NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON FINAL REGULATIONS REGARDING THE EFFECT OF SUBSEQUENT TRANSFERS OF ASSETS OR STOCK ON THE CONTINUING QUALIFICATION OF REORGANIZATIONS UNDER SECTION 368

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Report No. 1152

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON FINAL REGULATIONS REGARDING THE EFFECT OF SUBSEQUENT TRANSFERS OF ASSETS OR STOCK ON THE CONTINUING QUALIFICATION OF REORGANIZATIONS UNDER SECTION 368[1]

I. INTRODUCTION AND BACKGROUND

This report (the "Report") of the New York State Bar Association Tax Section (the "NYSBA Tax Section," or "We") comments on final regulations (the "Final Regulations")[2] issued by the Internal Revenue Service (the "IRS") and the U.S. Department of Treasury ("Treasury") addressing the effect of post-reorganization transfers of stock and/or assets on the continuity of business enterprise ("COBE") and other requirements for tax-free treatment under

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[1] The principal drafter of this Report was Gary Mandel, with substantial assistance from Jonathan Talansky. Substantial comments were received from Noah Beck, David Miller, Deborah Paul, Jodi Schwartz, Linda Swartz and Gordon Warnke. Helpful comments were received from Stephen Land and Michael Schler.

[2] T.D. 9361 (Oct. 25, 2007), amending Treas. Reg. Sections 1.368-1(d) and 1.368-2(k), with conforming amendments to the definition of "party to a reorganization" under Treas. Reg. Section 1.368-2(f).

Section 368.[3] The Final Regulations generally permit post-transaction distributions and certain other transfers to related entities, including partnerships.

Over the last few years, the IRS and Treasury have focused considerable attention on the impact of asset and stock transfers following otherwise tax-free reorganizations.[4] We commend the government for issuing the Final Regulations, which continue the trend of promoting flexibility in the context of corporate reorganizations by providing that certain post-transaction asset and stock transfers do not disqualify an otherwise tax-free reorganization.[5] This Report identifies particular areas in which clarification and guidance could enhance certainty and consistency in furtherance of the spirit and purpose of the Final Regulations. The balance of this

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3 Except as otherwise noted, "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to Regulations are to the Treasury Regulations promulgated thereunder.

4 Prior to the promulgation of the Final Regulations, the most recent regulatory enactments dealing with post-reorganization asset and stock transfers were in the form of proposed regulations issued on August 18, 2004, 69 Fed. Reg. 51209 (the "Proposed Regulations") which replaced an earlier set of proposed regulations issued on March 2, 2004, 69 Fed. Reg. 9771 (the "March 2004 Proposed Regulations"). Both of these sets of regulations were proposed to amend the COBE regulations that were enacted in final form in January 1998, and which significantly liberalized the COBE test. See T.D. 8760 (Jan. 23, 1998). The primary innovation of the Proposed Regulations was the treatment of post-reorganization distributions (push-ups) of acquired assets and stock, transactions that were not addressed by the March 2004 Proposed Regulations.

5 T.D. 9361, Background. As stated in the preamble to the Final Regulations (the "Preamble"), "these final regulations continue the trend of broadening the rules regarding transfers of assets or stock following an otherwise tax-free reorganization where the transaction adequately preserves the link between the former T shareholders and the T business assets."

Part I provides an overview of the relevant portions of the Proposed Regulations and related changes made by the Final Regulations.

A. The Proposed Regulations

The Proposed Regulations expanded upon the March 2004 Proposed Regulations and addressed whether reorganization status is affected by either a subsequent transfer of acquired assets to a partnership, or a subsequent distribution of assets or stock. By permitting specifically enumerated post-reorganization transfers, the Proposed Regulations continued the trend of effectively "turning off" the step transaction doctrine in certain circumstances.[6] The Proposed Regulations provided that a transaction otherwise qualifying as a reorganization under Section 368(a) will not be disqualified as a result of a subsequent distribution of acquired assets or stock, so long as:

> i) either a) no transferee receives *substantially all* of the acquired assets (or substantially all of the assets of the acquired or surviving corporation in a Section 368(a)(1)(B) reorganization or Section 368(a)(2)(E) reorganization, respectively) or stock constituting control of the acquired corporation, or b) the transfer is to one or more corporations controlled in each transfer by the transferor corporation

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[6] The safe harbor treatment of post-reorganization transfers of assets or stock began with the enactment of Section 368(a)(2)(C) in 1954. In published guidance, the IRS has applied Section 368(a)(2)(C) to transactions that were not covered by its literal language, pointing out that the statutory provision was intended to be permissive and not exclusive. See Rev. Rul. 64-73, 1964-1 C.B. 142 (permitting successive asset drop-downs); Rev. Rul. 2001-24, 2001-1 C.B. 1290 (permitting a drop-down of stock following a Section 368(a)(2)(D) reorganization); Rev. Rul. 2002-85, 2002-2 C.B. 986 (permitting a drop-down of assets following a Section 368(a)(1)(D) reorganization). This trend continued in the March 2004 Proposed Regulations, which specifically provided that Section 368(a)(2)(C) applies to all types of reorganizations. Finally, the Proposed Regulations extended these principles to certain upstream distributions of stock or assets.

(or to a partnership in which the transferor has an ownership interest immediately after the transfer);

ii) the transferee is either a member of the COBE qualified group or a partnership the business of which is treated as conducted by a member of the qualified group; and

iii) the COBE requirement is satisfied.[7]

The Proposed Regulations did not propose a rule regarding transfers of stock to partnerships, but solicited comments with regard to such transfers.[8]

B. The Final Regulations

1. *Distributions*

The Final Regulations establish safe harbors that permit acquiring corporations to distribute to shareholders the stock or assets acquired in a reorganization without disqualifying the acquisition as a tax-free reorganization, provided that the COBE requirement continues to be satisfied. Notably, under Treas. Reg. Section 1.368-2(k)(1)(i), a distribution is permitted as long as it does not result in the liquidation of the relevant entity for federal income tax purposes. The

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[7] Prop. Treas. Reg. Section 1.368-2(k)(1), as in effect prior to the Final Regulations.

[8] 69 Fed. Reg. 51209 (Aug. 18, 2004). Because the IRS and Treasury were actively considering the effect of stock transfers to affiliated partnerships, Example 3 of former Treas. Reg. Section 1.368-2(k) was omitted from the Proposed Regulations. That example involved a putative B reorganization followed by a transfer of the target stock to members of the qualified group followed by another contribution to a wholly owned partnership. Since such a transfer was not described in the -2(k) rules as then in effect, the example provides that step transaction principles are applicable. Consequently, since the acquiring corporation was no longer in control of the target following the transfer to the partnership, the transaction failed to qualify under Section 368(a)(1)(B). The Final Regulations have incorporated the newly liberalized COBE qualified group concept into the rules governing post-reorganization transfers, and have overruled the result in this example.

"liquidation" standard of the Final Regulations is generally more permissive than the "substantially all" standard of the Proposed Regulations; that is, a distribution of substantially all of the assets of the relevant entity would generally disqualify a tax-free reorganization under the Proposed Regulations, but the distribution does not disqualify the reorganization as tax-free under the Final Regulations unless the distribution causes a liquidation of the relevant entity (as determined under the Final Regulations).[9] For the purposes of applying this liquidation standard, any assets held prior to the transaction are disregarded. With regard to distributions of stock of the acquired corporation, the distributions must involve less than all of the acquired corporation stock that was acquired in the transaction, and must not cause the acquired corporation to cease to be a member of the COBE qualified group.[10] Furthermore, the Final Regulations provide that indirect distributions of assets are treated in the same manner as direct distributions.[11]

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[9] The corporation to which the liquidation standard is applied depends on the particular form of reorganization at issue and the nature of the distribution. For example, where the acquiring subsidiary in a triangular C reorganization distributes a portion of the acquired assets to its parent (the issuing corporation in the reorganization), the liquidation test is applied by evaluating whether the *acquiring* corporation has constructively liquidated (disregarding any of the assets held by the acquiring subsidiary prior to its acquisition of the target assets). See Treas. Reg. Section 1.368-2(k)(2), Example 2. On the other hand, in a reverse subsidiary merger described in Section 368(a)(2)(E), if a portion of the surviving corporation's assets are distributed to the issuing corporation after the transaction, the inquiry focuses on whether the distribution consisted of an amount of assets of the *surviving* corporation that would result in the liquidation of such corporation, disregarding the assets owned by the *merged* corporation prior to the reorganization.

[10] See Treas. Reg. Section 1.368-2(k)(1)(i).

[11] Treas. Reg. Section 1.368-2(k)(1)(i)(A)(1); Treas. Reg. Section 1.368-2(k)(2), Example 3.

2. *Other Transfers*

The Final Regulations also provide safe harbor treatment for another category of transfers ("other transfers") described in Treas. Reg. Section 1.368-2(k)(1)(ii). A post-reorganization transfer is an "other transfer" if:

i) it consists of acquired assets or stock;

ii) it is not described as a "distribution" in Treas. Reg. Section 1.368-2(k)(1)(i);

iii) it does not cause the corporation whose stock is transferred to cease to be a member of the qualified group; and

iv) it does not result in the termination of the corporate existence of the relevant entity.

3. *COBE*

COBE generally requires that the issuing corporation in a reorganization either continue the target corporation's historic business or use a significant portion of the target's business assets in a business.[12] For these purposes, the issuing corporation is treated as holding all of the businesses and assets of all of the members of its "qualified group."[13] The Final Regulations expand the definition of a COBE qualified group by permitting qualified group members to aggregate their stock ownership in a lower-tier corporation in determining whether

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[12] Treas. Reg. Section 1.368-1(d)(1).

[13] Treas. Reg. Section 1.368-1(d)(4)(i). While we welcome the flexibility embodied in the Final Regulations and are proposing certain areas of further clarification, we fully recognize that the reorganizations provisions (including COBE) are formalistic in nature and must be complied with in order to procure nonrecognition treatment under Section 368. For example, if all the acquired assets are dropped down into a corporation that is not a member of the issuing corporation's COBE qualified group, COBE is not met and the transaction will not qualify as a valid tax-free reorganization.

that lower-tier corporation is itself a member of the qualified group (provided, however, that the issuing corporation itself owns stock constituting Section 368(c) control in at least one other corporation).[14] This aggregation principle means that businesses or assets contributed to multiple controlled subsidiaries, including through a "diamond structure," can satisfy COBE.[15] The Final Regulations also provide that qualified group members are treated as owning the stock owned by a partnership if the members own interests in the partnership "meeting requirements equivalent to Section 368(c)" (the "368(c) partnership standard").[16]

As referenced above, the rules governing post-reorganization transfers in Treas. Reg. Section 1.368-2(k), as amended by the Final Regulations, cross reference the COBE rules. The result is that the step transaction doctrine will not apply to transfers within the COBE qualified group for the purpose of determining whether the transaction qualifies as a tax-free reorganization, so long as the other requirements of the -2(k) rules are met. Thus, for example, if

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[14] The Final Regulations incorporate this aggregation concept into the COBE regime by providing that "stock meeting the requirements of Section 368(c) in each of the corporations (except the issuing corporation) is owned directly (or indirectly as provided in paragraph (d)(4)(iii)(D) of this section) by one *or more* of the other corporations. Treas. Reg. Section 1.368-1(d)(4)(ii) (emphasis added). Compare Section 1504(a)(1)(B)(ii).

[15] The relaxation applies where acquired stock is dropped down into a number of controlled subsidiaries, with no individual subsidiary receiving control. For example, an acquiring corporation acquires the stock of a target corporation solely in exchange for stock of its parent. Following the acquisition, the acquiring subsidiary contributes 10% of the target stock to each of ten controlled subsidiaries. See Treas. Reg. Section 1.368-1(d)(5) Example 7. A diamond structure exists where acquired assets are dropped down to a number of controlled corporations which in turn drop the assets to a corporation in which none of the transferee corporations owns Section 368(c) control.

[16] Treas. Reg. Section 1.368-1(d)(4)(iii)(D).

the issuing corporation in a B reorganization (or a reverse triangular merger under Section 368(a)(2)(E)) contributes the acquired stock to a "Section 368(c) partnership," the transaction will not be newly tested (on an integrated basis) for "control" under Section 368(a)(1)(B) (or Section 368(a)(2)(E)).

II. SUMMARY OF RECOMMENDATIONS

By promulgating the Final Regulations, the IRS and Treasury have continued the trend of increasing the flexibility afforded to taxpayers engaging in tax-free reorganizations. Below is a summary of our recommendations, which are intended to clarify certain matters raised by the Final Regulations while implementing the broader policy objectives reflected therein. Specifically, we recommend that the IRS and Treasury:

- clarify how Section 368(c) principles should be applied to partnership interests in light of the complex nature of partnership arrangements;
- clarify, through specific examples, whether the liquidation standard of Treas. Reg. Section 1.368-2(k)(1)(i) contemplates the application of the authorities governing "de facto liquidations" under federal income tax law, which is generally an extremely high standard and deems a corporation to have de facto liquidated only if the corporation remains merely a corporate shell, retaining no assets and carrying on no activity (in this case, disregarding assets held prior to the reorganization);

- clarify whether the addition of the words, "or recharacterized," in Treas. Reg. Section 1.368-2(k)(1) is meant to "turn off" the step transaction doctrine as soon as the requirements of a tax-free reorganization are satisfied, notwithstanding subsequent steps that, if considered together with the initial step(s), would yield a different type of reorganization (i.e., whether this language represents the adoption of a "first to the finish line" approach to the step transaction doctrine in Section 368); and
- clarify, through specific examples, the effect of the Final Regulations on distributions of assets outside the COBE qualified group, and specifically to issuing corporation shareholders.

III. SECTION 368(c) CONTROLLED PARTNERSHIPS

We commend the IRS and Treasury for promulgating regulations that allow for the use of partnerships in post-reorganization planning. Prior to the issuance of the 1998 COBE Regulations, the IRS took the position that drop-downs of acquired assets into partnerships could run afoul of continuity principles.[17] Since the expansion of COBE and the introduction of the qualified group concept in the 1998 COBE Regulations, post-reorganization transfers of assets to partnerships do not preclude the satisfaction of COBE if 1) members of the qualified group, in the aggregate, own a significant interest in the partnership, or 2) at least one member of the

[17] See, e.g., G.C.M. 35117 (Nov. 15, 1972) (merger followed by a drop-down of all the acquired assets into a limited partnership of which the acquirer was the sole general partner); PLR 8302073 (Oct. 13, 1982).

qualified group performs active and substantial management functions as a partner with respect to the partnership business.[18] However, until the adoption of the Final Regulations, contributions of target stock to partnerships were not permitted under the COBE rules.[19] With the adoption of the Final Regulations, the IRS and Treasury concluded that further expansion of the COBE qualified group concept is consistent with tax-free reorganization policy.

As described above, the Final Regulations provide that stock will be attributed from a partnership to a COBE qualified group if qualified group members own partnership interests meeting "requirements equivalent to Section 368(c)."[20] The Preamble posits that the "section 368(c) equivalent control standard is applied to transfers of stock to a partnership in order to protect the section 368(c) control requirements applicable to triangular and stock

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[18] Treas. Reg. Section 1.368-1(d)(4)(iii)(B). Performance of active and substantial management functions, however, is not alone sufficient to satisfy COBE. Treas. Reg. Section 1.368-1(d)(4)(iii)(C). The regulatory examples demonstrate that a 33.3% partnership interest constitutes a "significant" interest for these purposes. Additionally, where qualified group members perform active and substantial management functions, a 20% partnership interest is sufficient to satisfy COBE, and a 1% interest is not. See Treas. Reg. Section 1.368-1(d)(5), Examples 8, 9 and 10.

[19] See Example 3 of former Treas. Reg. Section 1.368-2(k). The Final Regulations have incorporated the new expanded COBE qualified group concept, thus overruling the result in this example.

[20] Section 368(c) defines "control" to mean ownership of at least 80% of (1) the total combined voting power of all classes of stock entitled to vote, and (2) the total number of shares of all other classes of stock of the corporation. With regard to the nonvoting classes, the IRS has ruled that Section 368(c) control requires ownership of 80% of the number of shares in *each* non-voting class. Rev. Rul. 59-259, 1959-2 C.B. 115.

acquisition reorganizations."[21] Treas. Reg. Section 1.368-1(d)(5) Examples 14 and 15 reveal that a "straight up" 80% partnership interest is equivalent to Section 368(c) control, but that a 50% interest is not.

By focusing on the qualified group's ownership interest in the partnership, the Final Regulations adopt an approach that is consistent with the principles of Section 368(c). Consequently, contributions of acquired stock to partnerships are analyzed using the same control standard that applies generally to the reorganization provisions, thereby promoting consistency and uniformity. On the other hand, the 368(c) partnership standard raises a number of difficult interpretive questions. While we understand the application of the current standard with respect to basic partnership agreements, we believe that additional examples would help guide taxpayers in applying Section 368(c) to more complex arrangements that are typical in the context of commercial transactions involving partnerships.

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[21] T.D. 9361 section B.3. The Preamble adds that Section 368(c) is the more appropriate control standard precisely because it "is a major structural component underlying the statutory framework of the reorganization provisions." T.D. 9361 section A. The "control" test of Section 368(c), as it relates to COBE, has been addressed by several prior reports. See, e.g., New York State Bar Association Tax Section, Report No. 1064 on Transfers of Assets or Stock Following a Corporate Reorganization (July 20, 2004) (commenting on the March 2004 Proposed Regulations) ("Report No. 1064"); American Bar Association Section of Taxation ("ABA Tax Section"), Comments on the Continuity of Interest and Business Enterprise Proposed Regulation (April 28, 1997) (commenting on COBE regulations proposed in January 1997); ABA Tax Section, Comments on Proposed Regulations on Continuity of Business Enterprise and Certain Related Issues Under Section 368 (July 19, 2004) (commenting on the March 2004 Proposed Regulations); ABA Tax Section, Comments Regarding Proposed Regulations Addressing Transfers of Assets and Stock Following a Reorganization (February 7, 2005) (commenting on August 2004 Proposed Regulations).

Because of the many ways (other than tax) in which partnerships (including LLCs or other entities that may be taxed as partnerships) differ from corporations, the direct application of Section 368(c) to such entities can be difficult. A "tax partnership" represents an extremely flexible mode of business ownership. In this regard, partnership agreements may employ varying rights such as capital interests and profits interests, "catch-ups," clawbacks, preferred returns, and guaranteed payments, all of which may vary significantly over time. The dynamic nature of many partnerships makes it very difficult to apply the Section 368(c) control standard, which contemplates a somewhat mechanical determination of voting and value ownership more suitable to a domestic corporation.

State law dictates the permissible forms of corporate ownership and prescribes rules for the conduct of corporate affairs, which are generally more rigid than those governing partnerships. Fundamentally, corporate ownership and its attendant voting rights are evidenced by corporate stock, which lends itself to computations of "value" and "voting power," and thus to a more precise application of Section 368(c). On the other hand, in the context of partnerships, in which economic entitlements and rights to manage and control are largely left to the agreement between the partners, the application of Section 368(c) raises considerable interpretive difficulties.[22]

[22] We recognize that the application of Section 368(c) to unincorporated and foreign entities that "check the box" to be treated as corporations presents issues that are similar to the issues that affect partnerships. This Report does not address the application of Section 368(c) to non-traditional entities and arrangements that check the box to be treated as corporations for U.S. federal income tax purposes.

For instance, it is not clear how to apply Section 368(c) to entities that are not generally managed by a formal board of directors. Published guidance provides that Section 368(c) "voting power" refers to the right to vote for directors.[23] In addition, the determination of voting power can be affected where significant limitations are imposed on the directors' ability to manage the corporation's affairs.[24] In the partnership setting, it is not clear how "vote" should be defined, since partners may not directly elect directors, and management of the partnership will be as provided in the partnership agreement.

In this regard, we considered how a general partnership interest, or alternatively a managing membership interest in a limited liability company, would be analyzed with respect to "voting power."[25] For example, in most states, a sole general partner has the right to vote the stock owned by the partnership.[26] If a qualified group member were the general partner of a limited partnership but owned no economic interest (all of which interests were held by unrelated

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[23] Rev. Rul. 69-126, 1969-1 C.B. 218; Erie Lighting Co. v. Comm'r., 93 F.2d 883 (1st Cir. 1937).

[24] See, e.g., TAM 9452002 (Aug. 26, 1994).

[25] Similar issues arise, for example, where "voting power" in a foreign corporation must be determined for Subpart F purposes, where a U.S. Person owns corporate stock through a foreign partnership.

[26] In fact, other than with respect to amendments to the partnership agreement or disposition of substantially all of the partnership property, a general partner customarily manages all the activities and business of the partnership. See Uniform Limited Partnership Act ("ULPA") § 406 (2001) ("Except as expressly provided in this [Act], any matter relating to the activities of a limited partnership may be exclusively decided by the general partner or, if there is more than one general partner, by a majority of the general partners").

third parties), it could be argued that it nonetheless possessed the equivalent of voting control of such partnership. After all, a general partner carries out management functions much as a director of a state law corporation.[27]

On the other hand, the general partner owes a fiduciary duty to the limited partners and may not manage the partnership for its own interests.[28] Furthermore, there have been situations in which disproportionate voting stock was not respected by the IRS and the courts.[29] Thus, if a general partnership interest were analogized to ownership of "all-vote, no-value" corporate stock, a qualified group member holding such an interest may not own Section 368(c) equivalent control of such partnership. Finally, if the general partner interest is treated as a voting interest, the limited partner interests may be considered analogous to a class of non-voting stock, in which case Section 368(c) would require a general partner to own 80% of such interests as well.[30]

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[27] Compare ULPA § 406 to Del. Gen. Corp. Law § 141.

[28] See ULPA § 408. In several other contexts, the IRS has ruled that ownership of stock voting rights in a fiduciary capacity does not constitute true ownership of the underlying stock. See, e.g., Rev. Rul. 67-237, 1967-2 C.B. 167 (Section 422(b)(7); stock held by voting trustee).

[29] While recapitalizations creating substantial vote/value discrepancies have been respected in the Section 368(c) context, there can be a limit to such flexibility, at least in certain contexts. Cf. Kraus v. Comm'r, 490 F.2d 898 (2d Cir. 1974) (disproportionate voting power not respected for purposes of decontrolling a controlled foreign corporation where other very negative factors were present).

[30] Such issue could be further exacerbated in a case in which the various partnership interests had certain differences (e.g., interests subject to a preference with respect to distributions), in which case they could be characterized as multiple (non-voting) classes.

Adding additional complexity is the fact that Section 368(c) requires ownership of 80% of the total *number* of shares in each non-voting class. Presumably, application of this control test to a partnership would be made by reference to percentage share of the relevant class.

One possible alternative to applying Section 368(c) at the partnership level would be to adopt a look-through approach to the 368(c) partnership standard. Specifically, a contribution of stock to a partnership could be analyzed by evaluating (i) whether, in a deemed (in-kind) liquidation of the partnership immediately after the transfer, qualified group members would own stock in the corporation constituting 80% of the value of the corporation, taking into account the qualified group's economic interest in partnership assets, and (ii) whether, as a functional matter, qualified group members possess (through the partnership) 80% of the voting power in the corporation, or a person owing a fiduciary duty to the qualified group members holds that power and votes it on their behalf.

Focusing on a deemed liquidation of the partnership for purposes of evaluating whether the group members hold sufficient value is generally consistent with both the look-through nature of the 368(c) partnership standard as well as the principles of Subchapter K. While partnership arrangements may be dynamic and difficult to characterize on an on-going basis, using a deemed liquidation analysis as a means to determining the essence of the economic arrangement between the partners is at the very core of Section 704(b) in determining whether allocations are in accordance with the partners' interests in the partnership and should thus be respected. The stock attribution rule ultimately seeks to determine whether qualified group members own a sufficient (albeit indirect) interest in the corporation whose stock is held by a

partnership, and does not require an analysis of the nature of the partnership interests, which, as discussed above, can vary greatly over time.

To be sure, most partnership agreements specify only the value to which each partner is entitled upon liquidation, and not the way in which specified partnership assets are to be distributed. Where partnership agreements are silent as to the allocation of identified assets (or where they give the general partner or anyone else (e.g., the board of an LLC) the power to determine such allocation), the deemed liquidation standard could be applied by presuming that each partner receives, upon liquidation, a percentage of each asset that is proportionate to his or her liquidation rights under the agreement. This treatment applies the liquidation standard in a way that is consistent with the economic rights in the partnership assets.

We acknowledge that the test described above is merely one approach, and does not necessarily present an ideal solution to the complexity introduced by the use of partnerships. For example, instead of evaluating whether the qualified group possesses practical control of the corporation by virtue of its interest in the partnership (or that of a fiduciary), the IRS and Treasury could apply the voting test on a pure liquidation basis (i.e., by evaluating whether the qualified group members would have sufficient voting power after a liquidation). Such a position, while consistent with the look-through approach to the 368(c) partnership standard, arguably fails to sufficiently take into account the partners' existing voting rights through the partnership.

Another possible alternative would be to evaluate drop-downs of stock to partnerships using the same test that is used with regard to asset drop-downs. This standard

focuses on the qualified group's economic interest in the partnership as well as the extent of its participation in management of the partnership business.[31] Adoption of this test would create a uniform standard that could be applied to all post-reorganization contributions to partnerships. It would also provide a relatively clear rule that is well-understood by taxpayers. However, we acknowledge that asset transactions are ultimately distinct from stock transactions, and are so treated under many existing reorganization provisions.

We believe any proposal will have legitimate advantages and disadvantages, and thus will require a balancing of various considerations, including complexity, certainty and flexibility. Whichever standard is ultimately adopted by the IRS and Treasury with respect to contributions of stock to partnerships, we believe it is important that additional examples illustrate its application to complex fact patterns associated with partnership arrangements. If the approach in the current regulations is retained, we would recommend that additional regulatory examples be provided that may address the concerns we have described. We believe such examples would allow corporate groups to meet their practical commercial and corporate objectives when engaging in post-reorganization restructuring transactions.

IV. TRANSFERS UNDER TREAS. REG. SECTION 1.368-2(k)(1)

A. Clarifying the Liquidation Test of Treas. Reg. Section 1.368-2(k)(1)(i)

Treas. Reg. Section 1.368-2(k), as amended by the Final Regulations (the "-2(k) rules"), permits an acquiring corporation to distribute to certain shareholders part of the acquired

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[31] See Treas. Reg. Section 1.368-1(d)(4)(iii)(B).

assets or stock without affecting the status of the initial acquisition as a reorganization.[32] While the Proposed Regulations would disqualify the reorganization if the assets constituted "substantially all" of the assets acquired, the Final Regulations permit a distribution so long as it does not "result in the distributing corporation being treated as liquidated for federal income tax purposes."[33] In applying this standard, assets held by the acquiring corporation (or the merged corporation in a reverse subsidiary merger qualifying under Section 368(a)(2)(E)) prior to the reorganization are disregarded.

We commend the IRS and Treasury for offering substantial flexibility with regard to push-ups of stock and assets following reorganizations. Treas. Reg. Section 1.368-2(k)(1)(i) contemplates something less than an actual liquidation (or dissolution) of the corporation. We believe it would be helpful if the IRS and Treasury confirmed, through an example, (including one in which the acquiring corporation owns previously-held assets), that the liquidation standard in the -2(k) rules is intended to match the authority governing "de facto liquidations." Although guidance is sparse in this area, historically courts have focused on whether the corporation continues to carry on activity or represents merely "a lifeless shell."[34] Where a

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[32] Treas. Reg. Section 1.368-2(k)(1)(i).

[33] T.D. 9361 section B.1. With regard to "other transfers," Treas. Reg. Section 1.368-2(k)(1)(ii)(C) states that the transfer must not result in the termination of the corporate existence of the distributing corporation. This standard does not impose a limit on the allowable quantum of distributed assets. See Treas. Reg. Section 1.368-2(k)(2) Examples 1, 6, 8 and 9.

[34] See, e.g., Owens v. Comm'r, 568 F.2d 1233 (6th Cir. 1977), aff'g, 64 T.C. 1 (1975); Wier Long Leaf Lumber Co. v. Comm'r, 173 F.2d 549 (5th Cir. 1949). Also, Rev. Proc. 89-50,

corporation had retained only its corporate charter, the Tax Court stated that "there can be a de facto dissolution even though there is no de jure dissolution…the corporation had no capital, no income and no expenses. It was a mere empty shell."[35] Consistent with these authorities, the determination of whether a de facto liquidation has occurred should focus on whether the corporation has terminated all its activities and retained none of its assets. A de facto liquidation should only be found to exist where a corporation remains only a shell and has, in effect, wound up and terminated its corporate existence.[36]

Treas. Reg. 1.368-2(k)(1)(i) requires that assets held prior to the reorganization are disregarded for purposes of the liquidation analysis. Although in many cases, the acquiring corporation in a reorganization is a newly-formed merger subsidiary (or a subsidiary formed to

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provides a procedure for when the IRS will grant a favorable ruling that a constructive liquidation has occurred for purposes of application tax-free reorganization provisions. See 1989-2 C.B. 631; Section 368(a)(2)(G)(ii). Such a ruling is only granted under very narrow conditions (i.e., the target must retain only its charter and the minimum capital required for existence under state law). Notably, Rev. Proc. 89-50 states that this begrudging standard "is consistent with established law regarding de facto dissolutions."

[35] Kamin Chevrolet Co., 3 T.C. 1076, 1080 (1944). See also Rev. Rul. 61-191, 1961-2 C.B. 251; Treas. Reg. Section 1.6012-2(a)(2). Cf. Treas. Reg. Section 1.332-2(c), which states that in the context of liquidations under Section 332, where a corporation is liquidated through a series of distributions, a "status of liquidation" must exist at the time of the first distribution. The regulations provide that "a status of liquidation exists when the corporation ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders."

[36] See, e.g., Winter & Company, Inc. v. Commissioner, 13 T.C. 108 (1949); Rev. Rul. 61-191; Kamin Chevrolet Co., 3 T.C. 1076 (1944); Treas. Reg. Section 1.6012-2(a)(2). If the test in the -2(k) rules establishes a threshold that differs from existing authority on de facto liquidations, we would welcome a clarifying example to that effect.

consummate a triangular B or C reorganization) with no previously held assets, this is not always the case. In such circumstances, if these assets were not disregarded, the liquidation standard would have little meaning.[37] We applaud the IRS and Treasury for adopting a standard that appropriately disregards previously-held assets but retains the de-facto liquidation test.[38] We recommend additional guidance in the form of examples, which would allow taxpayers to apply this test with greater certainty and assurance.

B. Significance of the Addition of the Words, "Or Recharacterized," in the -2(k) Rules

We believe that clarification would be useful with regard to two words contained in the Final Regulations. Specifically, while the Proposed Regulations stated that "a transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified" as a result of a subsequent transfer described in Treas. Reg. Section 1.368-2(k), the Final Regulations provide that a permissible transfer will not cause the putative reorganization to be "disqualified *or recharacterized*."

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[37] In fact, the IRS and Treasury initially rejected the liquidation standard in the Proposed Regulations because of a fear of the "inappropriate results" that would obtain where an acquiring subsidiary distributed all the acquired assets to its parent while retaining previously-held assets. Although not rising to the level of a deemed liquidation, such distributions are clearly inconsistent with treating the subsidiary as the acquiring corporation and with Rev. Rul. 67-274, 1967-2 C.B. 141. See 69 Fed. Reg. 51209 section A.

[38] We note that a rule permitting all push-ups (even those involving all of the acquired assets, including actual liquidations) would provide welcome certainty and flexibility for taxpayers. However, we are aware that such an approach would have to be distinguished from core step-transaction principles, and would be inconsistent with rulings in which the IRS has recast putative reorganizations. See Rev. Rul. 67-274; Rev. Rul. 72-405, 1972-2 C.B. 217. See also Report No. 1064 at 14, n.32.

We understand that the addition of these two words may be intended to employ a "first to the finish line" approach to the step transaction doctrine under Section 368. Namely, if the first step of a transaction would qualify as a tax-free reorganization, that characterization will control (provided, of course, that the subsequent step is described in the -2(k) rules), even if the integrated transaction would also qualify as a good reorganization.

If this is the intended effect of the addition of these two words in the Final Regulations, examples clarifying this result would be very helpful in promoting certainty in this area. While the "first to the finish line" approach is not necessarily inconsistent with multi-step reorganizations precedents,[39] it could represent a change in the way certain commercial transactions are characterized in the marketplace. For example, if a corporation seeks to reincorporate the assets of a subsidiary in a new entity (perhaps for state law purposes), it may choose to do so by carrying out an upstream merger followed by a drop-down of all of the assets into a new corporation. Despite the fact that the parties may treat the transaction as a valid reorganization under Section 368(a)(1)(A) followed by a permissible drop-down under Section 368(a)(2)(C),[40] taxpayers may view the appropriate treatment (at least under existing law) as a

[39] We would note, for example, that in Rev. Rul. 2001-46 (Situation 2), 2001-2 C.B. 321, the IRS did not adopt a "first to the finish line" characterization. That transaction consisted first of a reverse subsidiary merger qualifying under Section 368(a)(2)(E) followed by an upstream merger of the target into the parent. The ruling held that the transaction should be integrated and tested under Section 368(a)(1)(A), even though the first step, when viewed independently, was a valid subsidiary merger. Since the upstream merger clearly is not a permissible distribution under Treas. Reg. Section 1.368-2(k)(1)(i), that provision would not apply to turn off the step transaction doctrine and the "first to the finish line" approach would not apply.

[40] Rev. Rul. 69-617, 1969-2 C.B. 57.

reincorporation subject to Section 368(a)(1)(F). It is not clear that this characterization would be consistent with the "first to the finish line" approach.

C. Further Guidance Regarding Distributions to Issuing Corporation Shareholders

While the Proposed Regulations permitted distributions of assets only to transferees that were members of the issuing corporation's COBE qualified group,[41] the Final Regulations do not contain such a limitation. Specifically, Treas. Reg. Section 1.368-2(k)(1) provides that "a transaction otherwise qualifying as a reorganization under Section 368(a) shall not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of [Treas. Reg. Section] 1.368-1(d) are satisfied," and the transfer is either a "distribution" described in subsection (i) or an "other transfer" described in subsection (ii). For these purposes, a distribution of assets to shareholders is described in subsection (i) so long as the distribution does not cause a deemed liquidation of the acquiring corporation, disregarding previously held assets. Therefore, the -2(k) rules appear to permit post-reorganization asset push-ups above the issuing corporation to its shareholders, despite the fact that such shareholders are not members of the issuing corporation's COBE qualified group, provided that the acquiring group would retain a target business, or sufficient assets, to satisfy the COBE rules.

We believe that in order to provide taxpayers with additional certainty regarding distributions outside their COBE qualified group, further guidance addressing these situations is

[41] See Prop. Treas. Reg. Section 1.368-2(k)(1)(ii), as in effect prior to the Final Regulations.

necessary.[42] While Example 3 of Treas. Reg. Section 1.368-2(k)(2) describes a distribution of assets to the acquiring corporation's shareholder, none of the examples in the Final Regulations (including Example 3) addresses distributions outside the issuing corporation's COBE qualified group. Consequently, we think additional examples focusing on these distributions would be helpful.

For example, assume corporation P acquires substantially all of the historic assets of corporation T solely in exchange for the stock of corporation P in a transaction otherwise qualifying as a reorganization for U.S. federal income tax purposes. After the reorganization, P contributes a portion of the acquired assets to a subsidiary, retaining an historic T business, and then distributes the subsidiary stock pro-rata to its shareholders (including former target shareholders).[43] This transaction constitutes an indirect distribution of acquired assets, and it does not result in a liquidation of the acquiring corporation for tax purposes. Additionally, since P retains an historic target business, COBE continues to be satisfied.[44] In such case, under the Final Regulations, the distribution is a transfer described in Treas. Reg. Section 1.368-2(k)(1)(i), and therefore the subsequent distribution would not affect the initial qualification of the

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[42] We note that the Preamble does not explain why the Final Regulations (unlike the Proposed Regulations) permit asset transfers outside the COBE qualified group. We believe that further guidance would also help shed light on this point. See also text at notes 46 and 47 below.

[43] Query whether it matters if the distribution qualifies as a tax-free spin-off under Section 355?

[44] COBE requires that the issuing corporation "either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business." Treas. Reg. Section 1.368-1(d)(1).

transaction as a tax-free reorganization.[45] An example confirming these conclusions would provide welcome certainty.

Distributions made in exchange for issuing corporation stock should also generally be considered to be covered by Treas. Reg. Section 1.368-2(k)(1)(i). However, we note that with respect to the effect of the Final Regulations on distributions outside of the issuer's COBE group, there are situations that may raise reorganization qualification concerns. For example, the Final Regulations would appear to permit the following transaction: Assume the same facts as described in the paragraph above, except that instead of distributing the stock pro-rata to its shareholders, P distributes a portion of the acquired assets solely to former T shareholders in redemption of some of their newly acquired P stock. This distribution is described in Treas. Reg. Section 1.368-2(k)(1)(i), even though the assets are distributed out of P's COBE group. Since COBE continues to be satisfied by P's retention of a T business, the -2(k) rules, on their face, will apply to the distribution. On the other hand, this type of transaction may be viewed as inconsistent with basic reorganization principles (such as continuity of interest[46] or "substantially all"[47]). An example dealing with these or similar facts would be helpful.

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[45] That result should obtain whether P owns no stock in T, a portion of the stock in T (as in Rev. Rul. 69-617), or all the stock in T prior to the transactions, and further guidance should so reflect. Additionally, since the -2(k) rules already contain examples of transactions involving successive asset contributions, we believe that an example describing successive distributions would be helpful. See Treas. Reg. Section 1.368-2(k)(2), Examples 1 and 6.

[46] See, e.g., Rev. Rul. 57-114, 1957-1 C.B. 122; Treas. Reg. Section 1.368-1(e)(1); Rev. Rul. 71-364, 1971-2 C.B. 182.

[47] See Rev. Rul. 88-48, 1988-1 C.B. 117; Rev. Rul. 2001-25, 2001-1 C.B. 1291. Compare Treas. Reg. Section 1.368-2(j)(3)(iii); Rev. Proc. 77-37, 1977-2 C.B. 568, section 3.01.