# NEW YORK STATE BAR ASSOCIATION TAX SECTION

# REPORT ON

# SELECTED ISSUES IN TRIANGULAR REORGANIZATIONS

## SELECTED ISSUES IN TRIANGULAR REORGANIZATIONS[1]

The finalization of Treasury regulations section 1.368-2(k) (the "-2k Regulations")[2] was a significant step in liberalizing the reorganization rules by eliminating many of the arbitrary distinctions between various types of reorganizations. This Report recommends certain changes relating to triangular reorganizations after the promulgation of the -2k Regulations.[3]

### SUMMARY

This Report recommends that the Internal Revenue Service ("IRS") and the Treasury Department issue published guidance that:

- In a triangular C reorganization, (i) permits a parent corporation to directly assume aggregate target liabilities equal to the amount of target liabilities that the parent could have assumed in a valid post-reorganization distribution by the acquisition subsidiary under the -2k Regulations; (ii) if the recommendation in clause (i) is not accepted, permits an acquisition subsidiary to direct the transfer of target assets and liabilities to the subsidiary's parent corporation to the same extent that the acquisition subsidiary could effect a valid post-reorganization distribution of such assets and liabilities under the -2k Regulations; or (iii) at a minimum, permits a parent corporation to substitute its compensatory stock options for target stock options;
- In a section 368(a)(2)(E) reorganization, clarifies that the determination of whether the parent corporation acquires stock representing section 368(c) control of the target corporation in exchange for parent voting stock (the "A2E control test") must be made upon the closing of the merger;

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2 *See* "NYSBA Members Comment on Continuity of Business Enterprise Regs.", 2008 TNT 68-23 (Apr. 8, 2008).

3 Although different statutory requirements apply in each case, section 368(a) permits triangular reorganizations in the case of section 368(a)(1)(A), (a)(1)(B), (a)(1)(C) and (a)(1)(G) reorganizations.

- In a section 368(a)(2)(E) reorganization in which the merger subsidiary is an operating company and target corporation shareholders retain some target stock, clarifies that the A2E control test is applied before parent is treated as receiving additional target stock for its merger subsidiary stock in the target merger;
- Confirms that the relevant point in time for determining whether a parent corporation holds section 368(c) control of its acquisition subsidiary is immediately after a triangular B or C reorganization or a section 368(a)(2)(D) reorganization;
- Confirms that a parent corporation may acquire the assets of a partially owned subsidiary in a section 368(a)(2)(D) reorganization; and
- In the case of triangular reorganizations generally, interprets the "cause to be directed" doctrine to permit transactions to qualify as triangular reorganizations—including triangular B reorganizations—where the acquisition agreement contains appropriate language directing the transfer of the acquired stock or assets, as applicable, and the acquiring corporation is a member of the issuing corporation's qualified group.

We also recommend that Congress amend section 368 to:

- Authorize regulations addressing fluctuations in parent's stock value between the signing and closing dates in applying the A2E control test; and
- Permit acquisitions in exchange for "grandparent" (or more remote) stock to the extent that (i) the acquiring corporation in a putative section 368(a)(2)(D) or triangular B or C reorganization is in the issuing corporation's qualified group, or (ii) a putative triangular B or section 368(a)(2)(E) reorganization occurs via a merger effected with a corporation in the issuing corporation's qualified group.

## PARENT'S ASSUMPTION OF LIABILITIES IN A TRIANGULAR C REORGANIZATION

For an acquisition to qualify as a section 368(a)(1)(C) reorganization (a "C reorganization"), the (i) acquiring corporation must acquire substantially all of the target corporation's assets solely in exchange for voting stock of the acquirer or its immediate parent corporation in a triangular C reorganization, or in exchange for such voting stock and boot representing up to 20 percent of the total consideration,[4] (ii) target corporation generally must

[4] *See* I.R.C. § 356(a)(1)(B) (boot is cash and property other than the stock or securities of a party to the reorganization).

distribute the stock received and any other assets to its shareholders in liquidation,[5] and (iii) acquisition must satisfy the business purpose, continuity of interest ("COI"), and continuity of business enterprise ("COBE") tests.[6] In applying the "solely for voting stock" requirement, the acquiring corporation's assumption of target liabilities is disregarded unless the acquirer also pays boot, in which case any assumed liabilities are also treated as boot.[7]

Section 368(a)(1)(C) does not expressly permit the parent in a triangular C reorganization to assume liabilities of the target. In Revenue Ruling 70-107,[8] the IRS held, based on the literal language of the statute, that liabilities assumed by the acquirer's parent constitute boot and, therefore, may disqualify an otherwise valid C reorganization.

However, as discussed below, we believe that Congress did not intend to prohibit parent corporations from assuming target liabilities in triangular C reorganizations. We also believe that permitting parents to assume liabilities in triangular C reorganizations would be good tax policy, and would be consistent with the overall framework of the reorganization provisions. We therefore recommend that the government promulgate guidance to that effect. We believe the IRS could issue this guidance in the form of a Revenue Ruling reversing Revenue Ruling 70-107, although we recognize that the IRS and the Treasury Department may wish to issue regulations to avoid even the possibility of whipsaw.

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5 *See* I.R.C. § 368(a)(1)(C), (2)(B), (2)(G).

6 *See* Treas. Reg. § 1.368-1(c)-(e).

7 *See* I.R.C. § 368(a)(2)(B).

8 1970-1 C.B. 78.

First, as mentioned above, we do not believe that Congress intended to prohibit parent corporations from assuming liabilities in triangular C reorganizations. Congress enacted the predecessor to section 368(a)(1)(C) in 1934 in order to permit corporations organized in states that had not yet adopted merger statutes to effect tax-free reorganizations for "practical mergers".[9] Section 368(a)(1)(C), by its terms, addresses only the acquiring corporation's assumption of target corporation liabilities and does not expressly prohibit the parent corporation from assuming target liabilities in a triangular C reorganization.[10]

In 1938, the Supreme Court decided *United States v. Hendler*,[11] which was interpreted to require a transferor corporation to recognize gain upon the assumption of its liabilities in an otherwise tax-free reorganization. The next year, Congress enacted the original rule permitting liability assumptions in reorganizations in order to overrule *Hendler* (the "anti-*Hendler* legislation").[12] Congress concluded that, unless reversed, *Hendler* would "largely nullify" the reorganization provisions because target liabilities "are almost invariably assumed" by the acquiring corporation.[13] Congress's negative reaction to *Hendler* was so strong that it generally applied the anti-*Hendler* legislation retroactively.[14] The anti-*Hendler* legislation does not

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9 *American Potash & Chemical Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968); Rev. Rul. 56-345, 1956-2 C.B. 206; *see also* S. Rep. 558, 73d Cong., 2d Sess. 16-17 (1934), *reprinted in* 1939-1 C.B. 586, 598 ("Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State. The committee believes that it is desirable to permit reorganizations in such cases. . . ."); *see* S. Rep. 558, 73d Cong., 2d Sess. 16-17 (1934), *reprinted in* 1939-1 C.B. 586, 598 ("The committee believes that these transactions . . . are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."). *See generally* NYSBA Tax Section, *Report on the Ancillary Tax Effects of Different Forms of Reorganizations*, 34 Tax L. Rev. 475, 485 (1978-79) (noting that parent can assume target liabilities in forward triangular merger, but not in triangular C reorganization).

10 *See* I.R.C. § 368(a)(1)(C).

11 303 U.S. 564 (1938).

12 *See* Internal Revenue Code of 1939, § 112(g)(1)(B), 53 Stat. 40.

13 H. Rep. No. 855, 76th Cong., 1st Sess. 18-19 (1939), *reprinted in* 1939-2 C.B. 504, 518-19.

14 *See* H. Rep. No. 855, 76th Cong., 1st Sess. 18-19 (1939), *reprinted in* 1939-2 C.B. 504, 519-20.

expressly permit a parent to assume target liabilities because triangular reorganizations were not yet permitted when the legislation was promulgated in 1939. Congress did not allow triangular C reorganizations, or permit post-reorganization asset dropdowns, until 1954. For this reason, the IRS has stated that the "failure to provide explicitly for assumption of liabilities by both [the parent corporation] and [the acquisition subsidiary] in a parenthetical C reorganization was not intentional but resulted from a failure to appreciate the necessity for such legislation."[15] Since the anti-*Hendler* legislation and the subsequent 1954 changes were both permissive, and there is no suggestion in the legislative history to either that Congress would have denied parent corporations the ability to assume liabilities in triangular C reorganizations, the absence of express statutory language is best understood as an inadvertent omission, and it is more consistent with Congressional intent to permit parents to assume liabilities in triangular C reorganizations.

Second, there are alternative means under current law for a parent to assume target's liabilities and achieve the same result as a triangular C reorganization, and the government has expressly and deliberately sanctioned these transactions. Under current law, a parent corporation may effect a straight C reorganization and contribute the acquired assets to its wholly owned subsidiary. The parent's liability assumption would be disregarded in that case (assuming no boot is paid) because the parent corporation would be the actual acquirer.[16] Alternatively, the parent corporation may direct the target to transfer assets to the parent's subsidiary under the "cause to be directed" doctrine. Moreover, the -2k Regulations permit an acquirer in a triangular

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[15] *See* G.C.M. 39102 (Dec. 21, 1983).

[16] *See* Rev. Rul. 64-73, 1964-1 C.B. 142.

C reorganization to distribute target assets (and permit the parent to assume target liabilities from the acquirer), subject only to the limitation that the distribution not result in the acquirer's liquidation for U.S. tax purposes.[17] The decision by the IRS and the Treasury Department in the -2k Regulations to permit asset distributions was made deliberately and expressly to allow taxpayers greater flexibility to effect tax-free reorganizations.[18] Therefore, the tax policies favor a liberal interpretation of the statute.

Third, since these alternatives permit a parent corporation indirectly to effectively assume target's liabilities, current law creates a trap for the unwary by potentially subjecting a putative triangular C reorganization where the parent assumes target liabilities to both corporate and shareholder tax when the same result could have been achieved in a tax-free manner under the -2k Regulations and/or through "cause to be directed" transfers.[19] We are not aware of any tax policy rationale that would support this anomaly.

Fourth, we note that guidance expressly allowing parent to assume target liabilities in a triangular C reorganization would be consistent with section 357(a), which, as a general matter, does not treat liabilities assumed by a party to the exchange as boot. The parent in a triangular C reorganization is a party to the reorganization under section 368(b).

We also recognize that Revenue Ruling 70-107[20] holds, based on the literal language of section 368(a)(1)(C), that liabilities assumed by the acquirer's parent corporation constitute boot

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17 *See* Treas. Reg. § 1.368-2(k)(1)(i).

18 *See* T.D. 9361, 2007-47 I.R.B. 1026.

19 *See* G.C.M. 39102 (Dec. 21, 1983).

20 1970-1 C.B. 78.

and, therefore, under Revenue Ruling 70-107, the assumption of liabilities by an acquirer's parent may disqualify an otherwise valid triangular C reorganization.[21] However, the IRS itself has repeatedly criticized this ruling, and even recommended its revocation,[22] and the -2k Regulations effectively minimize its potential application. The preamble to the -2k Regulations observes that the regulations "do not implicate the fact pattern addressed in Rev. Rul. 70-107,"[23] presumably because the acquisition subsidiary is respected as the acquiring corporation if the -2k Regulations are satisfied.[24] Nevertheless, the scope of the distributions now permitted under the -2k Regulations makes clear that there is no compelling policy reason to treat an acquisition in which a parent directly assumes a target liability differently than one in which an acquiring subsidiary assumes the liability and then distributes it to parent.

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21 We have previously addressed Revenue Ruling 70-107. *See, e.g.*, "NYSBA Seeks Greater Flexibility for Postreorganization Distributions", 2004 TNT 99-28 (May 21, 2004) ("[Revenue Ruling 70-107] is both arbitrary . . . as well as inconsistent with the legislature's intent to combat the negative treatment afforded liability assumption in the Supreme Court's decision in *Hendler*. . . . [W]e would welcome a reconsideration of the underlying policy motives behind Revenue Ruling 70-107. . . ."); "NYSBA Comments on COSI/COBE", 97 TNT 147-75 (July 31, 1997) ("The Committee supports overruling Revenue Ruling 70-107. . . .").

22 *See* G.C.M. 39102 (Dec. 21, 1983) ("Rev. Rul. 70-107 was incorrect in construing the term 'acquiring corporation' so narrowly. The phrase is properly interpreted for purposes of assumption of liabilities as encompassing 'all parties to the exchange' similar to the way such term is used in section 357(a)."); G.C.M. 34483 (Apr. 21, 1971) ("we would like to call to your attention certain problems that we believe arise from the conclusion reached in Rev. Rul. 70-107. . . . [Y]ou may wish to give further consideration to the correctness of the conclusion adopted in Rev. Rul. 70-107.").

In General Counsel Memorandum 39102, the government considered a transaction in which a subsidiary corporation "pushed up" a significant portion of the acquired assets to its parent corporation. The government concluded that the (i) parent was, in substance, the "acquiring corporation", and (ii) subsidiary's assumption of target liabilities nonetheless did not preclude reorganization treatment because any party to the reorganization may assume target liabilities. *See* G.C.M. 39102 (Dec. 21, 1983).

23 T.D. 9361, 2007-47 I.R.B. 1026.

24 *See* Treas. Reg. § 1.368-2(k)(1) ("A transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of § 1.368-1(d) are satisfied and the transfer(s) are described in either paragraph (k)(1)(i) or (k)(1)(ii) of this section."). We have addressed the -2k Regulations in detail in a prior report. *See* "NYSBA Members Comment on Continuity of Business Enterprise Regs.", 2008 TNT 68-23 (Apr. 8, 2008).

We observe that, while sections 368(a)(2)(D) and (a)(2)(E) are silent on whether a parent can assume target liabilities, the relevant Treasury regulations permit the parent to assume target liabilities in both a forward and reverse triangular merger.[25] Moreover, we note that the IRS treats the reference in section 368(a)(2)(C) to the acquiring corporation as "permissive rather than exclusive or restrictive" and, in Revenue Ruling 2002-85, permitted an acquiring corporation in a putative D reorganization to transfer assets to a controlled subsidiary, notwithstanding the absence of a specific reference to section 368(a)(1)(D) in section 368(a)(2)(C).[26] We believe that these authorities provide helpful precedent in the current context.

Accordingly, we recommend that the government issue formal guidance permitting a parent in a triangular C reorganization to directly assume aggregate target liabilities equal to the amount of target liabilities the parent could assume as part of a valid post-reorganization distribution by the acquisition subsidiary under the -2k Regulations.[27] We believe that this guidance could be issued in the form of a Revenue Ruling, although the Treasury Department and the IRS may wish to issue regulations to avoid even the possibility of whipsaw.

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25 *See* Treas. Reg. §§ 1.368-2(b)(2), -2(j)(4). *See also* Rev. Rul. 79-155, 1979-1 C.B. 153 (parent and acquiring corporations were jointly and severally liable for satisfaction of target convertible securities in a forward triangular merger).

26 Rev. Rul. 2002-85, 2002-2 C.B. 986.

27 In a prior report, we suggested that the Treasury Department seek "legislative authority to broadly construe section 368 in its entirety." "NYSBA Comments on Final Regs Defining Statutory Merger or Consolidation", 2006 TNT 200-17 (Oct. 13, 2006). We cited a parent's assumption of target liabilities in a putative triangular C reorganization as an example of the type of issue that the government could address with a grant of interpretive authority. While this is certainly true, we also believe for the reasons set forth herein that the current statute, as drafted, does not compel the construction applied in Revenue Ruling 70-107.

If the government declines to accept this recommendation, we recommend that it issue formal guidance permitting an acquisition subsidiary in a triangular C reorganization to direct the transfer of target assets and liabilities to the subsidiary's parent corporation to the same extent that the acquisition subsidiary could effect a valid post-reorganization distribution of such assets and liabilities under the -2k Regulations.[28] We understand that regulatory or other restrictions occasionally preclude corporations from taking legal title to certain property or actually assuming certain liabilities.[29] Accordingly, we believe that taxpayers would benefit from formal guidance confirming the availability of a "cause to be directed" transfer by an acquisition subsidiary to its parent corporation in a triangular C reorganization.[30]

In a triangular C reorganization, it will often be impossible for target options to be assumed by the subsidiary because employees will not want options on illiquid stock. However, the substitution of parent corporation stock options for target stock options could be viewed as an assumption of liabilities under section 368(a)(1)(C).[31] Therefore, for the reasons discussed

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[28] This is consistent with our recommendation in "Acquisitions for Grandparent Shares" below.

[29] Retransfers of assets are also time consuming and expensive to implement in regulated industries.

[30] *See* Rev. Rul. 70-224, 1970-1 C.B. 79.

[31] In an earlier report we noted that:

> [i]n general, the Committee believes that exchanges, substitutions, or assumptions of nonqualified stock options as part of a reorganization transaction should be treated either as continuing "open transactions" or as assumptions of liabilities by the acquirer which, in either case, should not give rise to current taxation to the holder of the option. *See, e.g.*, Rev. Rul. 68-637, 1968-2 C.B. 158 (holding that substitution of target stock with acquirer stock under terms of employee stock options issued by target qualified as an assumption of liability under Section 368(a)(1)(C) of the Code); P.L.R. 89-41-069 (July 19, 1989) (conversion of nonstatutory stock options into acquirer stock options in Section 368(a)(2)(E) reorganization does not result in income, gain or loss to holders of such options); P.L.R. 88-080-32 (Nov. 27, 1987) (providing similar result in a Section 368(a)(1)(B) reorganization); P.L.R. 96-440-80 (May 16, 1996) (according nonrecognition treatment in a Section 355 transaction upon exchange of nonqualified stock options of the distributing corporation for nonqualified stock options in shares of a newly-created, spun-off subsidiary).

*See* "NYSBA Suggests Modifications to Regs on Treatment of Stock Rights", 97 TNT 75-21 (Apr. 18, 1997). In that report, we did not take a position as to whether employee options should be treated as open transactions or
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below, we recommend that any guidance issued should, at the very least, permit a parent corporation to substitute its compensatory stock options for target stock options in a triangular C reorganization.[32]

The 1998 regulations addressing the receipt or exchange of stock rights in reorganizations recognize the unique nature of compensatory options and expressly provide that "[o]ther . . . provisions governing the treatment of rights to acquire stock [such as sections 83 and 421 through 424] may also apply to certain exchanges occurring in connection with a reorganization."[33] Treasury regulations addressing the forward triangular merger rules expressly permit a parent corporation to substitute its stock for target stock pursuant to an outstanding employee stock option agreement.[34] More generally, the substitution of compensatory stock options does not affect an acquisition's qualification as a tax-free reorganization.[35] Accordingly, we are unaware of any reason to preclude the parent's assumption of such liabilities in a triangular C reorganization.

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assumptions of liabilities, nor did we address the case of a parenthetical C reorganization. While this report addressed the treatment of holders, the report also supports the broader point that employee compensation issues generally receive unique treatment under the tax law.

[32] *See* Rev. Rul. 68-637, 1968-2 C.B. 158.

[33] Treas. Reg. § 1.354-1(e). *See also* "NYSBA Suggests Modifications to Regs on Treatment of Stock Rights", 97 TNT 75-21 (Apr. 18, 1997) ("The taxation of compensation-related stock options . . . presents unique issues . . . that bear no relationship to the principles underlying the reorganization provisions.").

[34] *See* Treas. Reg. § 1.368-2(b)(2).

[35] *See, e.g.*, Rev. Rul. 70-269, 1970-2 C.B. 82 (compensatory option exchange did not violate section 368(a)(1)(B) "solely for voting stock" requirement), *amplified by* Rev. Rul. 98-10, 1998-1 C.B. 643. *See also* Treas. Reg. § 1.354-1(e). The substitution of incentive stock options generally must satisfy the requirements of section 424, while the theory regarding the substitution of nonqualified stock options is that the grant of an option generally does not constitute a transfer of property to the employee for purposes of section 83 until the option is exercised. *See* Treas. Reg. § 1.83-7(a).

Finally, if the government declines to allow the parent to assume the target's compensatory stock option liabilities, we request that the government issue formal guidance respecting the acquisition subsidiary as the acquirer if the subsidiary assumes the target's compensatory stock options, converts them into parent compensatory stock options and agrees to cause parent shares to be issued upon the exercise of such options. The IRS has issued at least one private ruling treating an acquisition with these terms as a triangular C reorganization, and we believe that taxpayers would benefit from the release of formal guidance given the presence of compensatory stock option liabilities in many acquisitions.[36] While the statute, by its terms, does not expressly permit such a transaction, we believe its approval would be consistent with the government's longstanding recognition of the unique nature of employee compensation issues. In addition, we recommend that any such guidance reflect a workable rule that permits option rights to be exercisable against any member of the issuing corporation's qualified group.

**TIMING OF SECTION 368(a)(2)(E) CONTROL TEST**

For an acquisition to qualify as a reverse subsidiary merger under section 368(a)(2)(E), (i) parent must own stock representing section 368(c) control of the merger subsidiary before the merger, (ii) the target corporation's shareholders must satisfy the A2E control test by surrendering stock representing section 368(c) control of target in exchange for parent voting stock in the transaction, (iii) immediately after the merger, the target must hold substantially all of its and the merger subsidiary's properties, and (iv) the merger must satisfy the business

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[36] *See* P.L.R. 93-08-035 (Nov. 30, 1992). *See also* Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts*, ¶ 702.5.1 (Jan. 2008); Robert Willens, *Tax Surprises When Receiving Only Stock in Acquisitions*, 1999 TNT 11-120 (Jan. 19, 1999).

purpose, COI and COBE tests.[37] Section 368(a)(2)(E), as currently drafted, appears to measure compliance with the A2E control test upon the closing of the merger. This creates a trap for the unwary because shareholder continuity of interest, by contrast, can be measured on an acquisition's signing date. Accordingly, as discussed below, we recommend that (i) Congress amend the statute to authorize regulations that would address fluctuations in parent stock value between the signing and closing dates for purposes of applying the A2E control test, and (ii) the IRS confirm in the interim that the current statute requires taxpayers to satisfy the A2E control test as of closing.

Assume parent agrees to acquire all of the outstanding stock of the target corporation in a section 368(a)(2)(E) reorganization for 10 shares of parent voting stock ($8/share fair market value on the signing date) and $20 of cash, and the merger consideration is payable *pro rata* to target shareholders or subject to election/proration. If, on the closing date, parent stock has a $5/share fair market value, parent acquires only approximately 71.4% of target's stock in exchange for parent voting stock. We recommend that the IRS confirm in published guidance that this merger would not satisfy the A2E control test even though it would have satisfied this test on the signing date.

Under the COI test, stock of the issuing corporation generally must represent at least 40% of the aggregate consideration delivered to the target corporation's shareholders in the reorganization. Under certain circumstances, the Treasury regulations value the issuing corporation's stock for COI purposes on the last business day before an acquisition agreement is

[37] *See* I.R.C. § 368(a)(2)(E); Treas. Reg. § 1.368-2(j)(3). The Treasury regulations provide that the amount of target stock constituting control is measured immediately before the transaction. *See* Treas. Reg. § 1.368-2(j)(3)(i).

executed (the "signing date rule").[38] Section 368(a)(2)(E), however, does not appear to permit a similar "signing date" rule to apply for purposes of the A2E control test. The statute, by its terms, requires that shareholders of the target corporation exchange the requisite amount of stock of the target corporation "in the transaction."[39] It is impossible to ensure compliance with this statutory directive if parent's stock is valued as of the acquisition's signing date. Moreover, we previously recognized that the signing date rule may be more appropriate for the flexible COI doctrine,[40] explaining that "[i]t is more difficult to conclude that the section 368(a)(2)(E) control test should be measured at signing than it is to conclude that continuity of interest should be measured at signing. Continuity is inherently a flexible judicial doctrine, while the control test is a statutory bright-line rule."[41] Because the COI test and A2E control test are facially similar counting tests, we believe that a clear statement of the law would be beneficial and would avoid a trap for the unwary. Therefore we suggest that the IRS issue formal guidance clarifying that compliance with the A2E control test is measured as of the acquisition's closing.

Although we believe that section 368(a)(2)(E) in its current form requires compliance with the A2E control test only at closing, we also believe there are strong policy reasons for conforming the A2E control test to the COI test and applying both at signing under certain

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38 *See* Temp. Treas. Reg. § 1.368-1T(e).

39 *See* I.R.C. 368(a)(2)(E)(ii); *see also* S. Rep. No. 91-1533, at 3 (1970), *reprinted in* 1971-1 C.B. 622 (section 368(a)(2)(E) permits payment of boot and/or retention of target stock if "voting stock of the controlling corporation is used *in the exchange* to the extent described") (emphasis added).

40 *See, e.g.*, *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (38.5% stock interest in acquirer, represented by nonvoting preferred stock, constituted sufficient continuity); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) (creditors of insolvent debtor corporation hold proprietary interests in that corporation); Prop. Treas. Reg. § 1.368-1(e)(6) (same).

41 *See* "Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation", 2004 TNT 17-21 (Jan. 23, 2004). This report did not make a recommendation regarding the A2E control test because the relevant IRS Priority Guidance Plan did not include the issue.

circumstances. Therefore, we recommend that Congress amend section 368(a)(2)(E) to authorize regulations addressing fluctuations in parent stock value between the signing and closing dates for purposes of applying the A2E control test.[42] Any such regulations could establish the circumstances under which the IRS would apply the A2E control test as of an acquisition's signing date and thus more closely conform the application of COI and the A2E control test.

## MEASUREMENT OF CONTROL IN RETAINED SHARE MERGERS

As discussed above, to satisfy the A2E control test, the target corporation's shareholders must surrender, in the transaction, stock representing section 368(c) control of target in exchange for parent voting stock. The statute permits retention of target stock so long as "voting stock of [parent] is used in the exchange to the extent described," and confirms that the merger subsidiary may have "substantial properties" in excess of "the nominal capital required to organize it. . . ."[43] It is unclear, however, how "control" is determined where the merger subsidiary is an operating company and pre-merger target shareholders retain some target stock (a "Retained Stock Merger").

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[42] We also note that there is precedent for this type of approach in the Code. *Cf.* I.R.C. § 1504(a)(5)(F) (authorizing Treasury to promulgate regulations in determining affiliated group status that disregard changes in voting power to the extent disproportionate to related changes in value).

[43] *See* S. Rep. No. 91-1533, at 3 (1970), *reprinted in* 1971-1 C.B. 622. The examples in this Report assume that the target only has a single class of stock outstanding. We recognize that additional issues are raised where the target has more than one class of stock outstanding (and/or actually issues additional shares to acquirer in the transaction) and believe that the proposed approach would reach a sensible result in those cases as well.

An example in Treasury regulations section 1.368-2(j)(6) applies the A2E control test where the merger subsidiary is an operating company, but the target corporation shareholders retain no target corporation stock.

> Example 1: <u>No Target Stock Retention</u>
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> <u>Facts</u>: Y owns all 100 shares of target corporation's only class of stock ($100 FMV), and parent owns all 100 shares of the merger subsidiary's only class of stock ($200 FMV). The merger subsidiary merges into target, and Y exchanges all of its target stock for $100 of parent voting stock.
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> <u>Analysis</u>: The merger satisfies the control test because Y surrendered target stock representing control (100% of target stock) in exchange for parent voting stock. The A2E control test applies before the merger and, thus, ignores the additional target stock that parent receives in exchange for its merger subsidiary stock.[44]

Thus, (i) in applying the A2E control test, the amount of target corporation stock necessary to obtain control is measured prior to the merger, *i.e.*, before the acquisition of merger subsidiary's assets increases the target's value, and (ii) the A2E control test excludes target stock received by parent in exchange for its merger subsidiary stock.[45]

We request that the IRS issue guidance confirming that (i) so long as the post-merger value of target shareholders' retained target stock is less than or equal to its pre-merger value, a Retained Stock Merger is treated as if the target shareholders exchanged their target stock with parent for parent voting stock and other merger consideration (the "Parent Exchange"), and

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44 *See* Treas. Reg. § 1.368-2(j)(6), Ex. 6.

45 *See* Treas. Reg. § 1.368-2(j)(6), Ex. 6 (target stock received by parent in exchange for its interest in merger subsidiary "is not taken into account for purposes of [the A2E control test] since the amount of [target] stock constituting control of [target] is measured before the transaction"); *see also* T.D. 8059, 1985-2 C.B. 123 (A2E control test "may be satisfied despite the fact that, in the transaction . . . [parent] receives [target] stock in exchange for its prior interest in [merger subsidiary]"); NYSBA Tax Section, *Report on Reverse Triangular Mergers and Basis-Nonrecognition Rules in Triangular Reorganizations*, 36 Tax L. Rev. 395, 403 (1981) ("the acquisition of Target by merger can be viewed independently from any integrated acquisition of additional Target stock in order to determine whether control of Target has been acquired . . . in an exchange with former Target shareholders.").

parent received additional target stock from the target in exchange for parent's interest in merger subsidiary (the "Target Merger"), and (ii) the A2E control test is satisfied if parent delivers parent voting stock in the Parent Exchange equal in value to the portion of the pre-merger value of target stock constituting control. Parent, acting at arm's length, would presumably receive an amount of target stock in the Target Merger sufficient to dilute the target stock retained by the pre-merger target shareholders so that the post-merger value of their target stock would equal its pre-merger value.[46]

Our proposal is consistent with the statute and applicable Treasury regulations because, as discussed above, section 368(a)(2)(E) permits limited stock retention by target shareholders, and the Treasury regulations clarify that the A2E control test (in contrast to the section 368(a)(1)(D) control test) applies prior to the merger.

In addition, our proposal is consistent with the mechanical steps of a reverse subsidiary merger, which do not require parent to contribute merger consideration to the merger subsidiary for delivery to target shareholders in the merger. The Treasury regulations similarly suggest that parent may issue its stock directly to target shareholders in exchange for target stock by their separate treatment of parent's acquisition of target stock in the Parent Exchange and parent's acquisition of additional target stock in the Target Merger.[47] Consistent with this understanding, we recommend that the statute be interpreted to permit parent to be treated as delivering the

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[46] *Cf. Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954) (value of property received in exchange may be determined by reference to value of transferred property).

[47] *See* Treas. Reg. § 1.368-2(j)(6), Ex. 6. Commentators believe that a reverse subsidiary merger "without question can qualify as a tax-free [reverse subsidiary merger] even if [target] shareholders receive their [parent] shares directly from [parent].]" Martin D. Ginsburg & Jack S. Levin, *Mergers, Acquisitions and Buyouts*, ¶ 803, at 8-50 (Jan. 2008); *see also* P.L.R. 91-25-013 (Mar. 21, 1991) (reverse subsidiary merger where parent issues its stock directly to target shareholders in exchange for their target stock).

merger consideration directly to target shareholders in exchange for their target stock in the Parent Exchange, and the Target Merger to be treated as occurring separately from the Parent Exchange.[48]

Our approach comports with the Congressional intent to permit triangular reorganizations that do not require the parent to acquire the target's assets and assume its liabilities directly[49] and gives effect to the statutory merger between merger subsidiary and target. As discussed below, we also believe that our proposed approach is more consistent with the Treasury regulations and reorganization policy than other potential approaches.

We have considered whether the IRS could account for the fact that the post-merger target stock represents an interest in a different mix of assets than the pre-merger target stock by treating the pre-merger target shareholders who retain some target corporation stock as (i) selling a portion of their retained target stock immediately before the Target Merger, as determined by reference to the ratio of the merger subsidiary's pre-merger value to the target's post-merger value, and (ii) acquiring the target stock deemed sold in clause (i) immediately after the Target Merger.[50] We believe that this characterization would be inconsistent with the treatment of target and acquiring corporation shareholders in section 368(a)(1)(A) reorganizations (an "A

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[48] We believe that our interpretation of the statute would also be consistent with the mechanical steps of a reverse subsidiary merger if the statute required parent to contribute the merger consideration to the merger subsidiary rather than delivering it directly to target shareholders in exchange for their target stock, because (i) target shareholders' receipt of parent voting stock and other merger consideration could still be viewed as separate from parent's receipt of additional target stock in exchange for its merger subsidiary interests, and (ii) parent could receive an amount of target stock in the Target Merger sufficient to dilute the portion of stock retained by the target shareholders such that the post-merger value of target shareholders' retained target stock would equal its pre-merger value.

[49] *See* S. Rep. No. 91-1533, at 3 (1970) (discussed above), *reprinted in* 1971-1 C.B. 622.

[50] Under this recast, the retaining target shareholders would recognize gain with respect to the portion of their retained target stock deemed sold in clause (i).

reorganization") and C reorganizations, since those shareholders generally are not subject to tax simply because their stock represents an interest in a larger and different pool of assets after the merger. Accordingly, the fact that the retained target stock represents an interest in a different mix of assets is not an appropriate occasion to impose tax on either the corporation or the shareholders. In addition, this characterization would necessarily entail more steps than ours, as it would require treating a Retained Stock Merger as occurring in four steps, as opposed to two, due to the target shareholders' deemed sale of a portion of their target stock immediately before the Target Merger, and deemed purchase of such stock immediately after the Target Merger.[51]

We have also considered whether the IRS should treat the Parent Exchange as occurring after the Target Merger, in which case the A2E control test would require delivery of an amount of parent voting stock based on the target's post-merger combined value. We believe that this treatment would be inconsistent with the approach of the Treasury regulations, which measure the A2E control test before the merger,[52] and could effectively vitiate the ability to effect a reverse subsidiary merger in a Retained Stock Merger because, depending on the merger subsidiary's value, parent could be required to deliver to target shareholders an amount of parent voting stock in excess of target's pre-merger value.[53] In that case, target shareholders

[51] *Cf. Esmark v. Comm'r*, 90 T.C. 171 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989) (court refused to recast transaction because it would involve inventing additional steps that did not occur); *Pabst Brewing Co. v. Comm'r*, 69 T.C.M. (CCH) 2773 (1995) (step transaction doctrine did not apply to treat redemption as a sale because IRS recast invented illogical step).

[52] *See* Treas. Reg. § 1.368-2(j)(3)(i); *see also* Treas. Reg. § 1.368-2(j)(6), Ex. 7 (disregarding for purposes of A2E control test target stock received by parent in exchange for capital contribution effected in connection with merger).

[53] For example, if target has a value of $100 before the merger and $200 after the merger, parent would have to deliver $160 of parent voting stock to target shareholders in exchange for their target stock.

presumably would be deemed to dispose of their "excess" parent voting stock, thus creating an additional step.

The following examples illustrate our proposal.

Example 2: Disqualifying Retention of Target Stock

Facts: Same as Example 1, only (i) Y receives $70 of parent voting stock in exchange for 70 shares of target stock and retains 30 shares of target stock ($30 FMV), and (ii) merger subsidiary merges with and into target and in the merger parent receives an additional $100 of target stock.

Analysis: The transaction should be treated as (i) Y exchanging 70 target shares for $70 of parent voting stock in the Parent Exchange, and (ii) parent receiving an additional $100 of target stock in the Target Merger. The merger should not satisfy the A2E control test, because the $70 fair market value of parent voting stock delivered in the merger is less than the $80 pre-merger fair market value of target stock representing control.[54]

Example 3: Permitted Retention

Facts: Same facts as Example 1, except that Y receives $90 of parent voting stock in exchange for 90 shares of target stock and retains 10 shares of target stock ($10 FMV).

Analysis: The transaction should be treated as (i) Y exchanging 90 target shares for $90 of parent voting stock in the Parent Exchange, and (ii) parent receiving an additional $100 of target stock in the Target Merger. The merger should satisfy the A2E control test, because the $90 fair market value of parent voting stock delivered in the merger exceeds the $80 pre-merger fair market value of target stock representing control. Y's retention of $10 of target stock should not adversely affect the merger's qualification as a section 368(a)(2)(E) reorganization.

Example 4: Permitted Retention

Facts: Same facts as Example 1, except that Y owns 90 shares of target stock ($90 FMV) and X owns 10 shares of target stock ($10 FMV). Y exchanges all of its target stock for $90 of parent voting stock, and X retains all of its target stock.

Analysis: The transaction should be treated as (i) Y exchanging 90 target shares for $90 of parent voting stock in the Parent Exchange, and (ii) parent receiving an

[54] The consequences of a taxable Retained Stock Merger, including valuation issues, are beyond the scope of this Report. *Cf.* Treas. Reg. § 1.368-2(j)(6), Ex. 4 (omitting discussion of tax consequences of taxable reverse subsidiary merger).

additional $100 of target stock in the Target Merger. The merger should satisfy the A2E control test, because the $90 fair market value of parent voting stock delivered in the merger exceeds the $80 pre-merger fair market value of target stock representing control. X's retention of $10 of target stock should not adversely affect the merger's qualification as a section 368(a)(2)(E) reorganization.

We recommend that the IRS issue guidance clarifying that the A2E control test applies prior to a Retained Stock Merger, and parent is treated as receiving additional target stock in exchange for its merger subsidiary stock in the Target Merger.

**WHEN IS "CONTROL" MEASURED IN A TRIANGULAR C?**

To qualify as a triangular reorganization, parent must control the acquiring corporation or the merger subsidiary, as the case may be, within the meaning of the section 368(c) (the "section 368(c) control test").[55] Section 368 generally does not specify the precise point in time when control is measured in a triangular C reorganization.[56] The government has applied the section 368(c) control test immediately after a triangular section 368(a)(1)(B) reorganization (a "B reorganization") and a section 368(a)(2)(D) reorganization, and we recommend that it similarly apply the control test immediately after a triangular C reorganization.[57] Our approach would not contradict any statutory rule or policy and would be consistent with the control analysis for other triangular reorganizations.

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[55] *See* Rev. Rul. 59-259, 1959-2 C.B. 115.

[56] As discussed above, in a reverse subsidiary merger under section 368(a)(2)(E), the statute explicitly requires that parent control the merger subsidiary before the merger.

[57] The history of the tax basis regulations under section 358 supports this position. Former proposed Treasury regulations defined the parent corporation for triangular reorganization purposes as the party "that is in control (within the meaning of section 368(c)) immediately before the reorganization of another party to the reorganization" and the acquiring corporation as the party to the reorganization "that is controlled by [the parent corporation] before the reorganization." *See* Prop. Treas. Reg. § 1.358-6(b)(1), 59 Fed. Reg. 66280, 66283 (Dec. 23, 1994). The government removed the relevant language from the final regulations without explanation. *See* T.D. 8648, 1996-1 C.B. 37; Treas. Reg. § 1.358-6. This removal suggests that the government decided against a "control immediately before" approach.

An example in the final disregarded entity merger regulations applying section 368(a)(2)(D) to triangular amalgamations confirms that parent may satisfy the section 368(c) control test in a forward triangular merger by acquiring control of the acquiring corporation immediately after the merger.[58] The preamble explains:

> in triangular consolidations and triangular amalgamations, [parent] does not control the acquiring corporation . . . immediately before the transaction. Nonetheless, the IRS and Treasury Department do not believe that section 368(a)(2)(D) requires the corporation the stock of which is used in the transaction to control the acquiring corporation immediately prior to the transaction and that such corporation's control of the acquiring corporation immediately after the transaction is sufficient to satisfy that requirement of section 368(a)(2)(D).[59]

Similarly, a share exchange was recast as a triangular B reorganization in Revenue Ruling 73-16 even though parent only acquired control of the acquiring corporation immediately after the transaction.[60]

It should be noted that the triangular B reorganization, triangular C reorganization and forward triangular merger provisions each use <u>identical</u> language to describe the control requirement. More specifically, each provision defines the parent in the triangular reorganization as the "corporation which is in control of the acquiring corporation."[61]

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[58] *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 14. Similarly, an acquisition qualified as a forward triangular merger where the taxpayer represented that (i) state law precluded parent from holding stock representing section 368(c) control of the acquiring corporation prior to the merger, and (ii) in connection with the proposed transaction, parent would be in control of the acquiring corporation. *See* P.L.R. 2004-39-003 (Sept. 24, 2004). The ruling implies that the taxpayer could only satisfy the section 368(c) control test immediately after the transaction.

[59] *See* T.D. 9242, 2006-1 C.B. 422. While the IRS advance ruling guidelines require a representation that parent was in control of the acquiring corporation before a forward triangular merger, they are silent as to when parent must control the acquiring corporation in a triangular B or C reorganization. *See* Rev. Proc. 86-42, 1986-2 C.B. 722.

[60] *See* Rev. Rul. 73-16, 1973-1 C.B. 186 (consecutive section 368(a)(1)(B) reorganizations recast as simultaneous section 368(a)(1)(B) reorganization and triangular B reorganization).

[61] *See* I.R.C. § 368(a)(1)(B), (a)(1)(C), and (a)(2)(D). The Supreme Court has explained that "identical words used in different parts of the same act are intended to have the same meaning" and that "the Code must be given as
*(continued on next page)*

We are unaware of any reason to impose a more stringent control requirement under section 368(a)(1)(C) than that which would apply with respect to an asset reorganization, such as a forward triangular merger. Moreover, there is no indication in the legislative history or other authorities that Congress intended a different result. Thus, we recommend that Treasury and the IRS issue formal guidance confirming that the section 368(c) control test applies immediately after a triangular C reorganization.

## ACQUISITION OF TARGET BY A TARGET SHAREHOLDER IN A SECTION 368(A)(2)(D) REORGANIZATION

To qualify as a section 368(a)(2)(D) reorganization, (i) a merger subsidiary must acquire substantially all of the properties of a target corporation partly or entirely in exchange for stock of the merger subsidiary's immediate parent corporation, (ii) the transaction would have qualified under section 368(a)(1)(A) if the target had merged into the parent corporation, (iii) no stock of the merger subsidiary is used in the transaction (the "parent stock requirement"), and (iv) the merger also satisfies the business purpose, COI and COBE tests.[62] In a forward triangular merger involving a partially owned target corporation, there is a concern that "old and cold" ownership by parent or merger subsidiary of less than 80% of target's stock violates the prohibition on the use of the merger subsidiary stock. This question arises because the IRS could seek to treat some portion of parent's interest in the survivor in the merger as issued to parent effectively in respect of its "old and cold" target corporation stock.[63] For these reasons, we

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*(continued from previous page)*

great an internal symmetry and consistency as its words permit." *Comm'r v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 159 (1993) (internal quotations omitted).

62 *See* I.R.C. § 368(a)(2)(D); Treas. Reg. § 1.368-2(b)(2).

63 *Cf. Bausch & Lomb Optical Co. v. Comm'r*, 267 F.2d 75 (2d Cir. 1959).

recommend that the IRS publish guidance confirming that the historic ownership of target stock does not violate the parent stock requirement in section 368(a)(2)(D).

Congress enacted section 368(a)(2)(D) in order to permit taxpayers a more direct route to transactions that were permissible at the time. Congress acknowledged that, in the absence of section 368(a)(2)(D), taxpayers could merge the target corporation into parent, which could then contribute the target's assets to a controlled subsidiary.[64] Congress believed that taxpayers should be able to consummate such a transaction directly with the same results by merging the target into merger subsidiary.[65] Congress also noted that parent stock is permitted to be used in both B and C reorganizations and, thus, concluded that "there does not seem to any basis for denying the same treatment in the case of [section 368(a)(1)(A)] statutory mergers."[66]

Accordingly, Congress intended section 368(a)(2)(D) to permit target to merge with and into a merger subsidiary in exchange for parent stock (and possibly boot), and taxpayers did not propose that the merger subsidiary issue any of its stock in the transaction.[67] Congress observed:

> Apparently the use of a parent's stock in statutory mergers was not initially provided for because there was no special concern with the problem at the time of the adoption of the 1954 code. However, this is no longer true. The committee understands that a case has arisen in which it is desired to have an operating company merge into an operating subsidiary in exchange for the stock of the parent holding company. The committee agrees with the House that there is no reason why tax-free treatment should be denied in cases of this type where for any reason the

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64 *See, e.g.*, Rev. Rul. 69-617, 1969-2 C.B. 57.

65 S. Rep. No. 1653, 90th Cong., 2d Sess. (Oct. 9, 1968), *reprinted in* 1968-2 C.B. 849, 850.

66 *Id.*

67 Parent is only required to own stock constituting section 368(c) control of merger subsidiary. *See* I.R.C. § 368(a)(2)(D). Thus, if merger subsidiary stock could be used in the transaction, Congress would have had to grapple with the question of whether such issuance was consistent with the section 368(c) control test if the issuance resulted in parent no longer controlling the merger subsidiary.

> parent cannot or, for business or legal reasons, does not want to acquire the assets (even temporarily) through a merger.[68]

The IRS has privately ruled that, where parent owns a portion of "old and cold" target stock and target merges with and into merger subsidiary, the transaction qualifies as a forward triangular merger under section 368(a)(2)(D).[69] As stated above, under a number of IRS rulings, ownership by parent of "old and cold" target stock does not preclude non-triangular asset reorganizations followed by asset dropdowns. Accordingly, since Congress intended section 368(a)(2)(D) to permit taxpayers to reach the same result in a single step, the ownership by parent of "old and cold" target stock should not preclude section 368(a)(2)(D)'s application.

We also considered the potential application of the former *Bausch & Lomb* doctrine. Under prior law, an acquiring corporation could not own more than 20% of target's stock, or the transaction would fail to satisfy the C reorganization "solely for voting stock" requirement, because the acquirer was treated as acquiring a portion of target's assets in exchange for the acquirer's target stock interest.[70] Current law, however, provides that a parent's preexisting stock ownership in target does not, by itself, prevent compliance with the "solely for voting stock" requirement.[71]

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68 S. Rep. No. 1653, 90th Cong., 2d Sess. (Oct. 9, 1968), *reprinted in* 1968-2 C.B. 849, 850.

69 *See*, *e.g.*, P.L.R. 90-49-050 (Sept. 13, 1990); P.L.R. 88-48-050 (Sept. 7, 1988); P.L.R. 86-08-022 (Nov. 22, 1985).

70 *See Bausch & Lomb Optical Co. v. Comm'r*, 267 F.2d 75 (2d Cir. 1959); Rev. Rul. 54-396, 1954-2 C.B. 147. In *Bausch & Lomb*, the Second Circuit held that parent failed to acquire substantially all of the target's assets solely in exchange for parent voting stock, because parent actually acquired 79.95% of target's assets in exchange for parent's target stock in a section 331 liquidation of target and only 20.05% of target's assets in exchange for parent voting stock.

71 *See* Treas. Reg. § 1.368-2(d)(4)(i).

The government has repudiated *Bausch & Lomb*. It no longer has any vitality in the C reorganization context, and there is no indication in any authorities that the doctrine should apply in the case of a putative section 368(a)(2)(D) reorganization. The repeal of *Bausch & Lomb* runs counter to an analysis that parent received a portion of the merger subsidiary stock in a putative section 368(a)(2)(D) reorganization in exchange for parent's historic stake in target.[72] Accordingly, the *Bausch & Lomb* rationale should not apply to forward subsidiary mergers.[73] Even before the repeal of *Bausch & Lomb*, the IRS had publicly ruled that, where a parent owns a portion of target's stock and target transfers its assets to a direct parent subsidiary in exchange for parent voting stock, the transaction qualifies as a triangular C reorganization.[74] Similarly, the IRS has publicly ruled that, where parent (i) owns 79% of target's stock, (ii) acquires all of target's assets, and (iii) contributes the acquired assets to its newly formed subsidiary, the transaction qualifies as an A reorganization and section 368(a)(2)(C) dropdown.[75] Since section

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[72] *See* T.D. 8885, 2000-1 C.B. 1260 (parent's target stock ownership does not by itself prevent compliance with C reorganization "solely for voting stock" requirement); Rev. Rul. 2003-99, 2003-2 C.B. 388 (confirming obsolete status of Revenue Ruling 54-396).

[73] As further support against deeming a portion of the merger subsidiary stock owned by parent as a result of a forward triangular merger to have been received in exchange for parent's historic stake in target, we note that an amendment to the "meaningless gesture" regulations precludes that doctrine's application to forward subsidiary mergers if the transaction also qualifies as a section 368(a)(1)(D) reorganization. This could occur, for example, in a transaction where parent owns 100% of target and S1, S1 owns 100% of S2 and target merges into S2. The IRS stated that:

> the temporary regulations may cause a related party transaction that would otherwise qualify as a tax-free reorganization described in section 368(a)(1)(A) by reason of section 368(a)(2)(D) from so qualifying because the deemed issuance of a nominal share of stock of [merger subsidiary] would violate the requirements of section 368(a)(2)(D)(i). If so, the transaction would be treated as described only in a section 368(a)(1)(D), and the stock of the corporation in control of the acquiring corporation would be treated as boot. The IRS and Treasury Department did not intend for the temporary regulations to apply to such transactions.

T.D. 9313, 2007-1 C.B. 805.

[74] Rev. Rul. 57-278, 1957-1 C.B. 124; *see also* Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of greater than 80% owned subsidiary followed by dropdown of subsidiary's assets qualified as A reorganization and section 368(a)(2)(C) transfer).

[75] *See* Rev. Rul. 58-93, 1958-1 C.B. 188.

368(a)(2)(D)'s legislative history suggests that a forward triangular merger should be treated similarly to a triangular C reorganization or an A reorganization followed by an asset dropdown, we believe that the same rules should govern section 368(a)(2)(D)'s application.[76]

Finally, the over-the-top method contained in the section 358 basis regulations also supports the view that a forward triangular merger should be analyzed as target's merger into parent, followed by a dropdown of assets.[77] Under such construct, parent's "old and cold" target stock would not prevent reorganization treatment. In determining parent's merger subsidiary stock basis after a forward triangular merger, the IRS, relying on section 368(a)(2)(D)'s legislative history,[78] takes the approach that a forward triangular merger should have the same result as if parent (i) acquires target's assets directly from target in a reorganization, and (ii) transfers the acquired assets to merger subsidiary in a section 351 transaction.[79] The IRS reasoned: "Achieving comparability between a triangular reorganization and its counterpart parent/drop reorganization furthers sound tax policy by treating economically comparable reorganizations similarly."[80] While we recognize that the over-the-top rules address basis determination and, therefore, do not apply to reorganization qualification, we nonetheless think

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[76] S. Rep. No. 1653, 90th Cong., 2d Sess. (Oct. 9, 1968), *reprinted in* 1968-2 C.B. 849, 850.

[77] In the preamble to the 1994 "over-the-top" proposed regulations, the IRS sought comments regarding historic ownership of target by either parent or merger subsidiary. *See* 59 Fed. Reg. 66280, 66282 (Dec. 23, 1994) ("[f]or example, [merger subsidiary] may be a historic owner of some of the [target] stock outstanding at the time that [target] merges into [merger subsidiary], but Merger subsidiary receives no [parent] stock in exchange for its [target] stock. Comments are requested whether such a merger qualifies as a forward triangular merger. . . ."). In the preamble to the final "over-the-top" regulations, the IRS stated that "[t]he final regulations apply only for the purpose of determining [parent's] basis in its [merger subsidiary] or [target] stock following a transaction that otherwise qualifies as a reorganization within the meaning of section 368. They do not address issues concerning the qualification of a transaction as a reorganization." T.D. 8648, 1996-1 C.B. 37.

[78] *See* 59 Fed. Reg. 66280 (Dec. 23, 1994).

[79] *Id.* at 66281 ("[a]chieving comparability between a triangular reorganization and its counterpart parent/drop reorganization furthers sound tax policy by treating economically comparable reorganizations similarly.").

[80] *Id.* at 66281.

the basis rules are informative as to the types of transactions that the government believes may qualify as reorganizations.

## ACQUISITIONS FOR GRANDPARENT SHARES

To qualify as a triangular reorganization, the parent corporation must satisfy the section 368(c) control test with respect to the acquiring corporation or the merger subsidiary, as the case may be. In applying this test, the IRS and the courts require ownership of the relevant entity by its direct parent.[81] Thus, under this interpretation, a transaction does not qualify as a reorganization if grandparent stock (or stock of a more remote entity) is used.[82]

In contrast with this strict interpretation of the section 368(c) control test, the IRS liberally interprets and applies the rules in section 368(a)(2)(C) and the -2k Regulations, which allow taxpayers to drop down acquired assets and stock among controlled entities after tax-free reorganizations without affecting their status. A byproduct of this expansive interpretation of the dropdown rules is that taxpayers may achieve the same end result as though grandparent stock (or stock of a more remote entity) were used in a reorganization by dropping down acquired assets or stock to lower-tier entities after an otherwise qualifying reorganization. Thus, the current interpretation of the section 368(c) control test has the effect of requiring parties to engage in extra steps which may be costly and inefficient to achieve a result that, as a corporate legal matter, could be achieved in one step. Furthermore, under certain circumstances, legal

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81 *See* Rev. Rul. 56-613, 1956-2 C.B. 212 (B reorganization); Rev. Rul. 74-564, 1974-2 C.B. 124 (368(a)(2)(E) reorganization); Rev. Rul. 74-565, 1974-2 C.B. 125 (section 368(a)(2)(E) reorganization).

82 *See Groman v. Comm'r,* 302 U.S. 82 (1937); *Helvering v. Bashford*, 302 U.S. 454 (1938).

restrictions or commercial considerations (*e.g.*, cost, timing, regulatory filings or approvals) may, as a practical matter, prohibit the additional steps.

Over the past several years, the government has interpreted the law in the context of tax-free reorganizations in a manner that allows taxpayers increased flexibility to accomplish commercial transactions consistent with the policies underlying the reorganization provisions.[83] In this regard, the preamble to the -2k Regulations explicitly acknowledges this "trend of broadening the rules regarding transfers of assets or stock following an otherwise tax-free reorganization where the transaction adequately preserves the link between the former [target corporation's] shareholders and the [target corporation's] business assets." Moreover, the "cause to be directed" doctrine, with the addition of a few words to a contract, allows a reorganization to occur notwithstanding the lack of direct control at the end of the transaction.

As noted above, after an A, B or C reorganization (including their triangular counterparts), the -2k Regulations permit one or more contributions of the acquired assets or stock to corporate subsidiaries without affecting the status of the reorganization as long as each transferee corporation is a member of the issuing corporation's qualified group.[84] The qualified group consists of "one or more chains of corporations connected through stock ownership with the issuing corporation," provided that the parent corporation directly owns stock constituting

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[83] *See* Rev. Rul 64-73, 1964-1 C.B. 142 (double dropdown of assets); Rev. Rul. 68-261, 1968-1 C.B. 147 (dropdown of target assets to multiple subsidiaries); *See, e.g.*, T.D. 8760, 1998-1 C.B. 803 (broadening COI and COBE rules); T.D. 9361, 2007-47 I.R.B. 1026 (broadening Treasury regulations section 1.368-2(k)). *See also* T.D. 9361, 2007-47 I.R.B. 1026 ("Since the Supreme Court's decisions in *Groman* and *Bashford*, it has been recognized that other transactions, including transactions involving the same level of 'remoteness' as addressed in the *Groman* and *Bashford* decisions, adequately preserve the link between the former T shareholders and the T business assets and therefore constitute mere readjustments of continuing interests."); *see* "NYSBA Tax Section Suggests Changes to Proposed Regs. on Post-Reorganization Transfers", 2004 TNT 142-16 (July 23, 2004).

[84] *See* Treas. Reg. §§ 1.368-2(k), -1(d).

section 368(c) control in at least one other corporation in the chain, or chains and each other corporation (except the issuing corporation) is controlled through stock constituting section 368(c) control owned by one or more of the other corporations in the group.[85] Thus, the -2k Regulations generally would permit the parties to a reorganization to achieve the same outcome as would result if the acquisitions occurred directly with the relevant lower-tier entities.[86]

Significantly, the qualified group is defined specifically by reference to the control standard of section 368(c).[87] Thus, requiring the acquiring corporation (or target in the case of a reverse subsidiary merger) to be in the qualified group is consistent with and in furtherance of the reorganization provisions and the associated control requirement contained in the Code. Moreover, it is significant to note that section 368(a)(2)(C) merely states that a dropdown of assets or stock after a reorganization to a corporation "controlled by" the acquiring corporation will not disqualify an otherwise tax-free reorganization.[88] Thus, it is only through the -2k Regulations that this control requirement is implemented by reference to the qualified group.[89]

It is significant to note that the IRS has allowed the "cause to be directed" doctrine to permit tax-free reorganizations involving lower-tier entities for which control exists only

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85 *See* Treas. Reg. § 1.368-1(d)(4)(ii).

86 In fact, even wider latitude is permitted by reason of the dropdown rules, because such rules allow the taxpayer to "split up" the assets or stock acquired in a tax-free reorganization between various members of the qualified group immediately following the reorganization. Our proposal is still limited by the use of the reorganization rules generally and would therefore require a single entity to satisfy the reorganization requirements.

87 *See* Treas. Reg. § 1.368-1(d)(4)(ii).

88 *See* I.R.C. § 368(a)(2)(C).

89 For example, qualified group members can aggregate their stock ownership in a lower-tier corporation for purposes of determining whether that corporation is a member of the qualified group. Consequently, so-called "diamond structures" are permissible under the -2k Regulations, which evidences that a more permissive application of the control standard is consistent with the goals underlying the reorganization provisions.

indirectly.[90] Under these rulings, if a contract with the parent corporation provides that parent causes the assets to be directed to a subsidiary (even a remote subsidiary), the IRS treats the transaction as if the transactions were direct asset acquisitions by the parent corporation, followed by asset dropdowns.[91] Tested in this manner, the transactions qualify as reorganizations, even though, as a formal legal matter, the parent corporation generally did not possess direct control over the acquiring corporation.[92] Similar to the policy underlying section 368(a)(2)(C), the rationale behind the "cause to be directed" doctrine is that a transaction otherwise qualifying as a valid reorganization should not be disqualified due to a subsequent contribution that would qualify as a tax-free contribution under section 351(a).[93]

However, the "cause to be directed" doctrine has not been applied in connection with a B reorganization. Section 368(a)(1)(B) treats the acquisition of a target's stock solely in exchange for the acquiring corporation's voting stock as a reorganization, provided that the acquirer is in "control" of the target immediately after the acquisition (and the other applicable requirements are satisfied). Additionally, the parenthetical language in section 368(a)(1)(B) permits such a reorganization to be effected for voting stock of a corporation in control of the acquiring corporation.[94] Further, section 368(a)(2)(C) specifically permits the acquiring corporation to "drop down" target corporation stock acquired in the B reorganization to a corporation controlled

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[90] *See* Rev. Rul. 64-73, 1964-1 C.B. 142; Rev. Rul. 70-224, 1970-1 C.B. 79; P.L.R. 89-41-068 (July 19, 1989).

[91] *Id.*

[92] *Id.*

[93] *See* Rev. Rul. 64-73, 1964-1 C.B. 142; Rev. Rul. 70-224, 1970-1 C.B. 79.

[94] *See* I.R.C. § 368(a)(1)(B). Triangular reorganizations are similarly permitted in the context of A reorganizations, by virtue of section 368(a)(2)(D), and C reorganizations by reason of the parenthetical language provided in the statute.

by the acquiring corporation without disqualifying the prior reorganization.[95] In this case, the first step is treated as a B reorganization followed by a contribution qualifying under section 351(a).[96] Congress enacted these statutory provisions (triangular reorganizations and reorganizations followed by dropdowns) in response to the Supreme Court's holdings in *Groman v. Commissioner*[97] and *Helvering v. Bashford*.[98]

However, as noted above, since section 368(a)(2)(C), as originally drafted, only applied to A and C reorganizations, the early IRS rulings setting forth the "cause to be directed" doctrine specifically excluded the doctrine's application to B reorganizations (which were not yet included in section 368(a)(2)(C)). In fact, citing legislative history, Revenue Ruling 63-234 stated that *Groman* and *Bashford* continued to apply in the B reorganization context,[99] which prompted Congress to specifically amend section 368(a)(2)(C) to include B reorganizations. The IRS, however, has never expressly overruled Revenue Ruling 63-234, which thus remains to prohibit application of the "cause to be directed" doctrine in the B reorganization context. We are unaware of any principled reason for Revenue Ruling 63-234's continued vitality since, as explained above, Congress expressly intended to permit dropdowns after B reorganizations.[100] Therefore, we recommend that the IRS expressly revoke Revenue Ruling 63-234 and make clear that the "cause to be directed" doctrine applies to B reorganizations.

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95 *See* I.R.C. § 368(a)(2)(C); *see also* Treas. Reg. § 1.368-2(k)(ii).

96 *See, e.g.*, P.L.R. 91-51-036 (Sept. 25, 1991).

97 302 U.S. 82 (1937).

98 302 U.S. 454 (1938).

99 *See* Rev. Rul. 63-234, 1963-2 C.B. 148; *cf.* Rev. Rul. 64-73, 1964-1 C.B. 142.

100 *See* "NYSBA Tax Section Suggests Changes to Proposed Regs. on Post-Reorganization Transfers", 2004 TNT 142-16 (July 23, 2004).

Because there is no statutory or regulatory guidance addressing the "cause to be directed" doctrine, the doctrine's exact contours are uncertain. Accordingly, we recommend that the government issue published guidance addressing the doctrine and the requirements for its application. More specifically, following promulgation of the -2k Regulations, we recommend that the IRS issue published guidance (i) interpreting the "cause to be directed" doctrine to permit transactions to qualify as triangular reorganizations (including B reorganizations), assuming compliance with all other applicable reorganization requirements, where the acquisition agreement contains appropriate language directing the transfer of the acquired stock or assets, and the acquiring corporation is a member of the issuing corporation's qualified group, and (ii) revoking Revenue Ruling 63-234. Such an approach would increase efficiency by eliminating arbitrary distinctions, allowing taxpayers to avoid potentially costly intermediary steps and affording taxpayers the flexibility to structure around commercial and legal impediments to achieve transactions that produce appropriate substantive outcomes under the reorganization rules. Furthermore, such an approach is entirely consistent with the purpose of the reorganization rules, as the outcomes allowable under our proposal are already generally permitted through asset or stock dropdowns within the issuing corporation's qualified group, which the government has acknowledged adequately maintains the target shareholders' continuing interest in the assets or stock acquired in the reorganization.

Finally, we firmly believe that, as a policy matter, taxpayers should be permitted to engage in triangular reorganizations using the stock of a grandparent or higher-tier corporation, even if the "cause to be directed" doctrine is inapplicable. However, we recognize that section 368(c) has long been interpreted to prohibit those transactions. We therefore recommend that

Congress revise section 368(c) to expressly permit triangular reorganizations using grandparent (or more remote) stock.

More specifically, we recommend that the following triangular reorganization rules be adopted:

- An asset acquisition by a direct or indirect subsidiary of the issuing corporation would be analyzed under section 368(a)(1)(C) as a triangular C reorganization, provided the acquiring corporation is in the issuing corporation's qualified group;
- A stock acquisition by a direct or indirect subsidiary of the issuing corporation would be analyzed under section 368(a)(1)(B) as a triangular B reorganization, provided the acquiring corporation is in the issuing corporation's qualified group;
- A reverse merger involving a direct or indirect subsidiary of the issuing corporation would be analyzed under sections 368(a)(2)(E) or 368(a)(1)(B), provided the merger is with a corporation in the issuing corporation's qualified group; and
- A forward merger involving a direct or indirect subsidiary of the issuing corporation would be analyzed under section 368(a)(2)(D), provided the acquiring corporation is in the issuing corporation's qualified group.