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TAX SECTION

REPORT ON DISTRIBUTIONS IN CONNECTION WITH ACQUISITIONS

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Distributions in Connection with Acquisitions

This Report makes recommendations regarding the treatment of distributions of cash or other property in connection with acquisitions.[1] Specifically, we make recommendations relating to (1) the general framework for analyzing distributions in connection with potential reorganizations and Section 351 transactions, (2) qualified dividend income treatment if the dividend is made while an acquisition is pending and (3) the "substantially all" test when funds are borrowed by target or an entity that receives target assets in a reorganization.

First, the Report addresses the general framework. Numerous authorities make clear that a target corporation may distribute[2] funds to its shareholders prior to being acquired in a B reorganization without giving rise to impermissible boot.[3] Based on these authorities,

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1 The principal author of this Report is Deborah L. Paul. Jason Oh provided worthy and substantial assistance. Helpful comments were received from Peter Canellos, Gary Mandel, David Miller, Michael Schler, David Schnabel, Jodi Schwartz, David Sicular, Linda Swartz and Gordon Warnke.

2 In this Report, "distribution" includes both a distribution that occurs without an exchange of shares, such as a dividend under corporate law, and a distribution made in redemption of target shares. In this Report, "dividend" means a distribution that occurs without an exchange of shares.

3 Treas. Reg. § 1.368-1(e)(7), Ex. 9 (redemption by target using its own funds prior to a B reorganization does not affect continuity of proprietary interest); Rev. Rul. 55-440, 1955-2 C.B. 226 (target's redemption of preferred stock did not cause the B reorganization to violate the "control" requirement even though some preferred shares had not been surrendered on the date of the exchange); Rev. Rul. 56-184, 1956-1 C.B. 190 (pre-reorganization dividend by target reflecting target earnings between signing and closing was consistent with B reorganization treatment); Rev. Rul. 68-285, 1968-1 C.B. 147 (redemption of dissenters using cash sourced at target was consistent with B reorganization treatment, but the reorganization would fail if the acquiror paid the dissenters or reimbursed the target for such payment); Rev. Rul. 68-435, 1968-

distributions made in connection with potential stock reorganizations[4] generally are governed by a source rule (the "Source Rule"). Under the Source Rule, if the target is the source of the distribution, then the distribution is governed by Section 301 (in the absence of an exchange of the distributed property for target shares) or Section 302 (in the case of such an exchange), while if the acquiror is the source of the distribution, then the distribution is taken into account in determining whether the transaction is a reorganization and, if so, the distribution is governed by Section 356.

In the case of potential asset reorganizations, it is unclear whether the Source Rule applies. Certain authorities suggest that even if the source of the distribution is the target, a distribution made after the plan of reorganization has been adopted could be taken into account in determining whether the transaction qualifies as a reorganization and, if the transaction does so qualify, the distribution, even though sourced at the target, would be governed by Section 356

(footnote continued)
2 C.B. 155 (a dividend paid by target "from its own funds" to mirror a dividend paid by the acquiror that target shareholders would have received if the acquisition had not been delayed did not affect B reorganization qualification); Rev. Rul. 69-443, 1969-2 C.B. 54 (target's regular annual dividend declared before and paid after a B reorganization "out of its own funds" was governed by Section 301 and did not cause the transaction to fail the "solely for voting stock" requirement); Rev. Rul. 70-172, 1970-1 C.B. 77 (dividend of historic target property to target shareholders before a B reorganization was consistent with B reorganization treatment). Compare Rev. Rul. 75-360, 1975-2 C.B. 110 (target's redemption of preferred stock using borrowed funds followed by repayment of the debt using funds from the acquiror violated the "solely for voting stock" requirement).

[4] In this Report, "stock reorganization" means a reorganization under Section 368(a)(1)(B) or Section 368(a)(2)(E), and "asset reorganization" means a reorganization under Section 368(a)(1)(A) or (C) or Section 368(a)(2)(D).

The Report expresses no view regarding the framework for analyzing distributions in connection with reorganizations under Section 368(a)(1)(D), (E) or (F), because those transactions raise policy issues not present in the context of asset or stock acquisitions among unrelated parties. See infra Part I.D.

(the "Timing Rule").[5] However, certain other authorities suggest that asset reorganizations would be governed by the Source Rule.[6]

Thus, a distribution in connection with an acquisition could have different tax treatment depending on whether the acquisition is a potential asset reorganization or stock reorganization and whether the Source Rule in fact applies to asset reorganizations. Distributions that are treated as part of the acquisition affect the qualification of the transaction as a reorganization because such distributions are taken into account for purposes of measuring continuity of interest.[7] Moreover, Section 301 dividend treatment, Section 302 redemption treatment and Section 356 boot treatment differ from one another in terms of basis recovery, tax rate, the relevant measure of earnings and profits, withholding tax on non-US persons and eligibility for the dividends received deduction. Inconsistent treatment of stock and asset acquisitions can both change the tax treatment of the distribution to the target shareholders and affect whether the transaction qualifies in the first place as a reorganization.

The framework for analyzing distributions in connection with acquisitions should be clarified. One approach would be to apply the Source Rule to potential asset reorganizations.[8] The approach stems from the view that boot is properly understood as property received by

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[5] See Rev. Rul. 71-364, 1971-2 C.B. 182, infra note 19 and accompanying text; Sheldon v. Comm'r, 6 T.C. 510 (1946), infra note 20 and accompanying text.

[6] See I.R.S. Priv. Ltr. Rul. 200610007 (Mar. 10, 2006), infra note 22 and accompanying text.

[7] Distributions in connection with an acquisition would be taken into account for purposes of the "substantially all" requirement regardless of whether the distributions are governed by Section 301, 302 or 356.

[8] See infra Part I.C.

target or target shareholders from the acquiror and would have the virtue of conforming the treatment of asset acquisitions and stock acquisitions.

Although the Internal Revenue Code imposes different requirements on different types of reorganizations, all acquisitive reorganizations share a common purpose to permit tax-free combinations of corporations, and there is little tax policy reason to have different sets of rules for tax-free stock acquisitions, on the one hand, and tax-free asset acquisitions, on the other. Moreover, the Internal Revenue Service and the courts alike have had difficulty over the years navigating the distinctions among Section 301 distributions, Section 302 distributions and acquisition consideration in the context of taxable transactions and tax-free transactions.[9] Many authorities in these areas are formalistic at best. Conforming the rules for asset reorganizations and stock reorganizations eliminates one type of formalism.

The statutory framework defining boot also may be understood to support the Source Rule. Sections 354, 356, 361 and 368 work together to govern corporate combinations. Section 368 permits boot under certain circumstances. Sections 356 and 361 govern the boot that is permitted by Section 368. Under these rules, boot is meant to be taxed once, either at the corporate level under Section 361 if it is not distributed or under Section 356 if it is distributed. The concept of boot in Section 361 is of property coming from the acquiror. Thus, one might

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[9] Charles I. Kingson, The Deep Structure of Taxation: Dividend Distributions, 85 YALE L.J. 861, 865 (1976) (courts' attempts "to attribute economic substance to what is only a change in the form of asset ownership must end in confusion and futility").

Many commentators have weighed in over the years. See, e.g., id.; Gordon E. Warnke, Payments to Shareholders in Connection with Acquisitive Reorganizations: The Shareholders' Treatment, TAX FORUM NO. 580 (2005) (hereinafter, "Warnke, Shareholders' Treatment"); Jasper L. Cummings Jr., Form vs. Substance in the Treatment of Taxable Corporate Distributions, 85 TAXES 119 (2007); Glenn E. Coven, The Relevance of Fresh Investment to the Characterization of Corporate Distributions and Adjustments, 38 TAX L. REV. 419 (1983).

infer that, consistent with the Source Rule, the same concept of boot is inherent in Sections 356 and 368.[10]

The Source Rule, however, arguably runs afoul of Section 356. Section 356 applies to an exchange that would otherwise be governed by Section 354 except for the receipt of non-qualifying property. Section 354 applies if stock or securities are exchanged "in pursuance of the plan of reorganization," a concept that could be interpreted broadly.[11] A broad reading of "in pursuance of the plan" would suggest that Section 356 should apply to all distributions made in connection with a reorganization, whether a stock reorganization or an asset reorganization. Thus, under an alternative approach, the Source Rule would be applied to determine whether an acquisition qualifies as a reorganization, but Section 356 would apply to all distributions made in connection with a stock or asset reorganization. We refer to this approach as the "Pure 356 Approach."[12] The Pure 356 Approach is consistent with the many authorities in the B reorganization area that permit target-source distributions in connection with a B reorganization because the qualification of the transaction as a reorganization would continue to be governed by a Source Rule, while taxpayer treatment in the event that the transaction qualifies as a reorganization would be governed by Section 356. Thus, the Pure 356 Approach would permit boot in a B reorganization for purposes of Section 356, although not for reorganization qualification purposes. This approach is logically consistent, but goes further than many of us are willing to recommend.

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[10] It is not necessarily inherent in Section 361, however, that boot can only come from the acquiror. See infra Part I.C.

[11] See Rev. Rul. 98-10, 1998-1 C.B. 643, infra note 54 and accompanying text.

[12] See infra Part I.E.

We do believe, however, that once an acquisition occurs, it can become difficult to bifurcate a shareholder's receipt of consideration sourced at the target from consideration sourced at the acquiror. Accordingly, we recommend a third pragmatic approach that generally follows the Source Rule but draws a bright line distinction between pre-acquisition distributions and post-acquisition distributions in the case of asset reorganizations. We refer to this approach as the "Modified Source Rule."[13]

Specifically, we recommend that:

- Potential stock reorganizations continue to be governed by the Source Rule.
- In the case of potential asset reorganizations, the Source Rule govern distributions made at any time before (even a moment before) the acquisition.[14]
- In the case of potential asset reorganizations, distributions, whether sourced at the target or the acquiror, made pursuant to (i.e., as consideration in) the merger or consolidation (or, in the absence of a merger or consolidation, pursuant to the same corporate step as effects the distribution of the acquiror shares) be governed by Section 356.
- In the case of potential asset reorganizations, the treatment of distributions made after the merger or consolidation (or, in the absence of a merger or consolidation, the corporate step that effects the distribution of the acquiror shares) depend on the facts. In some circumstances, a distribution would best be viewed as being a distribution by the acquiror governed by Section 301.[15] In other cases, a distribution would best be viewed as an adjustment to the consideration received in the merger, in which case Section 356 would apply. And, in a third set of cases, a distribution would best be viewed as part of a pre-acquisition redemption or other distribution, in which case the Source Rule would apply.
- We interpret Treasury Regulation Section 1.368-1(e)(1)(ii) and -1(e)(7), Example 9, to mean that if a distribution is governed by Section 301 or 302, it is not taken into account for purposes of measuring continuity of interest. Thus, a redemption by the target of more than 60% of its shares for cash sourced at the target prior to a B reorganization

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13 See infra Part I.F.

14 In the case of a two step acquisition, we believe that, for purposes of the Modified Source Rule, "before the acquisition" would mean "before the merger."

15 See I.R.S. Priv. Ltr. Rul. 200752014 (Dec. 28, 2007), infra note 65 and accompanying text.

would not cause continuity of proprietary interest to be violated. Further, if our Modified Source Rule recommendation is adopted, a redemption by target of a portion of its shares for cash sourced at target (or a dividend by target of a portion of its equity value) followed by an acquisition of the remaining shares for mixed consideration of which up to 60% is cash would not violate continuity of proprietary interest.[16] We would appreciate confirmation.

- In applying the Modified Source Rule to asset acquisitions, the distributed funds be subject to the same tracing analysis applied to distributions in connection with stock acquisitions to determine whether target is the source of funds.
- The Source Rule apply to distributions in connection with acquisitions structured as Section 351 horizontal double dummy transactions.
- In the case of a pre-acquisition redemption by target using target's own funds, in applying Section 302, we believe that Zenz requires that the acquisition be taken into account when determining the reduction in the shareholder's interest. We would favor making such determination by looking through the acquiror so that the shareholder's indirect interest in the target after the transaction is taken into account, although we question whether there is statutory authority for such an approach.
- Even if the Modified Source Rule is not adopted, dividends be subject to the Source Rule both for stock reorganizations and asset reorganizations.

Before settling upon the Modified Source Rule as a reasonable compromise between the Source Rule and the Pure 356 Approach, we considered several other approaches that borrow aspects of the Source Rule or the Pure 356 Approach. One approach would apply the Source Rule to distributions in connection with a stock acquisition but would apply the Timing Rule to distributions in connection with an asset acquisition. Arguably, that approach more closely embodies current law, but it does not conform the treatment of distributions in connection with asset acquisitions with the treatment of distributions in connection with stock acquisitions. For that reason, we rejected it.

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[16] Such target-source consideration would count unfavorably in measuring whether the "substantially all" test has been satisfied.

Another approach would apply the Source Rule to determine shareholder consequences but would count all distributions, including target-source distributions, for purposes of continuity of interest. That alternative would be inconsistent with Treasury Regulation Section 1.368-1(e)(1)(ii), which indicates that a distribution governed by Section 301 or 302 does not affect continuity of interest. Specifically, in Treasury Regulation Section 1.368-1(e)(7), Example 9, a target-source redemption prior to a B reorganization is not taken into account for continuity of interest purposes. Yet another approach would apply the Pure 356 Approach to determine shareholder consequences and would count all distributions for continuity of interest purposes. That approach would also be inconsistent with Example 9. Because those approaches would be inconsistent with the government's most recent statement on continuity, we rejected them.

Finally, we considered applying the Source Rule to dividends made in connection with potential reorganizations, while applying the Pure 356 Approach to redemptions.[17] However, that approach would draw a formalistic distinction between dividends and redemptions, and therefore we did not embrace it. However, we do recommend that, for stock reorganizations and asset reorganizations alike, dividends be subject to the Source Rule (regardless of whether our primary recommendation to adopt the Modified Source Rule is adopted).

The following chart summarizes the treatment of target-source distributions under the alternatives that we considered:

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[17] Rev. Rul. 56-184, 1956-1 C.B. 190 and Rev. Rul. 69-443, 1969-2 C.B. 54, supra note 3 and accompanying text.

Are target-source ...	Source Rule	Modified Source Rule	Source Rule for Stock Reorganizations / Timing Rule for Asset Reorganizations	Source Rule for Treatment of Distributions / All Distributions Count Against Continuity of Interest	Pure 356 Approach	Pure 356 Approach for Treatment of Distributions / All Distributions Count Against Continuity of Interest
... distributions taken into account for continuity of interest?	No	No for stock reorganizations; No for asset reorganizations if pre-acquisition distribution	No for stock reorganizations; Yes for asset reorganizations	Yes	No	Yes
... dividends governed under Section 301?	Yes	Yes for stock reorganizations; Yes for asset reorganizations if pre-acquisition dividend	Yes for stock reorganizations; No for asset reorganizations	Yes	No (or Yes)	No (or Yes)
... redemptions governed under Section 302?	Yes	Yes for stock reorganizations; Yes for asset reorganizations if pre-acquisition redemption	Yes for stock reorganizations; No for asset reorganizations	Yes	No	No

In addition to proposing a framework for analyzing distributions in connection with acquisitions, we seek guidance on two ancillary questions involving distributions in connection with acquisitions. First, guidance would be helpful on whether a shareholder's holding period for purposes of eligibility for the reduced rate on qualified dividend income under Section 1(h)(11) is tolled when target enters into an acquisition agreement. Section 246(c)(4) tolls a shareholder's holding period for any period in which the shareholder is "under a contractual obligation to sell" substantially identical stock or securities. Based on the intent of Section 246(c)(4), as described in the legislative history, we believe that an acquisition agreement does not toll the target shareholder's holding period. Section 246(c)(4) was enacted to prevent shareholders from accomplishing a tax arbitrage without economic exposure to the underlying stock for the period required by Section 246(c)(1) and (2). We do not believe that Congress intended acquisition agreements to toll the holding period under Section 246(c)(4).

Second, in the context of reorganizations that have a "substantially all" requirement, we request guidance on the extent to which the company holding the target assets

after the acquisition can be the borrower of funds that finance the cash portion of the consideration. We believe that a borrowing by a newly formed corporation that will hold no assets other than target assets raises the same "substantially all" issue that is raised by a pre-merger borrowing by target because in both cases the only assets in the borrowing entity are the target's assets which assets have been burdened by the borrowing. However, we would welcome guidance regarding how to analyze "substantially all" when the corporation holding target assets also holds other independent assets that could support the borrowing.

I. General Framework for Analyzing Distributions in Connection with Reorganizations

A. Background

To set the stage, let us consider two examples. In the "B Reorg Example", public company Acquiror seeks to acquire public company Target in exchange for Acquiror stock. Target is worth $100. Target has $10 of excess cash that the parties would like to return to Target shareholders. Prior to the acquisition but in connection therewith, Target dividends $10 of cash to the Target shareholders. Acquiror acquires Target pursuant to a reverse triangular merger for Acquiror stock. We believe that the treatment of the cash distribution in the B Reorg Example is clear. Assuming the usual requirements are met, the transaction qualifies as a reorganization under Section 368(a)(1)(B) (and also under Section 368(a)(2)(E)), and the tax consequences of the cash distribution are determined under Section 301. In the B Reorg Example, the cash is not treated as boot that would prevent reorganization treatment, because the cash is sourced at Target. Numerous authorities support this conclusion.[18]

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[18] See supra note 3.

In the "(a)(2)(D) Example", the facts are the same, except that the parties effect the acquisition using a forward triangular merger, rather than a reverse triangular merger. Assuming the usual requirements are met, the acquisition qualifies under Section 368(a)(2)(D). We believe that the treatment of the cash distribution in this example should be the same as in the B Reorg Example, but that treatment under current law is less clear.

Certain authorities imply that the cash in the (a)(2)(D) Example would not be governed by Section 301 under the Source Rule, but instead would be viewed as part of the acquisition consideration, despite the cash being sourced at Target. In Rev. Rul. 71-364, the target in a transaction intended to qualify as a C reorganization retained an amount of cash to pay its dissolution expenses. After payment of all dissolution expenses, some cash remained and was distributed to target's former shareholders a year after the acquisition. Because the shareholders of the target received the cash distribution "as part of the plan of reorganization," the ruling holds that the distribution is treated under Section 356.[19] Likewise, in Sheldon v. Comm'r,[20] in connection with a statutory merger that was intended to qualify as a reorganization under Section 112 (the predecessor of Section 368), a target corporation distributed cash, securities and other property to its shareholders in order to equalize its assets with those of the acquiror corporation. The Tax Court concluded that based on the purpose of the distribution, its place in the sequence of events and the "surrounding circumstances," the distribution is an "integral part of the

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[19] Rev. Rul. 71-364, 1971-2 C.B. 182. The ruling does not discuss whether the cash distribution causes the transaction to fail to qualify as a C reorganization. The ruling seems to assume that the amount of cash and liability assumption is small enough that the boot-relaxation rule of Section 368(a)(2)(B) applies. The target retained only enough cash to pay liquidation expenses and distributed the residual amount.

[20] Sheldon v. Comm'r, 6 T.C. 510 (1946).

reorganization transaction as a whole and must be treated in connection with it." The court held that the distribution is governed by Section 112(c) (the predecessor to Section 356(a)).[21]

Two recent private rulings have added further uncertainty. In PLR 200610007, the IRS appears to have applied the Source Rule to an asset reorganization, treating the dividend as governed by Section 301.[22] That ruling states, "the sole source of the [d]ividend will be the paying corporation's own assets, and the paying corporation will not be reimbursed, directly or indirectly, by any party for any portion of the [d]ividend." By contrast, in PLR 200621011, a distribution sourced at the target in connection with an asset reorganization was held to be governed by Section 356.[23] There are distinctions between the two rulings: the former involved

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[21] See also I.R.C. § 368(a)(2)(G)(i) (a transaction will not qualify as a C reorganization unless the target distributes the stock, securities and properties it receives, "as well as its other properties, in pursuance of the plan of reorganization"); Rev. Rul. 73-102, 1973-1 C.B. 186 (acquiror's payment of cash to dissenters in a potential C reorganization constitutes boot for purposes of Section 368(a)(2)(B)).

[22] I.R.S. Priv. Ltr. Rul. 200610007 (Dec. 1, 2005). In PLR 200610007, a publicly traded corporation and a not-for-profit corporation intended to combine through a series of steps that included the not-for-profit reincorporating and then merging into an LLC. The reincorporation and the merger into the LLC were held to be one or more reorganizations. The parties agreed that either the not-for-profit or the publicly traded company would pay a distribution prior to the transaction for the purpose of maintaining a fixed ratio of cash held by the entities at closing. See also Rev. Rul. 71-266, 1971-1 C.B. 262 (distributions by target S corporation prior to a C reorganization were governed by Sections 1373 and 1375 and not Section 356); I.R.S. Priv. Ltr. Rul. 9041084 (Oct. 12, 1990) (dividends by targets to reduce cash reserves prior to an A reorganization were treated as Section 301 distributions, but post-acquisition target-source payments to target shareholders were governed by Section 356); G.C.M. 32,868 (June 26, 1964) (redemption of target preferred stock before a C reorganization was treated as a Section 302 redemption separate from the reorganization).

[23] I.R.S. Priv. Ltr. Rul. 200621011 (May 26, 2006). In PLR 200621011, an investment company acquired a target in a transaction intended to qualify as a C reorganization. Prior to the reorganization, the target redeemed shares representing up to 10% of the net value of the target from a shareholder holding more than 50% of the target stock. The ruling held that the distribution was governed by Section 356. The ruling also concluded that the transaction qualified as a C reorganization. Surprisingly, the ruling did not discuss the application of the

a dividend while the latter involved a redemption, the former involved a potential A or possibly F reorganization while the latter involved a potential C reorganization, the former involved a distribution based on a formula while the latter involved a distribution of a fixed amount. These distinctions, however, do not appear to explain the difference in treatment of the distribution.

B. Stakes

Significant consequences follow from the determination of whether a distribution is treated as separate from an acquisition or as a part of the acquisition.

The determination can affect qualification of the transaction as a reorganization on account of the continuity of proprietary interest rule. Under Treasury Regulation Section 1.368-1(e)(1)(ii), in determining whether continuity of proprietary interest has been satisfied, proprietary interests are not preserved to the extent that consideration received prior to a potential reorganization is treated as non-stock property under Section 356.[24] Thus, if a distribution is governed by Section 356, it is taken into account for purposes of measuring continuity. We believe that the converse is true—if a distribution is governed by Section 301 or

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(footnote continued)
boot-relaxation rule. Even though the redeemed shares represented only 10% of the net value of the target, liabilities assumed by the acquiror are also counted as boot. It is unclear why there is no discussion of the boot-relaxation rule in this ruling.

[24] That regulation contains a drafting peculiarity. If the transaction fails to be a reorganization, then Section 356 would not apply at all. Mark J. Silverman & Andrew J. Weinstein, The Continuity of Interest and Continuity of Business Enterprise Regulations, in 778 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 99, 117-18 (Louis S. Freeman ed., Practising Law Institute 2007) (hereinafter, "TAX STRATEGIES"); Gary B. Wilcox & Jared H. Gordon, Tax Treatment of Pre-Reorganization Distributions, in 778 TAX STRATEGIES 211, 226 (2007). Presumably, the regulation means that continuity is not preserved to the extent that such consideration would be governed by Section 356 if the transaction did qualify.

302, it is not taken into account for purposes of measuring continuity.[25] Thus, we believe that Treasury Regulation Section 1.368-1(e)(7), Example 9 (involving a redemption of target shares using target cash prior to a B reorganization) would apply even if target redeemed more than 60 percent of its shares prior to the acquisition. For example, if a Target worth $100 had $90 of excess cash on hand, it could pay a dividend to its shareholders or make a redemption of its shares using the $90 of cash and then be acquired for Acquiror stock in a B reorganization. We would appreciate confirmation of this interpretation of Example 9.

Assuming a transaction qualifies as a reorganization, the determination whether the distribution is a separate distribution by target or instead part of the acquisition affects the target shareholders' accounting for their proceeds. If the distribution is separate, then it is governed by Section 301 or, if target shareholders turn in target shares in exchange for the distribution, Section 302, while if it is part of the acquisition, Section 356 would apply. These regimes are different from one another from the perspective of basis recovery, tax rate (because holding period requirements differ for long term capital gain treatment as compared with

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[25] See Treas. Reg. § 1.368-1(e)(7), Ex. 9 (redemption by target using its own funds prior to a B reorganization does not affect continuity of proprietary interest). The final regulations reject the approach of Temporary Treasury Regulation Section 1.368-1T(e)(1)(ii), which provided that all redemptions and extraordinary distributions in connection with the potential reorganization counted unfavorably for continuity. According to the preamble:

> The final regulations provide that distributions and redemptions by a target corporation prior to a potential reorganization are taken into account for continuity of interest purposes to the extent that the consideration received by the target shareholder in the redemption or distribution is treated as other property or money under section 356 of the Internal Revenue Code.

T.D. 8898, 2000-2 C.B. 276 (emphasis added). See also Silverman & Weinstein, supra note 24, at 114-19; Wilcox & Gordon, supra note 24, at 223-28.

qualified dividend income treatment), the relevant measure of earnings and profits, withholding tax on non-US persons and eligibility for the dividends received deduction.[26]

C. Source Rule

Because of the significant stakes involved, we believe that guidance would be helpful regarding the framework for analyzing distributions in connection with acquisitions, and, in particular, whether a distribution that occurs in connection with an acquisition of assets should be considered to be part of the acquisition and therefore taken into account in measuring continuity of proprietary interest and governed by Section 356.

One approach would be to apply the Source Rule to potential asset acquisitions both for purposes of determining whether the acquisition qualifies as a reorganization and for purposes of determining the nature of the distribution. This approach would conform the

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[26] Section 301 distributions are treated as dividends to the extent of the target's earnings and profits with the possibility of a dividends received deduction for corporate shareholders under Section 243 and qualified dividend income treatment for individuals. To the extent the distribution exceeds earnings and profits, the distribution reduces the shareholder's basis in the shares to the extent of such basis and then is taxed as gain from the sale or exchange of property.

If the distribution is treated as a redemption under Section 302, then it is treated under Section 301 if the shareholder's proportionate interest in the corporation is not sufficiently reduced. Otherwise, it is treated as a sale or exchange. In the latter case, the shareholder recovers the basis of the shares of target stock that are exchanged in the redemption.

Section 356(a) provides a "basis last" rule, in which the shareholder would recognize any gain from the exchange, but not in excess of the amount of cash received in the distribution. Under Section 356(a)(2), all or a portion of such gain is treated as a dividend (within the tax meaning of the term) if the exchange "has the effect of the distribution of a dividend," but only to the extent that such gain is not in excess of the shareholder's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. Under Clark v. Comm'r, whether the exchange has the effect of the distribution of a dividend is determined by pretending that the target shareholder received only acquiror stock in the exchange and that the acquiror then redeemed a portion of that acquiror stock for cash. 489 U.S. 726 (1989), aff'g 828 F.2d 221 (4th Cir. 1987), aff'g 86 T.C. 138 (1986). The Section 356(a)(2) dividend-equivalency analysis thus differs from the analysis that would apply in the case of a redemption by a single corporation governed by Section 302.

authorities for stock and asset acquisitions which is consistent with the common purpose of both stock and asset reorganizations to permit corporations to combine on a tax-free basis.[27] As discussed below, the Source Rule stems from the view that Sections 354, 356, 361 and 368 are organized around a single concept of boot as property that comes from the acquiror. This framework aims at taxing boot once, either at the corporate level or the shareholder level.

Admittedly, there are numerous statutory distinctions among different types of reorganizations. These distinctions are in many cases historical artifact and in some cases do not serve a tax policy purpose. Indeed, Congress and the Internal Revenue Service have conformed the rules to an extent.[28] We believe that the treatment of distributions is another instance where conformity is warranted. The tax rules should not exacerbate distinctions among the rules

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27 See Treas. Reg. § 1.368-1(b) (the purpose of the reorganization provisions is to provide tax-free treatment when corporations enter into transactions that "effect only a readjustment of continuing interest in property under modified corporate forms"). See also Notice of Proposed Rulemaking: Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization, 69 Fed. Reg. 9771 (Mar. 2, 2004) (reorganization transactions "constitute readjustments of continuing interests in the reorganized business in modified corporate form").

28 The legislative history of P.L. 91-693, enacting Section 368(a)(2)(E), struck the theme of conformity between forward and reverse triangular mergers:

> The committee agrees with the House, that there is no reason why a merger in one direction … should be taxable, when the merger in the other direction … under identical circumstances, is tax-free. Moreover, it sees no reason why in cases of this type the acquisition needs to be made solely for stock.

S. REP. NO. 91-1533, at 2 (1970), reprinted in 1970 U.S.C.C.A.N. 6123, 6124. See also Rev. Rul. 2001-24, 2001-1 C.B. 1290 ("The legislative history of Section 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly."); Rev. Rul. 2001-25, 2001-1 C.B. 1291 ("The 'holds' requirement of section 368(a)(2)(E) does not impose requirements on the surviving corporation before and after the merger that would not have applied had such corporation transferred its properties to another corporation in a reorganization under section 368(a)(1)(C) or a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D)."); Rev. Rul. 2001-26, 2001-1 C.B. 1297 (conforming the treatment of reverse triangular reorganizations to that of forward triangular and parent-to-parent mergers, by permitting two-step acquisitions to qualify as reorganizations).

governing forward mergers and reverse triangular mergers. From a non-tax point of view, parties almost always prefer to effect an acquisition of a domestic target using a reverse triangular merger over any type of forward merger. A reverse triangular merger raises fewer conveyance problems and liability contamination issues than a forward merger as assets and liabilities of the historic target are not transferred. When parties instead choose a forward merger, it is almost always for a tax reason, specifically, that Section 368(a)(1)(A) and (a)(2)(D) permit more cash to be delivered as consideration than is permitted by Section 368(a)(2)(E) or (a)(1)(B).[29] There is little tax policy reason to encourage parties to use a particular reorganization format or to make the consequences of a distribution from the target vary depending on which structure is used. Despite the fact that the statute imposes different requirements on different types of reorganizations, the extra-statutory tax rules governing reorganizations should be conformed.

The Code may be interpreted to support the view that the Source Rule should apply for all purposes. Sections 354, 356, 361 and 368 create a comprehensive framework for corporate combinations. Having different notions of boot for different provisions does not seem to be intended. Section 361 discusses corporate level boot and addresses only property received pursuant to a plan of reorganization from the acquiror. That concept of boot does not encompass any property originating at the target. The definition of boot in Section 361(b)(1)(A) is relevant to the definition of boot in Section 356 because Sections 361(b)(1) and 356 work hand in hand to

[29] Another alternative for parties who wish to deliver more cash consideration than is permitted by Section 368(a)(2)(E) or (a)(1)(B) is to put a new holding company on top of both corporations in a Section 351 transaction. But, this structure is not always practical. Sometimes one corporation, especially one that is much bigger than the other or one that does many acquisitions, does not want to be placed underneath a new holding company. The structure may also require a shareholder vote that would otherwise be unnecessary.

ensure that boot is taxed at either the shareholder or the corporate level.[30] Since Sections 361(b)(1) and 356 are designed to impose a single level of tax on boot, one may infer from Section 361 that the proper scope of boot for purposes of Section 356 is the same as for purposes of Section 361, that is, property sourced at the acquiror.

However, arguably, Section 361(b) is not relevant for purposes of determining whether a target-source distribution is boot to the shareholders. Section 361(b) protects the target from taxable gain on the receipt of boot from the acquiror that, in turn, is distributed to target shareholders. Even if a distribution by target out of its own funds could be boot, there would be no risk of target tax liability on the receipt of such boot and thus no need for Section 361(b) to apply to target-source property. Thus, the fact that Section 361(b) is limited to acquiror-source boot as opposed to target-source boot could be interpreted to mean only that Section 361(b) covers every case where a non-taxability rule is needed but is not relevant for purposes of determining whether a target-source distribution is boot.

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[30] The purpose of the corporate level boot provision is to tax the transferor corporation's gain to the extent that the transfer is a completed sale and not just a corporate readjustment:

> [I]f the corporation which sells its assets in connection with the reorganization acts merely as a conduit in passing the proceeds of the sale on to its stockholders, no gain to the corporation is to be recognized, but if it retains all or any of the proceeds with the result that the transaction is in substance a real sale, then all or a part of the gain shall be recognized.

H.R. REP. NO. 179, 68th Cong., 1st Sess. 15 (1924).

Section 361(b)(1)(B) provides that if a corporation receives boot which it does not distribute, the gain, if any, to the corporation shall be recognized. Section 361(b)(1)(A) provides that if the boot is distributed, then there is no gain recognized at the corporate level, but the boot will then be subject to taxation at the shareholder level under Section 356. See Carlson, Boot at the Corporate Level in Tax-Free Reorganizations, 27 Tax L. Rev. 499, 508 (1971) (target should not be viewed as receiving taxable boot when funds are advanced by acquiror prior to an asset reorganization).

Aside from Section 361(b), the statutory tests of Section 368 and the Regulations thereunder generally apply a source rule, reinforcing the notion that boot is limited to amounts that are sourced at the acquiror. For purposes of the acquisition of control test in Section 368(a)(2)(E), under Treasury Regulation Section 1.368-2(j)(3)(i), stock in the target that is exchanged for consideration furnished by the target is considered not to be outstanding immediately before the transaction and thus is not taken into account in determining whether the acquiror acquired "control" of the target.[31] Likewise, the boot relaxation rule in Section 368(a)(2)(B), applicable to potential C reorganizations, is triggered if "the acquiring corporation exchanges money or other property" in addition to acquiror voting stock.[32]

Under the Source Rule, target-source distributions made before the merger, at the time of the merger or after the merger would be governed by Section 301 or 302, rather than Section 356. For example, if the target is the source of funds used to pay target shareholders exercising dissenters' rights, then such payments would not count as boot for continuity of proprietary interest purposes.[33] This would arguably be contrary to Revenue Ruling 73-102,

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31 Such consideration would count unfavorably in measuring whether the "substantially all" test has been satisfied, however.

32 I.R.C. § 368(a)(2)(B)(ii) (emphasis added). If the acquiring corporation does so exchange money or other property, then the 80 percent test is measured by reference to the fair market value of "all" the property of the target. Thus, it would appear that if target has $100 of assets, of which it distributes $10, the boot relaxation rule would be met if the acquiror delivered $80 of voting stock and $10 of cash, but it would not be met if the acquiror delivered $75 of voting stock and $15 of cash. Moreover, although "substantially all" would be a potential issue, the boot relaxation rule would be satisfied if the target distributed $25 of cash and the acquiror delivered solely $75 of acquiror voting stock in exchange for the remaining target assets.

33 However, payments made to dissenters by target do count towards "substantially all." Rev. Proc. 86-42, 1986-2 C.B. 722. Under any approach, target source payments should not count as boot for purposes of the boot relaxation rule applicable to C reorganizations. See supra note 32 and accompanying text.

which held that payments to dissenters in a potential C reorganization were boot. That Ruling does not indicate the source of the cash, however. As another example, if target merges into acquiror in a potential A reorganization[34] and, in the merger, target shareholders receive acquiror shares and target-source cash, under the Source Rule, the cash would be governed by Section 302.[35] The exchange pursuant to the merger would provide the requisite exchange for Section 302 purposes.[36]

The Source Rule could address one of the most vexing issues in reorganizations, namely, how to take account of post-closing contingent payments under the continuity of proprietary interest test. Suppose that target is intended to make a post-closing payment out of its own funds based on post-closing target earnings or some other post-closing variable. If, under the Source Rule, the payment is considered to be outside Section 356, then it may be outside of the continuity of proprietary interest calculation as well. However, this is not entirely clear. Treasury Regulation Section 1.368-1(e)(1)(ii) applies only to consideration "received prior to a potential reorganization" (emphasis added).

The Source Rule is itself formalistic. First, the Source Rule makes a distinction between funds sourced at target and funds sourced at acquiror when the economic result, from the shareholders' point of view, is identical. Second, the Source Rule is difficult to apply to post-acquisition distributions if target and acquiror assets end up in the same corporation, a result

[34] In this Report, "A reorganization" refers to a reorganization under Section 368(a)(1)(A), but not under Section 368(a)(2)(D) or (E).

[35] In Revenue Ruling 74-515, a shareholder that owned common and preferred stock in a target corporation received cash for the target preferred stock and acquiror stock for the target common stock in an A reorganization. Rev. Rul. 74-515, 1974-2 C.B. 118. The IRS held that Section 356 applied to such shareholder. That ruling does not indicate the source of the cash.

[36] See infra Part I.J.

that is more likely in asset reorganizations than in stock reorganizations. In stock acquisitions, target and acquiror assets are, at least initially, held in separate corporations. However, in parent-to-parent C reorganizations, parent-to-parent A reorganizations, and Section 368(a)(2)(D) reorganizations into historic subsidiaries, applying the Source Rule can present difficult tracing questions.

D. Timing Rule for Asset Reorganizations

Some would argue that distributions in connection with potential asset reorganizations should be treated as part of the acquisition if the distribution is made at or after the plan of reorganization has been adopted. In many cases, this would mean that distributions made after the acquisition agreement is signed would be considered part of the acquisition. The Timing Rule would derive from an analogy with rules for taxable liquidations.[37] Under this view, just as the Source Rule is applied to reorganizations involving an acquisition of stock based on precedents and authorities in the area of taxable acquisitions of stock,[38] the appropriate rule to

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[37] Under Treasury Regulation Section 1.332-2(c), a distribution is considered to be part of the liquidation if the distribution is made at or after the plan of liquidation has been adopted. The distribution must be made "in accordance with a plan of liquidation . . . Where there is more than one distribution, it is essential that a status of liquidation exist at the time the first distribution is made under the plan." Treas. Reg. § 1.332-2(c). See also Treas. Reg. § 1.332-4; Joseph Olmsted, 48 T.C.M. (CCH) 594 (1984) (applying a three-pronged test to determine whether a corporation is in a state of liquidation: "(1) whether there is a manifest intention to liquidate; (2) whether there is a continuing purpose to terminate corporate affairs and dissolve the corporation; and (3) whether the corporation's activities are directed and confined to that purpose.").

[38] See Waterman Steamship Corp. v. Comm'r, 430 F.2d 1185 (5th Cir. 1970) (court recast a last-minute pre-acquisition dividend by target to its parent in the form of a note as cash consideration paid by the acquiror to the parent of target because the acquiror was the source of funds); Rev. Rul. 75-493, 1975-2 C.B. 108 (target's extraordinary dividend of cash that the acquiror did not want is treated under Section 301 because the source of the funds is the target); Casner v. Comm'r, 450 F.2d 379 (5th Cir. 1971) (prior to a taxable sale of stock by target shareholders, target made a purported dividend from its paid-in capital; court recast the dividend as part of the purchase price received by sellers and treated the distribution as a dividend made

apply to a distribution in connection with a potential asset reorganization is the rule that applies to the closest taxable analogy to asset reorganizations, namely, taxable liquidations.

Under this view, moreover, the liquidation rules should apply to a potential asset reorganization, because a potential asset reorganization involves an actual or deemed transfer of assets by the target to the acquiror followed by a liquidation of the target. Properties sourced at the target could be viewed as being distributed as part of the actual or deemed liquidation along with the stock, securities or other properties received from the acquiror. Under that construct, one may question the rationale for separating target's distribution of target-source property and treating it as subject to Section 301 or 302, while target's distribution of the stock, securities and other property received from the acquiror are subject to Section 356.[39] Section 368(a)(2)(G)(i),

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(footnote continued)
by the target to the buyers). But see Litton Indus., Inc. v. Comm'r, 89 T.C. 1086 (1987) (court respected a distribution by target in the form of a note six months prior to target being acquired for cash because of the "substantial separat[ion] in time" between the dividend and the sale of stock and because the dividend was not conditioned on the execution of the sale); TSN Liquidating Corp., Inc. v. U.S., 624 F.2d 1328 (5th Cir. 1980) (court respected target's distribution of unwanted assets prior to target being acquired for cash because the distributed assets were retained by the selling stockholders and the distribution was not ultimately funded by the purchaser); Uniroyal Inc. and Consol. Subs. v. Comm'r, 65 T.C.M. (CCH) 2690 (1993) (a distribution from a subsidiary followed by a sale of the subsidiary stock qualified as a dividend and not as part of the sales price of the stock, where the dividend was declared and paid prior to the existence of a binding commitment by the parent to sell the subsidiary stock).

[39] Arguably, a reorganization under Section 368(a)(2)(E) also involves a construct in which the target shareholder makes an exchange with the target, rather than the acquiror. Specifically, one could view such a reorganization as involving a deemed transfer of parent stock (and potentially boot) from parent to the merger subsidiary, then a transfer of the parent stock (and boot) to the target pursuant to the merger in exchange for target stock, a liquidation of the merger subsidiary in which the target stock is distributed to the parent and an exchange by the target shareholders with the target of target stock for parent stock (and boot). Such a view of Section 368(a)(2)(E) transactions is arguably inconsistent with the view that a transaction can qualify as both a B reorganization and a Section 368(a)(2)(E) reorganization and the view that a transaction can qualify as a part of a Section 351 double dummy transaction and a Section 368(a)(2)(E) reorganization.

requiring the target to liquidate in a C reorganization, indicates that target-source properties may be distributed "in pursuance of the plan of reorganization," the touchstone for application of Section 354 and hence Section 356.

Nevertheless, we believe that conformity between asset and stock reorganizations is more desirable than conformity between asset reorganizations and taxable (or tax-free) liquidations. Conforming to the closest non-taxable analogy (other reorganizations) makes more sense than conforming to the closest taxable analogy (taxable liquidations) or otherwise conforming to liquidations.

First, the comparison between liquidations and asset reorganizations is inapt because there is no acquiror in a liquidation. In the case of liquidations, there is only one source of funds, i.e. the liquidating corporation. Thus, the rules applicable to liquidations are not designed to address a distinction based on the source of the funds, while the Source Rule is so designed.

Second, the liquidation rules are inapt because the treatment of distributions in the context of potential reorganizations involves both a qualification (of the reorganization) and a characterization (of the distribution) question, while the treatment of distributions in connection with a liquidation only goes to the latter point, i.e., whether the distribution is governed by Section 301, on the one hand, or Section 331 or 332, on the other hand. A distribution in the context of a liquidation does not generally affect the determination whether the corporation is liquidating.

Third, the concepts "plan of liquidation" and "plan of reorganization" differ critically in that, in a plan of liquidation, the liquidating 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,"[40] while in a "plan of reorganization," the continuity of business enterprise and continuity of proprietary interest doctrines ensure that the business continues as a going concern and the target shareholders retain a stake in such business. Distributions in the context of a liquidation effect the termination of the going concern, while, in the context of a reorganization, distributions enable shareholders to cash out of what is otherwise a continuing business. The rules for distributions in the context of reorganizations need not and should not be the same as those for distributions in the context of liquidations, because the business purposes of the two types of transactions, and the purposes of the respective tax regimes, differ significantly from one another.[41]

Indeed, the Treasury Regulations imply that the concept of a plan of reorganization is to be construed narrowly. Treasury Regulation Section 1.368-2(g) provides that:

> plan of reorganization… is not to be construed as broadening the definition of 'reorganization' as set forth in section 368(a), but is to be taken as limiting the non-recognition of gain or loss to such exchanges or distributions as are <u>directly</u> a part of the transaction specifically described as a reorganization in section 368(a) (emphasis added).

Along the same lines, Treasury Regulation 1.368-2(k) curtails the step transaction doctrine to permit certain contributions and distributions following a reorganization.

We do not believe that the transfer-and-liquidation construct for asset reorganizations should, in general, prevent the Source Rule from applying. One could as easily

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40 Treas. Reg. § 1.332-2(c).

41 <u>Cf</u>. <u>E. I. Du Pont de Nemours & Co.</u> v. <u>U.S.</u>, 471 F.2d 1211 (Ct. Cl. 1973) (rules for tax-free transfer of a patent to a controlled corporation differ from those for taxable sale of a patent, because the purposes of Section 351 and 1235 differ).

find in the context of an acquisition of stock that a dividend or redemption by the target is made in pursuance of the plan and hence subject to Section 356 by reason of the reference in Section 354 to "in pursuance of the plan of reorganization", but the authorities have not done so.[42]

Proponents of the Timing Rule may feel that conformity between asset reorganization and taxable liquidation rules is desirable in case a potential reorganization turns out to fail reorganization treatment on account of the distribution or for some other reason. Suppose that a distribution is sourced at the target and paid after the adoption of the plan of reorganization but before the acquisition. If the acquisition qualifies as a reorganization, then the distribution is characterized under Section 301 or 302 under the Source Rule, while if the acquisition fails to qualify as a reorganization, the distribution is characterized under Section 331 or 332. Thus, the distribution could be ordinary dividend income under Section 301 or an amount realized giving rise to capital gain or loss under Section 331, depending on whether the acquisition is a reorganization. While this may appear anomalous at first blush, it is not. If a transaction fails to qualify as a reorganization, many tax consequences differ, and this would be one of them. As discussed above, the purposes of the reorganization and liquidation rules differ from one another, and therefore it is not surprising to find that their consequences differ.

Advocates of the Timing Rule would assert that asset reorganizations and liquidations are interchangeable (i.e., that a taxpayer would often be in the position to choose whether to use one approach or the other) and, as a result, those rules should be conformed.

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[42] For example, in McDonald v. Comm'r, a shareholder owned almost all the shares of common stock and all the preferred stock of target. 52 T.C. 82 (1969). The target redeemed the preferred stock, and the shareholder exchanged target common stock for publicly-traded acquiror common stock in a purported B reorganization. The Tax Court held that the shareholder was entitled to sale or exchange treatment. See Rev. Rul. 56-184, 1956-1 C.B. 190, supra note 3. See also G.C.M. 32,868 (June 26, 1964), supra note 22.

However, while this may be true in a controlled corporation context, it is not true in general. Taxable liquidations of corporations rarely occur. Thus, the arguments described above in favor of applying the Source Rule to asset acquisitions may not apply to acquisitive D reorganizations. We believe that acquisitive D reorganizations raise policy issues that are less present in other asset acquisitions. For example, the controlled corporation context provides more opportunity for manipulation of character.[43] Indeed, by analogy with the application of Section 304 to acquisitions of stock, it is possible that in an acquisitive D reorganization, consideration furnished by the acquiror should in some cases be subject to Section 301 or 302, rather than 356. Furthermore, acquisitive D reorganizations often resemble E or F reorganizations, and thus the treatment of distributions in the context of acquisitive D reorganizations must be considered by reference to E and F reorganizations. We do not express a view with respect to the framework for analyzing acquisitive D reorganizations (or E or F reorganizations).

E. Pure Section 356 Approach

Since conformity between asset and stock reorganizations is desirable, one could consider whether a rule other than the Source Rule should apply to both types of acquisition structures. Some would argue that the Source Rule should determine reorganization qualification but that any distribution that is made in connection with a reorganization should be

[43] The liquidation/reincorporation doctrine and the acquisitive Section 368(a)(1)(D) rules are aimed at preventing taxpayers from converting dividend income into capital gain. Taxpayers have sought to bail out accumulated earnings of a corporation at preferential capital gains rates and obtain a step-up in the tax basis of assets by liquidating the corporation and transferring all or part of the corporation's assets to a related corporation owned by substantially the same shareholders. See Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 12-309 to -320 (7th ed. 2006); STAFF OF S. FIN. COMM., 99TH CONG., THE SUBCHAPTER C REVISION ACT OF 1985 26 (Comm. Print 1985).

subject to Section 356, even if the source of the funds is the target.[44] For purposes of determining shareholder consequences, the Pure 356 Approach effectively applies the Timing Rule both to asset and stock reorganizations. As discussed above in Part I.D, the transfer-and-liquidation construct supports application of Section 356 to asset acquisitions.[45] While the transfer-and-liquidation construct does not apply in the case of a stock reorganization, one could argue that acquisitions of stock should be conformed to acquisitions of assets, instead of vice-versa. Under the Pure 356 Approach, there could be boot in a B reorganization for purposes of Section 356, but not for reorganization qualification purposes.

The theory underlying the Pure 356 Approach is that in determining treatment of the distribution, the shareholder's perspective is of primary relevance. The target shareholders are indifferent to whether the source of the funds is the acquiror or the target. Thus, the Pure 356 Approach rejects a distinction between target- and acquiror-sourced funds, viewing it as formalistic. The Pure 356 Approach would simplify accounting for proceeds because all proceeds would be treated the same.

Moreover, the statute may support the Pure 356 Approach depending on how (1) "in pursuance of a plan of reorganization" in Section 356 and (2) "an exchange" and "the exchange" in Section 356 are interpreted. Section 354 applies if stock or securities are, "in pursuance of the plan of reorganization, exchanged" solely for stock or securities. Section 356 applies if Section 354 "would apply to an exchange but for the fact that . . . the property received in the exchange" consists not only of non-recognition property but also of other property or money.

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44 See Warnke, Shareholders' Treatment, supra note 9, at 69-78.

45 See Rev. Rul. 71-364, 1971-2 C.B. 182, supra note 5.

The phrase "in pursuance of the plan of reorganization" could be read to include target-source distributions to target shareholders that are made in connection with the reorganization. Section 356 arguably does not distinguish between property that comes from the acquiror and property that comes from the target, and Rev. Rul. 98-10 supports a broad reading of "in pursuance of the plan." In that ruling, the IRS held that a debenture-for-debenture exchange that occurred as part of an overall transaction that included a B reorganization was "in pursuance of the plan of reorganization."

However, such a broad reading of "in pursuance of the plan of reorganization" is not mandated by the statute, and the term could be read narrowly to exclude transactions between target shareholders and target that do not involve acquiror. In fact, the Treasury Regulations suggest a narrow reading of the concept of a plan of reorganization.[46] Indeed, even under the Pure 356 Approach, target-source distributions are not necessarily part of the reorganization for continuity of interest purposes, and "in pursuance of the plan of reorganization" might be read to embody the Source Rule, namely that only acquiror-sourced payments are governed by Section 356.[47]

Moreover, the references in Section 356 to "an exchange" and "the exchange" are arguably impediments to applying Section 356 to distributions in connection with acquisitions of stock, and to dividends in connection with asset acquisitions, as the phrases "an exchange" and "the exchange" may imply that there must be a single exchange.

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46 See Treas. Reg. § 1.368-2(g) ("plan of reorganization" limits the non-recognition of gain or loss to "such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a)").

47 But see I.R.C. § 368(a)(2)(G)(i) (target-source properties may be distributed "in pursuance of the plan of reorganization").

In the case of distributions in connection with asset acquisitions, there is always an exchange of target shares with target in the deemed liquidation. In an asset acquisition, both the distribution (whether a dividend or a redemption) and the acquisition consideration are arguably received in a single exchange because target shareholders receive all the consideration from target.

In the case of a target-source dividend in connection with a stock acquisition, there is no exchange at all. Indeed, in Revenue Ruling 56-184, the IRS held that a dividend by a target prior to a B reorganization was governed by Section 301. A target-source redemption in connection with a stock reorganization arguably requires two exchanges, one with acquiror and one with target. A redemption of target shares by target would appear to be a second exchange arguably not contemplated by the statute's implication that a single exchange is contemplated.[48]

Moreover, in the case of redemptions, the recently promulgated Section 358 regulations imply that there is more than one exchange, because they view each target share as being exchanged for consideration.[49] If a shareholder exchanges certain shares with the target and other shares with the acquiror, then the share-by-share approach of the Section 358 regulations reinforces the idea that there is more than one exchange.[50]

In defense of the Pure 356 Approach, one could argue that there is a single exchange in the case of any distribution that occurs as part of an overall integrated transaction. Step transaction principles could support this interpretation. The references to a single exchange

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[48] Arguably, a Section 368(a)(2)(E) reorganization involves a single exchange by the target shareholders with the target. See supra note 39.

[49] Treas. Reg. § 1.358-1; Treas. Reg. § 1.358-2.

[50] Id.

arguably were not intended to distinguish a payment upon the merger itself with a payment a moment before or otherwise in connection with the merger. Further, the fact that Section 358 adopts a share by share approach to exchanges that are already within Section 356 arguably should not determine the scope of Section 356 in the first place.

In any event, however, we believe that, even under a Pure 356 Approach, a dividend (as distinguished from a redemption) should be governed by Section 301, not Section 356, because it is more difficult to argue that a dividend is part of an exchange.[51] A dividend in form involves a distribution with respect to shares and not an exchange of shares. Thus, even if a Pure 356 Approach is adopted, dividends should be subject to the Source Rule both for stock reorganizations and asset reorganizations.

As mentioned above, the Pure 356 Approach would distinguish between the concept of boot for Section 356 purposes and for reorganization qualification purposes. Thus, the Pure 356 Approach is consistent with the many authorities permitting target distributions in connection with a B reorganization.[52] Indeed, we would not expect there to be an appetite for reconsidering the many Source Rule authorities in the context of testing reorganization qualification in the case of acquisitions of stock.[53]

The approach of having a different concept of boot for purposes of reorganization status and shareholder treatment is arguably inconsistent with Revenue Ruling 56-184, however.

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51 The line arguably blurs if the dividend is required under the transaction documents. See Warnke, Shareholders' Treatment, supra note 9, at 61, 79-86.

52 See supra note 3 and accompanying text.

53 See supra note 3 and accompanying text.

In that ruling, the IRS linked the two concepts of boot in the case of a pre-reorganization dividend:

> In the dividend transaction here involved, section 356 of such Code is not applicable because the cash distributed is not cash received in connection with an exchange of stock. If it were, section 368(a)(1)(B) of the Code, quoted above, would not apply because that section is applicable only if voting stock of the acquiring corporation is the sole consideration given for the stock acquired.

Further, a distinction between boot for purposes of Section 356 and 368 is in tension with the notion that Sections 356 and 368 are meant to work together. That is, Section 368 tests for reorganization status, permitting boot under some circumstances. If the transaction qualifies as a reorganization, then Section 356 characterizes the boot that Section 368 permitted.[54] Indeed, the IRS appears to agree. Treasury Regulation Section 1.368-1(e)(1)(ii) appears to equate boot for Section 356 purposes with boot for continuity of proprietary interest purposes.[55] Treasury Regulation Section 1.368-1(e)(7), Ex. 9 makes clear that a redemption that occurs in connection with a reorganization is not necessarily governed by Section 356 even if the target shareholder receives stock in the reorganization. The Pure 356 Approach is limited to addressing shareholder consequences, not reorganization qualification, in order to avoid a conflict with the B reorganization authorities. Being so limited, the Pure 356 Approach conflicts with Example 9 and Treasury Regulation Section 1.368-1(e)(1)(ii).

The Pure 356 Approach could be made more internally consistent by counting target-source distributions, as well as acquiror-source distributions, for purposes of continuity of proprietary interest. Insofar as post-acquisition target-source distributions count for continuity of

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54 Compare Rev. Rul. 98-10, 1998-1 C.B. 643 (debenture-for-debenture exchange in pursuance of the plan of reorganization is covered by Section 354).

55 See supra notes 24-25 and accompanying text.

proprietary interest purposes, while pre-acquisition target-source distributions do not, this modification of the Pure 356 Approach would eliminate that disparity. However, this modification would be inconsistent with Treasury Regulation Section 1.368-1(e)(7), Ex. 9, which provides that a pre-reorganization redemption does not count for purposes of continuity of proprietary interest. Moreover, the published rulings that permit the target to pay a distribution in connection with a B reorganization are often viewed as standing for the principle that target-source distributions do not count either for B reorganization statutory qualification purposes or for continuity of proprietary interest purposes.[56] The modification of the Pure 356 Approach to take target-source distributions into account for continuity of proprietary interest but not for statutory qualification would be in tension with that view.

Moreover, the Pure 356 Approach would have its own formalisms, regardless of whether it is so modified. Although the Pure 356 Approach does create consistent treatment of cash received by target shareholders regardless of source, it results in inconsistent treatment between distributions made by a target to target shareholders and distributions made by an acquiror to acquiror shareholders. For example, in connection with a parent-to-parent A reorganization, suppose that each of target and acquiror wished to redeem 10 percent of its stock before the merger. Despite the symmetry of the transaction, the Pure 356 Approach would treat the distribution to target shareholders as boot under Section 356 and the distribution to acquiror shareholders as a redemption under Section 302 because only target shareholders have the necessary Section 354 exchange to trigger Section 356. Since all transactions can be structured

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56 See supra note 3.

so that target and acquiror switch roles,[57] the Pure 356 Approach would allow some electivity. Thus, it is possible that taxpayers could avoid the application of the Pure 356 Approach by reversing the direction of the acquisition so that the corporation making the distribution is the nominal acquiror. This illustrates that formalism also exists in the Pure 356 Approach.

Both the Pure 356 Approach and the Source Rule conform the treatment of certain payments and distributions. The Pure 356 Approach conforms the treatment of payments made by target to target shareholders and payments made by acquiror to target shareholders. The Source Rule conforms the treatment of distributions made by target to target shareholders and distributions made by acquiror to acquiror shareholders. Unfortunately, it is impossible to construct a rule that simultaneously achieves both types of conformity. In the following section, we present a compromise between these two imperfect regimes.

F. Modified Source Rule

On balance, we would recommend a modified version of the Source Rule (the "Modified Source Rule"):

- Potential stock reorganizations would continue to be governed by the Source Rule.
- In the case of potential asset reorganizations, the Source Rule would govern distributions made at any time before the acquisition, even a moment before the acquisition.[58]
- In the case of potential asset reorganizations, distributions, whether sourced at the target or the acquiror, made pursuant to (i.e., as consideration in) the merger or consolidation (or, in the absence of a merger or consolidation, pursuant to the same

[57] In practice, reversing the roles of target and acquiror may not be desirable for non-tax reasons including shareholder vote requirements and increased transaction costs.

[58] In the case of a two step acquisition, we believe that, for purposes of the Modified Source Rule, "before the acquisition" would mean "before the merger."

corporate step as effects the distribution of the acquiror shares) would be governed by Section 356.

- In the case of potential asset reorganizations, the treatment of distributions made after the merger or consolidation (or, in the absence of a merger or consolidation, the corporate step that effects the distribution of the acquiror shares) would depend on the facts. In some circumstances, a distribution would best be viewed as being a distribution by the acquiror governed by Section 301.[59] In other cases, a distribution would best be viewed as an adjustment to the consideration received in the merger, in which case Section 356 would apply. And, in other cases, a distribution would best be viewed as part of a pre-acquisition redemption or other distribution, in which case the Source Rule would apply.

The Modified Source Rule reconciles most of the authorities and conforms the treatment of stock and asset reorganizations to a large degree. Notably, the Modified Source Rule is consistent with Revenue Rulings 71-364 and 74-515, the principal authorities requiring Section 356 treatment in an asset reorganization, because Revenue Ruling 71-364 involved a distribution of cash that occurred after the distribution of the acquiror voting stock in a C reorganization while Revenue Ruling 74-515 involved the exchange of preferred stock for cash pursuant to the merger.[60] At the same time, the Modified Source Rule is consistent with the B reorganization authorities that permit target-source payments. The only case or published ruling that the Modified Source Rule would appear to override is Sheldon.[61] Treasury Regulation Section 1.368-1(e)(1)(ii) appears to point toward the Modified Source Rule. It addresses only consideration "received prior to a potential reorganization" (emphasis added), distinguishing between such consideration that is and is not governed by Section 356. The implication perhaps is that all consideration received in or after the reorganization is governed by Section 356.

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[59] See I.R.S. Priv. Ltr. Rul. 200752014 (Dec. 28, 2007), infra note 65 and accompanying text.

[60] See supra notes 19 and 35 and accompanying text.

[61] See supra note 20 and accompanying text.

However, in describing pre-acquisition distributions, that regulation does not specify that only acquiror-source property can be boot, which at least leaves open the possibility that target-source distributions could be governed by Section 356 (contrary to the Modified Source Rule).

The Preamble to Treasury Regulation Section 1.368-2(k) provides further support for the distinction made by the Modified Source Rule between pre- and post-acquisition distributions and for its treatment of distributions made at the time of or after the acquisition. As discussed in greater detail below, the Preamble indicates that post-acquisition transfers of target property to former target shareholders as consideration for the target shareholders' proprietary interests "calls into question whether the underlying transaction satisfies the continuity of interest requirement in Treas. Reg. § 1.368-1(e) as well as certain statutory limitations on permissible consideration (such as the 'solely for voting stock' requirement in section 368(a)(1)(B) or (C))."[62]

The Modified Source Rule was applied by the IRS in PLR 9041084. In that private ruling, three target corporations were merged into an acquiring corporation in an A reorganization. Before the merger, the targets made pro rata cash dividends to their respective shareholders to reduce the net asset values of the respective targets to amounts specified in the merger agreement. The IRS held that those distributions were governed by Section 301.[63] Also, any target that had a dissenting shareholder after the target shareholder vote was required to set aside funds in a segregated reserve account. Any excess in the account was to be distributed to

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62 T.D. 9396, 2008-22 I.R.B. 1026 (May 9, 2008).

63 I.R.S. Priv. Ltr. Rul. 9041084 (Oct. 12, 1990), holding (1).

the target's non-dissenting shareholders after the merger. The IRS held that the latter distributions would be governed by Section 356.[64]

The Modified Source Rule would draw a line in the case of asset acquisitions between distributions that occur before (even immediately before) the merger and those that occur pursuant to the merger. Thus, we would envision that, all on the same day, a target could declare a dividend or effect a redemption of target shares (whether using its own excess funds or funds borrowed by the target) and then immediately be acquired in an asset reorganization (or in a stock reorganization) and have the distribution governed by Section 301 or 302, respectively. In the case of a forward merger (or other asset reorganization), the corporate mechanic for making the dividend or redemption would need to precede the merger (or other step effecting the distribution of acquiror shares to the target shareholders). Even if the distribution is expressly conditioned on the substantial certainty of the occurrence of the acquisition, the distribution should still be governed by Section 301 or 302 so long as the distribution precedes the merger.

Distributions made after the asset acquisition can arise in different ways, and it is difficult to state a single rule applicable to all. In PLR 200752014, a dividend was declared by the acquiror after the acquisition.[65] The IRS held that this was a Section 301 distribution by the acquiror, a sensible result. However, a purchase price adjustment sourced at the target would likely be viewed as relating back under Arrowsmith[66] to the merger and therefore governed by Section 356, because, in an asset reorganization, distributions made pursuant to the merger are

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64 Id., holding (13). This ruling also involved a non-pro rata redemption of certain target shareholders prior to the merger (step (iv)). The IRS did not rule on this step.

65 I.R.S. Priv. Ltr. Rul. 200752014 (Dec. 28, 2007).

66 Arrowsmith v. Comm'r, 344 U.S. 6 (1952).

governed by Section 356 under the Modified Source Rule. If before the merger target declared a dividend (or redeemed shares) of (or for) a fixed amount payable on a specified date after the merger, this would likely be viewed as a distribution of a debt instrument taxable under Section 301 (or 302) before the merger (subject potentially to installment reporting in the case of a Section 302 sale or exchange).

Distributions made after the asset acquisition also may implicate Treasury Regulation Section 1.368-2(k). That regulation provides a safe harbor under which certain post-reorganization transfers do not disqualify a potential reorganization transaction. The regulation provides that transfers of target assets to former target shareholders are outside the scope of the safe harbor protection if the transfers constitute receipt of consideration for proprietary interests in target. The Preamble states that any such transfer to target shareholders "calls into question whether the underlying transaction satisfies the continuity of interest requirement."[67] The Modified Source Rule arguably undercuts this regulation because it would allow target to make certain distributions a moment before the acquisition that, if they had been made a moment after the transaction, would not be within the -2(k) safe harbor and would, the Preamble implies, count against continuity of proprietary interest.

However, from a different point of view, the Modified Source Rule is entirely consistent with Treasury Regulation Section 1.368-2(k) because both draw a bright line distinction between pre- and post-acquisition actions. The regulation provides a safe harbor for certain transfers of target assets (other than to target shareholders) after the acquisition but is silent about transfers of targets assets that occur before or at the time of the acquisition. The regulation's safe harbors do not apply to pre-acquisition transfers of target assets. Indeed, the

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[67] T.D. 9396, 2008-22 I.R.B. 1026.

regime permits transactions after the acquisition that would clearly be prohibited at or prior to the acquisition. For example, under the regulation, multi-tier drop-downs of target stock after the acquisition will not disqualify the acquisition from being a reorganization. The target may not be acquired in the first instance, however, at a tier several levels below the acquiror in a reorganization. Similarly, under the Modified Source Rule, post-acquisition distributions are subject to a different more complicated analysis than is applied to pre-acquisition distributions. Both the Modified Source Rule and the regulation acknowledge that post-acquisition distributions raise different considerations from pre-acquisition distributions.

The Modified Source Rule admittedly places a premium on timing and form. However, we believe it strikes a reasonable, workable and pragmatic balance between the Source Rule and the Pure 356 Approach. By drawing a bright line at the time of the merger, the Modified Source Rule avoids (1) the tracing questions presented by post-acquisition distributions under the Source Rule and (2) the difficult questions as to which pre-reorganization distributions are "pursuant to a plan of reorganization" under the Timing Rule or the Pure 356 Approach.

G. Tracing the Source of Funds

The Source Rule requires that the source of funds of a distribution be traced. The fact that the target in fact pays the distribution does not mean that the target is the source of the funds.[68] We believe that, as a general matter, insofar as the Source Rule applies to potential asset reorganizations, potential asset reorganizations should be subject to the same tracing analysis that would apply to acquisitions of stock that are potential reorganizations.

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68 See Rev. Rul. 75-360, 1975-2 C.B. 110, supra note 3. See also Waterman Steamship Corp. v. Comm'r, 430 F.2d 1185, 1194 (5th Cir. 1970) ("Although the distribution was cast in the form of a dividend, the distribution was to be financed by [acquiror] with payment made to [shareholder] through [target]").

In many types of asset acquisitions, the tracing problem is no greater than it is in an acquisition of stock. For example, in a forward triangular merger under Section 368(a)(2)(D) or a triangular Section 368(a)(1)(C) reorganization, the target's assets, including cash, are transferred to a subsidiary which is typically a newly-formed entity holding no other assets. The Source Rule is as easily applied to these types of asset acquisitions as it is to an acquisition of stock. Furthermore, a forward merger (or transfer of substantially all the target's assets) into a newly formed limited liability company disregarded from its owner accomplishes the same segregation of target's assets and in that context, as well, normal tracing principles should be applied.

Certain types of asset acquisitions involve an extra twist, however. Specifically, normal tracing concepts can be especially difficult to apply where the entity that receives the target's assets in the reorganization also owns assets other than those received from target.[69] After such an asset acquisition, the target's cash and other assets are no longer held in a separate entity as they are after an acquisition of the target's stock, making it more difficult to confirm that the source of the funds is the target. For example, suppose target borrowed funds before the acquisition, distributed those funds to the target shareholders and then merged into the acquiror in an A reorganization. Under the Source Rule, in order for Section 301 to apply to the distribution, the acquiror cannot supply the funds to repay the debt.[70] Tracing is more difficult to apply than in a case where target is a separate corporation, as in a B reorganization, or where target merges into a newly formed subsidiary, as in a Section 368(a)(2)(D) reorganization.

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[69] The Source Rule for B reorganizations applies whether the distribution occurs before or after the reorganization. See Rev. Rul. 55-440, 1955-2 C.B. 226 and Rev. Rul. 69-443, 1969-2 C.B. 54, supra note 3 and accompanying text.

[70] Waterman Steamship, supra note 38; Rev. Rul. 75-360, 1975-2 C.B. 110, supra note 3.

However, it may be possible on the right facts for the target to demonstrate that the source of the funds used to repay the debt is the target. Indeed, the issue is also present in acquisitions of stock if the acquiror transfers assets to the target, or the target distributes assets to the acquiror, after the acquisition.

For acquisitions of stock and triangular acquisitions of assets, we believe that the Source Rule does not apply if cash moves from the target to the acquiror (in the case of an acquisition of stock) or the parent (in a triangular acquisition of assets) and then to the target shareholders. The Source Rule only applies if the target (or its successor) directly pays the target shareholders.

H. Quantum of Cash

Assuming that the Source Rule or the Modified Source Rule applies to asset acquisitions, we believe that in a potential A reorganization, Example 9 of Treasury Regulation Section 1.368-1(e)(7) implies that the target could distribute its own funds in a distribution under Section 301 or 302 and then be acquired for mixed consideration of which up to 60 percent is cash. For example, if a Target worth $100 had $50 of excess cash on hand, the Target could distribute the $50 of cash to its shareholders in a pro rata dividend or a redemption of shares and then be acquired for $30 of cash and $20 of Acquiror stock in an A reorganization. There is no "substantially all" test or "solely for voting stock" test under Section 368(a)(1)(A). Rather, continuity of business enterprise is the key test, and it is satisfied in this example, because only cash is distributed. The latter example would follow from Example 9 and our Modified Source Rule recommendation. We would appreciate confirmation.[71]

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[71] See discussion of Example 9, supra Part I.B.

I. Section 351 Transactions

A common acquisition technique is the "horizontal double dummy" pursuant to which a new holding company acquires two historic corporations by having a subsidiary merge into each historic corporation, with the shareholders of each historic corporation receiving holding company stock and, potentially, cash. The technique is often used to remedy reorganization qualification problems. For example, it is often used when the amount of cash that is intended to be delivered to either corporation's existing shareholders exceeds the amount that would be permitted by the continuity of proprietary interest doctrine.[72] The horizontal double dummy structure is intended to qualify under Section 351, which does not have a continuity of interest or "substantially all" requirement.[73] We believe that the Source Rule applies under current law to these transactions because they involve acquisitions of stock of each of the historic corporations. Thus, we believe that if shareholders receive cash and stock in the holding company, the source of the cash governs whether the distribution is treated under Section 351(b) (which would apply if the holding company is the source of the cash), on the one hand, or Section 301 or 302 (which would apply if the shareholder receives cash from the corporation of which it is a shareholder prior to the transaction).[74] If the other historic company (as distinguished from the holding company) is the source of the cash, we would envision Section 351(b) to apply on the view that the other historic company is treated as having

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72 See, e.g., Richard W. Bailine, Long Live the Horizontal Double Dummy!, 29 J. CORP. TAX'N 30 (2002).

73 Compare Rev. Rul. 84-44, 1984-1 C.B. 105 (transaction failed Section 351 where acquiror acquired one target in a Section 368(a)(2)(D) forward triangular merger and a portion of the other target's assets in exchange for acquiror shares).

74 Under certain circumstances involving overlapping shareholders, Section 304 could apply to cash received by shareholders.

distributed such funds to the holding company[75] (or lent the funds to the holding company if an intercompany note is created).

J. Redemptions

In the case of a distribution that is treated as separate from the acquisition, we believe that the distinction between whether Section 301 or 302 applies depends on whether the target shareholder turns in shares to the target in exchange for the distribution. If so, then Section 302 applies, and if not, then Section 301 applies.[76] Thus, if target has cash that is meant to be paid to the target shareholders, the parties could arrange the transaction to provide for more efficient basis recovery to the target shareholders than would apply under Section 356 (or 351(b)) by permitting the target shareholders to have a portion of their shares redeemed by the target in connection with the transaction.

For example, suppose that two corporations, X and Y, desire to combine using a horizontal double dummy structure, intended to qualify under Section 351. The shareholders of X are meant to receive only holding company stock for each share of X stock that they own, but the shareholders of Y are meant to receive $70 in cash and $30 of holding company stock for each Y share they own. Consider a Y shareholder who has ten shares, each with a basis of $30.

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75 If the holding company and the acquiror are both domestic, such intercompany distribution should not give rise to any income to the holding company either (1) because it should be viewed as a distribution between two members of the same consolidated group (see Treas. Reg. § 1.1502-13(f)(2)(ii)) or (2) possibly because a deemed distribution from the acquiror to the holding company should be disregarded at the corporate level under the principles articulated in Helen M. Webb, 67 T.C. 293 (1976) (rejecting the Service's prior view that the parent received a taxable dividend when there was a deemed distribution under Section 304). See also Rev. Rul. 80-189, 1980-2 C.B. 106 (the IRS intends to follow Webb).

76 Estate of Durkin v. Comm'r, 99 T.C. 561 (1992) (shareholders bought an asset at a discount from target prior to a planned sale of target; court held that the discount was a dividend under Section 301, and not a Section 302 exchange, because the shareholders did not turn in shares to target).

If the Y shareholder exchanges the Y shares for cash and stock from the holding company, the target shareholder will recognize $700 of gain. Suppose, however, that the Y shareholder were entitled to exchange one share of Y stock with Y for $100 (and therefore the remaining nine shares were entitled to be exchanged with the holding company for an aggregate of $600 of cash and $300 of holding company stock). In that case, the Y shareholder's exchange of one share for $100 cash with Y would be subject to Section 302.

Whether the transaction is a sale or exchange under Section 302 would be determined by reference to the Y shareholder's ownership interest in Y. We believe that Zenz v. Quinlivan[77] would apply such that the Y shareholder's ownership interest should be measured by reference to Y after the acquisition.[78] Under Section 318, Y would not be attributed any stock in Y owned by the holding company unless the Y shareholder owned at least 50 percent of the holding company.[79] Thus, the Y shareholder would recognize a total of $670 of gain (equal to $70 of gain recognized on the exchange of one share for the cash from Y and $600 of gain recognized on the exchange of nine Y shares for cash and holding company shares from the holding company). We believe that this result is implied by the Source Rule and thus already applies to acquisitions of stock of the target in potential reorganizations and Section 351

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77 213 F.2d 914 (6th Cir. 1954).

78 McDonald, supra note 42, applied Section 302 to a pre-reorganization redemption by comparing the shareholder's interest before and after the transaction. The Tax Court found that the shareholder's investment had been "changed radically," and held that, under Zenz, the shareholder was entitled to sale or exchange treatment. See also G.C.M. 32,868 (June 26, 1964), supra note 22.

79 I.R.C. § 318(a)(2)(C). If the transaction were subject to Section 304, the analysis would differ. Among other things, for purposes of calculating whether the target shareholder's percentage interest in the target has been sufficiently reduced, the target shareholder would be attributed ownership of target through the holding company no matter how little stock in the holding company the target shareholder owned. I.R.C. § 304(b)(1).

transactions.[80] Moreover, we believe that, in the case of acquisitions of stock, because a merger involves an exchange of shares, the necessary redemption can be effected by having the merger agreement specify that the appropriate portion of the target shares is exchanged with the target, rather than the acquiror, and having the funds flow accordingly.[81]

As mentioned, under current law, for purposes of applying Zenz, it seems that, because of the 50 percent threshold in Section 318(a)(2)(C), in a stock acquisition, the target shareholder's percentage ownership is reduced to zero for purposes of applying the tests in Section 302 unless the shareholder holds more than 50 percent of the acquiror stock. Similarly, if the acquisition is a triangular asset acquisition, the target shareholder's percentage ownership will be reduced to zero for purposes of applying the tests in Section 302. In both cases, the distribution will qualify as a sale or exchange (so long as the shareholder turns in shares) because the shareholder's interest in the target is terminated for purposes of Section 302.

That approach does not take into account, though, the target shareholder's continuing indirect interest in the target or its assets. A better approach would be to measure the shareholder's interest in the target (or the successor to the target in a triangular asset reorganization) by looking through the acquiror. The target shareholders continue to hold an

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[80] See McDonald, supra notes 42 and 78. Cf. Rev. Rul. 68-285, 1968-1 C.B. 147, supra note 3; Rev. Rul. 55-440, 1955-2 C.B. 226, supra note 3.

[81] Note that in a reverse subsidiary merger, the number of shares in the surviving corporation that remain outstanding after the transaction almost always changes. Under typical corporate law mechanics, the number of shares of the surviving corporation remaining outstanding after a merger is the number of merger subsidiary shares that were outstanding prior to the merger. That is, merger agreements typically provide that each share of the merger subsidiary that merges out of existence is converted into one share of the surviving corporation and that all the pre-existing shares of the surviving corporation are cancelled. Thus, the number of outstanding shares of the target outstanding after the transaction is not a good indication of whether shares were in fact turned in to the target as compared with the holding company.

economic interest in target through their ownership of acquiror stock, and in the case of an asset acquisition, the target shareholders continue to hold an economic interest in the target assets. We would favor the application of a look-through rule that takes into account the shareholder's indirect interest in the target stock or assets when applying the Section 302 rules.[82] Such a look-through rule would better serve the purpose of Section 302 in determining whether there has actually been a redemption of the target shareholder's interest.[83]

Arguably, Section 318 prevents the IRS from developing such a look-through rule absent a statutory amendment. Section 302(c) specifically refers to Section 318. Elsewhere in the Code, where attribution is intended, the Code sets out specific rules for doing so.[84] We believe that the Department of the Treasury and the IRS may nonetheless have the authority to promulgate a look-through rule in the context of distributions in connection with acquisitions. Such a rule would provide an elaboration of the Zenz doctrine in the specific circumstance where a transaction converts direct ownership of stock into indirect ownership. Zenz states only that the subsequent acquisition should be taken into account for purposes of determining the target shareholder's interest, but it does not specify how the indirect interest of the target shareholders should be taken into account for purposes of Section 302.[85]

Some would argue that it is inconsistent to treat a pre-acquisition redemption as separate under the Source Rule and therefore not subject to Section 356 while at the same time

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82 For example, the look-through rule could be modeled on the attribution rule applied in the context of redemptions by related corporations. See supra note 79.

83 Warnke, Shareholders' Treatment, supra note 9, at 46-55.

84 E.g., I.R.C § 267(c); I.R.C. § 1563(e).

85 See Warnke, Shareholders' Treatment, supra note 9, at 48-49.

applying the step transaction doctrine pursuant to Zenz and thus taking into account the reduction in the target shareholder's interest resulting from the acquisition when applying the Section 302 tests. In other words, under this argument, since Section 356 applies if the pre-reorganization redemption is considered to be "in pursuance of the plan of reorganization," once it is determined that a pre-acquisition redemption is not to be treated as part of the reorganization, then the reorganization should likewise not be taken into account for purposes of Zenz. Under this argument, our recommendation to apply Zenz, taking into account the acquisition, to a pre-acquisition redemption selectively turns the step transaction doctrine on and off. This argument would favor having the Section 302 calculation take into account only the reduction in the shareholder's interest that resulted directly from the redemption and would disregard the acquisition or, alternatively, it would favor applying the Pure 356 Approach, which avoids Section 302 altogether.

Our recommendation need not be viewed as selectively turning the step transaction doctrine on and off. The Source Rule does not deny that the steps are part of a single plan. Rather, it characterizes the types of proceeds that the shareholder receives in connection with the reorganization. The redemptions under discussion are all made in connection with the acquisition and therefore are part of the overall transaction in the step transaction sense. However, under the Source Rule, even though the distributions are part of the overall transaction, the distributions that derive from the target are not considered to be consideration in the acquisition. Indeed, the premise of Waterman Steamship is that it is possible to have an acquisition and a dividend occur as part of the same plan but be respected in accordance with their form. Although formalistic, there is a certain logic to a distinction based on source to determine whether the distribution is acquisition consideration. The formalism relates to

respecting the entities (acquiror versus target) rather than to respecting timing or ordering of steps. Since the step transaction doctrine is usually applied to disregard timing or ordering, our recommendation to respect the entities need not be viewed as turning off the step transaction doctrine at all.

However, even if one views our approach as turning the step transaction doctrine off selectively, there are many other contexts in which countervailing tax policy turns the step transaction doctrine off for certain purposes, while the doctrine continues to apply to a single overall transaction for other purposes. In Revenue Ruling 2008-25, for example, a target was acquired in a transaction that, standing alone, would have qualified under Section 368(a)(2)(E). As part of the plan, the target was liquidated into the acquiror. The IRS held that the step transaction doctrine applies to test reorganization qualification. Stepping the acquisition and the liquidation together, the transaction failed reorganization status. At the same time, since Congress indicated that Section 338 is the only means for an acquisition of stock to result in a cost basis in the assets of a target corporation, the acquisition was treated as a qualified stock purchase separate from the subsequent liquidation. Another example of step transaction doctrine applying to a transaction as a whole but not applying for a particular purpose would be a two-step acquisition (e.g., a stock purchase followed by a merger) that qualifies as a reorganization[86] followed by a transfer of assets or stock under the safe harbor of Treasury Regulation Section 1.368-2(k).

In the context of distributions in connection with acquisitions, if one views the step transaction doctrine as applicable and as being turned off, it would be turned off to treat the distribution as subject to Section 302 rather than Section 356 in order to advance tax policies

[86] See, e.g., Rev. Rul. 2001-46, 2001-2 C.B. 321.

discussed in this Report favoring the Modified Source Rule, including (1) conforming to a well-established line of authorities that applies the Source Rule to distributions in connection with stock acquisitions and (2) maintaining a consistent concept of boot across Sections 354, 356, 361 and 368.

II. Qualified Dividend Income and Acquisitions

We would appreciate guidance on whether a target shareholder is "under a contractual obligation to sell" for purposes of Section 1(h)(11)(B)(iii) that would prevent the shareholder from being eligible for the 15 percent rate on qualified dividend income during the period after a target enters into an acquisition agreement. In order to qualify for the reduced rate on qualified dividend income, a holder of stock must satisfy a modified version of the requirements set forth in Section 246(c). The taxpayer must hold the stock for more than 60 days out of the 121 day period starting 60 days before the date on which the stock becomes ex-dividend. Section 246(c)(4) tolls the holding period for any period in which the taxpayer is "under a contractual obligation to sell" substantially identical stock or securities. We believe that an acquisition agreement generally does not create "a contractual obligation to sell" that tolls shareholders' holding periods for these purposes.[87]

Agreements to acquire all or most of a target company are not the type of contractual obligation contemplated by Section 246(c). Section 246(c)(4) was enacted to prevent shareholders from obtaining the benefit of the dividends received deduction without being economically exposed to the underlying stock for the period required by Section 246(c)(1) and

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[87] A similar issue arises in the case of a redemption of shares, pursuant to a contractual obligation, by a single corporation if the redemption is subject to Section 301(c)(1).

(2). Acquisition agreements do not raise this type of concern because they are typically not within the control of individual shareholders and they contain closing conditions.

The legislative history of Section 246(c) describes the concerns motivating Section 246(c):

> It is understood that at the present time some corporations are buying stock just before a dividend is payable with the intention of receiving dividend income and then immediately after the dividend is received, selling the stock. In such cases, the selling price of the stock, other things being equal, is less than the purchase price by approximately the amount of the dividend. Thus, the corporation receives: (1) dividend income against which it can take a deduction for 85 percent of the amount received, and (2) a loss, of approximately the same size, which can be deducted in full against ordinary income in the case of dealers in securities or in other cases can be offset against capital gains. . .
>
> A similar problem is presented where a corporation maintains both a "long" and a "short" position over the dividend payment date. In this case the corporation receives: (1) Dividend income against which it can take a deduction of 85 percent for the dividend received; and (2) an ordinary business expense deduction, which is fully deductible, for the amount of the dividend which the corporation has to pay the person from whom it borrowed the stock. . .
>
> . . . To discourage this tax avoidance the House bill added a new provision (sec. 246(c)) to the Code which denies any dividends received deduction for dividend income where the corporation has held the stock for 10 days or less. Your committee has accepted this provision except that to give greater assurance of blocking any tax avoidance it would apply this new rule if the stock was held for no more than 15 days before the sale of the stock.
>
> Both the House and your committee's bill also deny the 85 percent dividends received deduction where the corporation is, on the dividend date, in both a "long" and "short" position with respect to substantially identical stock or securities (or otherwise under obligation to make corresponding payments with respect to these securities).[88]

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[88] S. REP. NO. 1983 (1958), reprinted in 1958 U.S.C.C.A.N. 4791, 4817.

One can infer that the purpose of Section 1(h)(11)(B)(iii) is similar, that is, to prevent a non-corporate taxpayer from converting high taxed short term capital gain to low taxed qualified dividend income. That is, it is intended to prevent a taxpayer from creating offsetting qualified dividend income (taxed at a reduced rate) and a short term capital loss (providing a tax benefit at the maximum rate) with no financial risk. Section 1(h)(11)(B)(iii) prevents this arbitrage by preventing such dividends from being qualified dividend income.

Since the holding period requirement is intended to address a situation where a shareholder trades in and out of the stock, Section 1(h)(11)(B)(iii) should not, in general, be applied to target shareholders, because they are not trading into the stock in anticipation of a dividend. Indeed, unlike the type of contractual obligation to sell contemplated by the statute, a target shareholder typically is not a party to the acquisition agreement and does not even have significant control over the target's entering into the agreement. Tolling the holding period of target shareholders does not, in general, prevent any abuse.

Furthermore, shareholders who own stock pending the closing of an acquisition agreement do not have the offsetting "long" and "short" positions that appear to be contemplated by the legislative history of Section 246(c), because the sale is subject to closing conditions and might therefore never occur.[89] An acquisition agreement for the sale of all or most of the

[89] Section 1259 provides a useful analogy. Section 1259 taxes a holder of an appreciated financial position if there is a "constructive sale." A taxpayer is treated as entering into a constructive sale if, for example, the taxpayer "enters into a futures or forward contract" to deliver the property or, under regulations, "enters into 1 or more other transactions" that have substantially the same effect. I.R.C. § 1259(c)(1). An exception applies if the taxpayer enters into a contract to sell stock (which is not a marketable security) and the contract settles within one year of the date the contract is entered into. I.R.C. § 1259(c)(2). Our Report regarding proposed Section 1259 interpreted the one-year rule as being intended to provide parties the opportunity to comply with commercially reasonable closing conditions. New York State Bar Association Tax Section, Comments on 'Short-Against-the-Box' Proposal, 96 TAX NOTES TODAY 46-35 (hereinafter "Section 1259 Report"), at V.B. and C (March 1, 1996).

company is almost certainly not motivated by the tax arbitrage that the statute was intended to prevent.

The statutory language—a "contractual obligation to sell"--buttresses the view that Section 246(c)(4) was not meant to cover acquisition agreements. In many cases, a shareholder's obligation to dispose is not contractual. In many cases (nearly all cases involving a public company target), when a target corporation agrees to be acquired, the shareholders are not parties to the acquisition agreement. Furthermore, when an acquisition is effected by means of a merger, a target shareholder who does not sign the acquisition agreement is never under a "contractual" obligation to dispose of the shareholder's shares. Rather, the shareholder is forced to relinquish ownership of its target shares through the statutory mechanic of a merger. A "contractual obligation to sell" also assumes that there will be an eventual "sale." Acquisitions involving an exchange of target stock solely for acquiror stock or for a mix of cash and acquiror stock are exchanges, rather than sales, under applicable authorities,[90] and therefore such transactions do not involve a "contractual obligation to sell."[91]

(footnote continued)

Section 901(k) is another helpful point of reference. Section 901(k) applies the tolling rules of Section 246(c)(4) in a manner consistent with their intent– to differentiate between existing shareholders (who deserve the tax benefit) and arbitrageurs that trade in and out of a stock (who do not deserve the tax benefit). Section 901(k) imposes a holding period requirement for the allowance of foreign withholding tax credits and foreign deemed paid tax credits under Section 902 and other provisions. Section 901(k)(6) contains an exception to the tolling rules in the case of a "contract for the bona fide sale of stock." Specifically, for purposes of the indirect foreign tax credit (but not the withholding tax credit), Section 901(k)(6) provides that if a person's holding period is reduced by reason of the application of Section 246(c)(4) to "any contract for the bona fide sale of stock", the holding period requirement is calculated by reference to the date that the contract is signed (instead of the ex-dividend date). By measuring the holding period relative to the signing of the contract, only shareholders who hold stock prior to the signing of the contract will receive the benefit of the indirect foreign tax credit.

[90] In Comm'r v. Brown, the Supreme Court stated that a sale is "a transfer of property for a fixed price in money or its equivalent." 380 U.S. 563, 571 (1965). Similarly, in Guest v.

In light of the purpose of Section 246(c), arguably, if a person buys target stock after an acquisition agreement providing for a fixed amount of cash proceeds to the target shareholders has been entered into and a distribution has been announced, such person's holding period should be tolled by reason of the acquisition agreement. For example, suppose an acquisition agreement provides for consideration of $100 per share and a dividend by the target of $10 per share. In such a case, a person could buy the stock for $110, receive the dividend potentially taxed at a 15 percent rate and enjoy a $10 short term capital loss when the acquisition closes, usable against short term capital gains. The acquisition agreement mitigates the target shareholder's risk of loss in the target stock. However, in reality, acquisition agreements contain closing conditions, which create uncertainty about whether the acquisition will in fact close. Because of that uncertainty, the public company target stock may trade above or below the sum of the dividend and the deal consideration ($110 in the above example). If the deal does close, the taxpayer will have dividend income and a short term capital loss that may differ significantly

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(footnote continued)
Comm'r, the Tax Court stated that a sale is "a transfer of property for money or a promise to pay money," while an exchange is "a reciprocal transfer of property." 77 T.C. 9, 24 (1981).

In acquisitions where the consideration is a mix of stock and cash, Section 356 states that there is an "exchange." Under Treasury Regulation Section 1.1002-1(d), "Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only" (emphasis added).

In an analogous context, our Report regarding proposed Section 1259 stated that we did not believe Section 1259 was intended to treat a tax-free reorganization, or the entering into of a contract to make such an exchange, as a constructive sale, even if the exchange entitled holders to a fixed dollar amount of the acquiror's stock at closing. Section 1259 Report, supra note 89, at VII.

[91] See I.R.S. Priv. Ltr. Rul. 8610016 (Nov. 29, 1985) (for purposes of Section 246(c)(4)(A), an option convert a share of "CAP" stock into a fixed dollar amount of common stock is not an option to "sell").

from the dividend. If the deal does not close, the taxpayer is stuck with a dividend and stock it might not otherwise want. In the case of a target shareholder who purchases stock after the acquisition and the dividend have been announced, we believe that such purchases are largely motivated by a bet on whether the merger will happen, rather than tax arbitrage.

For the reasons described above, we believe that, in general, a target shareholder's holding period should not be tolled by reason of the target entering into an agreement to be acquired. Even in cases where a historic target shareholder him or herself enters into the acquisition agreement, we believe that the shareholder's holding period should not be tolled because doing so would not serve the statutory purpose of preventing people from trading in and out of a stock in order to achieve a tax arbitrage.

III. Debt Financing and the "Substantially All" Requirement

In the case of a potential reorganization that must satisfy a "substantially all" test, we would appreciate guidance regarding the extent to which the borrower of funds that finance the cash portion of the consideration may be the company that holds the target assets after the acquisition.

A context in which this issue often arises is a Section 368(a)(2)(D) transaction involving a merger subsidiary and its parent in different taxing jurisdictions from one another.[92] Consider a case where Parent wishes to acquire Target for $50 cash and 50 Parent shares (worth $50). Parent owns Merger Sub (whether new or historic), and Target merges into Merger Sub in a transaction intended to qualify under Section 368(a)(2)(D). Suppose further that neither Parent

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[92] Another scenario in which the issue arises is where the lenders want to lend to the surviving corporation in the merger in order to be closer to the operating assets than they would be if they lent to the parent corporation.

nor Target nor Merger Sub has on hand the $50 of cash that is meant to be delivered to the Target shareholders and thus one of the parties will need to borrow those funds. In some cases, Parent will want Merger Sub to be the borrower in order to maximize the use of the interest expense deductions on the borrowing. For example, Parent may be subject to a lower State tax rate than Merger Sub after the merger. Alternatively, if Parent is foreign and Merger Sub and Target are domestic, Parent may not have sufficient income to absorb the interest expense, while Merger Sub, owning Target's business, may.

A borrowing by Parent should not raise a "substantially all" issue.[93] On the other hand, a borrowing by Target (before the merger) would raise a "substantially all" issue.[94] On these numbers, such a borrowing would be sufficient to cause the transaction to fall outside the IRS's ruling guidelines for the "substantially all" test.[95] Whether the transaction should fail the "substantially all" test under the law is debatable. The transaction is not divisive in that it does not involve the distribution of operating assets.[96]

We believe that a borrowing by a newly formed Merger Sub that will hold no assets other than those it receives from the Target raises the same "substantially all" issue that is

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93 In this discussion, we assume that the Plantation Patterns doctrine would not apply to treat the borrower for tax purposes as being different from the entity that is the borrower for corporate law purposes. Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972)

94 An intermediate case would involve a borrowing by parent followed by an assumption of the liability by surviving corporation after the merger.

95 Rev. Proc. 86-42, 1986-2 C.B. 722 (merger subsidiary must acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets of target).

96 See, e.g., Rev. Rul. 57-518, 1957-2 C.B. 253 ("substantially all" depends on the nature of the assets that are held back from the acquiror, including whether they are held back "for the purpose of engaging in any business").

raised by a borrowing by Target before the merger.[97] In both cases, the only assets in the borrower entity are the Target's assets, and those assets have been burdened by the borrowing, thus shrinking the size of the Target, a concern of the "substantially all" doctrine.

It would be helpful to have guidance regarding how "substantially all" should be analyzed in the case where Merger Sub is a historic company with independent assets (or a newly formed company to which independent assets will be transferred). For example, the rule could be that, as long as Merger Sub could support the debt without reference to Target's assets, then the debt is disregarded for "substantially all" purposes. Alternatively, the rule could be that a pro rata portion of the debt, based on the value of Target's net assets and the value of Merger Sub's net assets (other than those received from Target), is considered to burden the Target assets. The rule should perhaps take account of the fact that "substantially all" is primarily concerned with divisive transactions, those in which operating assets are distributed.

Another variation would be where Merger Sub owned a disregarded entity and the disregarded entity held independent assets and borrowed the funds, while Target merged into Merger Sub (or into a different disregarded entity). This case would appear to us not to raise "substantially all" concerns, as the Target's assets are not burdened by the debt any more than they would be if a historic corporate subsidiary of Merger Sub were the borrower.

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[97] PLR 200040023 held otherwise, apparently on the basis that the borrowing would be "repaid only from future earnings of [Merger Sub] or from capital contributions made to [Merger Sub] from [p]arent." I.R.S. Priv. Ltr. Rul. 200040023 (Oct. 6, 2000).