the principles of section 332, which require a distribution of assets in respect of stock of the liquidating company, apply to reorganizations under section 368).

38 *See* Treas. Reg. § 1.368-1(e)(1). A proprietary interest in the target corporation is also preserved to the extent that the target shareholder continues its investment in target (*i.e.*, the shareholder does not participate in the reorganization) or, in the case of upstream transactions, stock in the target corporation is exchanged for a direct interest in the assets of the target corporation.

proceeding, whether the shareholders constitute the owners of the proprietary interests or whether some or all of the creditors constitute the owners is not entirely clear, both as a legal and economic matter. The Proposed Regulations clarify the circumstances in which a continuity-giving proprietary interest will be preserved in the hands of a creditor.[39]

A. The Reorganization Net Value Requirement

The Reorganization Net Value requirement would require both a transfer and a receipt of net value by the target corporation in a purported reorganization. For asset reorganizations, the target corporation must transfer assets with a fair market value greater than the sum of the amount of liabilities assumed in the transaction by the acquiring corporation and the amount of boot received in the transaction.[40] Liabilities owed to the acquiring corporation that are extinguished in the transaction are treated as liabilities assumed in the transaction.[41] Thus, a merger of an insolvent target corporation into its sole creditor would not satisfy the Reorganization Net Value requirement.[42]

Stock reorganizations require a different formulation of the Reorganization Net Value requirement because the target corporation does not transfer assets. For B reorganizations and reverse triangular mergers, the Proposed Regulations provide that the fair market value of target corporation's assets must exceed the sum of the fair market value of boot received in the exchange and the amount of the target corporation's liabilities immediately prior to the exchange.[43] In contrast to the formula for asset reorganizations, liabilities extinguished in putative stock reorganizations generally do not reduce the fair market value of assets transferred.[44]

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[39] *See* Prop. Reg. § 1.368-1(e).

[40] Prop. Reg. § 1.368-1(f)(2). NQPS is not treated as boot for purposes of determining whether net value is transferred. *See* Prop. Reg. § 1.368-1(f)(2)(i) (providing that property received does not include stock permitted to be received under section 361(a) without the recognition of gain, which includes NQPS). Note that this treatment is different from the treatment of NQPS in the Section 351 Exchange requirement.

[41] *See* Prop. Reg. § 1.368-1(f)(2)(i).

[42] *See* Prop. Reg. § 1.368-1(f)(5), Ex. 5 (providing that insolvent target corporation's merger into acquiring corporation that holds all of the target corporation debt and 70% of its stock did not satisfy the Reorganization Net Value requirement because the liabilities of target corporation were treated as assumed by acquiring corporation).

[43] *See* Prop. Reg. § 1.368-1(f)(3)(i). The Reorganization Net Value requirement also allows the receipt of NQPS to qualify as other than boot.

[44] *See* Prop. Reg. § 1.368-1(f)(3)(i). *See also*, Prop. Reg. § 1.368-1(f)(5), Ex. 9 (providing that securities exchanged for stock of the acquiring corporation pursuant to a potential B reorganization did not prevent the transfer of net value).

The Proposed Regulations also provide a special rule for acquisitive D reorganizations because D reorganizations need not include stock consideration.[45] Under this special rule, a target corporation transfers net value if the fair market value of the target corporation assets transferred to the acquiring corporation exceeds the amount of target corporation liabilities immediately before the transaction.[46] Under this modified formulation of the Reorganization Net Value requirement, an all-cash transaction could continue to qualify as a D reorganization.

Finally, the Proposed Regulations also require that a target corporation or target shareholders receive stock with net value in both asset transactions and stock transactions.[47] For this purpose, stock has net value if the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.[48] Thus, the issuing corporation must be solvent after the transaction.

The Reorganization Net Value requirement does not preclude an insolvent corporation from participating in a reorganization under all circumstances. For example, a corporation that is not the primary creditor of the insolvent target corporation may acquire an insolvent corporation, in which case the target corporation generally would transfer the consideration received from the issuing corporation to its creditors.[49] Further, the Proposed Regulations would not prevent an insolvent corporation's acquisition of a solvent target corporation if the acquiring corporation becomes solvent as a result of the transaction.[50]

We believe that the Reorganization Net Value requirement adds unnecessary complexity and, in some cases, leads to inappropriate results. A majority of our members believe that the modified COI requirement in the Proposed Regulations would generally implement the policies stated by the Service and Treasury in the Preamble. In contrast to the Proposed Regulations, however, the majority position would preserve the holding of *Norman Scott, Inc. v. Comm'r*,[51] which did not recognize an exchange requirement for reorganizations involving commonly controlled insolvent corporations. The majority believes that the Proposed Regulation's clarification of the COI requirement provides a clear and rational rule without jeopardizing the

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45 *See* Rev. Rul. 70-240, 1970-1 C.B. 81; Rev. Rul. 2004-83, 2004-32 I.R.B. 157; *James Armour, Inc. v. Comm'r*, 43 T.C. 295 (1967).

46 *See* Prop. Reg. § 1.368-1(f)(4).

47 *See* REG-163314-03 ("This rule ensures that the target corporation receives stock (or is deemed to receive stock under the 'meaningless gesture' doctrine) having value. This rule is necessary because the IRS and the Treasury Department believe that the receipt of worthless stock in exchange for assets cannot be part of an exchange for stock.") (Mar. 10, 2005).

48 *See* Prop. Reg. § 1.368-1(f)(2)(ii), (3)(ii).

49 Of course, all other reorganization requirements must be satisfied. In this case, the COBE and COI requirements might be problematic.

50 *See* Prop. Reg. § 1.368-1(f)(5), Ex. 5 (providing that an insolvent corporation's acquisition of a solvent corporation's assets in exchange for insolvent acquiring corporation stock is treated as a transfer of net value where the acquiring corporation's assets exceeded its liabilities immediately after the transaction).

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

integrity of the reorganization provisions and questions whether the Reorganization Net Value requirement is supportable as a matter of law. Consequently, the majority does not believe that establishing this additional requirement is warranted or advisable and recommends that the Reorganization Net Value requirement be abandoned. In light of the fact that the Preamble discussion of the exchange requirement has created the issue of whether such a requirement is already part of the law, the majority further recommends that the Service and Treasury issue published guidance clarifying that no exchange requirement will be imposed on sideways reorganizations outside the bankruptcy context.[52]

1. Potential Effects of Adding an Exchange Requirement Through the Net Value Requirement

In examining the effects of the Reorganization Net Value requirement, we find that the requirement creates anomalies as well as denies tax-free treatment for certain transactions that satisfy the policies underlying the reorganization provisions. Consequently, the Reorganization Net Value requirement may deter legitimate business transactions.

The Proposed Regulations generally measure the transfer or receipt of value, and, thus, the qualification of a transaction as a reorganization, by the excess of the fair market value of assets over the amount of liabilities plus boot. Many legitimate corporate transactions, however, are effected based upon broader definitions of value, including potential value or option value. The Proposed Regulations do not recognize potential value or option value, even though stock with potential value or option value is generally not worthless for other purposes, including section 165(g).[53] Assume, for example, corporation T, which has assets with a fair market value

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52 A significant minority of our members, however, disagrees with the recommendations of the majority. While the minority concurs that the COI requirement insures that an arm's length transaction will be afforded tax-free treatment only if stock with value is actually exchanged in the transaction, the minority believes that the COI requirement may not provide adequate protection in respect of transactions involving commonly controlled insolvent corporations. In this context, COI may be satisfied through the common control without an issuance of acquiring corporation stock. Thus, under the majority's proposal, if an insolvent target corporation is merged into a commonly controlled acquiring corporation, the transaction would qualify as a tax-free reorganization regardless of whether the acquiring corporation transferred acquiring corporation stock to the target corporation. The minority of our members believes that, in certain circumstances, this case should not be characterized as a tax-free reorganization and accordingly supports some formulation of a net value requirement. Similar to the proposal made for section 351 transactions, the minority would propose that stock with value must be exchanged in order for a reorganization to qualify under section 368, unless the special rule relating to D reorganizations under the Proposed Regulations applies. The minority supports eliminating the requirement in the Proposed Regulations that the target corporation or target shareholders transfer assets or stock with a fair market value that exceeds the amount of liabilities and boot. (The majority notes that Revenue Ruling 70-240, 1970-1 C.B. 81, Revenue Ruling 2004-83, 2004-32 I.R.B. 157, and *Armour v. Comm'r,* 43 T.C. 295 (1967) allow similar transactions to qualify as D reorganizations without the issuance of acquiring corporation stock.)

53 *See, e.g., Corona v. Comm'r,* T.C. Memo 1992-406. The Proposed Regulations apply a strict calculation of the fair market value of assets transferred (or, in the case of stock transactions, assets held immediately before the transaction) and the amount of liabilities assumed (or, in the case of

of $100x and liabilities of $160x, is clearly insolvent, but T stock trades on an established securities market. Due to speculation on the potential of T to rebound, T stock trades at a price that represents an aggregate value of $15x for T. Corporation S has assets with a fair market value of $200x and no liabilities. S stock also trades on an established securities market at a price that represents an aggregate value of $200x for S. The S board of directors determines that T is an attractive target. T merges into S pursuant to which S acquires all of the assets of T in exchange for S stock with an aggregate fair market value of $15x and the assumption of T's $160x of liabilities. Because the amount of T liabilities assumed by S exceeded the fair market value of T's assets transferred to S, the merger does not satisfy the Reorganization Net Value requirement. Accordingly, the transaction could not qualify for tax-free reorganization treatment under the Proposed Regulations, despite its legitimate business purpose and satisfaction of all other reorganization requirements.

Similarly, the Proposed Regulations overlook value based on potential synergies. If corporation X is insolvent but engages in a business that is complimentary to the business of corporation Y, which is also insolvent, the combination of the two corporations into a single corporation would likely fail the Reorganization Net Value requirement, even if the value of the combined enterprise exceeds the liabilities.[54] Clearly such a combination represents a legitimate business combination that the reorganization provisions should encourage.

In the case of asset transactions involving insolvent corporations, the combination of a Reorganization Net Value requirement and the suggestion by the Service and Treasury that a valid reorganization requires a section 354 exchange can reach anomalous results. Because in the case of asset reorganizations the Reorganization Net Value requirement applies only at the corporate level and not at the shareholder or creditor level, a potential reorganization can satisfy the Reorganization Net Value requirement even though the shareholders or security holders receive no stock. For example, consider the merger of an insolvent target corporation, with only short term debt outstanding (*i.e.*, not "securities" for purposes of section 354), into a solvent acquiring corporation that does not assume the debt. In the transaction, the debt holders receive acquiring corporation stock and the target corporation stock is cancelled for no consideration. If the acquiring corporation is solvent immediately after the merger, the transaction clearly would satisfy the Reorganization Net Value requirement. However, since only short term debt holders receive acquiring corporation stock and no shareholders or security holders receive acquiring corporation stock, no exchange under section 354 occurs and a section 354 exchange requirement would not be satisfied.[55] Thus, the Reorganization Net Value requirement serves no function apart from the section 354 requirement suggested by the Service and Treasury and on

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stock transactions, liabilities immediately before the transaction). This calculation would omit option value.

54 For example, corporation X has liabilities of $80x and an operating business that would generate $50x if sold. Corporation Y has $60x of liabilities and an operating business that would generate $40x if sold. However, due to the complimentary nature of the businesses and such synergistic factors as streamlined operations, a combination of the businesses would produce an aggregate value of $160x, which exceeds the combined liabilities of $140x.

55 Although the creditors may be treated as proprietary interest holders for purposes of the COI test, as described below, they are generally not treated as stockholders. *See Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

balance adds unwarranted complexity and uncertainty to the determination of whether a transaction qualifies as a reorganization.[56]

2. Authority for the Reorganization Net Value Requirement

As authority and as a policy basis for the Reorganization Net Value requirement, the Service and Treasury rely on the existence of a section 354 exchange requirement and, similarly, a section 361 exchange requirement for all reorganization transactions to which the Reorganization Net Value requirement applies.[57] The Proposed Regulations would ensure an exchange requirement through the addition of the Reorganization Net Value requirement.[58] For A reorganizations and potentially D reorganizations, we do not believe that the Code or the case law generally requires that there be an exchange under section 354 or section 361, and we believe that the addition of one with the Reorganization Net Value requirement would unnecessarily complicate the reorganization requirements.

The existence of a section 354 or section 361 exchange requirement (generally, referred to as the "exchange requirements") depends upon whether the provisions of sections 354 and 361 are definitional, in the sense that they impose a requirement that must be satisfied in order to qualify as a reorganization, or merely descriptive, in the sense that they affect the tax treatment of the participants of a transaction otherwise qualifying as a reorganization. The issue arises only in transactions involving insolvent corporations and certain D reorganizations.[59] In a typical transaction, there is no question that an exchange of stock or securities occurs.

The Preamble references the language of section 354 and section 361 and cites Revenue Ruling 59-296 for its position that the sections are definitional. As the Preamble states, each of sections 354 and 361, two of the primary nonrecognition provisions for reorganization transactions, require that target corporation stock or securities (in the case of section 354) or target corporation property (in the case of section 361) must be exchanged solely for stock or securities of the acquiring corporation (or its parent) in order to avoid recognition of gain or loss. The Preamble compares this language with the language of section 332, which conditions

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[56] Both the majority's proposal to eliminate the Reorganization Net Value requirement and the minority's proposal to modify the Net Value requirement to provide only that stock with value be exchanged for the target corporation's stock or assets would address these identified problematic cases.

[57] The Preamble states that the net value requirement resolves uncertainties in the relevant authorities, which the Preamble cites as a conflict between Revenue Ruling 59-296, 1959-2 C.B. 87, and *Norman Scott, Inc. v. Comm'r*, 48 T.C. 598 (1967). *See* REG-163314-03.

[58] As the Preamble states, "[t]his rule ensures that a target corporation transfers property in exchange for stock," as required by section 361. The Proposed Regulations similarly incorporate a section 354 exchange requirement for stock transactions. In addition, the Proposed Regulations would require that the issuing corporation in a reorganization be solvent immediately after the transaction, which, according to the Service and Treasury, ensures that the stock received will not be "worthless."

[59] Revenue Ruling 70-240, 1970-1 C.B. 81, Revenue Ruling 2004-83, 32 I.R.B. 157, and *Armour v. Comm'r*, 43 T.C. 295 (1967), provide that an all-cash transaction may qualify as a D reorganization, thus raising the issue of whether an exchange of stock has occurred.

nonrecognition treatment to the parent corporation on the liquidation of its subsidiary corporation on the distribution of property in complete cancellation or redemption of the subsidiary corporation's stock, and section 351, which conditions nonrecognition treatment to a transferor of property to a controlled corporation on the receipt of stock of the transferee corporation.

Despite the similarity of the language, however, the statutory framework of sections 354 and 361 is significantly different than that of sections 332 or 351.[60] Section 368 provides the exclusive definitions for the nine types of reorganizations. The only types of reorganizations that reference section 354 are D reorganizations and reorganizations described in section 368(a)(1)(G) ("G reorganizations"). As discussed in our prior reports, we continue to believe that, even in the G reorganization and D reorganization contexts, a section 354 exchange requirement does not clearly exist.[61] Moreover, neither the language of section 354 nor section 361 suggests that the relevant section imposes an additional requirement for reorganization qualification. In fact, each provision applies if and only when a valid reorganization has occurred.[62] As an indication of this, in enacting section 351(g), Congress made clear that a transaction in which only NQPS is received by target corporation shareholders may qualify as a reorganization even though section 354 will not apply to the transaction.[63]

The Preamble also compares the reorganization provisions to the provisions of section 332 in connection with its discussion of Revenue Ruling 59-296. In Revenue Ruling 59-296, a solvent corporation owned all of the stock and debt of its insolvent subsidiary corporation, which merged into the solvent parent corporation. The Service held that, because the amount of the subsidiary corporation's liabilities exceeded its assets, the asset transfer occurred entirely with respect to the indebtedness and no amounts were received in respect of the subsidiary corporation stock. As a result, the merger did not qualify as either a nontaxable distribution under section 332 or an A reorganization. A distribution under section 332 generally requires at least a partial distribution in respect of the stock of the liquidating subsidiary.[64] As described in the Preamble, the Service and Treasury interpret Revenue Ruling 59-296 as holding that this principle also applies to reorganizations.

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60 In contrast, section 332 and section 351 do not rely on a separate definitional provision in the same manner. Although the application of section 332(a) depends upon the existence of a "complete liquidation" which is defined in section 346, section 332(b) also provides a definition of complete liquidation. Section 351 is generally not dependent upon definitional terms.

61 The reference in section 368(a)(1)(G) to the transfer or distribution of stock or securities of the acquiring corporation in a transaction that qualifies under section 354, 355, or 356 appears intended to incorporate the provisions of section 354(b). Nevertheless, the Service has required in its private letter rulings involving G reorganization representations that at least one shareholder or security holder of the transferor receive stock or securities of the acquiring corporation. *See, e.g.,* P.L.R. 98-41-006 (Oct. 9, 1998); P.L.R. 92-17-040 (April 25, 1997). See discussion in NYSBA 2003 Report and NYSBA 1985 Report.

62 The application of each of section 354 and section 361 is limited to "parties to a reorganization." *See* I.R.C. §§ 354(a)(1), 361(a).

63 Pursuant to section 354(a)(2)(C), NQPS received in exchange for stock other than NQPS is not treated as stock or securities for purposes of section 354.

64 *See* Treas. Reg. § 1.332-2(b); *H.G. Hill Stores, Inc. v. Comm'r*, 44 B.T.A. 1182 (1941).

As an initial matter, we note that a Revenue Ruling is simply the position of the Service. Even assuming that Revenue Ruling 59-296 has precedential authority, however, this reading would seem to us to extend significantly the holding of Revenue Ruling 59-296. The Revenue Ruling includes very little reasoning, and the reasoning that it does include closely tracks the statutory language of section 332 rather than that of section 368.[65] It provides no clear rationale for the failure of the merger to qualify as an A reorganization. In addition, the facts of the Revenue Ruling present a very specific situation—an upstream merger—that does not necessarily provide guidance for other reorganization forms.[66]

The Preamble concedes that case law does not support the Service and Treasury's reading of Revenue Ruling 59-296 and mentions *Norman Scott, Inc. v. Comm'r*[67] as the most notable case to the contrary.[68] In *Norman Scott*, two insolvent sister corporations merged into a third sister corporation. Two shareholders (husband and wife) owned each of the corporations in equal proportion (99%/1%) and the principal shareholder was also a significant creditor of the two insolvent corporations. Each of the shareholders received stock of the acquirer in each merger. Among other things, the Service asserted that the mergers failed to satisfy the section 361 exchange requirement, arguing that there must be such an exchange of stock for the transaction to qualify as a reorganization. The Tax Court, however, refused to apply an exchange requirement to the A reorganizations. Later that year, the Service acquiesced in the result of *Norman Scott*, but disagreed with the court's rationale.[69] The Service argued that, despite no explicit statement in section 368(a)(1)(A) requiring an exchange of stock, the language of sections 354 and 361 and the relationship between sections 361 and 381[70] support its position that an exchange of stock is required.[71]

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65 Revenue Ruling 59-296 states that "[s]ince all of the property of the subsidiary is worth less than the debt, no part of the transfer is attributable to the stock interest of the parent." The transfer of subsidiary corporation property in respect of the subsidiary corporation stock is more akin to a section 332 distribution than a transfer of assets in exchange for stock or an acquiring corporation under section 368.

66 *See, e.g., Bausch & Lomb Optical Co. v. Comm'r*, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959) (acquisition of all of the assets of a 79% owned subsidiary corporation by the parent corporation in exchange for parent corporation stock followed by the distribution of the parent corporation stock to the parent corporation and the minority shareholders treated as a taxable liquidation). Treasury Regulation section 1.368-2(d)(4)(i) currently provides that the prior ownership of target corporation stock will not alone prevent qualification of a similar transaction as a reorganization.

67 *Norman Scott, Inc. v. Comm'r*, 48 T.C. 598 (1967).

68 *See* REG-163314-03 ("However, other authorities are not consistent with the approach of Rev. Rul. 59-296.") (Mar. 10, 2005).

69 GCM 33859 (June 25, 1968).

70 Section 381(a)(2) provides that the acquirer corporation succeeds to the tax attributes of the transferor corporation only in the case of a transfer to which section 361 applies.

71 GCM 33859 (June 25, 1968).

Additionally, in *Helvering v. Southwest Consolidated Corp.*,[72] the Supreme Court declined to apply an exchange requirement in the context of an insolvent corporation's reorganization. The court held that a purported reorganization did not satisfy the requirements of the predecessor to section 368(a)(1)(D) because only the creditors received stock of the transferee corporation. Although the creditors qualified as proprietary interest holders for purposes of the COI test, they did not constitute shareholders. Consequently, the same shareholders were not in control of the target corporation both before and after the transfer. The Court's analysis of the creditors' status was necessary only because the Court did not apply an exchange requirement.

We appreciate the similarities between section 332 and the reorganization provision in the upstream context and, as discussed below, we believe that requiring an exchange in this context for reorganizations may be important to support the section 332 policies. We do not think, however, that section 332 policy justifies the extension of a net value/exchange requirement to sideways reorganizations and do not believe that Revenue Ruling 59-296 should form the basis of the Reorganization Net Value requirement in light of contrary case law.

3. The Unifying Standard

The Service and Treasury represent a desire to establish a standard that unifies and rationalizes the application of the subchapter C nonrecognition rules to insolvent corporation transactions.[73] Although these are worthy goals for any regulatory project, we question whether these goals are consistent with the current state of the subchapter C nonrecognition provisions, and the reorganization rules in particular. Neither Congress nor the Treasury has attempted to provide a more general unifying and rationalizing standard for the nonrecognition provisions of subchapter C outside of the insolvent corporation context, and we question why the Government would choose the limited context of insolvency transactions to propose a unifying standard for three very different sets of nonrecognition provisions.

The Preamble states that "[t]he IRS and the Treasury Department believe that the net value requirement is the appropriate unifying standard because it is more consistent with the statutory framework of subchapter C, case law, and published guidance than any other approach considered." If the Service and Treasury were considering these issues for the first time without the intervening law that has developed over the last decades, expanding the net value requirement beyond the confines of section 332 to the reorganization provisions might have merit.[74] However, each of the nonrecognition provisions has evolved separately over a

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72 *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), *reh'g denied*, 315 U.S. 829 (1942), *reh'g denied*, 316 U.S. 710 (1942).

73 *See* REG-163314-03 (Mar. 10, 2005).

74 Each of section 332, section 351, and sections 354 and 368 contain a similar statutory framework, and under each, assets generally enter corporate solution (or are transferred among corporations) in exchange for stock or securities, but the ultimate owners remain largely the same. In complete liquidations under section 332, assets are distributed in respect of, or transferred in redemption of the stock of the liquidating corporation in substantial part to the controlling corporate shareholder of the liquidating corporation. In transfers under section 351, the transferor generally exchanges property for stock of the transferee corporation (and, perhaps, other property) that the transferor and others

considerable period of time in a manner that reflects the different transactional forms and policy considerations, making a unified standard impractical.[75]

In addition, reorganization status is well protected by the judicially created doctrines of COI and COBE, which do not apply to section 332 or section 351 transactions. Further, while reorganizations clearly require a corporate business purpose in order to receive tax free treatment, section 332 does not require a business purpose and whether section 351 transactions require a business purpose is far from clear. As discussed above, the majority of our members believe that the Reorganization Net Value requirement does not appear to offer better safeguards against sale-like transactions qualifying as tax-free reorganizations than the COI requirement. The COI, COBE and business purpose requirements together adequately protect the reorganization provisions from this and other abuses without limiting legitimate business transactions.[76] Each of these non-statutory requirements is intended to ensure that a tax-free transaction represents merely a readjustment of a continuing interest in property held under modified corporate forms, and not a sale.[77] Assuming an arm's length transaction, the COI requirement should insure that an insolvent target corporation (or the target shareholders, in a stock transaction) will receive stock that is not worthless (*i.e.,* stock with value). Given arm's length dealings, the receipt of valuable stock presupposes an exchange of value and, thus, a transfer of value by the target corporation. If the Service and Treasury are concerned that parties may also engage in non-arm's length transactions, they can utilize various judicially created doctrines (*e.g*., "substance-over-form" and "step transaction") to prevent such taxpayer abuses. We believe that these broad doctrines provide the government with adequate tools to combat abusive transactions without the addition of the formal net value requirement.[78]

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control after the transfer. In asset reorganizations under section 368, one corporation generally transfers assets to another corporation in exchange for stock of the transferee corporation or its parent (and, perhaps, other property) and sufficient stock of the transferee corporation or its parent is distributed to the equity owners of the transferor corporation to maintain COI. Stock reorganizations present a slightly different form, since the assets remain in the target corporation, but the similarities remain.

75 For example, in the context of capitalizing intercompany liabilities to render a corporation solvent, Revenue Ruling 68-602, 1968-2 C.B. 135, generally provides that capitalization of debt owed by an insolvent liquidating subsidiary corporation to its parent corporation in connection with the liquidation will not be respected and, thus, will not render the subsidiary solvent for purposes of qualifying under section 332. By contrast, in the context of the reorganization provisions, Revenue Ruling 78-330, 1978-2 C.B. 147, generally provides that a parent corporation's capitalization of its subsidiary's debt will be respected in connection with the merger of the subsidiary corporation with another subsidiary corporation allowing the merged subsidiary to avoid the application of section 357(c).

76 *See* Treas. Reg. § 1.368-1(b), (d), and (e).

77 *See* Treas. Reg. § 1.368-1(b).

78 *See* Rev. Rul. 70-240, 1970-1 C.B. 81; Rev. Rul. 2004-83, 32 I.R.B. 157; *Armour v. Comm'r*, 43 T.C. 295 (1967).

4. Proposed Regulations' Example 9 and Revenue Ruling 59-222

In Proposed Regulation section 1.368-1(f)(5), Example 9, creditors holding insolvent target corporation securities exchange all of their securities for acquiring corporation voting stock, and the stockholders have their stock in the target corporation extinguished for no consideration. This example concludes that there is both a surrender and receipt of net value under the net value provisions applicable to B reorganizations – without otherwise commenting on the qualification of the transaction for reorganization treatment.

Based on its form, the transaction in the example technically fails to qualify as a B reorganization because the acquiring corporation does not acquire 80% control of the target corporation solely in exchange for its voting stock (or solely for voting stock of a parent corporation). Because none of the stockholders of the target corporation receives any stock of the acquiring corporation, the inclusion of this example can only be supported based on the application of Revenue Ruling 59-222.[79] In Revenue Ruling 59-222, the acquiring corporation issued part of its common stock to a bankrupt target corporation in exchange for newly issued target corporation common stock, which, following the execution of the plan of reorganization, constituted all of its outstanding common stock. The target corporation transferred the acquiring corporation stock to its creditors in satisfaction of their claims and cancelled its previously outstanding stock for no consideration. Viewing the creditors as the target corporation equity owners, the Service treated the creditors as exchanging their claims for target corporation stock in a recapitalization prior to the reorganization. As a result, the acquiring corporation was treated as acquiring all of the target corporation stock from the former creditors in exchange for acquiring company voting stock, resulting in a valid B reorganization.

We observe that our majority's recommendation to remove the Reorganization Net Value requirement would obviate the purpose for Example 9 and, thus, the need to consider the appropriateness of the example. We believe that Revenue Ruling 59-222 is inconsistent with the Supreme Court's holding in *Helvering v. Southwest Consolidated Corp.*,[80] in which an insolvent target corporation transferred its assets to a new acquiring corporation pursuant to a reorganization plan. Under the plan, the target corporation creditors received acquiring corporation common stock and the target corporation shareholders received acquiring corporation Class B warrants. The Supreme Court determined, among other things, that, because the target shareholders were not in control of the acquiring corporation immediately after the transaction, the transaction did not qualify as a reorganization under the predecessor to section 368(a)(1)(D). The Supreme Court declined to treat the target creditors as owning target "stock," despite the Supreme Court's companion decision in *Helvering v. Alabama Asphaltic Limestone Co.*,[81] which treated the creditors as "equity" holders for purposes of the COI requirement.[82]

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[79] Rev. Rul. 59-222, 1959-1 C.B. 80.

[80] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

[81] *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

[82] The court further declined to determine that the reorganization was a recapitalization under the predecessor to section 368(a)(1)(E), because it was not a "reshuffling of capital structure, within the framework of an existing corporation contemplated by the term 'recapitalization'."

The Service has sought to construe narrowly Revenue Ruling 59-222, apparently limiting the deemed two-step exchange to situations in which the taxpayer affirmatively sought its application.[83] To our knowledge, the Service has not issued any rulings applying Revenue Ruling 59-222 against the taxpayer's interest. In light of this background, we believe that the continued validity of Revenue Ruling 59-222 in debt-for-stock exchanges is suspect and that the inclusion of Example 9 in the Proposed Regulations—in what may very well be viewed as a regulatory codification of Revenue Ruling 59-222—is inappropriate and should be deleted. We suspect that the potential ancillary consequences of such an across-the-board application of the deemed two-step exchange have not been fully considered or addressed by Treasury, such as the possibility within the consolidated return context of a momentary deconsolidation.[84] When faced with the issue, the Service ignored the momentary deconsolidation without analysis.[85] Moreover, we believe that the deemed first-step recapitalization in Revenue Ruling 59-222 is inconsistent with, and undermines, the Supreme Court's determination in *Southwest Consolidated* that a creditor's claim does not itself constitute "stock" for purposes of the reorganization provisions. We also believe that it is inappropriate to rearrange a taxpayer's transaction in a manner that involves an equal number of steps where no abuse is present.[86] Consequently, if the Service and Treasury issue final regulations containing the Reorganization Net Value requirement, we recommend that any such regulations omit Example 9.

B. Continuity of Interest

To qualify as a tax-free reorganization, the owners of the proprietary interests in a corporation must establish that they have retained a sufficient continuing equity interest in the acquiring corporation.[87] The traditional purpose of the COI requirement is to confine tax-free reorganization treatment to those transactions that represent a substantial continuation of the equity interests of the target corporation[88] and, thus, to differentiate transactions that resemble

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83 *See* FSA, 1993 WL 1469500 (Sept. 22, 1993) (disregarding an actual two-step creditor exchange in a purported G reorganization and distinguishing Revenue Ruling 59-222 on the grounds that it did not involve an asset transfer); PLR 8914080 (Jan. 11, 1989) (taking the opposite position implicitly); PLR 8933001 (Aug. 22, 1988) (applying a deemed two-step creditor exchange where the transaction was originally intended to qualify as a B reorganization and the acquiring corporation was target corporation's insolvent parent); PLR 8852039 (Oct. 4, 1988) (involving an analogous fact pattern with a foreign parent corporation); PLR 9516025 (Jan. 18, 1995) (declining to apply a deemed two-step creditor exchange on similar facts).

84 Or the possibility that the second step exchange of debtor stock for acquiring corporation stock could give rise to an unexpected "reverse acquisition" under Treasury Regulation section 1.1502-76.

85 PLR 8933001 (Aug. 22, 1988).

86 *Cf.* Rev. Rul. 84-111, 1984-2 C.B. 88 (holding that taxpayers could choose between three alternative forms for incorporating a partnership, each having slightly different consequences but involving the same number of steps).

87 *See* Treas. Reg. § 1.368-1(e)(1).

88 *See, e.g.,* Treas. Reg. § 1.368-1(e)(1); *Cortland Specialty v. Comm'r*, 60 F.2d 937 (2d Cir. 1932); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935). *Cf.* Treas. Reg. § 1.1002-1(c).

sales from transactions that represent a readjustment of continuing interests.[89] In a typical reorganization, the shareholders own the proprietary target corporation interests and receive acquiring corporation shares and, thus, are the persons in respect of which COI is measured. Reorganizations involving insolvent, non-bankrupt corporations raise issues as to who holds the corporation's proprietary interests, in what circumstances proprietary interests shift from shareholders to creditors, and the extent to which a creditor's claim represents a proprietary interest. The G reorganization rules generally answer these questions for bankrupt target corporations, and the Proposed Regulations generally would extend these rules to reorganizations involving non-bankrupt, insolvent target corporations. We generally support that expansion; however, we recommend that final regulations clarify certain issues regarding the new COI rules.

1. Current Law

In certain circumstances, the courts have recognized that creditors can "step into the shoes" of the shareholders and become the proprietary (or "equity") owners of a target corporation for purposes of determining whether the COI requirement has been satisfied. The ability to look to creditors as the owners of the proprietary interests of a troubled target corporation recognizes that at some point the economics of such creditors' investments may shift, in whole or in part, to that of equity owners. However, the point at which that transition occurs is not entirely clear.

The Supreme Court in *Helvering v. Alabama Asphaltic Limestone Co.*,[90] the seminal case in this area, held that the creditors "stepped into the shoes" of the shareholders for COI purposes "not later than the time when the creditors took steps to enforce their demand against their insolvent debtor," which was the date bankruptcy proceedings were instituted.[91] Similarly, in *Palm Springs Holding Corp. v. Comm'r*,[92] the Supreme Court viewed creditors as the owners of the proprietary interests in the debtor corporation when a foreclosure action (as opposed to a bankruptcy proceeding) commenced. The critical fact was "that the old corporation was insolvent and that its creditors took steps to obtain effective command over its property."

In other cases, however, courts have found that COI is transferred to creditors even without a formal insolvency proceeding. For example, in each of *Sieberling Rubber Co. v. Comm'r*,[93] *Norman Scott, Inc. v. Comm'r*,[94] and *United States v. Adkins-Phelps, Inc.*,[95] the court

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89 *See* Treas. Reg. § 1.368-1(b).

90 *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

91 In that case, all of the stock of the acquiring corporation was received by noteholders and other creditors of the insolvent corporation in an involuntary bankruptcy proceeding. The Supreme Court held that the continuing equity interest of the insolvent corporation's creditors in the acquiring corporation satisfied the COI requirement. The Court stated that the creditors, by virtue of their right under the bankruptcy laws to "absolute priority" over the shareholders, had "stepped into the shoes" of the shareholders for COI purposes.

92 *Palm Springs Holding Corp. v. Comm'r*, 315 U.S. 185 (1942).

93 *Sieberling Rubber Co. v. Comm'r*, 169 F.2d 595 (6th Cir. 1948).

94 *Norman Scott, Inc. v. Comm'r*, 48 T.C. 598 (1967).

found that the COI requirement was satisfied despite a lack of any formal proceeding. However, in each case a major creditor receiving stock of the acquiring corporation was also a major shareholder. Thus, it is not clear whether a formal proceeding is required where the ownership of the target corporation's debt and stock does not overlap.

When a target corporation's creditors hold proprietary interests, one must determine which classes of creditors are treated as holding such interests. In *Atlas Oil & Refining Corp. v. Comm'r*,[96] the court effectively adopted a "relation back" approach to identify which creditors should be treated as the equity owners for COI purposes. The court explained that "[w]hile 'effective command' over the properties in an insolvency proceeding is necessary to transform the creditors into equity owners to satisfy continuity of interest, the fact that a protected class may have had 'effective command' over the assets in such proceedings will not make them equity owners for participation purposes if they do not in fact exercise their right to participate in the equity distribution of the new corporation."[97] Consequently, only the creditors that received stock of the acquiring corporation were treated as holding proprietary interests in the insolvent target corporation.

The Bankruptcy Tax Act of 1980 (the "1980 Act") clarified these issues for bankruptcy transactions and other similar cases, *e.g.*, receivership and foreclosure proceedings. In the 1980 Act, Congress embraced the principles of *Alabama Asphaltic* and the practicality of the "relation back" approach of *Atlas Oil* in connection with the enactment of a new G reorganization provision. Although the G reorganization provisions do not specifically address COI, the corresponding legislative history suggested a relaxation of the COI requirement for G reorganizations.[98] Congress stated its expectation that the courts and Treasury would generally test COI in a potential G reorganization by treating the most senior class of creditors who received stock, together with all interests equal and junior to them (including shareholders) as the holders of the proprietary interests in the corporation.[99] In furtherance of this directive, the

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95 *United States v. Adkins-Phelps, Inc.*, 400 F.2d. 737 (8th Cir. 1968).

96 *Atlas Oil & Refining Corp. v. Comm'r*, 36 T.C. 675 (1961).

97 *Id*. at 688 (emphasis in original). The Tax Court also stated that "practical adjustments" that might result in technical violations of the absolute priority rules—such as lowering the interest rates on senior debt where junior creditors are also allowed to participate—will not destroy COI, at least if the "unjustified" participation of the junior creditors can be described as "insubstantial."

98 *See* S. Rep. No. 96-1035 (1980). Such relaxation is consistent with the purpose of the G reorganization, which is designed "to facilitate the rehabilitation of corporate debtors in bankruptcy" and "to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions." S. Rep. No. 96-1035 (1980).

99 Congress stated:

> We expect that the courts and Treasury will apply COI rules to G reorganizations that take into account the modification by the Bankruptcy Reform Act of 1978 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

Service has issued several letter rulings employing the approach described in the legislative history.[100]

Congress, however, did not address the proper application of the COI requirement in the context of purported tax-free reorganizations of insolvent corporations under other (non-G) reorganization provisions. Thus, in the non-bankruptcy context, COI issues remained.

2. COI Provisions of Proposed Regulations

To a large extent, the Proposed Regulations extend the concepts of the 1980 Act legislative history to the non-bankruptcy context. The Proposed Regulations clarify the circumstances in which creditors are treated as holding proprietary interests, the types of creditors that are treated as holding proprietary interests, and the extent to which those creditors' claims are treated as proprietary interests. The provisions apply equally to transactions involving formal proceedings and transactions undertaken without such proceedings, resulting in a unified approach to the treatment of creditors in insolvency and bankruptcy reorganizations.

The Proposed Regulations adopt the "relation back" approach of *Atlas Oil*, and specifically provide that if (i) the debtor corporation is insolvent or is in a bankruptcy or similar insolvency proceeding, and (ii) any class of creditors of the debtor receives stock of the acquiring corporation in exchange for its claims, then every claim of that class and all equal and junior classes (in addition to the interests of shareholders) constitutes a proprietary interest in the debtor immediately prior to the potential reorganization.[101]

The Proposed Regulations also provide specific rules for determining the portion of a creditor's claim that is treated as a proprietary interest in the target company:

Bifurcating Senior Claims. For the most senior class of claims receiving stock and all equal classes, the Proposed Regulations bifurcate the claim, treating only a portion of the claim as representing a proprietary interest. The Proposed Regulations apply a two-step process. First, one determines the percentage of total consideration received by such senior creditors that is received in the form of acquiring corporation stock. For example, if such senior class of

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For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

S. Rep. No. 96-1035, 96th Cong. 2d Sess. 36-37 (1980).

[100] *See, e.g.,* PLR 8521083 (Feb. 27, 1985); PLR 8503064 (Oct. 24, 1984); PLR 8909007 (Nov. 30, 1988).

[101] Prop. Reg. § 1.368-1(e)(6).

creditors received, in the aggregate, $40 cash and $60 stock, the percentage would be 60%. Second, one applies that percentage to the fair market value of each claim in that class to determine the portion of each claim that represents a proprietary interest in the target corporation. Thus, if the fair market value of a creditor's claim were $30, based on the facts above, the claim would represent a proprietary interest of $18 (60% X $30). The creditor retains a proprietary interest to the extent the creditor receives stock of the acquiring corporation. As a result, any stock received in respect of a senior claim is effectively allocated first to the portion of the claim representing a proprietary interest. Consequently, if each creditor of the senior class receives the same proportion of stock, the proprietary interest of the entire class will be retained regardless of any cash or other property received.[102] As observed in the Preamble, if each senior claim receives the same proportionate amount of stock and non-stock (apparently regardless of how small the actual percentage of stock received) and no junior claim is satisfied with non-stock, there will be 100% COI.[103]

Value of Proprietary Interest. The Proposed Regulations generally provide that the value of the proprietary interest a creditor is treated as holding is "the fair market value of the creditor's claim,"[104] which the Preamble explains is "*generally*" determined by reference to the amount of money and the fair market value of other consideration received in respect of the claim.[105] Thus, each junior creditor class and the shareholders' interests "*generally*" represent proprietary interests to the extent of consideration received in the transaction.

Bifurcation of Partially Secured Claims. The Proposed Regulations recognize the bifurcation of partially secured creditor claims.[106] In the bankruptcy context, for example, Bankruptcy Code section 506 provides generally that an under-secured creditor's claim will be treated as a secured claim only to the extent of the value of the creditor's lien or secured interest in the debtor's property; the remaining allowed claim is treated as an unsecured claim. Pursuant to this bifurcation, the creditor's single claim becomes two claims of different priorities. The Proposed Regulations take the pragmatic position that any bifurcation of a creditor's claim, whether pursuant to a bankruptcy or similar proceeding or by agreement of the parties, will be respected for purposes of determining COI.

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[102] *See* Prop. Reg. § 1.368-1(e)(7), Ex. 10.

[103] REG-163314-03 (Mar. 10, 2005).

[104] Prop. Reg. § 1.368-1(e)(6)(ii).

[105] REG-163314-03 (Mar. 10, 2005). COI requires that a substantial portion of the value of the proprietary interests of the target corporation must be retained. Treas. Reg. § 1.368-1(e)(1). Consequently, the value of the proprietary interest is a crucial factor in determining COI. Like creditors' claims, the shareholders' interests represent a proprietary interest to the extent of their fair market value. *Id.* The insolvency of the target corporation does not necessarily mean that the stock has no value. The Proposed Regulations specifically provide that the treatment of creditors' claims as representing a proprietary interest does not prohibit the shareholders' interests from also representing a proprietary interest. Prop. Reg. § 1.368-1(e)(6)(iv).

[106] "Partially secured creditor claims" are secured creditor claims for which the value of the collateral is less than the amount of the claim allowed.

Pre-Reorganization Distributions. The Proposed Regulations contain a provision similar to the provision of the existing regulations treating any redemption of or distribution on target corporation stock made or received in connection with the transaction as affecting the COI retained in the transaction.[107] The Proposed Regulations' provision does not, however, require a connection between a payment to creditors and the transaction. The Proposed Regulations would take into account for creditor continuity purposes *any* payments made to the creditor prior to the potential reorganization—without regard to any apparent connection between the payment and the transaction—where the creditor owned a proprietary interest under the creditor COI rules (or would be treated as owning a proprietary interest if the payment was made in the transaction).[108]

Merging into the Creditor. As discussed, the Proposed Regulations distinguish, for purposes of the Reorganization Net Value requirement, between the treatment of a creditor directly receiving assets as a repayment of its claim and a creditor receiving acquiring corporation stock. The Proposed Regulations effectively adopt this same distinction for purposes of the COI requirement, treating only a claim in respect of which a creditor receives a proprietary interest in the acquiring corporation (*i.e.*, stock) as constituting a proprietary interest.[109] This should be contrasted with the situation in which an acquiring corporation owns a significant portion of the target corporation stock and the target corporation merges into the acquiring corporation. In that context, the existing COI regulations make clear that the portion of the assets received by the acquiring corporation in respect of its pre-existing stock interest in the target corporation qualifies for COI purposes.[110]

3. Comments and Recommendations

We generally agree with the approach taken by the Service and Treasury in the Proposed Regulations to address COI in the context of troubled companies. This approach implements the legislative history to Bankruptcy Tax Act of 1980 with respect to G reorganizations and, significantly, extends such approach to all the reorganization provisions both within and outside of bankruptcy in the case of insolvent target corporations. We believe that the general bias of the

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107 Treas. Reg. § 1.368-1(e)(1)(ii) ("[A] proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved to the extent that consideration received prior to a potential reorganization, either in a redemption of the target corporation stock or in a distribution with respect to the target corporation stock, is treated as other property or money received in the exchange for purposes of section 356, or would be so treated if the target shareholder also had received stock of the issuing corporation in exchange for stock owned by the shareholder in the target corporation.").

108 Prop. Reg. § 1.368-1(e)(1)(ii).

109 Prop. Reg. § 1.368-1(e)(6)(i). The Proposed Regulations do not explicitly address the treatment of an acquiring creditor corporation satisfying COI through the receipt of assets on its claim, although by negative implication it appears relatively clear that such transfer does not count toward COI and, in fact, counts against COI.

110 *See* Treas. Reg. § 1.368-1(e)(1) ("A proprietary interest in the target corporation is preserved if, in a potential reorganization, [i] it is exchanged for a proprietary interest in the issuing corporation . . . , [ii] *it is exchanged for a direct interest in the target corporation enterprise*, or [iii] it otherwise continues as a proprietary interest in the target corporation," emphasis added.).

COI provisions of the Proposed Regulations toward facilitating tax-free reorganizations is appropriate.[111]

We note that, under a strict reading of *Alabama Asphaltic* and its progeny, one might argue that, absent the institution of formal proceedings, creditors should not be counted for COI purposes.[112] Nevertheless, we believe that such expansion is consistent with Congress's modified approach to creditor COI in the 1980 Act in light of the relaxation of the absolute priority rule following the revisions of the bankruptcy laws in 1978. As modified, a negotiated consensual restructuring may be implemented to similar effect either in court or out-of-court (depending on the extent of creditor participation in the out-of-court restructuring).[113]

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[111] We recognize, however, that the creditors' ability to utilize such tax benefits has been significantly restricted since the 1980 Act due to, among other things, the repeal of the "stock-for-debt exception" to cancellation of debt income and the 1986 changes to section 382. As a result, debtor and creditors alike often find it more advantageous to structure a "taxable" two-company transaction (that is, a transaction that intentionally fails the tax-free reorganization provisions) in order to obtain a fresh "fair market value" tax basis in the debtor's assets, the utility of which is not constrained by section 382 and is unaffected by any attribute reduction from the cancellation of debt. Such transactions are in keeping with the long-recognized ability effectively to structure a transaction outside of the tax-free reorganization provisions.

[112] Although the Supreme Court in *Alabama Asphaltic* technically left open the potential for earlier events to trigger a shift of proprietary interests to creditors, the courts have generally required formal enforcement or insolvency proceedings. The only situations in which formal proceeds have not been required involve significant shareholder/creditor overlap. In such situations, it may be argued that the imposition of formal proceedings would have been a mere formality, although it is not clear what weight (if any) the respective courts placed on the relative priority of the shareholder's debt claim.

[113] In other areas, Congress has, from time to time, recognized that an out-of-court restructuring may be equally deserving of special treatment. Thus, for example, in the Deficit Reduction Act of 1984, when Congress restricted the general availability of the stock-for-debt exception to cancellation of debt income to either corporations in bankruptcy, or to non-bankrupt insolvent corporations *but only* to the extent of their insolvency, it initially included a "qualified workout" exception under which an insolvent corporation could obtain full benefit of the stock-for-debt exception even outside bankruptcy regardless of the extent of its insolvency. *See* Section 108(e)(10)(C), as in effect prior to the Tax Reform Act of 1986 (wherein this provision was repealed without explanation). The analogy to the stock-for-debt exception begs the question whether in the insolvency context where no formal proceedings have been implemented the application of creditor COI should employ a "to the extent of insolvency" type standard. In such event, only those classes of creditors that would not be paid in full upon a hypothetical liquidation would be counted as equity owners for COI purposes. We believe that such an approach, however, would exacerbate valuation disputes with no appreciable benefit over the more practical "relation back" approach of generally taking into account the classes of creditors actually receiving stock, and all equal and junior classes. The rejection of such an approach, however, creates a "cliff" effect whereby one dollar ($1) of insolvency may have a dramatic effect on the measurement of continuity. Accordingly, it is important that the Service and Treasury adopt objective rules for the computation of a corporation's insolvency for this purpose, which is discussed in more detail in Part VI. We note that such valuation rules are only necessary in the case of the net value requirement if our proposal for a more simplified approach is rejected. Nevertheless, such valuation rules would still be necessary for creditor COI purposes, but only in non-title 11 or similar cases.

Although we generally support the adoption of the COI provisions of the Proposed Regulations, we offer the following comments and recommendations to improve the rules as proposed.

Priority Claims. Under the Bankruptcy Code, certain unsecured claims are granted a priority and, as a pre-condition to confirmation of the debtor corporation's plan of reorganization by the bankruptcy court, must be paid in full in cash (although, in certain cases, such payments may be made in installments) pursuant to the plan of reorganization – even if doing so would mean that secured creditors must receive stock.[114] As a result, in the context of a bankruptcy reorganization, priority creditors should almost never acquire an interest in the equity of the debtor. Accordingly, as reflected in the NYSBA 1985 Report, we recommend that final regulations expressly provide that any consideration received in respect of a priority claim shall be disregarded for purposes of determining COI and that priority claims shall not represent proprietary interests in the target corporation.

Bifurcating Senior Claims. Although the Proposed Regulations contain an example demonstrating the bifurcation of senior claims where all creditors of the class receive proportionate amounts of acquiring corporation stock and other property,[115] the Proposed Regulations do not provide an example involving the receipt of disproportionate amounts. Presumably, the two-step process would operate in the following manner. Assume there are two senior claims of $100 each. The first receives $40 in cash, and the second receives $20 in cash and $20 in stock. Applying the two-step process, the overall stock percentage is 25% (i.e., $20 total stock, divided by $80 total consideration). Thus, 25% of the consideration received on each claim is considered received in respect of a proprietary interest, with the stock consideration allocated first to such portion. As result, $10 of the cash received on the first senior claim is counted in measuring COI, and only $10 of the stock received on the second senior claim is counted measuring COI – for a continuity percentage of 50%. We recommend that the Service and Treasury include such an additional example. Given the relatively clear application of the COI provisions in a proportionate context, we believe that an example demonstrating the consequences in a disproportionate context would provide greater guidance and further clarify the COI provisions.

In connection with the NYSBA 1985 Report,[116] we considered and rejected this type of bifurcation or split-claim approach, for two reasons. First, COI could be easily manipulated, merely by providing senior claims with stock, rather than non-stock consideration where necessary to satisfy COI. Second, the legislative history to the G reorganization provisions (quoted above) appears to take the position that the entire interest of a creditor who receives stock is to be treated as a proprietary interest.

Nevertheless, we also recognize that an approach that takes into account all consideration received in respect of a senior claim is also open to manipulation and may inappropriately preclude tax-free reorganization treatment where senior claim holders truly represent the

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[114] 11 U.S.C. §§ 507(a), 1129(a)(9).

[115] *See* Prop. Reg. § 1.368-1(e)(7), Ex. 10.

[116] *See* NYSBA 1985 Report, at part V.C.2.

proprietary interests in the debtor corporation, are receiving stock, and receive a substantial non-stock distribution (possibly in cash repayments or in new debt of the acquiring corporation).[117] As a result, we have no strong objection to the bifurcation approach taken in the Proposed Regulations.

In view of the relative ease in which a split-claim approach can be manipulated to satisfy COI, we considered whether a minimum percentage of the consideration received in respect of senior claims should consist of stock before the split-claim approach applies – similar in a way to the 10% accommodation transferor test under section 351.[118] The latter test applies if the primary purpose of the issuance was to qualify the transfer for section 351 treatment. We rejected a minimum percentage test that would apply regardless of purpose in that it would inappropriately deprive senior claim holders of tax-free reorganization treatment where the senior claim properly reflects a proprietary interest and the holders, for one reason or another, only want to convert a small portion of the value to equity at this point. This often occurs, particularly where the senior claims are currently collateralized (even if significantly under-secured). Even a one-way accommodation test that applies where there are junior claims receiving non-stock consideration does not provide a satisfactory solution, since the senior claims may properly represent a partial proprietary interest and desire to preserve a tax-free reorganization despite receiving a small portion of their consideration in stock that is just enough to offset the non-stock consideration received by junior claims.

Alternatively, we also considered whether the split-claim approach should only apply where the value recovered by senior claims is less than a fixed percentage, for example 90%, of the allowed claim, thereby providing an objective indication that the senior claims properly reflect at least a partial proprietary interest. This approach had more policy appeal than a minimum percentage, but suffered from similar problems. For example, assume senior claims receive close to a full recovery predominantly in non-stock consideration but also receive all of the stock of the acquiring corporation. Should COI be satisfied? Should it make a difference if junior claims receive a small distribution?

In the end, we did not believe that the potential abuses that would be curbed at the expense of otherwise legitimate continuity qualifying transactions justified the additional complexity that the imposition of either an "accommodation" test or a "recovery" test would entail.[119]

Value of Proprietary Interest. As described above, the Preamble states that the value of a proprietary interest represented by a creditor's claim is the fair market value of the claim, which is "generally" the amount of cash and fair market value of property received in exchange for the

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[117] The split-claim approach is also consistent to a degree with the position of the Proposed Regulations – which we, on balance, support (as discussed below) – that assets received directly by an acquiring creditor corporation in respect of the creditor's claim against the debtor do not count toward COI.

[118] *See* Treas. Reg. § 1.351-1(a)(1)(ii); Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568.

[119] In evaluating each test, we considered whether the effect of failing such test would be to treat senior claims as a proprietary interest in their entirety or, alternatively, to disregard senior claims in their entirety. The latter seemed more in keeping with the purposes of such tests.

claim. The use of "generally" suggests that the Service may disregard the fair market value of consideration received in certain situations. For example, the Service might attempt to disregard *de minimis* or gratuitous distributions received by junior claims or by existing shareholders in an effort to satisfy COI and qualify for tax-free reorganization treatment. We generally have no objection to this position. As discussed in the NYSBA 1985 Report, it generally has been accepted that stock acquired by existing equity holders attributable to the contribution of new capital should be disregarded in determining continuity.[120] Similarly, in *Detroit-Michigan Stove Co. v. United States*,[121] a transfer to shareholders whose stock interests were, as a practical matter, worthless, was considered "gratuitous" rather than a continuation of the shareholder's proprietary interest in the debtor. The same is no less true in the case of junior claims.

However, we believe that the Service should not use this provision to disregard value that a shareholder or junior claim holder receives by "leveraging" its position, such as the value paid to a junior claim holder to vote or consent to the plan of reorganization and thereby avoid the delay and costs involved in a prolonged proceeding – in short, the "nuisance" value of a claim or stock interest.

In the NYSBA 1985 Report, we recommended that proposed regulations provide that stock received by shareholders or junior claim holders count in determining COI, *provided that* such stock was not received for the sole purpose of ensuring COI *and* the value of the stock received by the shareholders or junior claim holders was not *de minimis* in relation to the consideration received by all creditors and shareholders in the reorganization.[122] We recommend a similar provision here. In addition, because the imposition of such a *de minimis* rule is necessarily imprecise and in practice may operate to exclude more good stock consideration than bad stock consideration, the Service and Treasury should consider creating a fixed standard for *de minimis* consideration, perhaps one percent or two percent of the fair market value of all of the consideration received in the transaction.

<u>Bifurcation of Partially Secured Claims</u>. The Proposed Regulations do not address the appropriate allocation of consideration received in respect of partially secured creditor claims in the absence of a court approved allocation or an allocation agreed to by the parties. It is not uncommon in out-of-court restructurings, and even in bankruptcy reorganizations where there is a major secured creditor with a potential deficiency claim, for the plan of reorganization to provide a unitary distribution to a partially secured creditor in satisfaction of such creditor's entire claim, without allocation.

In these situations, we recommend that the Service and Treasury follow Treasury Regulation section 1.108-1(d)(6), which determines the secured portion of an under-secured debt for purposes of section 108(e)(8)(B). These regulations provide that:

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[120] *See* NYSBA 1985 Report, at part V.C.6.; *Mascot Stove Co. v. Comm'r*, 120 F.2d 153 (6th Cir. 1941); *Templeton's Jewelers, Inc. v. United States*, 126 F.2d 251 (6th Cir. 1942).

[121] *Detroit-Michigan Stove Co. v. United States*, 121 F. Supp. 892 (Ct. Cl. 1954).

[122] *See* NYSBA 1985 Report, at part V.D.2.

> Absent strong evidence to the contrary, the value of the property securing the indebtedness is presumed to be equal to the issue price of any new secured indebtedness received for the indebtedness plus the value of any other consideration (except stock or new unsecured indebtedness) received for the indebtedness. A valuation of that property by a court in a title 11 case is a factor in determining value, but is not controlling.

We recommend that the Proposed Regulations take a similar approach where neither a court approved allocation nor an agreement on allocation has been obtained.

Pre-Reorganization Distributions. We believe that the provisions regarding the receipt of pre-transaction payments by creditors should be consistent with the general COI provisions regarding pre-transaction redemptions of and distributions on target corporation stock. That is, payments to creditors should not affect COI unless they relate to the putative reorganization. Accordingly, we recommend that the proposed provision be revised to read as follows:

> A proprietary interest in the target corporation is not preserved to the extent that creditors (or former creditors) of the target corporation that own a proprietary interest in the corporation under paragraph (e)(6) of this section (or would be so treated if they had received the consideration in the potential reorganization) receive payment for the claim prior to the potential reorganization and the payment would be treated as other property or money received in the exchange for purposes of section 356 had it been a distribution with respect to stock.

Merging into the Creditor. We support the distinction between a creditor receiving acquiring corporation stock in exchange for its claim and receiving target corporation assets. The quintessential remedy of a creditor is the ability to take the debtor's assets, voluntarily or involuntarily, in whole or partial satisfaction of its claim. The fact that this occurs as part of an overall transaction pursuant to which at least some creditor stock is issued in consideration for the remainder of the assets should not change this result.[123]

V. UPSTREAM RESTRUCTURINGS

A. Summary of Current Law

In order to qualify as a complete liquidation under section 332, a distribution (or series thereof) must be "in complete cancellation or redemption" of all of the stock of a subsidiary. Additionally, the parent corporation must own stock in the subsidiary meeting the requirements of section 1504(a)(2) at the time the subsidiary adopts its plan of complete liquidation and at all times thereafter until the last liquidating distribution is received.

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[123] It should be noted that a creditor desiring to access the debtor corporation's tax benefits can engage in self-help by, for example, structuring the acquisition through a subsidiary and issuing creditor corporation stock (including to itself). Moreover, such a transaction may be effectively required in the case of a bankruptcy reorganization pursuant to which the creditor desires to avail itself of the special bankruptcy relief rule in section 382(l)(5), which requires that qualified creditors receive at least 50% of the vote and value of the reorganized debtor corporation.

Under Treasury Regulation section 1.332-2(b), section 332 applies to "only those cases in which the recipient corporation receives at least partial payment for the stock it owns" in the liquidating corporation. Thus, section 332 appears not to apply in the case of a liquidation of an insolvent corporation because the corporate shareholder would not receive any payment for its stock. The Service consistently has followed this analysis in published and private rulings.[124] Case law has reached the same result, establishing that in order for section 332 to apply, at least partial payment must be made to the parent corporation with respect to each class of subsidiary stock held by the parent. [125]

Further, according to *H.K. Porter Co. v. Comm'r,*[126] and *Spaulding Bakeries, Inc. v. Comm'r*,[127] section 332 or its predecessor does not apply to the complete liquidation of a subsidiary with outstanding common and preferred stock where the liquidated corporation's net asset value was less than the preference on the outstanding preferred stock, and no assets were thus distributed in exchange for the common stock (hereinafter, a "*Spaulding Bakeries* fact pattern"). These cases also concluded that the liquidation yielded a worthless securities deduction with respect to the common stock under section 165(g) or its predecessor, with the possibility of ordinary character if the requirements of section 165(g)(3) are satisfied.

Existing administrative authorities are clear that an upstream merger of an insolvent subsidiary cannot qualify as a reorganization under section 368. The Service reached this conclusion in Revenue Ruling 59-296[128] and reaffirmed its position in Revenue Ruling 70-489,[129] issued three years after the decision in *Norman Scott.* Further, while not addressing the issue directly, Revenue Ruling 2003-125[130] effectively presumes that section 368 does not apply to an upstream restructuring of an insolvent corporation. The case law appears to be consistent with the Service's view.[131]

Such a transaction cannot qualify as a tax-free liquidation or reorganization by having the parent corporation make a capital contribution to the subsidiary (*e.g.*, by contributing the

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124 *See, e.g.*, Rev. Rul. 59-296, 1959-2 C.B. 87 (providing that an upstream merger of an insolvent subsidiary did not qualify under section 332); Rev. Rul. 70-489, 1970-2 C.B. 53 (amplifying Revenue Ruling 59-296 to provide the same result even though the parent corporation continued the subsidiary's business following the liquidation); Rev. Rul. 2003-125, 2003-52 I.R.B. 1249 (superseding Revenue Ruling 70-489, but applying the same result where the liquidation of the insolvent subsidiary occurred by virtue of an election under Treasury Regulation section 301.7701-3).

125 *See, e.g.*, *H.G. Hill Stores, Inc. v. Comm'r*, 44 B.T.A. 1182 (1941); *Spaulding Bakeries, Inc. v. Comm'r*, 252 F.2d 693 (2d Cir. 1958), *aff'g*, 27 T.C. 684 (1957); *H.K. Porter Co. v. Comm'r,* 87 T.C. 689 (1986).

126 *H.K. Porter Co. v. Comm'r*, 87 T.C. 689 (1986).

127 *Spalding Bakeries, Inc. v. Comm'r*, 252 F.2d 693 (2d Cir. 1958).

128 Rev. Rul. 59-296, 1959-2 C.B. 87.

129 Rev. Rul. 70-489, 1970-2 C.B. 53.

130 Rev. Rul. 2003-125, 2003-52 I.R.B. 1243.

131 *H.G. Hill Stores* does not directly address reorganization treatment, but implicitly assumes that it does not apply.

subsidiary's debt to capital) to render it solvent in anticipation of the transaction. Applying step-transaction principles, Revenue Ruling 68-602 disregards the capital contribution as transitory.[132]

Presumably, where the subsidiary corporation transfers its assets to the parent corporation with respect to the parent's preferred stock in a *Spaulding Bakeries* fact pattern, the upstream transaction may qualify as a reorganization. COI would be preserved by the parent corporation's direct ownership of the subsidiary's assets.[133] It is not clear, however, whether the parent would be entitled to a worthless stock deduction with respect to the subsidiary's common stock.

B. Proposed Regulations

The Proposed Regulations explicitly require that, for purposes of section 332, the liquidating corporation must make a distribution in at least partial payment for each class of stock that the shareholder owns in the liquidating corporation;[134] as described above, this requirement is consistent with current law, as interpreted by case law. The Proposed Regulations also provide that as long as the parent corporation receives at least a partial payment in exchange for one or more classes of subsidiary stock, the transaction may qualify as an upstream reorganization even if it does not qualify as a liquidation under section 332.[135] The Proposed Regulations clarify that, if section 332 does not apply because the parent does not receive at least partial payment in exchange for each class of subsidiary stock, the parent generally will be permitted a worthless stock deduction under section 165(g) with respect to any class with respect to which it receives no payment, regardless of whether the transaction qualifies as an upstream reorganization under section 368(a).[136] Finally, the Proposed Regulations reaffirm that the step-transaction principles embodied in Revenue Ruling 68-602 will be applied in determining whether an upstream restructuring qualifies under section 332 or 368.

C. Comments and Recommendations for Further Guidance

Set forth below are three sets of comments. The first section addresses general issues raised by the Proposed Regulations. Following, we address specific issues raised by *Spaulding Bakeries* fact patterns and issues unique to consolidated return taxpayers.

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[132] Rev. Rul. 68-602, 1968-2 C.B. 135.

[133] Treas. Reg. § 1.368-1(e)(1)(i). Prior to the repeal of the so-called Bausch & Lomb doctrine through the issuance of Treasury Regulation section 1.368-2(c)(4), this issue would not have arisen unless the upstream transaction were affected as a merger of the subsidiary into the parent corporation, because the upstream transaction could not have qualified as a C reorganization. *Bausch & Lomb Optical Co. v. Comm'r*, 267 F.2d 75 (2d Cir. 1959) (holding that the acquiror's previous ownership of some of the target's stock disqualified an asset acquisition from being a C reorganization).

[134] Prop. Reg. § 1.332-2(b).

[135] *See* Prop. Reg. § 1.368-1(b)(1) and (f).

[136] Prop. Reg. § 1.332-2(e), Ex. 2.

1. Upstream Restructurings Are Not Tax-Free (Excluding Certain *Spaulding Bakeries* Fact Patterns)[137]

Assuming that the government is not inclined to adopt our recommendations for a broader revision of current law discussed in the NYSBA 2003 Report, we support, on balance, the rule in the Proposed Regulations that the upstream merger or liquidation of an insolvent company into its parent creditor where no assets are economically received by the parent in exchange for the subsidiary's stock may not be accomplished tax-free – a result that cannot be changed through transitory steps or formalistic differences in structure.[138] However, we would note that the conclusion in the Proposed Regulations is likely to exacerbate certain problems that we identified in the 2003 NYSBA Report and that motivated our recommendations then.

We appreciate that the conclusion reached in the Proposed Regulations is well grounded in existing law. As such, it has the virtue of validating prevailing expectations about the treatment of upstream restructurings of insolvent subsidiaries. In addition, it represents a logical interpretation (though not the only possible interpretation) of the statutory framework, as applied to such restructurings. Section 332 requires one or more distributions in complete cancellation or redemption of *all* of the subsidiary's stock. It seems reasonable to interpret this statutory language as requiring a distribution of net value with respect to each class of subsidiary stock. Similarly, section 368 requires a continuity of interest by the subsidiary's shareholders. It seems appropriate to conclude that a parent creditor that receives the business and assets of its subsidiary debtor through the merger or liquidation of the subsidiary into the parent has received such business and assets in a creditor capacity, not a proprietor capacity. Accordingly, the transaction looks more like a debt repayment transaction, rather than a tax-free liquidation or reorganization.

Our conclusion with respect to upstream restructurings is not inconsistent with our recommendation to remove the Reorganization Net Value requirement in the context of sideways reorganizations. The liquidation or merger of an insolvent subsidiary would fail to qualify as a reorganization if it does not satisfy the COI requirement; the Reorganization Net Value requirement is not necessary to insure this result. As described more fully in Section IV above, we appreciate the distinction between a transaction in which a creditor receives stock of an acquiring corporation and a transaction in which the creditor directly receives the assets of the debtor. In the former case, the creditor may be viewed as acting as a proprietor; in the latter case, the creditor is simply receiving payment (or partial payment) on its debt claim. Thus, COI

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[137] As discussed above, if the parent corporation receives at least a partial payment in exchange for one or more classes of subsidiary stock, the transaction may qualify as an upstream reorganization even if it does not qualify as a liquidation under section 332.

[138] In this regard, we support the principle that the net value determination in the section 332 context should be applied by reference to current liquidating value because the upstream restructuring, by definition, destroys the potential for the shareholder to realize any option value. *See* Rev. Rul. 2003-125, *supra*.

is not satisfied. While the parent corporation does have an interest in the subsidiary's assets and business going forward, the continuing interest results from its historic capacity as a creditor.[139]

Nevertheless, despite the logic and precedent supporting the technical result reached in the Proposed Regulations concerning an upstream restructuring of an insolvent subsidiary, we find some of its practical implications troubling. We are concerned that the Proposed Regulations perpetuate and effectively widen the gap between the treatment of sideways and upstream restructurings – a gap that could be viewed as inappropriate given the reality that many such restructurings occur within a single consolidated group and the economic difference to the group between the two restructurings is not likely to be significant. Reorganization treatment is essentially elective for sideways restructurings where insolvency stems from the existence of intercompany debt. A group can choose to avoid reorganization treatment by having the acquiring corporation assume debt, or to satisfy the reorganization provisions by contributing the debt to capital in advance of the restructuring.[140] Alternatively, the insolvent corporation may transfer only its assets to an acquiring corporation in exchange for stock, and then transfer such stock to its creditors. While the creditor's receipt of the insolvent corporation's assets (in exchange for debt) would have been considered as having occurred in the creditor's capacity as a creditor (rather than proprietor), the receipt of stock of the acquiring corporation by the same creditor (albeit representing an interest in the same assets) will be viewed as occurring in the creditor's capacity as a proprietor, and thus as satisfying the COI requirement of reorganizations.[141]

A second objection to the general treatment of upstream restructurings in the Proposed Regulations is that it allows intercompany debt to play an enormous role in determining federal income tax consequences even though such debt often has little economic significance. As a practical matter, the absence or existence of intercompany debt often will determine whether the subsidiary is solvent or insolvent. In many groups, the existence and level of intercompany debt is a product of state tax considerations and/or internal accounting processes and is not viewed by management or the market as having any significant economic consequence for the group's business. Yet, under the Proposed Regulations, intercompany debt may determine whether an upstream transfer is tax-free. In the context of a consolidated group, this result may be viewed as inconsistent with the goals of Treasury Regulation section 1.1502-13(g), which generally attempts to prevent intercompany debt from distorting consolidated taxable income.

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139 We recognize that there is some force to the argument that direct ownership of the subsidiary's assets by the creditor/shareholder should be held to satisfy the COI requirement. In fact, the current regulations contemplate that proprietary interest may be maintained through a direct interest in the target's assets. Treasury Regulations section 1.368-1(e)(1)(i) provides that "a proprietary interest in the target corporation is preserved if . . . it is exchanged by the acquiring corporation in exchange for a direct interest in the target corporation enterprise." Because the parent has just converted its indirect interest in the subsidiary into a direct interest in its assets, its proprietary interest could be viewed as continuing in no lesser sense than if the parent received stock of an acquiring corporation.

140 *See* Rev. Rul. 78-330, 1978-2 C.B. 147.

141 *See* Rev. Rul. 54-610, 1954-2 C.B. 152; Rev. Rul. 59-222, 1959-1 C.B. 80; Prop. Reg. § 1.368-1(e)(6)(i).

A third objection to the general treatment of upstream restructurings in the Proposed Regulations is that it accentuates the importance of valuations. Vastly different tax consequences depend on whether the subsidiary has at least one dollar of net value. Making such valuations with precision in the context of intragroup restructurings may be challenging for the Service and taxpayers alike, multiplying uncertainties and opportunities for dispute.

Accordingly, we think that the Service and the Treasury ought to give further consideration to adopting, at least in certain contexts (*e.g.,* within a consolidated group), a regime that better addresses these adverse implications of the general treatment of upstream restructurings under the Proposed Regulations.

2. *Spaulding Bakeries* Fact Patterns

The proposals with respect to *Spaulding Bakeries* fact patterns raise several issues that should be considered by the Service and Treasury. We offer some observations and recommendations below.

<u>Worthless Stock Deduction</u>. The Proposed Regulations confirm that the parent corporation may be permitted a worthless stock deduction for its common stock. We believe generally that claiming a worthless stock deduction is not inconsistent with reorganization treatment – for example, it is not unusual in the G reorganization context. If the worthless stock deduction were denied at the time of the transaction, because the common stock is cancelled in the upstream transaction, it could not be taken later. On the other hand, because the parent corporation's overall investment in the business is being continued, an argument could be made that a worthless stock deduction is not appropriate under these circumstances because the parent succeeds to the subsidiary's tax attributes under section 381 and continues to own the subsidiary's business and assets. We would observe that it is possible to interpret section 332 as providing, contrary to the Proposed Regulations, for non-recognition under section 332 as long as the parent corporation receives net value on any class of subsidiary stock that the parent corporation holds. Adopting such a rule would eliminate the worthless stock deduction in a *Spaulding Bakeries* fact pattern. On balance, however, we believe the Proposed Regulations reach the appropriate result.

<u>Application of Substance Over Form Principles</u>. The issue of whether the substance over form principles of Revenue Ruling 68-602 should apply in the context of a *Spaulding Bakeries* fact pattern should be considered. For example, a parent corporation may cause its subsidiary to recapitalize from one class of stock into two classes of stock, or from two classes of stock into one class, in anticipation of a liquidation in order to affect the tax consequences thereof. One may argue that applying Revenue Ruling 68-602 principles to disregard the recapitalization is not appropriate because the distinction between preferred and common stock is not as great for tax purposes as that between debt and equity (for example, deductibility of interest, etc.), and the shareholder was always a shareholder (not a creditor). A recapitalization in connection with the upstream restructuring is clearly transitory, however, and should be disregarded. Accordingly, the Service and Treasury should clarify that Revenue Ruling 68-602 principles apply in a *Spaulding Bakeries* fact pattern.

Duplication Issues. In a *Spaulding Bakeries* fact pattern that qualifies as a reorganization under section 368 because assets are transferred with respect to the preferred stock, section 381 will apply to allow the parent to succeed to the tax attributes of the subsidiary, including net operating losses and built-in losses in assets ("inside losses"). Under the Proposed Regulations, it is clear that the parent would be entitled to a worthless stock loss under section 165(g) with respect to the subsidiary's common stock, even if section 381 also applies, creating the potential for duplication of tax benefits attributable to the same economic loss. While common law doctrines may limit or preclude the ability of the parent to achieve loss duplication, it may not be appropriate for the Service to have to rely on uncertain common law doctrines to address loss duplication.

Under section 382(g)(4)(D), if a 50 percent shareholder treats any stock it holds as becoming worthless during such shareholder's taxable year and the relevant stock is held by the shareholder as of the close of such taxable year, the shareholder will be treated as having acquired such stock on the first day of its first succeeding taxable year, and shall not be treated as having owned such stock during any prior period for purposes of determining whether an ownership change occurs after the close of the taxable year. Where applicable, this rule would subject the loss corporation to a zero section 382 limitation on its tax attributes.[142]

The application of section 382(g)(4)(D) to a *Spaulding Bakeries* fact pattern is far from clear. Because section 382(g)(4)(D) requires that the shareholder continue to own the stock of the loss corporation at the close of the shareholder's taxable year, there is an implication that the loss corporation must continue in existence beyond the taxable year, which would not be the case with respect to an upstream restructuring. It is possible that the rule treating the acquiring corporation (the parent) in a section 381 transaction as the successor to the loss corporation (the subsidiary) may be employed to address the technical issue.[143] However, the fiction of the parent owning stock in itself is unrealistic and awkward.

If the Service and Treasury create rules under section 382(g)(4)(D) to address the duplication issue, we have two concerns that should be considered. First, in the case in which losses have been funded by the preferred stock rather than the common stock, there is no duplication with respect to such losses because the parent recognizes no loss with respect to the preferred stock in the upstream restructuring.[144] Second, any such rule is likely to increase complexity and may eliminate even a single deduction for true economic loss. Accordingly, we recommend that a parent corporation be permitted to elect to succeed to the inside losses of the subsidiary without limitation and forego the stock loss that relates to the inside losses.[145]

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[142] The applicable section 382 limitation may be increased under section 382(h) in respect of certain recognized built-in gains. *See* Notice 2003-65, 2003-40 I.R.B. 147.

[143] Treas. Reg. § 1.382-2(a)(1)(v).

[144] I.R.C. § 354(a).

[145] This election is consistent with the fact that section 382(g)(4)(D) itself only applies if the shareholder "treats" the stock as worthless. This formulation appears to allow the taxpayer to avoid the taint by not claiming the worthless stock deduction.

3. Consolidated Return Issues

The Proposed Regulations may create a number of consequences under existing consolidated return regulations under section 1502 that should be considered and addressed by future guidance since many transactions governed by the Proposed Regulations will occur within a consolidated group. Set forth below are several such issues we have identified. We would be happy to consider the issues further and make more detailed recommendations at your request.

<u>Timing of Worthless Stock Loss</u>. The timing of the worthless stock loss with respect to stock of a consolidated group member may be deferred under the consolidated return regulations. Generally, the loss is not taken in account, notwithstanding the section 165(g) rules, until the subsidiary either (i) disposes of substantially all of its assets and uses the proceeds to satisfy liabilities, or (ii) ceases to be a member of the consolidated group.[146] However, where the subsidiary is insolvent, the parent's worthless stock loss resulting from an upstream restructuring should not be deferred under Treasury Regulation section 1.1502-80T(c), because the subsidiary has in effect left the group. A similar result should apply if, in a *Spaulding Bakeries* fact pattern, the upstream transaction fails to qualify as a reorganization.

If an upstream transaction qualifies as a reorganization (*i.e.*, in a *Spaulding Bakeries* fact pattern), however, the analysis is more complicated. The parent is treated as the subsidiary's successor for certain purposes, including the provisions of the intercompany transaction regulations.[147] Under these regulations, the parent would inherit any intercompany gain or loss items not previously taken into account by the subsidiary. However, there is no reference to a "successor" member in Treasury Regulation section 1.1502-80T(c). Consequently, if the subsidiary is treated as having left the group for purposes of the regulation, the parent's worthless stock loss would ripen. It seems anomalous for the parent to recognize a worthless stock loss before taking into account the subsidiary's intercompany items in determining its basis in the subsidiary's stock. On the other hand, if the subsidiary is not treated as leaving the group for Treasury Regulation section 1.1502-80T(c) purposes, it is not clear if and when the parent will be entitled to take into account its worthless stock loss (which may or may not be duplicated in the tax attributes to which the parent succeeds under section 381).

<u>Duplication of Tax Losses</u>. In a *Spaulding Bakeries* fact pattern that qualifies as a reorganization under section 368, Treasury Regulation section 1.1502-35T(f)(1) eliminates the portion of the group's consolidated net operating loss ("CNOL") attributable to the subsidiary. Thus, there is no potential that the worthless stock loss will duplicate that portion of the CNOL. Treasury Regulation section 1.1502-35T(f)(1) may not eliminate all opportunities for loss duplication, however. For example, the parent's basis in the subsidiary's common stock may be duplicated in the subsidiary's basis in its assets (*i.e.*, the subsidiary has built-in loss assets). If the upstream transaction qualifies as a tax-free reorganization, the parent will succeed to these built-in losses, in addition to having a worthless stock loss with respect to the subsidiary's common stock. Treasury Regulation section 1.1502-35T(c)(1) does not appear to suspend the parent's loss, because it suspends a loss on subsidiary stock recognized by a member to the

[146] Treas. Reg. § 1.1502-80T(c).

[147] Treas. Reg. § 1.1502-13(j)(2).

extent of the duplicated loss only if, immediately after the disposition, the subsidiary remains a member of the group (or any successor group). Because the subsidiary ceases to be a member of the group and Treasury Regulation section 1.1502-35T(c)(1) does not refer to a "successor" member, it appears that it does not suspend the parent's worthless stock loss.

The applicability of the anti-loss reimportation rules of Treasury Regulation section 1.1502-35T(g)(3)(i)(B)(3) is also unclear, and this section may disallow built-in losses inherited by the parent. For the provision to apply, the subsidiary or its successor must cease to be a member of the group, and it is unclear whether this occurs where the subsidiary leaves the group in a transaction in which another member is its successor which remains a member of the group.

Further, assume that the subsidiary previously recognized losses that have not been taken into account under the intercompany transaction rules of Treasury Regulation section 1.1502-13. In the upstream reorganization, the parent will succeed to these losses under Treasury Regulation section 1.1502-13(j)(2)(ii). It appears that such losses fall outside the reach of the various anti-duplication provisions: Treasury Regulation section 1.1502-35T(f)(1) (eliminates only the subsidiary's portion of consolidated items already taken into account, such as the CNOL); Treasury Regulation section 1.1502-35T(c)(1) (not applicable because the subsidiary will no longer be a member of the group and there is no mention of a successor) and Treasury Regulation section 1.1502-35T(g)(3) (applicable only to built-in loss assets). Thus, the subsidiary's deferred losses may be duplicated.

<u>Elimination of Tax Losses for True Economic Losses.</u> The interaction of the Proposed Regulations and the consolidated return rules may also eliminate some tax losses corresponding to real economic losses. In a *Spaulding Bakeries* fact pattern that qualifies under section 368, assume the subsidiary has incurred losses funded by both common and preferred stock that have not yet been absorbed by the group. The Proposed Regulations may disallow true economic loss because (i) the parent's loss on its subsidiary preferred stock apparently is not recognized under section 354(a) and (ii) the anti-duplication rules of Treasury Regulation section 1.1502-35T(f)(1) would eliminate all of the apportioned CNOL–not just the amount funded by the worthless common stock. Thus, while the parent will be entitled to the outside loss on its common stock (as a worthless stock loss), both the inside and outside losses will be disallowed with respect to the preferred stock as a result of the application of Treasury Regulation section 1.1502-35T(f)(1).

VI. LIABILITIES

The net value requirements of the Proposed Regulations depend on valuations of assets and liabilities, and determinations of whether liabilities are assumed. The Section 351 Net Value requirements necessitate a determination of the amount of liabilities of the transferor assumed by the transferee corporation in connection with the transfer and the amount of the liabilities of the transferee corporation immediately after the transfer. The Reorganization Net Value requirement necessitates a determination of the amount of liabilities of the target corporation assumed by the acquiring corporation in connection with the exchange (in the case of an asset transaction), or the amount of liabilities of the target corporation immediately before the exchange (in the case of a stock transaction), as well as a determination of the amount of liabilities of the issuing corporation immediately after the exchange. Moreover, for purposes of assessing qualification of a liquidation under section 332, it is necessary to determine the amount of liabilities of the liquidated corporation assumed by the recipient corporation.

Although our recommendations to eliminate the Reorganization Net Value requirement and modify the Section 351 Net Value requirements to require only that stock with value is issued by the transferee would diminish the importance of the valuation and assumption questions raised by the Proposed Regulations, liabilities remain significant in the determination of whether stock with value is issued in section 351 transactions and whether the COI requirement is satisfied for reorganizations.

A. Definition of Liabilities

The Proposed Regulations do not define the term "liability." However, the Preamble indicates that the Government intends to interpret it broadly to include any "obligation" of the taxpayer, whether or not the liability is debt for federal income tax purposes or is taken into account under any other Code sections: "[g]enerally an obligation is something that reduces the net worth of the obligor."[148]

We agree that liabilities should be broadly defined for purposes of determining net value to the extent any net value requirements are adopted, and we recommend the adoption of a definition of liability similar to the definition of "obligation" in Treasury Regulation section 1.752-1(a)(4)(ii). Using a narrow definition could cause an unwarranted disconnect between the economic reality of the transaction and its tax characterization. We recognize that adopting a broad definition will necessarily lead to difficult valuation issues in some cases and will create some definitional issues (despite the broad definition) as to what is or is not an obligation. For example, if Corporation X has a retiree medical plan that it can terminate at will, but doing so will likely lead to a strike that would harm the value of its future business (by damaging its good will and going concern value), a fair question is presented as to whether any "obligation" exists with respect to future medical expenses under the plan.

B. Amount of Liabilities

While the Proposed Regulations provide no specific guidance regarding liability valuation, the Preamble states that the Service and Treasury are considering various approaches for valuing liabilities. One such approach would use a fair market value determination based on what a willing assignor would pay to a willing assignee to take on the liability in an arm's length

[148] The Preamble notes that the regulations under section 752 similarly define "obligations" for purposes of implementing section 358(h) principles in subchapter K, as any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Treas. Reg. § 1.752-1(a)(4)(ii). Section 358(h) principles are implemented in subchapter K of the Code principally through Treasury Regulation section 1.752-7. It states that obligations "include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contacts, future contracts and swaps." Similarly, section 358(h)(3) itself provides that the term liability "shall include any fixed or contingent obligation to make a payment, without regard to whether the obligation is otherwise taken into account for purposes of this title."

transaction, similar to the approach used in Treasury Regulation section 1.752-7(b)(3) to determine the fair market value of a liability. Another approach would value liabilities represented by debt instruments (perhaps with some exceptions for contingent payment debt instruments) on the basis of their "adjusted issue price" as determined under sections 1271-1275, while utilizing a fair market value approach to value other obligations. Another possible approach suggested by the Preamble is to borrow from the authorities determining whether insolvency exists under section 108(d)(3). Some of these authorities take into account only contingent liabilities that the taxpayer can establish are more likely than not to be paid.[149] Under this approach a contingent liability has a zero value if the likelihood it will be paid is fifty percent or less.

We generally recommend valuing all liabilities using a fair market value approach, because it offers the best economic determination of whether net value has been surrendered and received. In view of the valuation difficulties this rule may present, we recommend allowing taxpayers to elect to use certain simplifying safe harbors. These could include allowing non-contingent debt instruments that are not publicly traded to be valued based on their adjusted issue price or imputed principal amount determined under section 1274,[150] and allowing taxpayers to value contingent liabilities (and assets) at zero if the probability of liability (or recovery) is remote, *e.g.*, less than 20 percent. Any such safe harbor should be purely elective, as requiring the use of adjusted issue price, for example, could lead to improper (non-economic) results where, for example, an assumed liability clearly has lower fair market value than its adjusted issue price because of an increase in interest rates.[151]

We do not support the adoption of the section 108(d)(3) standard. While this methodology has simplifying advantages in some contexts, it may produce economically inappropriate results, particularly when the liability would likely be compromised.[152] Moreover,

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[149] *Merkel v. Comm'r*, 192 F.3d 844 (9th Cir. 1999), *aff'g* 109 T.C. 463 (1997). While this approach has been adopted for purposes of section 108(d)(3), the fair market value approach is used to determine insolvency for non-tax bankruptcy purposes. *See, e.g.*, *Covy v. Commercial Nat'l Bank*, 960 F.2d 657, 660 (7th Cir. 1992).

[150] The imputed principal amount of a debt instrument is defined in section 1274(b)(1) to generally equal the sum of the present values (using AFR, compounded semi-annually) of all payments due under the debt instrument.

[151] For example, consider the case of a non traded note that has a principal of $1,000,000, provides for current pay interest at 6% per annum payable annually, and has a remaining maturity of 10 years. Under this rule if the long term AFR is 10%, the debtor should be able to value the liability at $752,217 (the present value, at a 10% discount rate, of all payments due under the note).

[152] The court in *Merkel* based its decision on the language of section 108(d)(3) where the term "fair market value" modifies only the reference to assets and not the reference to liabilities. The court noted that it agreed with the dissent that while as a general proposition determining the value of contingent liabilities based on a discounting of such liability for the probability of their occurrence is "good economics and thus good law," "it is not the law congress enacted when it sought to "accommodate" bankruptcy policy with tax policy." *Merkel* at 850.

the section 108(d)(3) approach does not address cases where the maximum amount of the liability is uncertain.[153]

C. Special Rules for Non-Recourse Debt

The Preamble states that the Service and Treasury are considering a rule that would limit the amount of a non-recourse liability to the fair market value of the property securing the liability to determine the amount of assumed liabilities. This rule would follow the approach of Rev. Rul. 92-53, which addresses the treatment of non-recourse liabilities in measuring insolvency.[154] It is also consistent with the basic approach of the determining the fair market value of assets transferred since the value of what is transferred should not be reduced by more than the value of the assets securing the non-recourse debt. We generally agree that limiting the non-recourse liability to the property's value accurately reflects whether there has been a transfer of net value or receipt of net value. Further, we recommend treating debt that is recourse only to the assets of a disregarded entity as non-recourse debt secured by the assets of the disregarded entity.[155]

This rule would be relevant only where both property subject to the non-recourse debt and other property is either transferred or held by the target or issuing corporation. Assume, for example, that A transfers a building with a fair market value of $175x, subject to a non-recourse liability of $190x to a corporation, and also transfers an adjacent parcel of land with a fair market value of $10x (not subject to the liability) to the corporation. Under this rule, the net value of the transfer would be $10x, since the $190x liability is only taken into account to the extent of the fair market value of the property securing it.

We note that limiting the amount of non-recourse debt as described above raises a significant question as to whether the transfer of property securing excess non-recourse debt should under any circumstances be separated from the balance of the transaction and be considered a separate sale of property by the transferor to the transferee. This issue is most

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[153] Further if this approach were adopted, it would seem appropriate to also adopt a similar approach for contingent assets (such as potential legal recoveries) which would require certain contingent assets to be valued at either their full recovery value or zero. For example, if A transfers to corporation C (i) a potential damage recovery for $1,100,000 with a 40% chance of prevailing, or (ii) a potential tort liability for $1,000,000 with a 40% chance of prevailing (not having to pay), the valuation methods should be the same. Based on mathematical expectations the transfer would have a net value of $40,000 (40% x 1,100,000 – 40% x 1,000,000). Under the section 108 approach the liability would be valued at zero (since less than a 50% chance have to pay) and if the same rule applied to the contingent asset, the net value of the transfer would be zero. On the other hand if the liability were so valued, but the contingent asset was valued at fair market value, there would presumably be significant net value (using mathematical expectation for the asset and zero for the liability, the net value of A's C stock would be $440,000).

[154] Rev. Rul. 92-53,1992-2 C.B. 46.

[155] *See* Prop. Reg. § 1.752-2 (adopting a similar rule with respect to such liabilities). *See also,* N.Y. St. Bar Assoc. Tax Sec., *Proposed Regulations under section 752 Relating to the Allocation of Partnership Liabilities where a Disregarded Entity is an Obligor,* 2005 Tax Notes 10-18 (Jan. 11, 2005).

salient in the section 351 context. We do not believe such bifurcation is appropriate because it is inconsistent with the aggregate notions upon which section 351 has been developed.[156]

D. Debt Assumptions and Guarantees

The Preamble states that the Service and Treasury solicit comments regarding whether and to what extent the principles of section 357(d) should be incorporated into the regulations. Under section 357(d), a recourse liability (or portion thereof), is treated as assumed by a transferee if, based on all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability (or portion thereof), whether or not the transferor has been relieved of the liability.[157] A nonrecourse liability is assumed by the transferee of any property securing the liability, unless other assets not transferred also secure the liability and the transferor agrees with the transferee to, and is expected to, satisfy the liability.[158] The Service and Treasury recently announced that they are considering publishing a notice of proposed rulemaking to modify section 357(d),[159] in the case of non-recourse debt. We believe that the liability assumption rules of section 357(d), as potentially amended, should be used consistently throughout the net value provisions.

Moreover, special consideration should be given to the situation where the combining corporations have overlapping liabilities, including the common fact pattern where the acquiring corporation (P) is the primary obligor on certain indebtedness and the target corporation (S) has secondary liability, and both P and S are in financial distress. In such instance, the question arises whether or not the secondary liability should be taken into account in determining the insolvency/net value of S (or the economic value of S stock) where S is merged or otherwise combined with P. This has particular significance where S would be solvent but for the secondary liability. We believe that, in this instance, it would be appropriate to *disregard* S's liability, since from the perspective of P, P's aggregate liabilities are not increased by reason of the assumption of S's secondary liability, yet P has received additional (net) assets.

[156] Consider, for example, that section 357(c) applies on an aggregate basis.

[157] I.R.C. § 357(d)(1).

[158] I.R.C. § 357(d)(2).

[159] Ann. 2003-37, 2003-1 C.B. 1025. Section 357(d)(3) directs the Secretary to prescribe such regulations as may be necessary to carry out the purposes of sections 357(d) and 362(d), and to prescribe regulations providing that the manner in which a liability is treated as assumed under section 357(d) is applied, where appropriate, elsewhere in the Code.